

## BOARD OF DIRECTORS

### DEVELOPMENT EFFECTIVENESS COMMITTEE

#### **Chairperson's Summary of the Committee's Discussion on 25 August 2004 of the Special Evaluation Study on Project Cost Estimates**

1. With its meeting on 25 August 2004, the Development Effectiveness Committee (DEC) started its August 2004 – July 2005 review cycle. At this first meeting, the DEC considered two reports by the Operations Evaluation Department (OED): (i) *Special Evaluation Study on Project Cost Estimates*; and (ii) *Project Performance Audit Report on the Livestock Development Project (Loan 973-PAK[Sf]) in Pakistan*. This Chairperson's Summary covers the DEC's discussion of the first report.
2. As background, in its discussion of the annual review of evaluation activities in August 2002, the DEC had focused, among other things, on the issue of the persistent variances between project cost estimates and actual costs, as reported by OED. The DEC thought the issue warranted a thorough examination and recommended that a special evaluation study be initiated as part of OED's 2003 work program. Specifically, the DEC recommended that the OED study investigate the reasons why actual costs differed from appraisal estimates, with a view to making project cost estimates more realistic. In July 2004, OED circulated its final report, *Special Evaluation Study on Project Cost Estimates*, simultaneously to Management and the Board in advance of public disclosure so that Management response to the report, if any, and the DEC's views could be obtained and publicly disclosed together with the report.
3. The DEC appreciated that Management, in its response, supported the recommendations of the report in principle. At the same time, Management has qualified that "for those recommendations which may require further study, we (Management and staff) will consider them based on a careful analysis of the associated costs and benefits".
4. The DEC generally endorsed the special evaluation study's conclusions and the objectives of its main recommendations, as summarized on pages v-vii of the Executive Summary and discussed in greater detail in Section V. The DEC considered the report to be a major and important input to an action plan that needed to be formulated as the next step. At the same time, the DEC emphasized that more accurate cost estimation was not the end, but a means to the objective of improving efficiency and effectiveness in the allocation of ADB's scarce resources and reducing negative impacts to borrowing members. With the total amount of loan cancellations having doubled in the last five years, the need for immediate action was real and pressing.
5. The solution to the issue of persistent project cost underruns would not be achieved overnight, but monitorable change had to start. Such change might require fundamentally new business processes and systems, instead of mere adjustments to the existing system. The DEC remains concerned that borrowing member countries may be incurring excess commitment charges on OCR loans for projects that ultimately have major cost underruns. At the same time, ADB and the borrowing members share the responsibility for good project design.

6. The DEC agreed with Director General, OED on the larger significance of this study. The initial motivation for the study had been concern over technical and due diligence issues related to project preparation and implementation procedures; significant changes in the nature of the lending program over the years might have resulted in gaps in the skills mix of staff, which could have led to some weakening in technical abilities for cost estimation. At the same time, the study's analysis and findings point to more fundamental potential issues involving ADB's policies as a lender, including implications for ADB income. For instance, as a consequence of the study, further consideration should be given to a need to review ADB's current policies or practices on: determining the size of loans, local cost financing, procedures covering physical and price contingencies and their amounts, treatment of interest during construction, commitment charge accrual, supplementary loans, and use of loan savings.

7. At the discussion, individual DEC members voiced their respective key concerns in considering the findings of the study. In particular, these included the following.

- Improvement of project cost estimation is directly related to capacity building in executing agencies of borrowing members.
- In reviewing ADB's supplementary loan policy, there is room for the Board to consider further delegation of related decision making to Management. In this context, the concept of a "two-part loan system" – the first part for base cost, the second for contingencies and a fixed percentage for cost overruns, with approval for use of the second part possibly delegated to Management - could be further analyzed and subjected to careful consultation with borrowing members. However, increased flexibility should not be at the expense of any due diligence responsibility of the Board.
- Innovative solutions, such as the option for a borrowing member not to borrow for contingencies, should be considered.
- The issue of inconsistent application of ADB guidelines in estimation of price contingencies must be further examined. Accountability for ensuring consistent application of the guidelines ADB-wide must be clarified and established.
- Since corruption and poor governance issues were perceived by staff and consultants as major factors for project cost variances, these deserve further specific examination.
- The effect of increased loan conditionalities on cost overruns should be assessed.
- The implicit financial effects of poor project cost estimates on the borrowing member government should be further defined so that these could be explicitly addressed in the future.

9. In all these, recognizing that the recommendations might not be budget neutral if substantially implemented and that ADB had limited budget resources, a cost-benefit analysis should provide the basis for proceeding with a recommendation. Since it was clear that action should be taken, the DEC wished to engage Management in the consideration of more specific next steps to be taken on each of the recommendations of the study.

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Chairperson  
Development Effectiveness Committee

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