



Major Change in Scope

Project Number: 35448
Loan Numbers: 2099/2100
August 2007

Federated States of Micronesia: Omnibus
Infrastructure and Development Project

I. INTRODUCTION

1. The Omnibus Infrastructure Development Project (Loan Nos. 2099(SF)/2100-FSM) will enhance public health and environmental quality through improved water supply, wastewater infrastructure, and power generation in the Federated States of Micronesia (FSM). The financing plan is in the table.

Financing Plan for the Omnibus Infrastructure Development in FSM
(\$ million)

Source	Foreign Exchange	Local Currency	Total Cost	Percentage
A. Asian Development Bank				
ADF	14.2		14.2	47.0
OCR	4.8		4.8	15.7
Subtotal (A)	19.0		19.0	62.7
B. Government Utility				
Internal Funds ^a	1.8		1.8	5.9
Land		0.6	0.6	1.8
Government Cash Contribution	3.3	5.6	8.9	29.6
Subtotal (B)	5.1	6.2	11.3	37.3
Total	24.1	6.2	30.2	100.0

ADF = Asian Development Fund, OCR = ordinary capital resources.

Note: Figures may not add up to total because of rounding.

^a Chuuk Public Utilities Corporation (CPUC) financing of the operation, maintenance, and management service contract.

Source: Asian Development Bank estimates.

2. The loans were approved on 5 November 2004, became effective on 23 March 2006, and are due for completion on 26 August 2011.

3. The Board of Directors of the Asian Development Bank (ADB) is requested to approve the inclusion of local taxes for ADB financing under the financing plan with no increase to the ADB financing. The change is necessary to enable project implementation as the Government is unable to appropriate the funds required for payment of local taxes and has passed legislation that only exempts tax obligations on grant funds.

II. BACKGROUND

4. The project objectives include (i) improved public health through enhanced groundwater quality and access to potable water, (ii) enhanced public health and environmental quality from improved wastewater management, and (iii) economic growth and environmental improvements through power generation and distribution improvements leading to reduced poverty. The Project also advances private sector development by providing improved infrastructure and an enhanced business environment.

5. Project outputs include (i) wastewater system improvements in Pohnpei, (ii) power rehabilitation in Chuuk, (iii) water supply system upgrading in Kosrae, (iv) water supply development and rehabilitation in Yap, and (v) project implementation assistance.

6. The Executing Agency is the Department of Transportation, Communications and Infrastructure (DTC&I). Loan funds will be re-lent to the utility corporations in each state. A steering committee was established and project implementation assistance (PIA) consultants were identified following a consultant selection process. Contract negotiations with the first ranked consulting firm, International Consultants and Technocrats Pvt. Ltd. (ICT) of India, were held from 9 to 11 May 2007. The Financial Proposal submitted by ICT was exclusive of taxes payable in the FSM in accordance with the Consultant Request for Proposals (RFP).

7. The contract negotiations with ICT of India were not concluded because the Government of the FSM was unable to sign a contract with ICT as the funds required for payment of the PIA consultant's tax liabilities in the FSM arising from services provided in the FSM had not been appropriated. FSM tax legislation requires the national and state governments to pay all local tax obligations and prohibits national and state governments from entering into contracts without prior appropriation of the funds required to meet contractual obligations. The only exemption applies to grants from donor countries. Negotiators for the Government requested ICT to extend the validity period of its consultancy proposal until October 2007 to enable DTC&I to seek an appropriation for the payment of taxes through the Legislature.

8. DTC&I informed ADB on 5 June 2007 that it was unlikely that the FSM Legislature would approve an appropriation for payment of taxes for the PIA consultants. On 19 July 2007, the Acting Secretary for the Department of Finance and Administration formally requested ADB to finance the PIA consultant tax liabilities in the FSM, which were assessed to be approximately \$100,000 (Appendix 1). The Loan Agreements dated 28 June 2005 specifically state that no loan withdrawals shall be made in respect of any local taxes.

III. THE PROPOSED CHANGE

9. It is proposed that the scope of the Project be changed to allow ADB to finance taxes and duties payable on project expenditure associated with the provision of services by the PIA consultants in the FSM. ADB financing of these taxes and duties will be capped at \$100,000. The project financing plan under the ADF loan has a contingency allocation of \$1.5 million comprising both physical and price contingencies, which could be used to pay the abovementioned taxes and duties. The payment of taxes and duties will begin upon the signing of the contract agreement between the Government and the PIA consulting firm.

IV. ASSESSMENT

10. Implementation of the Omnibus Infrastructure Project is stalled pending the signing of the PIA contract. The bid price does not incorporate local taxes, and provision needs to be made under the Loan to incorporate these taxes into the PIA consultancy contract sum. The Pacific Department (PARD) seeks endorsement to make the changes to the loan documentation to put that provision into effect.

11. Incorporation of local taxes will not adversely affect the deliverables specified in the loan. The estimated sum of \$100,000 is negligible. The works have not yet been contracted out; therefore the amounts for implementing infrastructure works remain estimates.¹

V. THE PRESIDENT'S RECOMMENDATION

12. The President recommends for Board approval a change to the scope of the Project to allow ADB financing of taxes and duties associated with the provision of services by the PIA consultants in the FSM. ADB financing of these taxes and duties will be capped at \$100,000 and will be funded from the contingency sum provided in the ADF Loan Financing Plan.

13. After approval of the recommended change by the Board, ADB's Office of the General Counsel will be requested to amend the Loan Agreement for the ADF loan to reflect the changes.

¹ ADB.2005 *Cost Sharing and Eligibility of Expenditures for Asian Development Bank Financing: A New Approach*. Manila (approved on 25 August), allows taxes and duties related to project expenditure to be eligible for ADB financing. Board approval for ADB financing of taxes in this case is necessary because the paper does not contain any provision for retroactive application. (Loans 2099-FSM for \$14.7 million, and 2100-FSM for \$4.8 million were approved on 5 November 2004 prior to the approval of the paper). It is noteworthy that the justifications in the paper for allowing taxes and duties to be eligible for ADB financing apply in this case, e.g., the "reasonable amount" limit, share of the investment plan, limitation to ADB-financed projects, and materiality and relevance to the success of the Project.



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July 19, 2007

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Re: Loan Nos. 2099-FSM(SF)/2100-FSM
FSM Omnibus Infrastructure Development Project

Dear Mr. Bhushan:


On behalf of the National Government of the Federated States of Micronesia, I request a change in the scope of the Omnibus Infrastructure Development Project to enable financing of taxes and duties payable in respect to services rendered by the Project Implementation Assistance (PIA) consultants in the FSM. The taxes and duties that will be incurred in the FSM over the course of the four (4) year consultancy are estimated to be \$100,000.00.

The change to the project's scope is required as the FSM Government does not have the budget to cover payment of the PIA consultants' FSM tax liabilities and it is unlikely that the National Congress would approve a special appropriation to cover the payment of the taxes.

Please note that the taxes and duties that would be incurred under the PIA consultancy represent approximately 6% of the PIA consultancy contract amount of \$1.6 million.

If you need more information to support this request, please let us know. Thank you very much for your assistance and consideration.

Sincerely,


Ihlen Joseph
Acting Secretary

Cc: Secretary, Dept. of TC&I
Assistant Secretary for Infrastructure