



Major Change in Scope

Project Number: 28153
Loan Number: 1575
20 September 2006

SRI: Third Water Supply and Sanitation Sector Project Using Surplus Loan Proceeds

LOAN 1575-SRI(SF): THIRD WATER SUPPLY AND SANITATION SECTOR PROJECT USING SURPLUS LOAN PROCEEDS

I. PROPOSAL

1. I submit for your approval, on a no-objection basis, a request for the surplus loan proceeds of \$5.1 million from the recently completed Urban Development Low-Income Housing Sector Project¹ (Loan 1632) to be used in the ongoing Third Water Supply and Sanitation Sector Project² (the Project) to finance its cost overruns. The report also describes (a) the cancellation of surplus loan proceeds from Loan 1632, which is necessary before such proceeds can be used in the Project; and (b) major changes in scope and implementation arrangements for the Project. If the Board approves the proposed use of surplus loan proceeds, then (i) the director general, acting under the authority provided in the Project Administration Instructions (PAIs),³ will be deemed to have approved the cancellation of surplus loan proceeds from Loan 1632; and (ii) the vice-president, acting under the authority provided in the PAI,⁴ will be deemed to have approved the major change in scope and implementation arrangements.

II. INTRODUCTION

2. The project loan (footnote 2) was approved on 6 November 1997 for a total of \$121 million equivalent, of which \$75 million equivalent is financed from the Special Fund Resources of the Asian Development Bank (ADB). The remaining cost is cofinanced, on a parallel basis, by the Government of France, the Government of Norway through the Norwegian Agency for International Cooperation (NORAD), counterpart financing by the Government of Sri Lanka, and contributions from local beneficiaries. The Project became effective on 17 July 1998. The revised scheduled loan closing date is 30 June 2007. The Project is a core poverty intervention.

3. In parallel with project implementation, the Ministry of Finance and Planning (MOFP) has requested the transfer of surplus loan proceeds of \$5.1 million from Loan 1632 to cover a net increase in the total Project cost of \$19.2 million (16% of the original project cost). Factors leading to the cost overrun include increases in Government taxes and duties for goods and services and price escalation. A significant part of the cost increase (\$10.8 million) has been covered through counterpart funding during 2001–2005,⁵ and an additional \$3.3 million will be allocated to the Project by the Government. However, because of financial constraints, aggravated by the tsunami, the Government will not be able to provide all the required funding to cover the cost overrun by FY2007. If surplus loan proceeds are not used, the Project completion date would have to be extended and implementation delayed, jeopardizing the sustainability of the economic and social benefits already achieved under the Project.

III. BACKGROUND

4. The overall goal of the Project is to ensure the long-term sustainability of water and sanitation sector development through policy reforms, and to improve the health and well-being of a projected 1 million people in the districts of Anuradhapura, Hambantota, Kalutara, Kegalle, Monaragala, and Puttalam, by improving water supply and sanitation and hygiene education.

¹ ADB. 1998. *Urban Development and Low-Income Housing Sector Project*. Manila (Loan 1632-SRI).

² ADB. 1997. *Third Water Supply and Sanitation Sector Project*. Manila (Loan 1575-SRI).

³ PAI 4.04 para. 10(ii), para. 11(iv) and para. 16

⁴ PAI 5.04 para. 15, PAI 5.05 para. 6.

⁵ The increased Government counterpart funding also covers the reduced cofinancing contribution of \$8.5 million equivalent from Government funds.

The project objectives are to (i) introduce policy reforms, including private sector participation, to promote efficient and equitable use of water; (ii) improve communities' access to safe water; (iii) improve the environment and quality of life by investing in sustainable sanitation systems; and (iv) improve public awareness of hygiene and sanitation as well as people's participation in sustainable water management. The project framework is in Appendix 1.

5. The Project consists of four components: (i) improvement of rural water supply and sanitation systems, (ii) improvement of urban water supply, (iii) improvement of the Anuradhapura water supply system, and (iv) institutional development and sectoral reforms.

