SUBCONTRACTING IN PUBLIC PROCUREMENT – THE IMPACT OF THE 2017 PREFERENTIAL PROCUREMENT REGULATIONS ON THE CONSTRUCTION INDUSTRY

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1 Introduction

In the last two decades, public procurement has received increasing attention from both academia and the government. Many pieces of legislation have been promulgated in an attempt to shape a more efficient and effective public procurement system. Amongst them is the Preferential Procurement Policy Framework Act 5 of 2000 ("PPPFA") and its Regulations[1] that came into operation during 2017. It is well known that public procurement can be used for collateral objectives other than obtaining goods, works or services at the best value. One of these objectives includes the advancement of previously disadvantaged individuals and companies. This is primarily what the PPPFA seeks to promote.

The construction industry has been one of the industries in South Africa in which a sophisticated public procurement system has been created. As in the case of public procurement in general, procurement in the construction industry or construction procurement has the promotion of previous- or historically disadvantaged contractors as a primary goal. This article aims to determine how provisions on subcontracting in the 2017 Regulations affect construction procurement and whether there are any pitfalls in its implementation. The article will set out the regulation of construction procurement law, the manner in which preferential procurement is implemented in South Africa, and the impact of the subcontracting provisions on construction procurement. Lastly, recommendations are made for the interpretation of these Regulations.

2 Regulatory framework for construction procurement

Section 217(1) of the Constitution of the Republic of South Africa, 1996 ("Constitution") provides that when contracting for goods or services, organs of state in the national, provincial or local sphere of government or institutions identified in national legislation must do so in accordance with a system that is fair, equitable, transparent, competitive and cost-effective. Section 217(2) in

[1] GN R 32 in *GG* 40553 of 20-01-2017.

turn provides for the use of procurement as a policy tool. This provision states that organs of state or institutions in subsection (1) are not prevented from implementing procurement policies providing for categories of preference in the allocation of contracts and the protection or advancement of persons, or categories of persons disadvantaged by unfair discrimination. Section 217(3) prescribes that a national legislative framework must be enacted in terms of which preferential procurement policies as contemplated in subsection (2) must be implemented. This legislative framework is the PPPFA.

The legislation applicable to public sector construction procurement are those applicable to public procurement in general,[2] namely, the Construction Industry Development Board Act 38 of 2000 ("CIDB Act"), the Regulations to the Act[3] and the prescripts issued by the Construction Industry Development Board ("CIDB") in terms of the CIDB Act. Section 2 of the CIDB Act establishes the CIDB as a juristic person and regulatory board for the construction industry and construction procurement in particular. The Act delineates the powers and functions of the board and requires a register of contractors to be created to ensure efficient procurement practices and to facilitate public sector construction procurement. Contractors are required to apply for registration on the Register of Contractors in order to tender for government construction contracts. Regulation 2 of the 2017 Regulations states that those entities bound by the Regulations are those that qualify as "organs of state" as defined by the PPPFA. Section 1 of the Act defines an organ of state as:

> "*(a)* a national or provincial department as defined in the Public Finance Management Act, 1999 (Act No. 1 of 1999);
> *(b)* a municipality as contemplated in the Constitution;
> *(c)* a constitutional institution defined in the Public Finance Management Act, 1999 (Act No. 1 of 1999);
> *(d)* Parliament;
> *(e)* a provincial legislature;
> *(f)* *any* other institution or category of institutions included in the definition of "organ of state" in section 239 of the Constitution and recognised by the Minister by notice in the *Government Gazette* as an institution or category of institutions to which this Act applies;"[4]

The CIDB resorts under subsection (f) of the above section. It is an institution as defined in national legislation, particularly in section 239(b)(ii) of the Constitution which refers to an institution identified in national legislation (the Public Finance Management Act 1 of 1999 (PFMA)) which

