



Country Operations Business Plan

October 2006

Sri Lanka
2007–2008

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 29 September 2006)

Currency Unit	–	Sri Lankan rupee (SLRe/SLRs)
SLRe1.00	=	\$ 0.01
\$1.00	=	SLRe 103.2

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CSP	–	country strategy and program
CPS	–	country partnership strategy
GDP	–	gross domestic product
OCR	–	ordinary capital resources
MDG	–	Millennium Development Goal
STDP	–	Southern Development Transport Project

NOTE

In this report, "\$" refers to US dollars.

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I. CONSISTENCY OF BUSINESS PLAN WITH CURRENT COUNTRY STRATEGY AND PROGRAM

1. The country strategy and program (CSP)¹, presented to the ADB Board in 2003, was formulated in parallel with the Government's "Regaining Sri Lanka" poverty reduction strategy. The core sectors of the CSP are transport, education, water supply and sanitation, energy, and rural development (small and medium-sized enterprises and agriculture). Since then, a new Government was voted into power in November 2005. The 2-year rolling business plan is in line with these priorities and also with the emerging strategy of the new Government. Its key emphasis is spreading development to rural areas so as to (i) achieve the Millennium Development Goals (MDGs), and (ii) reduce regional inequality and income poverty levels. The country is well-placed to achieve the MDGs, except those addressing income poverty, child malnutrition, and environmental sustainability. To achieve rural development, the Government places a high emphasis on large infrastructure projects, ranging from highways to ports and airports that will help in linking the rural economy to international markets. While committed to public-private partnerships, the Government sees the state as having an increasing role to play in promoting economic growth, and public investment (excluding tsunami-related expenditure) is expected to reach 7% of GDP in 2007. Plans to reduce rural poverty range from helping farmers market their products (strengthening linkages between producers and sellers) to large tax incentives for companies to shift their production bases to the rural provinces (a program rapidly taken up by the private sector). The Government intends to finalize its 10-year development plan by early 2007. This development plan will form the basis for ADB's new country partnership strategy (CPS), which will be finalized by the second half of 2007.

II. INDICATIVE LENDING AND NONLENDING PROGRAM

2. The business plan covers just 2 years to allow greater flexibility for ADB and the Government jointly to define the scope of ADB's strategy. ADB's overall commitment for the 2 years is \$868.3 million, out of which \$193.3 million is from the Asian Development Fund (ADF) and grants and \$675 million is from ordinary capital resources (OCR). This amount is higher than in the past, as three projects—Colombo Port Expansion Project, Supplementary Financing for the Southern Transport Development Project (STDP), and Jaffna Water Supply and Sanitation—slipped to 2007. Processing of both the Colombo Port Expansion Project and Supplementary STDP will be completed in the first quarter of 2007. The expansion of the Colombo Port will be the largest public infrastructure development project undertaken by public-private partnership in Sri Lanka. Its expected impact on economic growth and export competitiveness is significant. The Government took a final decision on the financing mode in September 2006, confirmed the original design, and requested ADB's public sector financing for the breakwater complemented by open competitive bidding for concessions on the container terminals. The supplementary financing for the STDP is required to cover cost overruns and expand the project to four-lane standards, and it is subject to fulfilling the action plan of the compliance review. Due to the worsening security situation, the Jaffna Water Supply and Sanitation Project, originally scheduled in 2006, has been deferred to 2007.² The worsening security situation has thus far had a relatively limited impact on ADB supported programs in the affected areas: while no ADB financed infrastructure (except one ADB financed ambulance) has been damaged, ADB postponed implementing large infrastructure projects until the security situation and the availability of construction material improves. However, offices of projects

¹ ADB. 2003. *Country Strategy and Program (2004-2008): Socialist Republic of Sri Lanka*. Manila.

² A Board Information Paper that provides an update of the current situation is being circulated separately.

supported by ADB in the north and east, staffed by government officials, largely continue to function.