6. The Executing Agency for the Project is the National Water Supply and Drainage Board (NWSDB) of the Ministry of Urban Development and Water Supply. A project management unit has been established within the Rural Water Supply section of NWSDB to provide management and policy support to the project implementation units, one in each district.

7. Project implementation is satisfactory and, as of 11 August 2006, physical progress was estimated at 95.2%, while 93.0% of the loan period has elapsed; cumulative awards and disbursements were \$74.411 million (98.71%) and \$76.179 million (97.75%). As of June 2006, under the rural water supply and sanitation component, 90% of village subprojects (798 out of 886) had been completed and 10% (88) are under construction. Of 47 identified subprojects in small towns, 70% (33) have been completed and 29% (14) are still under construction. Of the targeted 84,000 sanitary latrines, 94% (79,526) have been completed. All remaining works are expected to be completed by 31 December 2006. Under the improvement of urban water supply component, the Kalutara urban water scheme has been completed, while the remaining five water schemes are at various stages of completion, with physical progress varying from 79% to 95%. All remaining works are expected to be completed in the fourth quarter of 2006. The Anuradhapura water supply component, which involves building a new treatment plant and intake, has been completed. Rehabilitation and distribution system expansion are ongoing and will be completed by 31 December 2006. The institutional development component has been completed while, despite Government commitment, policy reforms have been slowed down by political instability and lack of financial resources. The latest data collected for the benefit-monitoring evaluation (30 September 2005) revealed that 980,000 people out of a targeted 1 million were already receiving water from the completed project facilities in rural subprojects and urban water supply systems.

8. Most loan covenants were complied with on time, except for those covering (i) private sector involvement in operation and maintenance of water supply and sewerage schemes and (ii) sector reforms. The Government has taken steps to comply with the remaining loan covenants on sector reforms. ADB has included compliance with the relevant loan covenants as prerequisites to process three loans in the lending pipeline: the Jaffna Water Supply Project, the Greater Colombo Waste Water Management Project, and the Secondary Town Water Supply Project. The project performance report classifies the Project as "satisfactory" in implementation progress and achievement of development objectives.

IV. THE PROPOSED CHANGES

9. In December 2005, at the request of the Executing Agency, ADB fielded a special loan review mission to discuss the reported cost overrun. After a thorough analysis by the mission of the actual contracted amounts, estimated value of the remaining works to be done, and materials yet to be procured, a revised project cost estimate was prepared by the Executing Agency. The revised cost estimate showed a net increase in the total project cost of \$19.2 million. The cost increased primarily because duties and taxes went up after the introduction of the value-added tax (15%) in 2001. Rising prices have also contributed to cost escalation,

notably in international market rates for construction materials and price escalation resulting from the post-tsunami construction boom. The national NWSDB book rates and rates of the Sri Lanka Institute of Construction, Training and Development indicate a significant increase for basic construction material.⁶ Increases in the price of internationally sourced goods (steel, oil, and iron) were significant, as well. Data analysis reveals that the tsunami exacerbated prices by distorting local market conditions through increased reconstruction activity, shortage of supplies, and higher demand for services. No price contingencies were provided under the original design.

10. MOFP requested ADB through its letter of 22 December 2005, to transfer the savings of \$5.1 million from Loan 1632 to the Project to cover the cost overrun of \$19.2 million. A significant part of this increase (\$10.8 million) was covered by Government counterpart funding during 2001–2005, and the Government will provide additional funding for the difference of \$3.3 million. As the cost overrun is more than 15% of the original project cost, the increase amounts to a major change in scope and requires the vice-president's approval.⁷

11. The proposed use of surplus loan proceeds will finance foreign exchange (36%) and local currency cost (64%), which is in accordance with the share of foreign exchange and local currency cost as stipulated in the loan agreement of the Project. The local currency ceiling is \$44,181,679, of which awarded contracts in local currency are \$43,080,043 (97.5%). The proposed use of loan proceeds will result in a 2% increase in the overall ceiling for local currency cost financing. When reallocation from a foreign exchange category to a local currency category results in an increase in the overall ceiling for local currency cost financed by ADB (as stipulated in the loan agreement), such reallocation is treated as a major change in implementation arrangements, and the vice-president is the approving authority.⁸ The major change in scope and implementation arrangements will take effect upon the Board's approval of the use of loan proceeds.

