

**ASIAN DEVELOPMENT BANK**



**PROJECT PROCUREMENT- RELATED REVIEW REPORT  
Loan 1772-PHI  
INFRASTRUCTURE FOR RURAL PRODUCTIVITY ENHANCEMENT SECTOR  
PROJECT**

This report has been redacted in accordance with the Asian Development Bank's Public Communications Policy (PCP). In particular, it excludes confidential and other information in accordance with paragraph 126 of the PCP, items 9, 11, 12, 14 & 15.

**Office of Anticorruption and Integrity  
April 2010**

## ABBREVIATIONS

### CURRENCY EQUIVALENTS

(as of 31 March 2009)

Currency Unit	=	Philippine Peso (PHP)
PHP1.00	=	\$ 0.020610
\$1.00	=	PHP 48.519997

### ABBREVIATIONS

ADB	-	Asian Development Bank
CIS	-	Communal Irrigation System
COA	-	Commission on Audit
DA	-	Department of Agriculture
DED	-	detailed engineering design
DPWH	-	Department of Public Works and Highways
EA	-	executing agency
FMR	-	farm-to-market road
FS	-	feasibility study
ICB	-	international competitive bidding
IMA	-	Implementation Management Agreement
InfRES	-	Infrastructure for Rural Productivity Enhancement Sector Project
LCB	-	local (national) competitive bidding
LGU	-	Local Government Unit
MDFO	-	Municipal Development Fund Office, Department of Finance
OAI	-	ADB Office of Anticorruption and Integrity
PCO	-	Project Coordination Office
PHCO	-	ADB's Philippine Country Office
PO	-	Project Office
PPRR	-	project procurement-related review
RWS	-	rural potable water supply
SEAE	-	Agriculture, Environment, and Natural Resources Division, SERD
SERD	-	ADB's South East Asia Department
SPAR	-	Subproject Appraisal Report
SSAF	-	statement of sources and application of funds
SORD	-	statement of receipts and disbursements

### NOTE

In this report, \$ refers to US dollars.

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**A Project Procurement-Related Review (PPRR) is**

a review undertaken by OAI on ongoing ADB-financed projects, to confirm compliance with applicable ADB's policies, guidelines, and the loan agreement, with a focus on preventing and detecting fraud, corruption, or abuse as defined under ADB's *Anticorruption Policy*. The PPRR assesses internal controls in place, identifies irregularities and instances of noncompliance, inspects the project outputs, and recommends enhancements to mitigate or eliminate opportunities for fraud, corruption, or abuse of resources and to help improve development effectiveness of future projects.

**A Project Procurement-Related Review is not**

an evaluation to assess development effectiveness of ADB's ADB-funded projects. It does not review project outcomes or development impact, which can only be assessed after the finalization of a project.

**PPRR Loan 1772-PHI: InfRES Timeline**

June 2009	Commencement and Planning Phase
July – September 2009	Fieldwork conducted in Southern Philippines
July – October 2009	Fieldwork conducted in Manila
21 October 2009	Closing Conference held to convey findings to date
November 2009	Fieldwork finalized and findings collated
December 2009	Preliminary draft report prepared
January 2010	Consultation within ADB on preliminary draft report
February 2010	Consultation with DA and MDFO on preliminary draft report
March 2010	Formal draft report prepared with incorporating input from consultation process as appropriate

## EXECUTIVE SUMMARY

1. This report presents findings and recommendations as a result of the project procurement-related review (PPRR) undertaken by the Asian Development Bank's (ADB) Office of Anticorruption and Integrity (OAI) on Loan 1772-PHI: Infrastructure for Rural Productivity Enhancement Sector Project (InfRES). The loan was approved on 31 October 2000, and the *Loan Agreement* signed on 12 December 2002.
2. InfRES' long-term objective is to increase rural incomes with distributional gains favoring the poor in areas with high agricultural potential. The immediate objectives of the Project are to (1) remove constraints to the improvement of agricultural productivity caused by absent or inadequate rural infrastructure; and (2) reduce rural poverty by increasing agricultural productivity and profitability. The total cost of InfRES is \$150 million, with ADB funding 50% or \$75 million, with the ILO co-financing with \$1 million, and the Government, with local government counterparts – local government units (LGUs), providing the remaining \$74 million.
3. The PPRR focuses on InfRES procurement activity, to assess its conformity with ADB's *Procurement Guidelines*, *Guidelines on the Use of Consultants*, and the *Loan Agreement* between the Government of the Philippines (the Government) and ADB. Contracts were reviewed to form an opinion as to whether project funds are used for intended purposes and intended beneficiaries, in accordance with contract terms and conditions, and effectively delivered.
4. Findings and recommendations presented in this report are intended to further improve development effectiveness of InfRES and similar projects in the Philippines. Comments on development effectiveness throughout this report are limited to PPRR observations, and how recommendations made here – with respect to anticorruption measures, strong internal controls and compliance with applicable guidelines – can increase development effectiveness. This report does not and cannot comment on the overall development effectiveness of the project.
5. Based on PPRR observations from limited field visits, rural infrastructure has been improved through InfRES, LGUs have had the additional project implementation and management experience to enhance capacity, the selected sites were found to be in place as recorded. PPRR findings pertain to procurement and financial management issues, quality of construction, and the efficiency with which InfRES funds have been utilized.
6. This is the first time that the Local Government Units (LGUs) in the Philippines are tasked to manage contracts for ADB-funded projects. An InfRES Project Office was therefore established to train and support LGUs in project preparatory and implementation matters. Notwithstanding this, weak institutional capacity, limited experience in understanding ADB's Procurement Guidelines, limited resources in managing contract portfolios, and unclear division of responsibilities at central and local levels may have been inevitable and contributed to the challenges and shortcomings identified in this report. The large number of LGUs involved added to the complexity of project management.
7. The PPRR Team recognizes that the Executing Agency (EA) - Department of Agriculture (DA), Municipal Development Fund Office (MDFO), the InfRES Project Office and the Agriculture, Environment and Natural Resources Division, South East Asia Department of ADB (SEAE), have identified and taken action during 2009 and 2010 to address many of the