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[2] It includes the Public Finance Management Act 1 of 1999, the Local Government: Municipal Finance Management Act 56 of 2003 and the Local Government: Municipal Systems Act 32 of 2000. The Supreme Court of Appeal has held that the invitation, evaluation and award of tenders is of an administrative law nature, therefore the Promotion of Administrative Justice Act 3 of 2000 applies. Furthermore, the Promotion of Access to Information Act 2 of 2000 is applicable as it regulates access to any information held by both the government and private parties. The Broad-Based Black Economic Empowerment Act 53 of 2003 ("BBBEE Act") is applicable to preferential procurement in that it regulates black economic empowerment. Lastly, the Prevention and Combating of Corrupt Activities Act 12 of 2004 is aimed at curbing corruption in procurement processes and is therefore relevant. Legislation, which regulate procurement in general, also prescribe that the specific prescripts of the CIDB apply to construction procurement alongside the general legislation.

[3] GN R8986 in *GG* 31603 of 14-11-2008.

[4] Original emphasis.

performs a public function or exercises a public power in terms of legislation (the CIDB Act). The PPPFA and its Regulations therefore bind the CIDB in the creation of its construction procurement rules for the industry. The following section will explain the implementation of preferential procurement as dictated by the PPPFA.

3 Preferential procurement in South Africa

3 1 Brief background

Based on South Africa's political past in which discriminatory policies and practices prevented the majority of the country to participate in government contracting, new legislation was enacted after 1994 in order to redress this. The most relevant piece of legislation was the PPPFA. In applying a points system when awarding government contracts, the Act seeks to encourage the involvement of historically disadvantaged individuals to tender for government contracts. In what follows, the manner in which the Act must be implemented in construction procurement will be discussed.

3 2 Points system

Section 2 of the PPPFA provides for a points system in terms of which preference must be awarded. This is set out in Regulations 6 and 7 of the 2017 Regulations which provide for an 80/20 points system in respect of contracts up to a value of R50 million and a 90/10 points system in respect of contracts exceeding R50 million, respectively. This means that 80 or 90 points must be awarded for the price[5] of a tender and 20 or 10 points for preference.

In addition, Regulations 6 and 7 indicate for which preference points must be awarded. It states that a tenderer must provide proof of its Broad-Based Black Economic Empowerment ("B-BBEE") status level of contributor.[6] A failure to do so will not lead to the tenderer being disqualified, but that points only for price out of 80 or 90 will be awarded. B-BBEE is referred to in Regulation 1 as broad-based black economic empowerment as defined in section 1 of the B-BBEE Act. The Act, in turn, defines B-BBEE as

> "the economic empowerment of all black people[7] including women, workers, youth, people with disabilities[8] and people living in rural areas through diverse but integrated socio-economic strategies that include, but are not limited to –

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5 Regulation 1 provides that price include all applicable taxes less all unconditional discounts.

6 B-BEE status level of contributor is defined in Regulation 1 as "the B-BBEE status of an entity in terms of a code of good practice on black economic empowerment issued in terms of section 9(1) of the Broad-Based Black Economic Empowerment Act". Proof of B-BBEE status level of contributor means (a) the B-BBEE status level certificate issued by an authorised body or person; (b) a sworn affidavit as prescribed by the B-BBEE Codes of Good Practice; or (c) any other requirement prescribed in terms of the BBBEE Act. See Regs 6(4)(a) and (b) and 7(4)(a) and (b).

7 Black people are referred to in Regulation 1 as having the same definition as that in s 1 of the B-BBEEA. This Act in turn provides that "black people" is a generic term that means Africans, Coloureds and Indians.

8 This is said in Regulation 1 to have the same meaning as that found in s 1 of the Employment Equity Act 55 of 1998. This Act defines people with disabilities as people who have a long-term or recurring physical or mental impairment that substantially limits their prospects of entry into, or advancement in employment.

(a) increasing the number of black people that manage, own and control enterprises and productive assets;
(b) facilitating ownership and management of enterprises and productive assets by communities, workers, cooperative and other collective enterprises;
(c) human resource and skills development;
(d) achieving equitable representation in all occupational categories and levels in the workforce:
(e) public procurement; and
(f) investment in enterprises that are owned or managed by black people."

In the next section, an explanation of the new subcontracting regulations is provided, followed by a critical analysis of the impact of these provisions.