3. The second tranche of the Power Sector Development Program³ loan was cancelled in June 2006. A healthy power sector is crucial for Sri Lanka's economic development. However, a substantially different political environment compared to the time of the loan design made achievement of the reform measures designed 4 years ago unlikely. At the same time, urgent investments are required to increase generation capacity as well as to strengthen and expand the transmission system and distribution network (including rural electrification). Since the cancellation of the loan, the Government has increased electricity tariffs by more than 30% and reached financial closure on two major generation projects. It also proposes to retire and/or restructure part of the debt of Ceylon Electricity Board. This will alleviate the immediate financial crisis in the sector. However, these measures should be accompanied by institutional and structural reforms to ensure the long-term financial sustainability of the sector, and ADB will review with an open mind alternative proposals currently being developed by the Government to determine if and how ADB can be of further assistance to the sector.

4. The size of OCR lending will have to be compatible with the Government's debt strategy and safe prudential limits, and the results of an ADB debt sustainability assessment will be available before the end of the year. Projects with a strong payback capacity and economic rationale, such as the Colombo Port Expansion Project, will be financed through OCR lending. Nonsovereign lending (for example to private sector institutions) will be explored more fully as part of the CPS preparations, since it does not add to the public sector debt burden. OCR needs to be used strategically and be allocated to projects that have a significant impact on economic growth. Given the worsening of the security situation in the north and east since early 2006, and the breakdown of the latest round of peace talks in Geneva in October 2006, ADB will carefully assess whether OCR-financed projects will (i) be able to deliver the expected economic returns, and (ii) ensure that the principle of "do no harm" is strictly applied. This principle means in conflict resolution terms that in cases where development interventions do not actively benefit all groups, it should at least not harm any group involved as this could add to the grievances of this group. As a result, ADB discusses all projects in the north and east both in their design and implementation stages with all stakeholders involved. Management information system based in project offices monitors the allocation of each subproject and is able immediately to identify the main beneficiaries. This helps provide equitable distribution of subprojects to which all parties have agreed. For sectors such as water supply and provincial roads, ADB and the Government will seek to attract grant or softer cofinancing to soften the terms of the OCR component.

5. The country specific ADF allocation has been derived on the basis of the results of the 2005 country performance assessment exercise, after applying the Performance Based Allocation formula. The ADF allocation for Sri Lanka for 2007-2008 has been set at \$135 million. ADF is allocated to education projects (\$65 million), agriculture (\$30 million), and water supply (\$20 million). Sri Lanka is eligible for 15% grant contribution during 2005/06, and similar amounts, pending confirmation, are expected for the 2007/08 allocation. These grants have been allocated to water supply projects in poor rural areas and include projects with the National Water Supply and Drainage Board (\$15 million), the proposed Jaffna Water Supply and Sanitation Project (\$15 million), and to HIV/AIDS⁴ education in schools (\$5 million). Management has approved shifting \$58.3 million in ADF and grant from 2006 to 2007 due to

³ ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Power Sector Development Program*. Manila.

⁴ HIV/AIDS = human immunodeficiency virus/acquired immunodeficiency syndrome.

delays in processing because of the uncertain security situation. The nonlending program prioritized several cases for project preparatory technical assistance. The 2007–2008 firm allocation has been reduced to \$3.9 million and is slightly under-programmed in 2008 to allow for greater flexibility in the CPS discussions.

III. SUMMARY OF CHANGES TO LENDING AND NONLENDING PROGRAMS

6. Changes to the lending program are mostly related to unexpected cost escalation, change in scope, and the resurging conflict. The Small Towns and Rural Arid Areas Water Supply and Sanitation Project has moved to standby in 2007 to accommodate the additional supplementary loan for the water supply and sanitation sector added to the program and processed in 2006. Due to the conflict, Jaffna Water Supply and Sanitation Project has been deferred to 2007, but technical preparations are largely complete. The Colombo Port Expansion Project slipped to 2007, but it is expected to be presented for Board approval in the first half of 2007, as processing is well advanced. The supplementary finance loan for the Southern Transport Development Project was on standby in 2006 and should also be ready for Board approval during the first half of 2007. For 2008, more significant changes have been agreed with the Government: (i) Fiscal Management Reform II has shifted to standby, pending an assessment of the effectiveness of the first project; (ii) the Rural Finance Project is likely to be project-based, but the project preparatory technical assistance will explore both program- and project-type support; (iii) the Improving Service Delivery Project, a pilot project, has been removed as a stand-alone project, and advisory technical assistance will work with existing and planned sector interventions to improve service delivery. Finally, there is a risk that the Agribusiness Development Project, a project that promotes public-private partnership in the agricultural sector might slip to 2009, as processing of the project preparatory technical assistance has been delayed, while the Road Network Project could potentially explore a multitranches facility of up to \$300 million.