shortcomings and concerns contained in this report for the remaining life of InfRES.<sup>1</sup> Their feedback is included in the relevant sections.

8. The report is written cognizant of the finalization of the country operations business plan (COBP) 2010-2012 as agreed between the Government and ADB. It is sincerely hoped that this report will provide useful input to the finalization of an updated country partnership strategy (CPS) in 2010, and will complement the evaluation provided by ADB's Independent Evaluations Department in July 2008<sup>2</sup> and efforts of ADB's Philippine Country Office (PHCO) in assisting the Government to enhance development aid effectiveness and to progress toward the Millennium Development Goals for the Philippines.

### ***Scope Limitations***

9. The wide geographical distribution of InfRES limited the PPRR Team's ability to visit all project sites. The project covered 142 sites (as of 31 March 2009) in Southern Philippines. The PPRR Team visited only 15 sites due to geographical and resource constraints. Findings and recommendations on asset verification are based solely on the results of these physical inspections.

10. The scope of the audit was further limited by the PPRR Team's inability to locate original project procurement and financial documents. The PPRR Team chose \$15 million of the \$37 million civil works contracts (41%) for review. There was difficulty obtaining original documentation for review pertaining to \$14 million (37% of total \$37 million civil works contracts, or 93% of \$15 million sampled contracts) of the civil works contracts.<sup>3</sup> This is in breach of the loan covenants which requires that the Government provide requested InfRES records and documents for ADB review.<sup>4</sup> The EA has noted this.

### ***Overall Findings***

#### *Procurement*

11. The inability of many LGUs to adequately document procurement decisions is of concern. Amongst the LGUs reviewed, the level of compliance with ADB procurement guidelines was poor particularly in the areas of bid processing and bid evaluation. The EA have attributed this to the sometimes considerable gap between when training was delivered, and actual implementation.

12. Regular review of contract documentation with bid evaluation reports by ADB did not appear to be done for two years, a time when procurement activity was high, as bid evaluation reports were not reviewed regularly by ADB until December 2008. InfRES thus lost the opportunity to draw lessons from procurement experience and improve compliance.

13. In spite of the scope limitations, but based on a review of 41% of procurement, it can be concluded that at least in a number of cases, ADB's procurement guidelines have not been followed.

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<sup>1</sup> The PPRR Team has not made an assessment of corrective actions taken, as this was beyond the scope of the PPRR. InfRES is now projected to be finalized by 30 June 2011.

<sup>2</sup> A Country Assistance Program Evaluation for the Philippines was conducted in 2008.

<sup>3</sup> The sample selected for review was based on all contracts awarded up to and including 31 March 2009.

<sup>4</sup> Loan Agreement, Section 4.06(b)(iv), 4.07(a) and 4.08.

### *Financial Management*

14. Audit opinions on InfRES financial statements have been qualified for at least three years – 2006, 2007 and 2008. Complete audited financial statements for year ending 31 December 2008 were only received in January 2010. This is in breach of the loan covenant which requires submission of audited financial reports within nine months of year-end.<sup>5</sup> The EA has undertaken to adhere to this covenant.

15. There remains a significant discrepancy - \$9.94 million as of 31 December 2008 - in the balance of advances to LGUs that remain un-liquidated, between the LGUs' statements of sources and applications of funds, and the MDFO consolidated financial statements.<sup>6</sup> This has been attributed to timing differences between MDFO and LGU reporting. Subsequent to PPRR fieldwork, the MDFO indicated that all LGU liquidated advances were taken up in February 2010.

16. The review of audited financial statements within ADB (SEAE) appears to be confined to ensuring these are submitted when due. ADB should also review InfRES audited financial statements to assess if these are acceptable to ADB.<sup>7</sup> SEAE has indicated that this will be addressed.

17. The PPRR identified a general lack of internal controls over financial transactions at LGU level.<sup>8</sup> Bank reconciliations were significantly delayed, with long outstanding un-reconciled items.

### *Asset Verification*

18. As of 31 March 2009, 142 sites were either still undergoing construction, or had been completed. 15 sites were visited as part of the PPRR – 14 FMR and 1 for community irrigation system (CIS).

19. Of the 15 sites visited, it would appear that 14 sites did not comply with detailed engineering specifications. Construction implementation was found to be of unacceptable quality for six of the sites. Segregation of base material, inadequate slope protection and ineffective drainage were noted, compromising the longevity of project-financed infrastructure.

20. The EA has attributed the above to the lack of LGU capacity, economic cost-benefit restrictions on design and extreme weather conditions.

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<sup>5</sup> Loan Agreement, Section 4.06(b).

<sup>6</sup> \$8.51 million of this resulted from 2008 activity, and appears to be for the most part due to timing differences.

