

An investigation of the franchising option for water services operation in South Africa

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Abstract

There is a need in South Africa for institutional innovations aimed at increasing the coverage of water services, and sustaining those services. The paper describes an investigation of an alternative service delivery institutional concept, viz. the franchising of the operation of water services, and outlines the need to formulate a franchise model that could be developed and made available to emerging entrepreneurs as the basis of a viable business. The franchising would be in respect of components of the water services value chain that are suitable for small businesses in that they can be readily systematized.

Introduction

The capacity of many municipalities in South Africa to adequately provide even basic levels of water services to all their citizens is in question. The need for new alternative service provider institutions is apparent.

Both the parastatal regional bulk water supplier Rand Water and the national Department of Water Affairs and Forestry (DWAf) have for a number of years considered that the potential for franchising in the water services industry water ought to be investigated. For various reasons this has never been done.

The CSIR report

This paper summarises the findings of an investigation undertaken by the CSIR, and funded by the Water Research Commission (WRC) and the CSIR, into the concept of franchising in the water services sector in South Africa. This investigation comprised:

- Background investigation of franchising generically (i.e. not in the water services sector) and of South African experience and best practice
- Background investigation of water services delivery in South Africa
- Background investigation of research into and experience in franchising in the water services sector worldwide
- Assessment of appropriateness of franchising to the water services sector in South Africa.

This paper follows the sequence of the CSIR investigation (Wall, 2005), and also reports the latest developments.

Franchising

Many goods and services are supplied by small-, medium- and micro-enterprises (SMMEs). However, starting a small business is never an easy task; difficulties to be resolved include those of understanding the business method, establishing the

need for the product and an image for the product, setting up the business (with attendant capital costs), finding out which regulations apply and then complying with them, and recruiting and training staff.

The barriers to entry for the start-up SMME in any field of enterprise are substantial. If these could be overcome, then many more business opportunities will be enabled and the probability of business failure will be reduced.

Franchising (more correctly 'business format franchising') is a way of using tried and tested methodology to accelerate the development of a business. The right is granted by a business entity ('the franchisor'), to a smaller entity ('the franchisee'), to use a business method or system. In return, the smaller entity pays fees to the larger. The assistance that the franchisor gives with setting up the franchisee's business, and ongoing training of the franchisee and quality control of the goods or services, are usually also part of the business deal.

Thus the franchise system firstly correlates and systematises the business, and then the franchisor facilitates the setting up of the business, and supports and disciplines it thereafter. For good reason, franchising can be summed up in the slogan: 'Being in business for yourself but not by yourself'.

There is no direct contractual relationship between the franchisor and the customer/end user of the goods or services.

Whereas the incentive to start up a small business is the prospect of a quantifiable financial outcome (profits, dividends

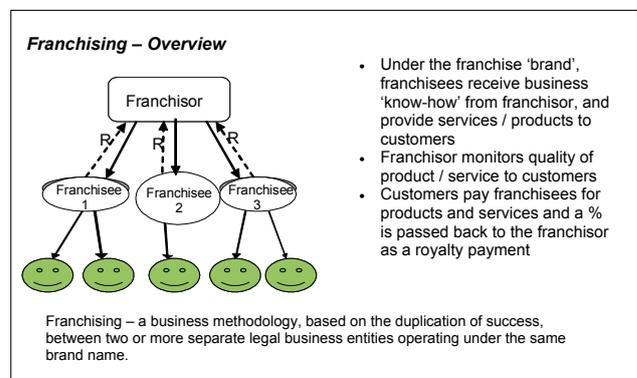


Figure 1
Franchising overview

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or surplus), the presence of a successful business model that can be copied is the incentive to follow a franchise route as opposed to following a route without the support of franchising. These, the prospect of profits/dividends/surplus, and the model that can be copied, are the **twin driving forces** of the franchise concept.

The cardinal elements of the franchise process are thus:

- Identifying a component (or components) of the value chain that is simple enough to systematise
- Discovering best practice
- Systematising the business
- Selecting franchisors and franchisees
- Training
- Preparing operations manuals
- Research and development
- Continuing support, control and discipline of the on-going business.

For-profit franchising of commercial goods and services in South Africa is extensive, generally viable, and growing rapidly. Nearly 400 franchised systems operate through more than 26 000 franchised outlets, and generate retail turnover that (excluding retail petroleum outlets) accounts for just under 6.5% of all retail turnover in South Africa (FASA, 2003; FRAIN, 2004). Significant numbers of jobs have been created and 280 000 people are employed in the franchising sector. There is much evidence that, everything else being equal, franchised businesses have a far lower failure rate than do independent businesses.