4 Subcontracting as a condition of tender and after award of a tender[9]

Regulation 9 is a new addition to the Regulations. It provides that if it is feasible to subcontract in a contract above R30 million, an organ of state must do so in order to advance designated groups.[10] If an organ of state intends to apply subcontracting in terms of this Regulation, it must advertise the tender with the specific condition that the successful tenderer must subcontract a minimum of 30% of the value of the contract to those groups identified in Regulation 4(1).[11] In addition to these groups, are exempted micro enterprises ("EMEs")[12] or qualifying small business enterprises ("QSEs")[13] which are 51% owned by black people who live in rural or underdeveloped areas or townships and EMEs or SQEs which are at least 51% owned by black people who are military veterans.[14] Since feasibility is not defined in the Regulations, it remains to be seen which criteria will be applied to determine whether subcontracting is feasible or not. What the phrase "if feasible" could mean will be explored below.

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[9] A subcontractor is defined in CIDB prescripts as "a natural or juristic person or partnership who is contracted by the contractor to assist the latter in the performance of his contract by providing certain supplies, services, or engineering and construction works." See CIDB Code of Conduct for all Parties Engaged in Construction Procurement BN 127 in *GG* 25656 of 31-10-2003 18.

[10] Regulation 9(1). A designated group is defined in Regulation 1 as black designated groups, black people, women, people with disabilities, or small enterprises as defined in s 1 of the National Small Enterprise Act 102 of 1996.

[11] Regulation 9(2).

[12] Defined in Regulation 1 as an "exempted micro enterprise in terms of a code of good practice on black economic empowerment issued in terms of section 9(1) of the Broad-Based Black Economic Empowerment Act".

[13] Defined in Regulation 1 as "a qualifying small business enterprise in terms of a code of good practice on black economic empowerment issued in terms of section 9(1) of the Broad-Based Black Economic Empowerment Act".

[14] A military veteran is described in Regulation 1 as having the same meaning as that in s 1 of the Military Veterans Act 18 of 2011 which defines it as any South African citizen who (a) rendered military services to any of the military organisations, statutory or non-statutory, which were involved on all sides of South Africa's Liberation War from 1960 to 1994; (b) served in the Union Defence Force before 1961; or (c) became a member of the new South African National Defence Force after 1994, and has completed his or her military training and no longer performs military service, and has not been dishonourably discharged from that military organisation or force: Provided that this definition does not exclude any person referred to paragraph (a), (b) or (c) who could not complete his or her military training due to an injury sustained during military training or a disease contracted or association with military training.

In addition to Regulation 9, Regulation 12 provides for subcontracting after a tender has been awarded. In other words, a distinction is made between providing for subcontracting as a tender condition and subcontracting after award of a tender, which has generally been the case until the 2017 Regulations came into operation. The 2017 Regulations have therefore made subcontracting compulsory to a determined group of contracts. The 2011 PPPFA Regulations[15] defined subcontracting,[16] but no further provision for subcontracting was made in the 2017 Regulations. This was also the case in the 2001 Regulations. Therefore, one can assume that subcontracting was a generally permitted practice, despite the absence of a theoretical framework for it.

5 Current subcontracting practices in construction procurement

The fact that subcontracting is provided for as a qualification criterion and after the award of a contract is indicative of a recognition or acknowledgement of the importance of subcontracting. Subcontracting has been general practice in construction procurement; therefore, the enactment of subcontracting provisions in the 2017 Regulations solidifies a long-standing practice. Various reasons why subcontracting in construction procurement occurs exist.[17] There may be a need for specific expertise amongst subcontracts necessary for a specific project or there may be a need to increase the main contractor's contracting capacity or in order to comply with B-BBEE requirements by engaging small, medium and micro enterprises ("SMMEs") in construction procurement tenders.

At present, there are three types of subcontractors in construction procurement.[18] First, a domestic subcontractor that is appointed by the main contractor at its discretion. Secondly, a nominated subcontractor that is nominated by the procuring entity and appointed by the main contractor. Lastly, a selected subcontractor that is selected by the main contractor in consultation with the procuring entity in terms of contract requirements.