<sup>7</sup> This is a separate review, and may not have direct bearing on the success or otherwise of InfRES.

<sup>8</sup> It must be pointed out that findings relating to LGU transactions do not necessarily mean that these have been withdrawn or reimbursed from ADB funds; MDFO scrutinizes all LGU InfRES-related claims, does not lodge a withdrawal application with ADB for these if it is not satisfied.

### *Project Management & Framework*

21. InfRES is a highly decentralized project spread over a wide geographical area with an equally decentralized project implementation structure. Some LGUs are located in more rural and remote locations. Given that inherent risks are very high for a project such as InfRES, active collaboration from all government bodies from formulation to implementation of InfRES between DA, MDFO, and LGUs is vital. The PPRR Team believes that the poor project administration and complex arrangements, coupled with ADB's lack of supervision contributed to the significant adverse findings noted above.

22. The internal control environment of many LGUs was found to be poor and they require strong support and training. It would appear that project implementation responsibilities were devolved too quickly to LGUs. Central project management needed to be more robust and consistent. Procedures to maintain documentation, to ensure accountability by LGUs, were not established or agreed at the outset, resulting in a lack of assurance as to the propriety with which InfRES funds have been spent. While not verified by the PPRR, indications are that greater technical assistance to the LGUs did commence from mid 2009.

### ***Major Recommendations***

23. Recommendations are made recognizing that InfRES is nearing completion,<sup>9</sup> and that there are projects for rural infrastructure development in the pipeline.<sup>10</sup> Notably, these recommendations, if implemented, would enable the Government and the DA to better manage similarly structured projects for development effectiveness, in accordance with project objectives and for the benefit of intended beneficiaries.

24. For the remaining life of InfRES:

- The remaining LGUs with ongoing contracts under InfRES need to be strongly supported by the central project management team, to ensure financial accountability and strong contract supervision. ADB monitoring and vigilance must remain high.
- For advances to LGUs that remain un-liquidated and ineligible expenses identified in this report paid out of the loan proceeds, ADB should require the Government to fund these expenses and/or refund the loan account before InfRES can be closed.
- EA and MDFO must address the causes behind qualified opinions rendered on InfRES accounts, and ADB must coordinate with relevant government agencies to improve timeliness and quality of same.

25. It is recommended that future similar decentralized projects being considered for the Philippines must fully consider and address all issues and concerns noted in the main body of this report. These will help mitigate inherent risks, improve accountability and compliance especially at LGU level, and strengthen monitoring mechanisms. Some aspects include:

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<sup>9</sup> It is understood that it has been extended a further 12 months, to June 2011.

<sup>10</sup> COBP 2010-2011, Appendix 1, 2011 Firm Loans: Rural Infrastructure for Agribusiness Development Project (\$80 million), and 2012 Firm Loans: Rural Infrastructure Development Project (\$100 million).

- Assessing the capacity of executing and implementing agencies to accommodate complex administrative structures, and where necessary, incorporating capacity support into project design and implementation arrangements;
- Simplifying as far as possible administrative arrangements layers required for funds and documents flows;
- Establishing clear guidelines for maintenance of project documents that facilitate accountability – original documents should be stored in a central repository;
- Ensuring all government bodies actively collaborate to achieve project objectives;
- Carefully and progressively delegating project responsibilities to LGUs and providing training/support requirements in line with assessed LGU capacity;
- Implementing the project in phases, possibly by geographical clusters;
- Establishing a roving/satellite project office that follows geographical clusters;
- Considering strengthening support to subproject preparatory activities when designing a sector loan where capacity appears to be severely constrained; and
- Providing continuous, strong support to the LGUs.

26. It is recommended that the EA share findings from this PPRR with the relevant LGUs, as an opportunity to improve their capacity. Other recommendations are provided in the main body of the report.

### ***Red Flags***

27. The PPRR Team noted several irregularities or ‘red flags’ at the LGU level, which may indicate that fraudulent and corrupt activity has taken place. These pertain to procurement as well as financial management. A number of these ‘red flags’ were clustered around certain LGUs. These are of particular concern given the environment of poor internal controls in some LGUs, and the large amount of advances that remain un-liquidated at MDFO level. OAI will review these in more depth and investigate as appropriate.

28. In the meantime, it is strongly recommended that the EA escalate these findings to the appropriate Government agencies, to conduct their own investigations and to take corrective action as appropriate.

### ***Final Comments***

29. Although the PPRR was restricted to examining mainly photocopied documents as were made available to the PPRR Team, and included site visits to only 15 of the 142 locations, numerous significant deficiencies and concerns were identified. While many of the ‘red flags’ were clustered around certain LGUs, the majority of the LGUs had similarly weak internal controls. It is therefore reasonable to infer that similar problems are likely to be occurring for sites not visited, and for contracts either not selected for review or which could not be properly reviewed due to scope limitations.

30. The PPRR Team has identified non-compliance with at least two loan covenants. In addition, based on the sample of contracts, LGUs and sites covered in this review, it is of the opinion that loan proceeds could have been much more efficiently utilized to achieve intended project outcomes. The PPRR Team is pleased that the EA has taken note of these, and has indicated that it will continue to take steps to improve project implementation.

31. It is therefore recommended that ADB and the Borrower fully consider and address issues and risks identified in this report when designing future similar decentralized projects being considered for the Philippines. It is also recommended that decentralized projects be designed to take into account the findings in this report on (i) the LGUs and incorporate appropriate front-ended risk mitigation measures including capacity development and training, and establishing an effective monitoring mechanism; and (ii) the impact of a complex project implementation structure on the delivery of desired outcomes and development impact.

