south africa's regulatory framework

municipal land disposition and development partnerships

March 2016

Report

- This presentation is a summary of key findings of a recent report done for World Bank by ENSafrica
- Project part of National Treasury Cities Support Programme
- Assess the impact of SA regulatory framework on municipal land disposition and partnering with private sector for development of metro land
- Final report only just issued
- This a summary of highlights – not all findings/analysis

Background to Report

Common assertions about regulatory constraints:

- *Less flexibility* - pre-MFMA metros had more flexibility to execute creative land development projects and could tailor transactions to market conditions
- *Legal uncertainty* – unclear what SA law permits for land disposal & partnerships with private developers
- *Difficult to partner with private parties* - onerous legal rules limit ability to partner with private sector, despite potential benefits - e.g. innovation, technical know-how, risk mitigation, funding etc

Scope of Report

- Test assertions against SA regulatory framework. Are constraints real or perceived?
- Assess primary approaches used by metros to dispose or redevelop municipal land post-MFMA (high level case studies)
- Can global best practices for (re)developing metro land be pursued under SA regulatory framework?
- Is legislative reform needed to increase pool of global best practices available to metros?
- Note - excludes private sector 'partnerships' for developing metro land for municipal services (i.e. s78 Systems Act outsourcing). Considers 'partnerships' with private developers in wider sense (not strict PPP sense)

General Context

- Constitutional obligation to promote social & economic development and create safe, health environments and human settlements. Development of metro land important role in fulfilling these socio-economic obligations
- But not limited to projects with direct *socio-economic / public purposes* (e.g. developing metro land for municipal offices, public transport, clinics, affordable housing etc)
- Includes *pure revenue generating* projects where metro leverages surplus or under-utilized land to create high value, income-yielding assets. Revenue streams used for public purposes (e.g. retail/commercial development in CBD)

General Context

Flexibility vs regulatory oversight

- Sound public policy objectives behind most regulatory requirements e.g. ensuring prudent risk & financial management, transparency, accountability, fairness, protection of assets etc
- Generally - metro should focus on providing public services rather than commercial, revenue-generating projects (but this not mean revenue generating projects are prohibited)
- Where to draw line between *need for flexibility* vs *need for regulatory oversight* is policy question. Mere existence of a regulatory 'challenge' does not mean law needs to change

Municipal Property Development Projects

- No agreed single meaning for 'municipal property development project'. Covers range of contractual arrangements, land disposal methods
- Projects vary widely in scale and complexity (1) modest, single-use development on small property, to (2) large-scale, mixed-use, multi-year development (e.g. Cornubia)
- For convenience categorized broadly into 'sale' / 'lease':
  - Sale – permanent disposal, transfer of metro land (e.g. sale, swap, donation)
  - Lease – any grant of rights in land where metro retains ownership (e.g. lease, land availability agreement, PPP)

Types of Projects – 'Sale'

<u>'Simple' sale</u>

- Arm's length sale to highest bidder. No development conditions. Objective maximize price

<u>'Complex' sale</u>

- sale to developer subject to development conditions. Transfer pre or post-development. If transfer pre-development may be conditions in title deeds. If post then LAA for development period. May include donating/swapping land with developer in exchange for providing public infrastructure; **OR**

- sale to end-users on completion, developer has land availability rights and assists metro in sale/transfer to end-users; **OR**

- combination of both (some parcels sold to developer, others to end-users)

Types of Projects – 'Lease'

- Simple lease
  - Arm's length lease to highest bidder
  - No development conditions. Objective maximize rental revenues
- Complex lease
  - rights to lease/use metro land subject to development criteria
  - developer will run/manage developed property for long duration, find tenants etc
  - Metro may take up space in developed property

Types of Projects – Complex Projects

Complex projects can be any combination of 'sale' or 'lease' with many variables. Single, large-scale project may include:

- mixed use - retail, commercial, residential (open market, affordable housing, social housing etc)
- phased release of parcels (long term, multi-year project)
- sale of parcel(s) to developer
- transfer parcel(s) to social housing institute
- metro retain ownership of others
- PPP on a parcel (e.g. private party providing municipal function)
- metro leasing back portions for own use
- land swap with developer and/or other spheres government