CIDB prescripts note a number of challenges in subcontracting.[19] Firstly, subcontractors often experience problems regarding non-payment from main contractors. Secondly, there is a lack of (legal or labour) representation of subcontractors in the case of disputes. This is problematic based on the inability of subcontractors to enforce their rights in arbitration or litigation, which are the main forms of dispute resolution in construction procurement. It is also an expensive exercise for subcontractors to enforce their rights legally since they do not have the financial capacity that main contractors have. Thirdly, sole authoritarian rights are given to the main contractor, leaving

[15] GN R 502 in *GG* 34350 of 08-06-2011.
[16] Defined in Reg 1(r) as "the primary contractor's assigning, leasing, making out work to, or employing, another person to support such primary contractor in the execution of part of a project in terms of the contract;". The same definition was used in Reg 1 of the 2001 Regulations GN R725 in *GG* 22549 of 10-08-2001.
[17] CIDB Inform Practice Note 7 *Subcontracting Issues* (May 2007) 2.
[18] 2-3.
[19] 2.

the subcontractor in a precarious position, which leads to them having less bargaining power based on their dependence on main contractors for work. In the fourth instance, the main contract and the subcontract often tend to be removed from one another. Subcontractors allege that the conditions of the latter are less favourable than the former, leaving them with fewer rights. In a traditional subcontracting arrangement, the contract is concluded between the main contractor and the subcontractor. Therefore, the procuring entity from whom the main contractor won the tender is completely removed from this relationship.[20] The subcontractor can therefore only call on external sources, such as a court of law, for legal redress.

6 The impact of the 2017 Regulations on construction procurement

It is submitted that the result of the enactment of subcontracting rules in the 2017 Regulations is not only that subcontracting has become compulsory in a certain group of contracts, but also that the relationships in a subcontracting arrangement have changed. The Regulations effectively establish a relationship between the procuring government entity and the subcontractor. Therefore, a measure of protection is provided to subcontractors when contracting in projects above the value indicated in the Regulations. A further consequence is that the main contract and the subcontract can no longer be significantly different. Although it was never legally permitted to be different based on the constitutional section 217 right to procedural fairness, the 2017 Regulations solidify this position.

From these Regulations it would appear that a tripartite relationship is in fact created. A relationship between the procuring entity and the main contractor, a relationship between the main contractor and the subcontractor and, most importantly, a relationship between the procuring entity and the subcontractor exists. The latter is an additional relationship that is formed, and a procurement network is thus formed. This means that all three parties must act fairly and honestly toward one another and no single party has power over the relationship. Therefore, it creates an expectation that subcontractors will no longer be the victims of financial monopoly as more direct dispute resolution involving the organ of state, based on its involvement with the subcontractor, is now permitted. The nominated contractor appointed by the procuring organ of state, as permitted by CIDB prescripts, established a relationship between the subcontractor and the organ of state even before the promulgation of the 2017 Regulations. A means of protection should thus have already been available to subcontractors. The enactment of Regulation 9, however, solidifies this relationship in legislation, rather than prescripts, which may in practice be regarded as optional to comply with. It should be noted that based on this tripartite relationship, the subcontractor does not cease to be one. Instructions and payments will still be received from the

[20] CIDB Best Practice Guideline D1 *Subcontracting Arrangements* (March 2004) 1.

main contractor. Furthermore, the subcontractor performs only a percentage of the contract and not the full contract value.

It is further submitted that although Regulation 9 can be commended, a further amendment should be made. When 30% of R30 million as stated in Regulation 9 is calculated, it amounts to R9 million. This means that a minimum of R9 million must be subcontracted. The significance of this is that the CIDB uses a grading system in order to determine the works and financial capability of construction contractors.[21] In terms of section 18(1) of the Act, subcontractors must adhere to this scheme and apply for registration on the Register of Contractors provided by the CIDB Act. Contractors are then graded according to their ability to complete a contract or project of a certain value.[22] This means that subcontractors cannot perform any work awarded by an organ of state to a main contractor without being registered on the CIDB register. Based on the R9 million threshold above, a level six contractor and up would qualify as a subcontractor in terms of Regulation 9.[23] These are "medium capacity" contractors who can tender for work up to a value of R13 million according to the grading system of the CIDB. In other words, they are not SMMEs. Regulation 9 is specifically geared towards the development of black people, youth, women, those with disabilities and small businesses. However, based on the grading of construction contractors, this Regulation fails to address the need to involve and develop SMMEs in construction procurement adequately. It is therefore recommended that the threshold of R30 million be decreased in order to facilitate the involvement and long-term training of smaller contractors.