32. PPRR Team would like to thank InfRES officers for their co-operation, particularly the DA, MDFO, the InfRES Project Office, sampled LGUS and SEAE. ADB values the courtesies and support extended to the PPRR Team.

## I. PROJECT BACKGROUND

1. Loan 1772-PHI: Infrastructure for Rural Productivity Enhancement Sector Project (InfRES) was designed to remove constraints to agricultural productivity by investing in rural infrastructure in southern Philippines regions with high poverty incidence and high agricultural potential. InfRES is driven by the needs and demands of communities that lack the infrastructure essential for them to more fully realize the productive potential of their land. Local government units (LGUs) propose subprojects that are eligible for financing under InfRES, if they meet established feasibility criteria. Using fully decentralized implementation arrangements, InfRES also aims to advance the decentralization of rural infrastructure planning and management.

2. Most of the rural poor in the Philippines are engaged in subsistence agriculture and concentrated in the eastern-central and southern Philippines, particularly the Bicol region, eastern Visayas, the Autonomous Region of Muslim Mindanao (ARMM), and central Mindanao.<sup>11</sup> In these areas, poverty is caused and sustained by inadequate agricultural and rural development. A chief constraint is the lack of access infrastructure, which makes it difficult and expensive to haul inputs to farms and outputs to markets.

3. The long-term development goal is to increase rural incomes with distributional gains favouring the poor in areas with high agricultural potential. The immediate objectives of the Project are to (a) remove constraints to the improvement of agricultural productivity caused by the lack of, or inadequacy in, rural infrastructure, and (b) reduce rural poverty by increasing agricultural productivity and profitability.<sup>12</sup>

### *Project Components*

4. InfRES is divided into four components as follows:

- Part A – Improved rural infrastructure
- Part B – Capacity building for devolved project implementation and management
- Part C – Project management and coordination, and
- Part D – Integrated rural accessibility planning

5. ADB approved the Project loan on 31 October 2000. The loan agreement was signed 12 December 2002. Total project cost is \$150 million, of which \$75 million is financed by ADB. \$74 million is financed by the Government, LGUs and beneficiaries (Parts A, B, and C), with the remaining \$1 million financed by the ILO (Part D). Most of the proceeds of the ADB loan is targeted towards rural infrastructure, and channelled to LGUs through the Municipal Development Fund Office (MDFO) within the Department of Finance. On-lending terms to the LGU will be those prevailing for the MDFO. The Project was originally scheduled for completion on 30 June 2008. It was subsequently extended to 30 June 2011.

6. The following tables provide a summary contributions by different sources, and of how the ADB Loan of \$75 million is to be utilized respectively:

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<sup>11</sup> *Report and Recommendation to the President [RRP]*, 10 October 2000. Footnote 11 to paragraph 14.

<sup>12</sup> RRP, page ii.

<b>Financing Plan</b>		
<i>Source</i>	<i>Total (US\$000)</i>	<i>Percent</i>
ADB	75,000	50.0
Government	37,200	24.8
LGUs	28,300	18.9
Beneficiaries	8,500	5.6
International Labour Organization	1,000	0.7
<b>Total</b>	<b>150,000</b>	<b>100.0</b>

Source: ADB

<b>Utilization of ADB Funds</b>			
Category Name	Part	Category Reference	Loan Allocation (US\$000)
Civil works	A	01	50,600
Equipment	B	02	600
Vehicles	B	03	200
Training	B	04	2,600
Consultancy	C	05	4,100
O&M, Incremental Admin Costs	C	06	3,100
Interest & Commitment Charges	-	07	12,000
Front End Fee	-	08	750
Prior TA Cost	-	09	439
Unallocated	-	10	611
<b>Total</b>			<b>75,000</b>

Source: ADB

### *Project's Structure and Operations*

7. The Department of Agriculture (DA) is the executing agency (EA) for InfRES. The DA is responsible for the overall coordination and management of InfRES through a project management committee and a project coordination office (PCO). The DA implements the components for capacity building for devolved project implementation and management, and project management coordination (Parts B, C and D). LGUs<sup>13</sup> will implement the improved rural infrastructure component (Part A). Day-to-day tasks for project management and technical assistance to the participating LGUs will be provided by a project office (PO), run by a project consultancy firm.

8. InfRES aims to benefit farm and non-farm households in approximately 100 municipalities in the southern Philippines. Beneficiaries from rural roads are expected to experience cost savings and increased production that together result in an increase of average

<sup>13</sup> These may be provincial, municipal or city LGUs depending on the area.

annual household incomes from crop production from \$94 to \$553. Annual income from crop production for farmers with irrigated holdings is expected to increase from 82% to 215% following investment in irrigation facilities. The analysis of 10 core subprojects indicates that InfRES will directly benefit some 700,000 people (50% of which are poor) and indirectly benefit another 160,000 people (47% of which are poor).

### *Project Status*

9. All procurement of InfRES goods and services is subject to ADB's *Procurement Guidelines*.<sup>14</sup> Engagement of InfRES consultants are subject to ADB's *Guidelines on the Use of Consultants*.<sup>15</sup> Loan disbursements are to be made in accordance with ADB's *Loan Disbursement Handbook*.<sup>16</sup> In addition, the InfRES *Loan Agreement*<sup>17</sup> between the Government and ADB details specific terms and conditions peculiar to InfRES.