General Features - Legislative Framework

- Legal framework – designed on general principles. Property development covered but not regulated as distinct project category
- 'Gap' in regulation on letting & what processes to follow. Arguably provides flexibility but in practice can create uncertainty
- More regulation since MFMA (2004) directly relevant to property projects, include:
  - 2005 - PPP Regulations
  - 2005 - SCM Regulations
  - 2008 - Municipal Asset Transfer Regulations (MATR)
  - 2011 - New regs under PPPFA

Material Regulatory Challenges

- Identified many regulatory challenges – but regard three as material

Material Regulatory Challenge #1 - MATR

- MATR prohibition on private party ceding or subcontracting the right to another person (MATR reg 45(2)(x))
- Three main impacts:
  - Developer sub-lease to tenants
  - Funding impact. Lender security - step-in rights, cession of lease rights as security, bond
  - May be legitimate commercial reason for developer to house project in SPV/subsidiary
- Note – applicable <u>only</u> if metro retains ownership & project is not classified as a PPP

Material Regulatory Challenge #2 - PPP

- Lack of clarity on status of property development projects under PPP Regulations. Distinct legislative regime – PPP vs non-PPP. No discretion – if it falls in PPP definition, PPP regime must be followed. Legal risk
- Typical property development project meets most requirements (e.g. private party uses metro land for own commercial purposes, assumes substantial risk transfer)
- Unclear re payments. If metro not paying developer, then *only* a PPP if developer collects fees/charges from users/ customers for 'service' provided to them. Apply to developer charging rental to tenants?
- Note – usually only applies if metro remains land owner

Material Regulatory Challenge #3 - Systems Act

- Strict restrictions on metro establishing, acquiring or holding interest in corporate entities (s86B(2) Systems Act)
- Must be private company and if another private shareholder – metro must have controlling shareholding
- Limits corporatized JV arrangements / 'partnerships' between private party and metro (e.g. metro contributes land & private party contributes funding/skills into JV structure)
- JV must be controlled by metro - so inevitably will be 'municipal entity' (assuming metro can establish municipal entity for this purpose – which also debatable)

Other Regulatory Challenges

Others regulatory challenges can be material depending on project context/facts

- Extra compliance time
  - MATR (council approval(s), public comments etc) – 6 to 8 months?
  - PPP (strict process, NT comments etc) – 1 year in theory, practice 2 to 3 years?
- Procurement or disposal?
  - Procuring developer services or disposing of land to developer? Or both? Unclear legally (recent case - public entity leasing space to retail tenant is 'procurement')
  - Different legislative regimes/metro depts – creates legal risk

Other Regulatory Challenges

- Prohibition on 'commercial activity' (MFMA s164)
  - 'Commercial activity' permitted but only if conducted in exercise of metro's powers/functions
  - Uncertainty – where to draw line between core mandate 'local economic development' and prohibited 'commercial activities
  - Is pure revenue-generating commercial development by metro (e.g. no municipal service etc) an exercise of its powers/functions? Sharing revenues with developer?
  - No definition, no case law – open to interpretation = legal risk (note one metro got two conflicting SC opinions)
  - Overly restrictive interpretation can constrain metro from implementing catalytic economic development projects. Effect - metros may avoid arrangements where they share in long term benefits of commercial activity on metro land

Other Regulatory Challenges

- Competitive process/unsolicited bids
  - Competitive process typically mandatory (sale s14 MFMA) and strict rules on unsolicited bids – metro cannot respond to attractive development proposals, adds compliance time
  - But some metros indicate – do not want to encourage unsolicited bids – easier to run tender processes than be swamped by unsolicited bids

Other Regulatory Challenges

- <u>Section 33 MFMA</u>
  - Only applies if metro incurs 'financial obligation' 3 years
  - Unlikely to be triggered often – but may apply if metro agrees to take lease space in development or agrees to incur some other project-related financial obligation
  - 'financial obligation' versus 'future budgetary implications'? Unclear if financial obligation to be interpreted narrowly. Property development can have long-term 'budgetary implications' even if metro not paying developer directly (e.g. donating land)
  - Public participation under s33 not dovetail/duplicates MATR & PPP participation requirements