The water services investigations

Municipalities in South Africa have a huge responsibility for water services operation. Since 1994 alone, municipalities have received grant and loan funding to acquire more than R30 bn. of water services infrastructure (at construction cost; current replacement value would be more). The replacement value of pre-1994 water services infrastructure in their care is unknown, but almost certainly much larger. (R30 bn. is of the order of US\$5 000 m. at current exchange rates.) Operating all of this has become the responsibility of municipalities or groups of municipalities in their role as the statutory water services authorities (WSAs). In addition, a significant proportion of the South African population does not enjoy safe water and/or acceptable sanitation – this represents a huge responsibility for the construction of new infrastructure and, after its construction, its operation by municipalities.

Even if all the existing institutional role-players were coping with the water services operational responsibility, there would be good reason to investigate alternative institutional concepts, on the grounds that it needs to be established whether alternatives could:

- Be more cost-effective
- Allow existing role-players to focus on their other responsibilities
- Offer a range of other advantages (including greater community participation)
- Assist in addressing problem areas such as that even in the well-resourced cities, water losses, for example, are significant, due largely to a legacy of under-funded maintenance budgets and inadequate maintenance practices.

Thus, given that the existing institutional role-players are clearly not coping with all the needs, there is definitely a strong 'push

factor' reason to investigate alternative institutional concepts for water services operation.

Internationally, it has been recognised that there is a need for partnerships between public, private and civil institutions to achieve water services delivery objectives. The variety of partnerships that has been implemented, viz. private sector concessions, build-operate-transfer (BOT), build-operate-train-transfer (BOTT), etc., has enjoyed mixed success overseas and in South Africa. Most have been 'big business' partnerships for infrastructure construction and operation over large areas, and generally, investment (public or private) in new infrastructure plays a prominent role.

There is a need for alternative service delivery institutional concepts that are suited more for the ongoing operation of water services systems, rather than for investment in new infrastructure, and that are friendly to small business. While SMMEs need by no means to be franchisees, it is the franchising of water services that was the subject of the CSIR investigation and is the subject of this paper.

Neither of the 'twin driving forces' of the franchise concept, referred to above, is currently in evidence in the water services sector in South Africa. Furthermore, there are many pitfalls when it comes to implementation even under the most favourable of circumstances.

There is little experience of water services franchising anywhere in the world, and no experience in South Africa, although some existing partnerships have some of the characteristics of the franchise approach. A survey of overseas literature, while conceding that the topic of water services franchising is a very new one, and implementation even at a pilot scale is yet to take place, found that water services franchising is considered to show great promise (Roche et al., 2001; Van Ginneken et al., 2003), especially in respect of water services to small towns and to multi-village schemes.

The need in South Africa for less unemployment, for higher household incomes, and for more entrepreneurs, is unquestionable. It is intolerable that of the order of 40% of those between 15 and 65 are not formally employed. Furthermore, South Africa ranks low in global entrepreneurship surveys, indicating inadequacies in creating a climate in which sufficient numbers of emerging businesses can grow and thrive. Thus there is without question a 'pull factor', i.e. the need for local economic development, and in particular the need for the creation and nurturing of SMMEs, that also strongly motivates the investigation of franchising in South Africa as a water services delivery concept in addition to, and complementary to, the current operational models.

Resources allocated to a programme for the franchising of water services would be well spent in terms of the improvement in water services delivery that would almost certainly ensue. The franchisees would have every incentive to perform to specification, as the viability of their business would be dependent on performance. And the franchisors would have the incentive to assist them to perform.

The findings

The CSIR report found that the great need for alternative water services provider systems, and for local economic development, is indisputable, and that water services franchising has the potential to simultaneously deliver water services, and promote local economic development, SMME development and (a major national government objective) Black economic empowerment.