10. As at 31 March 2009, ADB had 129 distinct procurement clusters<sup>18</sup> listed - internally referred to as PCSS<sup>19</sup> - totalling \$46.82 million. These include 142 civil works contract packages under Part A, and one (1) \$9.69 million consultancy contract<sup>20</sup> procured under ADB's international competitive bidding (ICB) under Part C. The majority of the other contracts were procured through local (national) competitive bidding (LCB).

11. As at 31 March 2009, disbursements totalled \$17.75 million.<sup>21</sup> An imprest account is held by the MDFO (\$3 million,<sup>22</sup> for Part A: Civil Works, to be directed to LGUs), and the DA (\$0.5 million, Parts B & C). The Statement of Expenditure (SOE)<sup>23</sup> procedure may be used for reimbursement of eligible expenditures under \$50,000 and to liquidate advances provided into the imprest account.<sup>24</sup>

## **II. REVIEW OBJECTIVES, METHODOLOGY & SCOPE**

12. The overall PPRR objective is to prevent and detect fraud and corruption as defined under ADB's *Anticorruption Policy*.<sup>25</sup> This policy, along with ADB's *Procurement Guidelines* and *Guidelines on the Use of Consultants* require borrowers, bidders, suppliers and contractors to maintain the highest ethical standards for ADB-financed activities. To ensure such ethical

<sup>14</sup> As amended from time to time. <http://www.adb.org/Documents/Guidelines/Procurement/>

<sup>15</sup> As amended from time to time. <http://www.adb.org/documents/guidelines/consulting/>

<sup>16</sup> As amended from time to time. [http://www.adb.org/documents/handbooks/loan\\_disbursement/](http://www.adb.org/documents/handbooks/loan_disbursement/)

<sup>17</sup> The Loan Agreement was signed on 22 October 2001, subsequently amended and restated on 12 December 2002.

<sup>18</sup> Each cluster may represent a single contract, multiple contracts grouped together, transfers, or contracts with transfers. Transfers may include cash advances, reimbursements for administration or other expenses, liquidations, and/or capitalized interest charges.

<sup>19</sup> Procurement Contract Summary Sheet

<sup>20</sup> PCSS 001

<sup>21</sup> Disbursements were low in 2008, but were higher during 2009.

<sup>22</sup> It is understood that this has recently been increased to \$5 million on a conditional basis.

<sup>23</sup> SOE is a procedure whereby application for liquidation/reimbursement is supported by statement of expenditures, in lieu of the normal supporting documentation.

<sup>24</sup> Schedule 3, paragraph 17(b)

<sup>25</sup> <http://www.adb.org/Documents/Policies/Anticorruption/> Paragraphs 66-67.

standards, ADB's Anticorruption Policy prohibits fraudulent and corrupt practices in ADB-financed operations and defines

- a *fraudulent* practice as any action or omission, including misrepresentation, to obtain a financial or other benefit or avoid an obligation by deception,
- a *corrupt* practice as the offering, giving, receiving, soliciting, directly or indirectly anything of value to improperly influence the actions of another party,
- a *collusive* practice as an arrangement between two or more entities without the knowledge, but designed to improperly influence the actions of another party; and
- a *coercive* practice as impairing or harming, or threatening to impair or harm, directly or indirectly, any party or the property of the party to influence improperly the actions of a party.

13. In addition,

- a *conflict of interest* is a situation in which a party has interests that could improperly influence that party's performance of official duties and responsibilities, contractual obligations, or compliance with applicable laws and regulations, and that such conflict of interest may contribute to or constitute a prohibited practice under the anticorruption policy.

14. The PPRR is intended to:

- identify whether the procurement of goods, works and services complied with ADB's *Procurement Guidelines, Guidelines on Use of Consultants* and the *Loan Agreement*,
- determine whether contracts were implemented according to agreed terms,
- ensure ADB's funds were used for their intended purposes, and
- recommend improvements to internal controls that mitigate opportunities for fraud, corruption or abuse in InfRES and in future ADB-financed projects in the Philippines.

15. PPRRs are conducted in line with ADB's efforts to manage for development results. This PPRR assesses internal controls in place for InfRES and recommends enhancements to mitigate or eliminate opportunities for fraud, corruption, or abuse of resources. Effective internal control mechanisms enhance the assurance that project funds are directed towards its intended purpose and targeted beneficiaries. This PPRR thus contributes to ensuring ADB-financed projects are managed to produce intended development results.

16. The population available for the PPRR Team to review was \$46.82 million<sup>26</sup> of contracts awarded as of 31 March 2009. To achieve the PPRR objectives, the PPRR Team:

- Evaluated the Project's procurement process for 58 contracts<sup>27</sup> totaling \$25.38 million or 54% of the total value of contracts awarded. \$9.68 million was procured through international competitive bidding, \$0.29 million procured directly, and

<sup>26</sup> Note that contract and disbursement values throughout this report refer to the ADB-financed portion only, which is generally 50% of the full project values.

<sup>27</sup> Sample selection was made by the PPRR Team independently, with due consideration to ensure geographical spread, and included both ongoing and finalized contracts.

\$15.40 million – comprising 46 civil works contracts managed by LGUs - procured through local competitive bidding.