Other Regulatory Challenges

Section 33 MFMA - contd

- Council must approve '*entire contract exactly as it is to be executed*'
- Practical difficulties:
  - Ability to conclude deals in fast moving market
  - Contract negotiation must be final before council meeting
  - Long lead time for council meetings – developer may not want to be in limbo and take political risk
  - No scope for last minute minor changes (common for most contracts)

Conclusions

- There is substantially more regulation since MFMA and some material regulatory challenges
- As asserted:
  - there is *less flexibility* to design innovative projects. Whether the reduced flexibility justifiable/reasonable separate question (balancing risk vs flexibility)
  - there is *lack of clarity* in some areas on what is permissible for land disposition / partnerships. Legal uncertainty may lead to adopting risk averse project designs, inhibit innovation
  - it is *more difficult to 'partner'* with private parties (Systems Act & PPP)

Conclusions

- Key determinant for regulatory interface is whether metro retains land ownership. 'Lease' based transactions - more regulatory challenges:
  - Simple sale (least regulatory challenges)
  - Complex lease (almost all regulatory challenges)
- But benefits of a project cannot be judged solely on regulatory impact. Complex projects (sale or lease) more likely to deliver long-term, sustainable benefits
- Metro may have valid reasons to want to retain ownership e.g. unlock commercial development opportunities, leverage its assets / generate revenue stream

Conclusions

- Assuming (1) a narrow interpretation of 'commercial activities' prohibition, and (2) developer does not need to cede/subcontract its rights, in theory all but one identified global best practices can be implemented in SA
- Exception is corporatized JV (if developer wants 50% or more)
- Noting the difference between technically possible/lawful, and practically feasible, bankable etc
- Difficult to assess the effect of risk averse project designs, preferring sale over lease etc. Hypothetical scenarios
- Also difficult assess true impact MATR – long lead time means few completed projects since 2008

Issues for Consideration

- Not all regulatory challenges need to be addressed by legislative reform – valid policy reasons for many provisions
- Legislative reform – only where clearly justified and no material adverse consequences

<u>National Treasury Guideline (s168(1)(g) MFMA)</u>

- To address fact regulatory regime does not distinctly cover property development and address 'gap' in processes for letting metro land
- Could focus only on municipal land disposition/partnership with private sector in urban development. Or could be wider include e.g. integration of planning laws (SPLUMA), environment, heritage etc in metro context

Issues for Consideration

<u>Amend MATR prohibition on cession/subcontracting</u>

- Not delete entirely. Important protections. But amend to allow cession/subcontracting in specified cases. Options:
  - Permit cession/subcontracting but make subject to metro approval
  - Keep prohibition but carve out property development issues as an exception either (a) by amending the reg or (b) adding as an ‘exemption’ MATR reg 50
  - Apply to NT for departure on case by case basis (s170 MFMA)
- Pros and cons for all these. We recommend reg 50 exemption or permit but subject to municipal approval

Issues for Consideration

<u>Clarify PPP definition</u>

- Amend PPP regs so clear if metro property development is PPP or not
- Policy decision whether to include or not
- We recommend not - arguably MATR offers adequate protection for high value, non-PPP projects (e.g. council resolutions, public participation, NT and provincial treasury engagement)

Issues for Consideration

<u>Clarify prohibition on commercial activity</u>

- Important policy reasons for prohibition. Should not be diluted. But need to clarify scope of prohibition for commercial development of metro land
- Options:
  - NT guidance
  - Minister Finance exemption (s177 MFMA)
  - Amend s164 (formal legislative amendment)
- If not NT guidance then recommend exemption rather than MFMA amendment

Issues for Consideration

Section 33 of MFMA

- Duplicated public participation provisions - amend MATR and PPP regs to dovetail with s33 (not other way round as s33 rarely triggered for these projects)
- Clarify meaning of 'financial obligations' so clear when s33 is triggered. NT guidance? Or amend s33 to clarify if it includes 'budgetary implications' and contingent liabilities
- Approval of entire contract as to be executed. NT guidance? Consider amending so council approve term sheet/draft subject to execution version not substantially deviating

Conclusion

THANK YOU