

STANDBY PAPER 1

Tackling the preferential procurement regulations, 2017 SMME subcontracting challenge

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ABSTRACT

The revised Preferential Procurement Regulations, 2017 aims to promote socio-economic transformation and develop and empower targeted categories, called Small Medium and Micro Enterprises (SMMEs), through procurement.

A need arose for a strategy to achieve the procurement goals which require organs of state, where it is feasible, to apply subcontracting to SMMEs to a minimum of 30% of the contract value, to contracts above R30 million.

To adhere to the revised regulations two strategies have been identified for SMME procurement. Both strategies firstly require determining if it is feasible to subcontract by conducting an objective analysis which provides facts to substantiate the decision. The first strategy entails that the tenderer submit proof of subcontracting arrangements with SMMEs from the Central Supplier Database (CSD) with the tender.

The responsibility of subcontracting a minimum of 30% of the contract value to competent and capable subcontractors remains fully with the main contractor. In the second strategy the responsibility of implementing the requirements of subcontracting to SMMEs is shared between the employer and the main contractor.

This strategy entails that the employer, with the aid of the employer's agent, compiles pre-determined SMME work packages to an agreed percentage of the required 30% of the contract value and procure SMMEs for these packages before the tender period. These SMMEs will be provided to the tenderer as selected subcontractors.

The tenderer then submits proof of additional subcontracting arrangements with SMMEs from the CSD with the tender to achieve the minimum of 30% of the contract value.

The first strategy's advantages are a normal tender period and a less costly process. A disadvantage of this strategy is that the tenderer needs only to comply by selecting SMMEs from the CSD without necessarily favouring local enterprises. This may lead to the risk of the community rejecting the project.

Furthermore, the SMMEs could be susceptible to exploitation. The second strategy's advantages are that SMMEs can submit competitive prices, local enterprises can be favoured and SMMEs can be trained in tendering procedures.

The second strategy's disadvantages are that it requires a longer time-frame and is more costly.

Both strategies have their advantages and disadvantages and all parties to the process must be aware of these when entering into a contract so as to provide sufficient budgets and to allow for adequate planning and risk management to achieve the desired goals.

INTRODUCTION AND LEGISLATION

The need to provide for a mechanism to empower targeted categories, called SMMEs, through procurement was an outcome of social dialogue on the New Growth Path wherein a Local Procurement Accord was signed on 31 October 2011 between the government and social partners (South Africa, 2017c). SMMEs are also classified as Exempted Micro Enterprises (EMEs) or Qualifying Small Enterprises (QSEs), Co-operatives, Township and Rural enterprises (South Africa, 2017c).

The revision of the Preferential Procurement Regulations (PPRs), 2011, initially promulgated in 2001, was initiated by this need. The revised PPRs, 2017 is therefore the second revision and it aims to promote socio-economic transformation and develop and empower SMMEs through the use of public procurement (South Africa, 2017c).

The revised regulations also adheres to the pronouncement of the President in his 2015 State of the Nation Address that *"government will set-aside 30% of appropriate categories of State procurement for purchasing from SMMEs, Co-operatives as well as Township and Rural enterprises"* (South Africa, 2017c).

The PPRs, 2017 requires the following as a condition of tender:

"If feasible to subcontract for a contract above R30 million, an organ of state must apply subcontracting to advance designated groups" (South Africa, 2017b:27).

This requirement takes into account that tenders with a value of R30 million and above are usually awarded to larger, established companies with the capacity to execute the works and smaller, upcoming businesses do not get the opportunities. The revised regulations now require all those companies who are awarded the larger tenders to subcontract to the targeted categories in aid of the aspiring businesses (South Africa, 2017c).

Although the regulations do not make subcontracting compulsory, the PPRs, 2017 do require that if an organ of state deems it feasible to subcontract and *"if an organ of state applies subcontracting... the organ of state must advertise the tender with a specific tendering condition that the successful tenderer must subcontract a minimum of 30% of the value of the contract"* (South Africa, 2017b:27) to SMMEs.

The goal of the revised PPRs, 2017 is therefore to, where it is feasible, apply subcontracting to SMMEs to a minimum of 30% of the contract value, to contracts above R30 million. A need arose out of the requirements of the revised PPRs, 2017 for a suitable strategy to achieve these subcontracting and procurement goals.

CHALLENGES IN ACHIEVING THE SUBCONTRACTING GOALS

In order to develop a strategy to implement the new regulations of subcontracting as a condition of tender, it is necessary to understand the requirements and challenges.

The PPRs, 2017 specifically include the term “if feasible to subcontract”, recognising that in some tenders it may not be possible to subcontract due to the type of tender and the scope of works (South Africa, 2017a:15).

The inclusion of this term implies that the feasibility of subcontracting must be determined for all tenders above R30 million.

The responsibility of determining the feasibility of subcontracting rests with the employer.