- Assessed InfRES' financial management through review of selected disbursements totaling \$12.38 million<sup>28</sup> relating to 27 of the previously selected 58 contracts (15 civil works, 4 goods, 1 training, 6 consultancy and 1 operating costs).
- Inspected project assets and works in 15 completed project sites (covered by 11 contracts) enable an assessment of satisfactory delivery of contract terms and conditions. A quantity surveyor was part of the Team that conducted the visits.

### III. REVIEW FINDINGS

17. The PPRR findings are summarized in the following sections: (i) Procurement & Consultancy Services; (ii) Financial Management; (iii) Asset Inspection; and (iv) Project Management & Framework. Compliance, internal controls and procedural issues are included in each section as relevant. A separate section of the report presents the PPRR Team's findings on irregularities or 'red flags'.

#### A. Procurement & Consultancy Services

18. Schedule 3 of the *Loan Agreement* outlines ADB requirements for the procurement of goods and services, while Schedule 4 outlines requirements for procurement of consulting services. These schedules refer to ADB's *Procurement Guidelines* and *Guidelines on the Use of Consultants* respectively.

##### *Advertising period too short for Internationally Bid Contract*<sup>29</sup>

19. The DA engaged the services of a consultancy firm to assist with the coordination management of InfRES. The PPRR Team noted that the call for expressions of interest from bidders was only advertised for 15 days (from 1-15 September 2000) contrary to the minimum 30 days required.<sup>30</sup>

20. It is considered that 15 days is too short to maximize opportunities for all potential bidders to be informed of the opportunity, or be provided reasonable time to prepare their submission. The DA assured the PPRR Team that ADB clearance was obtained at each stage of the bidding process; however there is no record on file justifying the decision for a short advertising period, or concurrence by ADB.

21. The PPRR Team was not provided evidence that the proceeds from the sale of pre-qualification documentation, if received, were appropriately recorded in InfRES or DA books.

<sup>28</sup> Note that the figure here is indicative only, given the currency of transaction for civil works contracts is in Philippine Peso (PHP), which in ADB's books is converted on a variable basis, but in this report converted using a fixed rate of PHP 48.52.

<sup>29</sup> In accordance with the *RRP*, paragraph 98, *Loan Agreement*, Schedule 4. This finding relates to PCSS No. 1.

<sup>30</sup> Project Administration Instructions (PAIs) outline policies and procedures to be followed by ADB staff involved in the administration of ADB-financed loan and technical assistance loan projects. Project Administration Instruction (PAI) 2.02E, paragraph 23

Subsequent to the PPRR, the DA has indicated that no fees were required from interested bidders for pre-qualification documents.

*Inadequate mechanism for handling negative press*

22. Due to the lack of documentation on InfRES files, it is not immediately apparent whether and how the DA handled negative press in 2001 and 2002 pertaining to the hiring of the consultancy firm,<sup>31</sup> nor the extent to which these were discussed with ADB.<sup>32</sup> The PPRR Team found no record of discussions within the Government and with ADB, or of any actions taken to address the negative press kept with the PCO.

23. Further review revealed that the record of action taken is retained at both a separate office at the DA, and SEAE. For completeness, handling of negative press (including complaints) of all InfRES-related matters should be retained with other InfRES records.

*LGUs and Locally Bid Contracts*

24. The table below provides a brief picture, as at 31 March 2009, of civil works contracts which were bid under local competitive bidding, and managed by the LGUs under InfRES:

	Number of LGUs	Civil Works Contracts		
		Number	Value (\$ m)	Percentage
Total	93	142	\$38.11	100%
Selected for procurement review	25*	46	\$15.53	41%
*Of these, procurement review was also conducted at LGU	11	15	\$ 5.74	15%

25. The PPRR Team reviewed 46 locally bid contracts across 25 LGUs. The LGU is responsible for procurement of locally bid contracts, and performing construction work for farm-to-market roads (FMRs), communal irrigation system (CIS) and rural potable water supply (RWS).

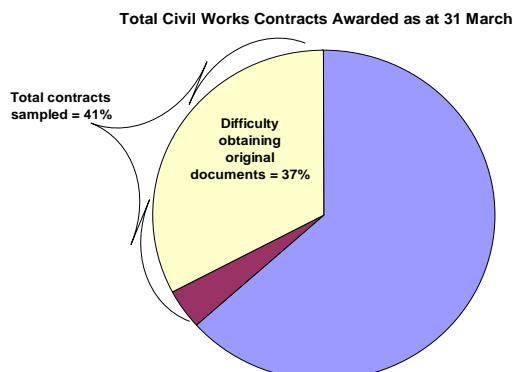
26. There were significant scope limitations encountered by the PPRR Team. The review of procurement documentation was restricted to photocopies<sup>33</sup> for 42 of the 46 contracts (23 of the 25 LGUs). For 11 of the 25 LGUs, the PPRR Team sought original documents while on site, but was successful only in two LGUs. Photocopies are not considered adequate evidence that those transactions and/or events that took place were properly supported, authorized, legitimate or accurately recorded. This is in breach of the loan covenants which requires that the

<sup>31</sup> Manila Bulletin 26 July 2001. "US Consultant raps DA Project Bidding" & 6 October 2002 "DA seeks change in Project Consultant".

<sup>32</sup> Subsequent to the PPRR, OAI became aware that there have been local press reports in 2009 that reflect negatively on contracts under InfRES.

<sup>33</sup> These were sometimes 'certified' as true copies of originals by LGU or project officers, but as the PPRR Team does not consider these as independent parties, these certifications did not provide additional comfort as to their authenticity.