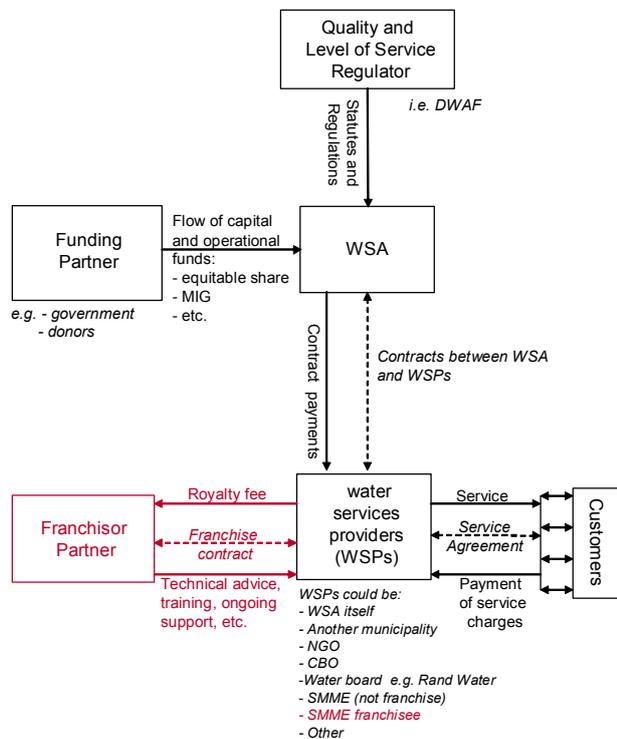


Figure 2
Simplified present relationships with franchising alternative added (in red)

Thus 'franchisee' must be added to the list of possible water services provider (WSP) types in South African water services practice.

However, franchising would by no means be free of many of the issues that equally affect other water services delivery alternatives. Franchising would be just as dependent on the criteria for sustainable operations being in place, and just as dependent as current delivery institutions are, on any external sources of finance.

The CSIR report found the following to be essential to the success of water services franchising, *inter alia*:

- Service to customers meets the specification in the franchise contract with the water services authority
- Suitable franchisors are willing and available
- Local entrepreneurs are willing to take up water services franchise opportunities
- Franchising proves to be a viable business for franchisor and franchisee alike
- Funding partners support water services franchising in just the same way as they support in comparable circumstances water services provision by other institutional means.

On the last of these points: Franchising must benefit from the funding streams (e.g. the *Equitable Share Programme*, a major national government welfare funding programme directed at the poorer municipalities) to the water services authority (i.e. municipality) to the same extent as these streams benefit any other type of water services provider. National government must perceive that going the franchise route has in a significant number of circumstances at least as good or maybe an even better chance of providing sustainable water services than any other option has, and therefore it must facilitate the participation of franchised water services providers.

Franchisee water services providers have a greater incentive

to perform than, for example, in-house water services authority personnel would usually have, and they would also enjoy the benefit of the franchisors' expert guidance and quality assurance. Caveats include that the water services authority client has the competence to monitor performance and enforce contract compliance.

It is not unreasonable that the private sector could be contracted to supply water services, and take the profits that the contracts permit. There should be no ideological barrier to this, and given that there are currently not enough water services providers in South Africa, entrepreneurs should be offered the opportunity to assist. Franchising, being a type of private sector participation, will be challenged in the same way as private sector participation in water services operation generally has been challenged in South Africa – challenged, that is, both politically (e.g. union opposition) and institutionally (where procurement legislation puts hurdles in the way). Given, however, the need for SMME development, and the advantages of the franchising of water services operation that can in theory be demonstrated and that it is hoped a programme of pilot projects will demonstrate in practice, it is trusted that these challenges will in due course be overcome.

However, the case for franchising does not depend on the case for or against the participation of for-profit organisations. There are current activities in the water services sector in South Africa that have some elements in common with franchising. Nevertheless, they also have differences, the most important of which is that the participants are generally not for-profits (for example, that in which a water services authority appoints a 'support services agent' to support small local community-based water services providers). Although these are not franchising, development of the franchising concept can definitely learn from their experience, and it could also be that they could benefit from adoption of some of the characteristics of franchising.

Two organisations, one a parastatal and one from the private sector, that have the expertise and resources to play a franchisor role, have expressed interest in playing such a role, should the opportunities arise. There is little doubt that other capable organisations would be interested were they to see the potential.

Many useful pointers for the water services franchisee development programme that will be needed, if franchising of water services is to take off, can be found not only in business format franchising franchisee development programmes, but also in engineering infrastructure contractor development programmes that already have a track record in South Africa (for example the Soweto Contractor Development Programme (Watermeyer, 1999)).