Regulation 9 further states that 30% of a R30 million contract must be subcontracted *if it is feasible* to do so. However, the Regulations do not indicate what feasibility means neither does it provide a test for feasibility. Therefore, it remains to be seen under which circumstances this Regulation will be implemented. The requirements to meet feasibility will also have to be stated in a call for tenders or request for proposals. It appears that this Regulation may permit some discretion as to when it will be feasible to implement, which indicates a shift towards a more flexible form of contracting in public procurement. The question that remains is whether a regulation making subcontracting mandatory is legally permissible or legally enforceable. In other words, does legal regulation or a legal framework or rules exist in which subcontracting in public procurement can function? Currently, there exists no such framework for a provision newly included in the Regulations with no legal basis.[24]

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21 See ch 3 of the CIDB Act.

22 Regulations 7 and 7A set out the requirements to be met by contractors in order to be registered in grades 1 to 9 with grade 1 being the smallest amount that can be tendered for and grade 9 the largest value contracts than can be completed by a contractor.

23 See the amendment to the CIDB Regulations GN R464 in *GG* 36629 of 02-07-2013, which provide that grade 5 contractors may tender for a contract to the value of R13 million and more.

24 See AM Anthony *The Legal Regulation of Construction Procurement as a Relational Construct in South Africa* LLD dissertation, Stellenbosch University (2018) in which a legal framework for these provisions is proffered.

In the next section, a few recommendations for the meaning or interpretation of Regulation 9 are made.

7 Meaning of feasibility

As noted, although feasibility in relation to subcontracting is required by the 2017 Regulations, no definition for feasibility is provided. Regulation 9(1) appears to be written in peremptory terms in its wording that "an organ of state *must* apply subcontracting".[25] However, the phrase "if feasible" appears to create an opportunity to demonstrate that it may not be feasible[26] to engage in subcontracting. Feasibility is also not defined in any CIDB prescripts. The newly published Standard for Minimum Requirements of Engaging Contractors and Sub-Contractors on Construction Works Contracts[27] does not appear to assist in this regard either, as it mainly defines the various parties involved in subcontracting.[28] However, the Standard for Developing Skills through Infrastructure Contracts[29] provides some guidelines as to how to approach subcontracting in construction procurement. The Standard provides for the achievement of contract skills development goals ("CSDG")[30] and contract skills development credits, which are "the number of learners employed by the contractor and placed for continuous training opportunities in a three month period".[31] These would be the subcontractors successfully up-skilled after the necessary training by the main contractor. The Standard provides for four methods through which a CSDG can be achieved[32] and the aim is that subcontractors be trained to achieve a qualification in the industry. The Standard also provides for a denial of credits where the training opportunities are not provided for on-site or cannot be directly linked to the contract. It will also be denied where *inter alia* no mentorship plan is indicated; interim or final contract compliance reports are lacking; no training

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25 Own emphasis.

26 Described by the *Oxford English Dictionary* as "possible and practical to do easily or conveniently; likely; probable".

27 GN R881 in *GG* 41237 of 10-11-2017.

28 These include the employer defined as a "person or organization entering into the contract with the principal contractor for the provision of goods, service, or engineering and construction works" which would constitute the procuring organ of state. A principal contractor is a "contractor who contracts with the employer for the provision of construction works, and who may subcontract part of this contract" and a sub-contractor is "the contractor who contracts with the principal contractor for the provision of portions of construction works". See para 2 at 2 of the Standard.

29 GN R863 in *GG* 36760 of 23-08-2013.

30 Defined in para 2 at 2 as "the number of hours or head count of skills development opportunities that a contractor contracts to provide in relation to work directly related to the contract or order up to: a) completion in the case of a professional service contract; b) the end of the service period in the case of a service contract; and c) practical completion in the case of an engineering and construction works contract."