Government provide requested InfRES records and documents for ADB review.<sup>34</sup> A graphic depiction of the value of civil works contracts affected follows:



27. In addition, supporting documentation for 10 of the 46 contracts (7 of the 25 LGUs) had manual erasures and/or corrections which were not countersigned – again these are inadequate evidence of transactions and/or events that took place. Further, procurement documentation was incomplete with respect to 37 of the 46 contracts (20 of the 25 LGUs).

28. The following table presents a high level summary of findings which occurred more than once. These are procedural and compliance issues, with some considered possible ‘red flags’ (fraud and corruption related). To put these into perspective, statistics pertaining to non-availability of original documents and missing documents are included directly afterwards.

<b>Area</b>	<b>Finding</b>	<b>No. of Contracts (Total 46)</b>	<b>No. of LGUs (Total 25)</b>
Advertisement	Date of advertisement calling for bids cannot be ascertained	4	4
Bid Process	No evidence that all interested bidders had received the addendums to bidding documents	8	5
Bid Validity	Contract signed after expiration of bid validity, which was not extended to complete the evaluation, obtain necessary approvals and award the contract.”	11	8
Bid Evaluation	The evaluation did not capture or reflect pertinent information to describe the evaluation process or justify choice of winning bidder.	12	8
	The bid evaluation report was not signed by all bid committee members.	4	2
	Financial requirements were not met, but ignored during the evaluation process.	3	3
	Contracts awarded to bidders with expired PCAB licenses. <sup>35</sup>	3	2

<sup>34</sup> Loan Agreement, Section 4.08.

<sup>35</sup> PCAB = Philippines Contractors Accreditation Board, which grants licenses to local business indicating approval to practice.

<b>Area</b>	<b>Finding</b>	<b>No. of Contracts (Total 46)</b>	<b>No. of LGUs (Total 25)</b>
Bid Security	Unclear if bid securities (some in the form of Bank Manager's Cheque) were returned.	7	5
	Advance payment security (for mobilization) not obtained, although required per bid documents. <sup>36</sup>	41	22
<b>Area</b>	<b>Finding</b>	<b>No. of Contracts (Total 46)</b>	<b>No. of LGUs (Total 25)</b>
Contract Variation	Variations were effected, and works commenced, prior to these being properly approved by the EA.	2	2
Scope Limitations	Some documents available only as photocopies. <sup>37</sup>	42	23
	Documents with manual edits and erasures, not countersigned/authenticated.	10	7
	Incomplete procurement documentation.	37	20

29. LGUs covered by the PPRR generally have weak procurement capacity and/or did not receive adequate or timely training or support from the EA/PO.<sup>38</sup> There were numerous findings at LGU level despite scope limitations.

30. The EA has identified that among the factors affecting the efficiency of the training provided to LGUs were (i) gaps of up to two years between training and actual implementation; (ii) varying LGU capacity to adequately absorb training, and (iii) changes in LGU personnel subsequent to training.

31. Based on the review of the 46 selected contracts, notwithstanding scope limitations, the PPRR Team can conclude that at least in a number of cases, ADB's *Procurement Guidelines* or the *Loan Agreement* have not been followed.

## Recommendations

32. On the basis of the findings set out in this section, the PPRR Team recommend that the EA:

- Assess the procurement capacity of its LGUs as part of eligibility processes, and provide mandatory, appropriate and timely training and support accordingly;
- Establish a central repository for all project-related procurement documentation to facilitate reference and accountability;

<sup>36</sup> Advance payment security is required if a mobilization advance is given to the contractor. In the Philippines, a mobilization advance is commonly provided to civil works contractors.

<sup>37</sup> LGUs are required to submit original documents to the local office of the Philippines Commission of Audit (CoA) for safekeeping. The PPRR Team tried to coordinate with COA at the commencement of the PPRR to try and ensure that documents pertaining to contracts selected were made available for review, but was not able to.

<sup>38</sup> This is a condition of an LGU's eligibility to participate in InfRES is satisfactory financial, institutional and organizational capability and commitment. Loan Agreement, Schedule 5, section 11(ii).

- Improve maintenance of documentation at LGU level, again to facilitate reference and accountability;
- Ensure the call for bids is advertised for a sufficient time to ensure interested parties have sufficient time to prepare bid submissions, and/or document justification and approval for shorter advertising periods;
- Communicate all changes in bid documents to all interested parties;
- Ensure bid evaluation reports contain all pertinent information, accurately reflect events, and are signed by all bid evaluation committee members;
- Ensure all bid requirements – including working capital ratio, credit lines, bid securities values, financial reports, currency of licenses – are submitted by bidders, and duly evaluated;
- Return bid securities to losing bidders, to prevent InfRES being exposed to allegations of misappropriation of bidders' funds;
- Require advance payment securities for mobilization advances made to contractors, to protect the LGU from non-delivery of contract deliverables; and
- Ensure variation orders are approved by the EA prior to commencement of work.

33. To protect ADB and the Government from reputational harm, it is also recommended that ADB and the Government consider for future projects establishing a protocol for the handling of complaints which implementing agencies should be strictly required to adhere to.