IV. INDICATIVE RESOURCE REQUIREMENTS

7. Approximately 128 person-months will be needed for processing of projects and technical assistance included in the 2-year business plan.

V. RESULTS-BASED MONITORING

8. The 2003 CSP was not results-based, and its road maps had no medium-term goals and targets. The CPS planned for 2007 will be results-based, and regular reporting and updating will start from 2008 onward.

INDICATIVE ASSISTANCE PIPELINE FOR 2007–2008

Table A1.1: Assistance Pipeline for Lending Products

Sector Project/Program Name	Targeting Classifi- cation	Thematic Priority	Division	Year of Project Preparatory Assistance	Total	Cost (\$ million)				Gov- ern- ment	Cofi- nanc- ing
						OCR	ADB ADF		Total		
							Loans	Grants			
2007 Firm Loans											
Social Infrastructure											
1. Education Sector Development	TI	ISD	SANS	2006	tbd	0.0	65.0	0.0	5.0	70.0	tbd
2. Greater Colombo Wastewater Management	TI	ENV/PSD	SAUD	2004	tbd	50.0	0.0	0.0	0.0	50.0	tbd
3. Jaffna Water Supply and Waste Management ^a	TI	HD	SAUD	2003	tbd	0.0	43.3	15.0	0.0	58.3	tbd
Subtotal						50.0	108.3	15.0	5.0	178.3	tbd
Transport											
4. Colombo Port Expansion Project ^b			SATC			300.0	0.0	0.0	0.0	300.0	
5. Southern Transport Development Supplementary Financing ^c						85.0	0.0	0.0	0.0	85.0	
Subtotal						385.0	0.0	0.0	0.0	385.0	
Total						435.0	108.3	15.0	5.0	563.3	tbd
2007 Standby Loans											
6. Agribusiness Development	TI	ECO/PSD	SANS		tbd	30.0	30.0	0.0		60.0	tbd
7. Road Network Project	GI	ECO/PSD	SATC		tbd	150.0	0.0	0.0		150.0	tbd
8. Small Towns and Rural Arid Areas Water Supply and Sanitation Project	TI	ENV/ISD	SAUD		tbd	30.0	20.0	15.0		65.0	tbd
2008 Firm Loans											
Agriculture and Natural Resources											
1. Agribusiness Development	TI	ECO/PSD	SANS		tbd	30.0	30.0	0.0		60.0	tbd
Subtotal						30.0	30.0	0.0		60.0	tbd
Industry and Trade											
2. Rural Finance Project	TI	GG/PSD	SAGF		tbd	30.0	0.0	0.0		30.0	tbd
Subtotal						30.0	0.0	0.0		30.0	tbd

Sector Project/Program Name	Targeting Classifi- cation	Thematic Priority	Division	Year of Project Preparatory Assistance	Total	Cost (\$ million)			Gov- ern-	Cofi- nanc-
						OCR	ADB ADF	Total		
Social Infrastructure										
3. Small Towns and Rural Arid Areas Water Supply and Sanitation Project	TI	ENV/ISD	SAUD		tbd	30.0	20.0	15.0	65.0	tbd
Subtotal						30.0	20.0	15.0	65.0	
Transport										
4. Road Network Project	GI	ECO/PSD	SATC		tbd	150.0	0.0	0.0	150.0	tbd
Subtotal						150.0	0.0	0.0	150.0	tbd
Total						240.0	50.0	15.0	305.0	tbd
2008 Standby Loans										
5. Fiscal Management Reform Cluster loan		GG/ECO	SAGF		tbd	100.0	10.0	0.0	110.0	tbd

ADB = Asian Development Bank, ADF = Asian Development Fund, ECO = sustainable economic growth, ENV = environmental sustainability, GG = general governance, HD = human development, OCR = ordinary capital resources, PSD = private sector development, SAGF = South Asia Governance, Finance and Trade Division, SANS = South Asia Agriculture and Natural Resource Division, SATC = South Asia Transport and Communications Division, SAUD = South Asia Urban Development Division, tbd = to be determined.