An objective analysis is required which provides facts to substantiate the decision, since this requirement cannot be dismissed purely on the basis that it is not feasible without providing proof.

Previously the employer did not have to consider the feasibility of subcontracting. This is now an additional requirement which necessitates additional time and budget to execute.

In some cases a tender is straight forward and determining if it is feasible to subcontract is fairly easy. For example, the supply of one large piece of machinery may not be feasible to subcontract (South Africa, 2017a:15).

Construction tenders, however, are mostly intricate and require an in depth analysis since one tender can consist of divergent types of work. Every section of work needs to be investigated in terms of which items can be subcontracted, can the items be made up into packages, how many subcontracts are required, what the values of the subcontracts are and if the values add up to the requirement of 30% of the contract value. This investigation will take time to complete as well as additional budget.

When an organ of state has determined that it is feasible to subcontract the organ of state is responsible for including a compulsory subcontracting clause in the tender and the tender must be advertised with the specific tendering condition (South Africa, 2017a:16). The tender must also make it clear that tenderers who fail to meet the requirements will be disqualified.

Not only is it necessary to determine if it is feasible to subcontract, it is also necessary to determine if there are sufficient SMMEs eligible for subcontracting. The employer is required to conduct market and industry research to determine the availability of eligible SMMEs (South Africa, 2017a:15). This too requires additional time and budget.

Furthermore, although the regulations do not limit the area from which SMMEs may be sourced, it is to the benefit of the community to source local SMMEs. This means that the employer needs to conduct investigations and consult with the local communities in order to determine the number of eligible local SMMEs as well as their capabilities, resulting in an even longer timeframe and additional budget. Small communities located in remote areas might not have sufficient SMMEs capable of conducting the work.

SMMEs will then need to be sourced from wider areas which will not benefit the local community. If the employer decides to include an additional requirement which favours local SMMEs, the specific criteria needs to be stipulated clearly in the tender documentation.

An addition to the functionality clause in the tender can be used to favour tenderers who subcontract with local SMMEs. The CSD provides a search function with additional filters, such as location, which can be used to identify local SMMEs (South Africa, 2017a:16).

The organ of state must make the list of suppliers registered on the CSD, who can provide the services or goods, available to tenderers for selection (South Africa, 2017a:17). Where it is a tendering condition the tenderer must submit proof of subcontracting arrangements between the main tenderer and the subcontractor (South Africa, 2017a:7).

It remains the responsibility of the main tenderer to select and subcontract with subcontractors who are capable and competent and who meet the tender requirements (South Africa, 2017a:16). The main contractor will remain liable for performance in terms of contractual obligations since the contract will be concluded between the employer and the main contractor and not between the employer and the subcontractor directly. (South Africa, 2017a:16).

The main contractor will therefore remain responsible for the quality of work and the performance of the subcontractors. The tenderer needs to price the tender accordingly to allow for a built in management fee as well as a budget for training of the SMMEs. This will increase the overall cost of the project.

Although it is a requirement that tenders are not to be subcontracted in such a way that main contractors have no incentive to tender (South Africa, 2017a:8), subcontracting 30% of the value of the contract has the potential to activate this risk. For example, 10% to 20% of the value of a contract is normally in the preliminary and general items, therefore only about 80% of the value of the contract could be classified as actual work items. If a further 30% of the value of the contract is subcontracted, only 50% of actual work items remains for the main contractor.

This percentage may be acceptable, however, some contracts require specialist work which could make up another 10% to 20%, leaving only 30% of the value of the contract to the main contractor in terms of actual work items.

This begs the question if there is still incentive for an established contractor to tender or if it leans towards a contractor who mainly specialises in contract management and who has little or no expertise to ensure quality work.

Since the regulations do not specify that local SMMEs are to be used or that the SMMEs are to have specific Construction Industry Development Board (CIDB) contractor grading levels, the tenderer has full say over who is subcontracted, provided that the subcontractor is on the CSD, what is subcontracted and how the subcontracts are set up. The tenderer can thus negotiate the terms which might lead to exploitation of the subcontractor.

If an organ of state therefore decides to add additional requirements, such as favouring local SMMEs or using an SMME with a specific CIDB contractor grading level, and if they want to limit the potential exploitation of the SMMEs, additional work and documentation is required which prolongs the tendering period and increases the cost of the project.

So now the question arises: do we leave it up to the contractor to fulfil the subcontracting requirements or does the organ of state intervene?

PROPOSED SMME PROCUREMENT STRATEGIES

Two strategies have been identified for procuring SMMEs to adhere to the revised regulations for subcontracting as a condition of tender. The proposed options are not exhaustive and other possibilities should be investigated. However, these options highlight the issues that need to be taken into account when addressing the requirements of the revised regulations.

The two strategies differ according to the level of intervention by the organ of state. However, both strategies firstly require determining if it is feasible to subcontract by conducting an objective analysis which provides facts to substantiate the decision as described in the previous section.