V. ASSESSMENT

12. The Project is under category B in accordance with ADB's environment policy.⁹ In compliance with ADB's environmental requirements, an initial environmental examination was conducted for the Project. The subprojects to be financed by ADB were shown to have no significant environment impacts, and overall the Project is expected to result in substantial environmental benefits. The Project has obtained the required environmental clearances from the Government's Central Environmental Authority. The project scope will remain the same except for the cost increase. The surplus funds will not fund additional civil works, hence there will be no incremental impact on resettlement or indigenous peoples. Minor resettlement during project implementation has been addressed, and the Executing Agency and ADB review mission have confirmed that there are no outstanding issues.

13. Provision of safe drinking water and sanitation represents a major milestone in the Government's New Development Strategy, and is therefore a priority of the Government. The Project continues to be consistent with the Government's efforts to (i) promote regionally balanced development, and (ii) reduce poverty and promote equitable development. The surplus loan proceeds will help the Government deliver the originally defined objectives,

⁶ Price increases over 2002–2006 include sand (about 200%), cement (45%), and pipes (about 40% for PVC pipes and 60–90% for ductile iron pipes). Oil prices, which increased by about 60–90%, have also led to higher manufacturing, shipping and transportation costs. Labor costs are reported to have gone up significantly, and although NWSDB rates suggest an average increase of 50–60% for unskilled labor, field reports indicate that it could be 200–500%.

⁷ PAI 5.04 para 15.

⁸ PAI 5.05 para 6.

⁹ ADB. 2002. *Environment Policy*. Manila.

including reducing poverty and promoting human development by reducing the incidence of water-borne diseases. If the surplus loan proceeds are not used, the project objectives would not be accomplished, depriving about 20,000 people¹⁰ of water and sanitation.

14. The proposed use of surplus loan proceeds does not alter the Project's objectives and outputs as defined in the project framework. An overall viability assessment has been carried out for two ongoing urban subprojects, two small town subprojects, and two village subprojects. For the six water supply schemes combined, the overall economic internal rate of return is estimated at 22.29%, which is above the threshold value of 12.00%. Financial analysis showed an estimated overall financial internal rate of return of 5.77% (the summary financial and economic analysis is in Appendix 2).

15. Considering the good performance of the Project, the positive results of the revised economic and financial analysis, and the low risks associated with the proposed changes, approval of the transfer of surplus loan proceeds is recommended to avoid further implementation delays, which could jeopardize the sustainability of the economic and social benefits already achieved under the Project.

VI. THE PRESIDENT'S RECOMMENDATION

16. The President recommends that the Board approve, on a no-objection basis, the use of surplus loan proceeds of \$5.1 million from Loan 1632 in the Project as described in paras. 10 and 11. If the recommendation is approved, the loan documents will be amended to reflect the changes.

¹⁰ The expected number of beneficiaries is 1 million, and 980,000 have already benefited from water supply and sanitation provided by the Project.

PROJECT FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions And Risks
1. Impact	Better health and well-being for one million people	Local institute to monitor health statistics, time carting water, reliability of water, understanding of hygiene	Other matters may also affect health
2. Outcome	Sustainable water supply and sanitation facilities for one million people	Local Institute to monitor latrines used, cost recovery, community operation and maintenance (O&M)	Technical backup when needed from local authority and the National Water Supply and Drainage Board (NWSDB)
3. Outputs	Number of households	Loan reviews and quarterly progress reports	Demand and willingness to pay have been accurately estimated from technical assistance and District Development plans
Latrine (ventilated improved pit)	20,000		
Latrine (pour flush)	64,000	Local institute to monitor and evaluate at 3, 5, 7, 9 years	
Latrine (rehab)	34,000		
Dug well (new)	12,000		
Dug well (rehab)	24,000		
Tube well (new)	28,000		Unit costs and Project implementation period have been correctly estimated
Tube well (rehab)	29,000		
Spring	3,000		
Rainwater	8,000		
Piped (new)	16,000		
Piped (rehab/expansion)	71,000		
300 schools and hospitals			
4. Training Agents	Persons to benefit: NWSDB : 1,000 Loc. Auth : 1,000	Loan reviews and quarterly progress reports	Training program approved by NWSDB
Consultants Overseas courses	Nongovernmental Organizations : 500 Community-based organizations : 500		
5. Community Awareness	All communities with more than 500 persons in the six districts to be addressed	Consultant reports; local institute to random sample	Quality and efficiency of the exercise
Hygiene Education Participation			
6. Policy Reform		Regional water utility will monitor all policy reforms at 3, 5, 7, 9 years	