^a Postponed to 2007 because of the conflict.

^b Government requested increase to \$300 million during fact-finding. Because of cost increases, \$300 million would be 67% of total project costs.

^c Shifted to 2007 so that STDP is in full compliance with compliance review.

Source: ADB estimates.

Table A1.2: Assistance Pipeline for Nonlending Products and Services

Sector Assistance Name	Responsible Division	Assistance Type	Sources of Funding				Total (\$'000)
			ADB		Others		
			Source	Amount (\$'000)	Source	Amount (\$'000)	
2007							
Agriculture and Natural Resources							
1. Agribusiness Development (piggyback)	SANS	PP		700.0		0.0	700.0
Subtotal				700.0		0.0	700.0
T							
Industry and Finance							
2. Fiscal Management	SAGF	PP		500.0		0.0	700.0
3. Rural Finance/Microfinance	SAGF	PP		700.0		0.0	700.0
Subtotal				1,400.0		0.0	1,400.0
Total				2,100.0		0.0	2,100.0
2007 Standby							
4. Distance Education Modernization II	SANS	PP		600.0		0.0	600.0
5. Private Sector Development II	SAGF	PP		600.0		0.0	600.0
6. Petroleum Resources Exploration ^a	SAEN	AD		700.0			700.0
7. Improving Service Delivery ^a	SAGF	AD		300.0		tbd	
2008							
Agriculture and Natural Resources							
1. Commercialization of Agriculture	SANS	PP		600.0		0.0	600.0
Subtotal				600.0		0.0	600.0
Industry and Finance							
2. Private Sector Development II	SAGF	PP		600.0		0.0	600.0
Subtotal				600.0		0.0	600.0
Social Infrastructure							
3. Distance Education Modernization II	SANS	PP		600.0		0.0	600.0
Subtotal				600.0		0.0	600.0
Total				1,800.0		0.0	1,800.0
2008 Standby							
4. Technical Education	SANS	PP		600.0		0.0	600.0
5. Local Government Sector Development	SAUD	PP		600.0		0.0	600.0

ADB = Asian Development Bank, PP = project preparatory, AD = advisory, SAEN = South Asia Energy Division, SAGF = South Asia Governance, Finance and Trade Division, SANS = South Asia Agriculture, Natural Resources and Social Sector Division, SAUD = South Asia Urban Development Division.

^a Pending further discussion.

Source: ADB estimates.

PRELIMINARY SUMMARY INFORMATION ON PROPOSED INDICATIVE LENDING AND NONLENDING PRODUCTS AND SERVICES FOR THE FIRST YEAR OF THE BUSINESS PLAN

A. Education Sector Development Project

1. Based on an assessment of the ongoing interventions in the sector, which include secondary education, tertiary education, and technical education and vocational training, identified areas will be strengthened to improve the quality and efficiency of general education in Sri Lanka and make it more responsive to labor market requirements. In particular, the Project will promote decentralization of education, teacher training, deployment and transfer system, curriculum modernization, student assessment reform, and public-private partnership in education.

2. Expected results will be a more devolved management and institutional structure, a modernized curriculum responsive to labor market requirements, a more capable teaching force, a more efficient assessment system, and, as a result, improved access to and quality of education, as measured by higher learning achievements. This, in turn, will lead to a better qualified workforce and better educated pool of entrants to tertiary education. Improved equity of access to quality education will also lead to greater opportunities for students from disadvantaged areas.