Once it has been determined that it is feasible to subcontract, the first strategy entails that the organ of state includes the compulsory subcontracting clause which requires the tenderer to subcontract a minimum

of 30% of the value of the contract, in the tender. The tender is advertised with the specific condition of tender. The tenderer then fulfils the subcontracting requirements as set out in the regulations by submitting proof of subcontracting arrangements with SMMEs from the CSD with the tender.

The tenderers are responsible for negotiating the subcontracts with the subcontractors during tendering and the tenderers who fail to meet the requirements are to be disqualified.

The responsibility of subcontracting a minimum of 30% of the contract value to competent and capable subcontractors remains fully with the main contractor.

In the second strategy the responsibility of implementing the requirements of subcontracting to SMMEs is shared between the employer and the main contractor. This strategy entails that the employer, with the aid of the employer's agent, compiles pre-determined SMME work packages from the actual work items in the main tender, to an agreed percentage of the required 30% of the contract value.

SMMEs are procured for these work packages before the tender period through an agreed procurement process involving consultations and meetings with the community and SMMEs as well as a request for quotation process.

These SMMEs are provided to the tenderers as selected subcontractors. The organ of state includes a special compulsory subcontracting clause in the tender describing the shared responsibility procedures and the tender is advertised with this special condition of tender.

The tenderers are then required to submit, with the tenders, proof of the subcontracting arrangements with the selected subcontractors as well as proof of additional subcontracting arrangements with SMMEs chosen from the CSD to achieve the minimum of 30% of the contract value.

The tenderers who fail to meet the requirements are to be disqualified.

ADVANTAGES AND DISADVANTAGES OF PROPOSED SMME PROCUREMENT STRATEGIES

The first strategy has the advantage that the tender period is not prolonged by an additional SMME procurement process. This normal tender procedure is a less costly process and the overall project costs are kept to a minimum.

A disadvantage of the first strategy is that the tenderer needs only to comply by selecting SMMEs from the CSD without necessarily favouring local enterprises. The local community may therefore not benefit from the SMME subcontracts as expected, which may lead to the risk of the community rejecting the project.

Furthermore, SMMEs who are not from local wards can have a socio-economic impact on the community, whether negative or positive. The community might not approve of SMMEs from other areas entering the community, thus resulting in them rejecting the project. This risk can cause a major delay to the project and unwantedly prolong the installation of basic, necessary services. This will also increase the overall project cost.

Another disadvantage is that the tenderer directly negotiates the subcontracts with the SMMEs and the organ of state has no input into the subcontractors chosen by the tenderer from the CSD, which work items are subcontracted, if the prices are fair or how many subcontractors are employed.

The SMMEs could therefore be susceptible to exploitation. The organ of state might, however, still choose to include a preferred locality from which the subcontractors are to be sourced in the tender. This could be

done as an additional requirement in the test for functionality which will favour subcontracting to local SMMEs.

The questions arising from the first strategy are firstly, what benefit does the SMMEs as well as the community actually obtain from the subcontracts or are they just exploited and secondly, what input can the employer have on the chosen subcontracts to ensure a benefit to the community and the SMMEs? The second strategy has therefore been developed which might address these questions and issues to some extent.

The second strategy's advantages are that the organ of state has a greater input into the SMME subcontracts. During the consultation and request for quotation processes the SMMEs can submit competitive prices and therefore they will not be exploited. This strategy will also target local enterprises which will benefit the community.

Furthermore, the SMMEs can be trained in tendering procedures during this process to enable them to correctly tender or negotiate fair prices in future.

The first disadvantage of the second strategy is, however, that it requires a longer timeframe to implement. The SMME procurement process is estimated to take up to six months to complete.

This prolonged project completion timeframe delays the installation of the required services which negatively impacts the community. This may lead to the risk of the community negatively reacting against the slow progress of the project.

The second disadvantage is that it is a more costly exercise for the employer. It is estimated that it will increase the project cost between 10% and 25% and the costs incurred by tax payers will therefore increase as a result.

THE WAY FORWARD

Both proposed strategies have their advantages and disadvantages and all parties to the process must be aware of these when entering into a contract, so as to provide sufficient budgets and to allow for adequate planning and risk management to achieve the desired goals.

Only by further investigation and implementation of the proposed strategies will it be determined if the SMMEs are actually benefitting from the process as expected and if there is still incentive for established contractors to tender.

It is, however clear that the employer must be specific about targeting local enterprises and furthermore, timeframes and budgets must be taken into account to include adequate provisions for procurement of and subcontracting to SMMEs during the whole project.

From the outcomes of implementing the proposed strategies, further solutions need to be developed that will benefit SMMEs without hindering the main contractor or resulting in poor quality work and which will minimise the increase in the cost to the employer and tax payers.

REFERENCES

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