31 See para 2 of the Standard.

32 These are first by providing "structured workplace learning opportunities for learners toward the attainment of a part or a full occupation qualification;" secondly, "structured workplace learning opportunities for apprentices or other artisan learners towards the attainment of a trade qualification leading to a listed trade … subject to at least 60% of the artisan learners being holders of public FET college qualifications;" thirdly by providing "work integrated learning opportunities for University of Technology or Comprehensive University students completing their national diplomas;" and lastly by providing "structured workplace opportunities for candidates towards registration in a professional category by a statutory council listed in Table 1" provided in the Standard.

plans for learners are provided; the mentorship is not in accordance with the requirements of the applicable professional body or statutory council; and the structured workplace learning is not in line with the curriculum requirements of the qualifications for professional registration.[33]

The listed factors for denial of credits could form a basis for feasibility of subcontracting as required by Regulation 9. This would include demonstrating a training plan, indicating that the training complies with professional body requirements, indicating the persons directly responsible for the training and when reports will be made available. Should this be regarded as too onerous or too comprehensive to submit in time for a tender closure date and time, it is recommended that contractors should indicate their record for subcontracting over a period of time such as five years as one of the requirements for the test of feasibility.[34] In other words, contractors who have not subcontracted in accordance with a certain threshold such as 30% of the contract value should indicate how they intend to implement contracting in the contract tendered for. Another requirement could be an indication of a certain number of professionals employed by the tenderer, which could potentially indicate the ability of the contractor to provide training to subcontractors. It is submitted that "economic feasibility" as a potential requirement should be avoided as contractors may attempt to prove that it is not economically feasible by tendering abnormally low prices. Awarding extra points for subcontracting may also not be permissible as Regulation 4 already provides for evaluation of preference as a pre-qualification criterion where a minimum of 30% of the contract value is shown to be subcontracted to an EME or SQE.

8 Conclusion

Subcontracting has for the longest time been common practice in the construction industry. With the promulgation of the 2017 PPPFA Regulations, subcontracting was introduced as a compulsory element of procuring goods and services in the case of contracts above a certain value. This substantially changed the relationships in government contracting. Previously, subcontracting was a contractual relationship between the main contractor and the subcontractor only. However, the introduction of these regulations now creates a relationship between the procuring organ of state and the subcontractor. This in turn provides a measure of protection to subcontractors who previously had no recourse in the case of abuse or non-payment for their work. A tripartite relationship is thus established between the organ of state and the main contractor, the main contractor and the subcontractor and lastly between the organ of state and the subcontractor.

In addition to making subcontracting compulsory, the Regulations introduced the requirement of *feasibility* for subcontracting. In other words, a main contractor must contract a certain value of the contract to a subcontractor

[33] See paras 3.3 and 3.4 of the Standard.

[34] The five years is synonymous with the time for which contractors must provide their financial and works information to the CIDB in order to tender for government contracts in Reg 11 of the CIDB Regulations.

if it is feasible to do so. However, no indication of what feasibility could mean is given. Neither a definition nor a test for feasibility is provided. It is thus recommended that the factors for a denial of credits in the Standard for Developing Skills through Infrastructure Contracts noted above may serve as a basis from which to build criteria to determine feasibility. This would include *inter alia* a demonstration on the part of the main contractor that it is able to provide the necessary training in order to up-skill the subcontractor so that the subcontracting arrangement can have optimal benefits for all parties involved. It is further recommended that economic feasibility not be used as a factor in order to avoid the submission of abnormally low bids. If these vacuums in the Regulations can be addressed adequately, it could go a long way in developing subcontractors to become competitive contractors in construction procurement.

SUMMARY

The 2017 Preferential Procurement Regulations brought about vast changes to the legal landscape of construction procurement, specifically with regard to subcontracting. This article evaluates the impact of these regulations and the effect these changes may have on construction procurement and the construction industry at large. Recommendations are made where vacuums in the legal framework are found.