B. Greater Colombo Wastewater Management

3. The Project will assist the Government to improve the living conditions of the urban population in Greater Colombo and to minimize the negative environmental impacts of increasing levels of domestic waste. The Project will rehabilitate the Greater Colombo Sewerage System and improve onsite sanitation. It will support and advance current policy reforms in the sector. The proposed investments will primarily include rehabilitation and upgrading of the sewer network and pumping stations, as well as repairs to the sewer outfalls. In addition, institutional and capacity building components will be formulated to improve asset management, financial management, and operations management of the sewerage system.

C. Colombo Port South Harbor Development

4. The Project aims to increase the capacity of Colombo Port to ensure it can continue to be a hub port for the South Asian region. This is essential, as the current container handling capacity of Colombo Port is nearing its capacity and if there is no capacity enhancement major shipping lines will shift away from Colombo Port.

5. As an outcome of the Project, the private sector will develop container terminals and purchase moveable assets to operate the terminal under lease from the Port Authority. The capacity of Colombo Port will double to 5 million 20-foot equivalent units.

D. Jaffna Water Supply and Wastewater Management

6. The Project will directly benefit 370,000 people in the Jaffna peninsula by providing safe drinking water. One hundred thousand people will be served by a sewerage scheme and 130,000 will receive adequate waste collection services in Jaffna town. The Project combines the three principal thrusts of policy improvement, capacity building, and investment in infrastructure facilities. The Project will have a strong poverty reduction focus. The Project will

comprise three components. Component 1 will cover the rehabilitation, expansion, and development of water and environmental infrastructure for the Jaffna peninsula, including (i) urban and rural water supply, (ii) sewerage and sanitation, and (iii) solid waste management for Jaffna city. Component 2 will strengthen water resource management in the Jaffna peninsula by providing the foundations to (i) operationalize a water management committee to coordinate, plan, and oversee monitoring activities in Jaffna; and (ii) increase public awareness. Component 3 will enhance implementation and management capacity of key institutions and provide support for project management and implementation activities.

ASSISTANCE PIPELINE FOR 2006

Table A3.1: Assistance Pipeline for Lending Products

Sector Project/Program Name	Targeting Classifi- cation	Thematic Priority	Division	Year of Project Preparatory Assistance	Total	Cost (\$ million)				Gov- ern- ment	Cofi- nanc- ing
						OCR	ADB		Total		
							Loans	Grants			
2006 Firm Loans											
Industry and Trade											
1. SME II			SAGF			60.0	10.0	0.0	0.0	70.0	tbd
Subtotal						60.0	10.0	0.0	0.0	70.0	tbd
Social Infrastructure											
2. Supplementary Finance			SAUD			13.5	46.5	0.0	0.0	60.0	
Secondary Towns and Rural Community Based Water Supply											
Subtotal						13.5	46.5	0.0	0.0	60.0	
Total						73.5	56.5	0.0	0.0	130.0	tbd

ADB = Asian Development Bank, ADF = Asian Development Fund, OCR = ordinary capital resources, SAGF = South Asia Governance, Finance and Trade Division, SAUD = South Asia Urban Development Division, tbd = to be determined.

Source: ADB estimates.

Table 3.2: Assistance Pipeline for Nonlending Products and Services

Sector Assistance Name	Responsible Division	Assistance Type	Sources of Funding				Total (\$'000)
			ADB		Others		
			Source	Amount (\$'000)	Source	Amount (\$'000)	
2006							
Agriculture and Natural Resources							
1. Agribusiness Development Project	SANS	PP		800			800
Subtotal							
Social Infrastructure							
2. Small Towns and Rural Arid Areas Water and Sanitation (formerly Secondary Towns and Community- Based Water Supply and Sanitation [Phase II])	SAUD	PP		870			870
Industry and Finance							
3. Microinsurance Sector Development	SAGF	AD		600			600
Subtotal							
Total				2,270			2,270

ADB = Asian Development Bank, PP = Project Preparatory, AD = Advisory, SAGF = South Asia Governance, Finance and Trade Division, SAUD = South Asia Urban Development Division, tbd = to be determined.
Source: ADB estimates.