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions And Risks
Tariffs	Tariff policy, O&M scheme specific and cross-subsidy from nondomestic to domestic reduced; NWSDB financial viability maintained)))Loan covenants))and)Loan review)	
Regulatory	Regulatory body by 31 Dec. 2000	Loan review	Continued commitment by the central and local government levels to the policy reforms is necessary
Sewerage Tariff	O&M costs fully recovered by 31 Jan. 2002	Regulatory system	
Private Participation	Sector Private sector participation in management of Greater Colombo water supply and sewerage by 31 Dec. 2001	Funding agency	Funding agencies united approach to the policy reforms will mitigate against any interventions
Financial Management	NWSDB financial management staff by 01 Jan. 1998	Loan effectiveness	
Loan Authorities	Manual by 31 Dec. 2000. Training courses 2001-2003	Loan review	
Water Rights	Policies and Procedures by 31 Dec. 2000	Bank – TA	
Water Resources Management(WRM)	The Government to adopt National Water Policy by 31 Mar. 1999 and National Water Act by 31 Mar. 2000	Bank – TA and Loan review	Continued Bank support for WRM

NWSDB = National Water Supply and Drainage Board, O&M = operation and maintenance, TA = technical assistance, WRM = Water Resources Management.

SUMMARY FINANCIAL AND ECONOMIC ANALYSIS (Sensitivity Analysis)

The financial analysis assessed the probable capital cost of completing these ongoing subprojects, and their projected incremental operations and maintenance (O&M) costs and the associated revenues during the design life. Anticipated economic benefits are based on, and sensitivity analysis has been done for, the following scenarios: (i) increasing capital cost, (ii) decreasing revenue, (iii) increasing O&M cost, and (iv) all three combined effects, which could be governed by the associated risk factors either during subproject implementation or the Project's lifetime. Assuming variations of 10% for all cases, the analysis ascertains the net effect on the Project's financial internal rate of return (FIRR) and economic internal rate of return (EIRR).

Table A2.1: Financial Internal Rate of Return
(%)

Sensitivity Scenarios	Kekirawa	Wellawa	Julump	Wekan	Mawel	Puhul
FIRR Base Case	5.06	4.17	6.74	5.15	9.19	4.33
Capital Cost Increment: by 10%	4.15	3.45	5.97	4.45	8.16	3.41
O&M Increment: by 10%	3.26	3.68	5.94	3.83	8.24	3.33
Revenue Decrement: by 10%	2.25	2.84	5.03	2.95	7.02	2.23
Combine	1.61	1.59	3.39	0.72	4.94	0.16

FIRR = financial internal rate of return, O&M = operation and maintenance.

Table A2.2: Economic Internal Rate of Return
(%)

Sensitivity Scenarios	Kekirawa	Wellawa	Julump	Wekan	Mawel	Puhul
EIRR Base Case	15.40	14.72	22.30	25.30	28.80	27.27
Capital Cost Increment: by 10%	14.21	13.70	20.51	23.32	26.37	24.85
O&M Increment: by 10%	14.70	14.50	21.85	24.68	28.24	26.82
Revenue Decrement: by 10%	14.15	13.95	21.39	24.37	25.51	24.12
Combine	12.24	13.49	19.17	21.81	24.67	21.42

EIRR = economic internal rate of return, O&M = operation and maintenance.