A South African water services franchising programme must commence by learning from the performance of other water services institutional arrangements. Experience must also be derived from franchising experience in business sectors other than water services. Only thereafter can the implementation of such a programme be contemplated, and even then at pilot scale as field experiments, and subject to structured research methodology. Furthermore, the initial piloting must be done in the easiest of circumstances, where there is the greatest chance of success. If initial piloting is attempted in a problematic area, and if the pilot is not completely successful, not enough would have been learned from the pilot implementation to draw any worthwhile conclusions. Subsequent implementation can be more adventurous, exploring circumstances within which the concept can be replicated, and progressively pushing the boundaries.

To sum up the CSIR's findings:

- Water services franchising is clearly shown to have potential
- The time is ripe for a more in-depth investigation into water services franchising, to be followed by implementation at pilot scale.

The way forward

The latest development at the time of writing is that the WRC has appointed a team led by the CSIR to take the first steps of that more in-depth investigation into water services franchising, but stopping short of implementation even at pilot scale. Deliverables will include:

- Review of statutory, procurement, and other issues which could impact on water services franchising, and development of guidelines for regulating franchising
- Identification of elements in the water services delivery chain which offer the greatest scope for franchising, development of franchising models, and case study of an element or elements in a hypothetical situation, to see how the models would work
- Development of guidelines for setting up water services franchising.

Completion of the new investigation is scheduled for 2007, after which piloting of the concept might be contemplated.

The investigation will *inter alia* look into a number of water services institutional arrangements that exhibit some of the characteristics of business format franchising, in order to assess if these concepts might also be valuable alternatives for water services operation in South Africa. An example of this is eThekweni Water Services' 'Franchisee contract for the evacuation of pit latrines' which is not by any means true franchising, but does have influences of franchising, management contracting, and other antecedents.

At the same time, the CSIR has been formulating a number of proposals that it is hoped will in due course become pilot projects. These proposals can readily be grouped into two types, as follows:

- Proposals that would lead to the establishment of franchisee water services providers offering a full range of water services
- Proposals that would lead to the establishment of franchisees who would offer selected services under contract to water services providers.

In respect of the first, initial discussions have been with DWAF, with a view to structuring a partnership between themselves (providing technical and funding support) and a water services authority (a municipality) that is responsible for areas including small towns and rural villages. The intention is to set up a pilot project in a selected area that would involve the development of a local franchisee as the full-service water services provider for the area. The franchisor could be one of the well-resourced organisations that have already expressed interest in playing this role.

Another 'full-service' type of project is being worked on that will, if it is approved, be led by a regional bulk water supplier that also has responsibilities for water services to small towns and rural areas. If this goes ahead, the end result in a few years' time should be a couple of pilot schemes in operation, and a strategy for rolling water services franchising out across a portion of a province. Before then, however, a lot of work

will have to have been done on systematising water services provision, preparation of operations manuals, design of systems to support the on-going business, and the preparation and approval of business plans.

The second type of proposal that is being worked on is somewhat different, and may best be explained by way of describing what at the time of writing is the most comprehensively formulated of the several promising prospects being worked upon. About two dozen years ago, a young Pretoria plumber who had started out on his own realised that the best way to increase his turnover (and profit) through replication of the prompt service that had become his business' trademark, was to franchise the business. Which he duly did, and the business has grown rapidly ever since. He subsequently added an electrical business, and in due course franchised that also. (It is of note that in this competitive market the franchisees operate under the franchisor's brand name. Brands are important in competitive retail or service markets, but there is much less (if any) experience of the use of branding in markets where competition is limited or non-existent. The value of brands, and their appropriateness to water services operation, is an issue that needs to be explored.)

However, all of his custom has been received from the owners of commercial properties and the higher-income residential properties. The current proposal is to extend, to the vast residential townships where the municipality is the property owner, the kind of service that he provides elsewhere. Affordability in these townships is, generally speaking, low, and when a plumbing problem occurs the residents either wait for the municipality to repair it (which could take days, and meantime water is wasted or wastewater backs up, depending on the nature of the problem), or they repair it themselves or get a neighbourhood amateur to do it for them, invariably inadequately. The proposal is to structure a deal with the municipality, whereby the plumber-businessman referred to above selects local residents, sets them up as franchisees, trains them in the technical and business skills, and in all ways acts as franchisor as he does elsewhere in Pretoria.

The municipality would have to subvent the business to make it viable (much as it subvents its own plumbing operations in the townships). However, preliminary estimates suggest that this will cost the municipality less than it is presently spending in the townships, and it will also be granted the assurance that the residents will receive a much better service than they presently do.

Although it is at the time of writing still early days in respect of these proposals, the prospects for water services franchising in South Africa do appear promising.

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