## **B. Financial Management**

### *Scope Limitations*

34. The PPRR of financial management was conducted at the DA, project office, MDFO, and the 11 LGUs. The PPRA Team also coordinated with the local Commission on Audit (COA) representative where possible (the COA's local office acts as the point of last review and is ultimate repository for LGU financial documentation). Despite these efforts, many documents were not made available for review. This is in breach of the loan covenants which requires that the Government provide requested InfRES records and documents for ADB review.<sup>39</sup>

### *Un-liquidated advances to LGUs*

35. The Loan Agreement requires that InfRES funds be maintained,<sup>40</sup> and that these be audited annually. In compliance with this, MDFO and DA prepare separate consolidated financial statements for InfRES-related funds each receives from all sources, which are audited annually by the Philippines Commission on Audit (CoA).<sup>41</sup> The audit opinion on these has been qualified for years ending 2006, 2007 and 2008.

36. One major reason for the qualification is the significant un-reconciled difference of the balance of advances to LGUs that remain un-liquidated, between the annual SSAF of the LGUs, and the consolidated financial statements of MDFO InfRES funds.<sup>42</sup> This difference has steadily increased between 2005 and 2007, and ballooned in 2008, as illustrated in the following table:

<sup>39</sup> Loan Agreement, Section 4.06(b)(iv), 4.07(a) and 4.08.

<sup>40</sup> Section 4.06(a)

<sup>41</sup> While not explicit in the audited accounts, given InfRES funding arrangements, it is reasonable to infer that half the value of assets, liabilities, income and expenses indicated is funded by ADB.

<sup>42</sup> As LGUs directly contract with the ultimate supplier/construction firms, the MDFO provides LGUs with advances (tranches) so that they pay progress payments when due. The LGUs are then required to

As at date 31 December	Un-liquidated balance per MDFO	Un- liquidated balance per LGUs	Difference (\$ equivalent)	Comments
2005	<i>Unknown</i>	<i>Unknown</i>	<i>PHP 7.5 m (\$0.15 m)</i>	The PPRR team was not provided the 2005 audited MDFO consolidated financial statements – however the 2006 audited accounts refer to an opening balance of PHP 7.5 m (see * below).
2006	PHP 60 m	PHP 17 m	PHP 42.4 m (\$0.88 m)	Extracted from 2006 audited MDFO consolidated financial statements. Relates primarily to 9 LGUs (PHP 34.9 m) and the opening balance (PHP 7.5 m).*
2007	PHP 99 m	PHP 30 m	PHP 68.7 m (\$1.43 m)	Extracted from 2007 audited MFDO consolidated financial statements.
2008	PHP 713 m	PHP 230 m	PHP 482 m (\$9.94 m)	Extracted from 2008 audited MDFO consolidated financial statements.

37. The majority of the difference of \$0.88 million at the end of 2006 pertained primarily to nine LGUs. In contrast, the difference of \$9.94 million at the end of 2008 pertained to 82 LGUs. The InfRES Project Office has continually sent requests to the relevant LGUs to liquidate or refund outstanding advances.

38. The sizeable difference at the end of 2008 is of concern. Per SEAE, LGU liquidations have improved in 2009. ADB's Controller's Department (CTL) has had preliminary discussions with MDFO, which has attributed the majority of the difference to timing differences exacerbated by considerable increase in InfRES activity during 2008 as compared to previous years. The MDFO attributes this to internal organizational reasons which they have indicated are now resolved.

39. During 2007, the MDFO imprest account was increased by \$1.5 million to \$3.0 million. Subsequent to the PPRR fieldwork, in November 2009,<sup>43</sup> a further \$2 million was *temporarily* provided by ADB to increase the imprest account balance to \$5 million, to ensure adequate cash flow for ongoing contracts. This was provided conditional upon the results of an ADB loan disbursements review conducted by CTL in November 2009, and satisfactory review of the 2008 audited financial statements. One of CTL's requirements at its loan disbursements review was satisfactory resolution of the above difference in the different balances of un-liquidated advances to LGUs.

40. Subsequent to the PPRR fieldwork, and subsequent to CTL's disbursements review in November 2009, MDFO indicated that it has now in 2010 accounted for previously unrecorded LGU liquidations from 2005 to 2008.

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liquidate previous advances in order to receive further advances for subsequent payments to suppliers/construction firms.

<sup>43</sup> Note that this was undertaken after the PPRR fieldwork was completed.

### *Late Submission of Audited Accounts*

41. Loan Agreement, Section 4.06(a)(iii) requires that the audited InfRES accounts be furnished not later than nine months after year end, that is, by 30 September the following year. The list of 2008 audited accounts prepared and audited by CoA follows, with the date each was received by ADB. Each was furnished late, in breach of this loan covenant, between one and more than four months after the 30 September 2009 deadline as highlighted below.

- DA consolidated financial statements, incorporating InfRES funds from all sources coursed through the DA. Received in October 2009,
- MDFO consolidated financial statements, incorporating InfRES funds from all sources coursed through the MDFO. Received 15 January 2010.
- SSAF for the \$3.0 million imprest account funded by ADB, managed by the MDFO. Received 15 January 2010.
- SSAF for each LGU which received InfRES funds. Received 15 January 2010.

The MDFO attributed the delays primarily to late submission of financial records from the LGUs.

### *Review of InfRES audited accounts*

42. The PPRR Team noted in January 2010 that the DA consolidated financial statements for 2008, received in October 2009, had yet to be reviewed by the Agriculture, Environment, and Natural Resources Division (SEAE), within ADB's Southeast Asia Department (SERD). This does not comply with ADB requirement that SEAE promptly acknowledge receipt of the audited accounts, and review these within four weeks to determine if the quality is satisfactory and that it fully complies with the provisions of the loan and project agreements.<sup>44</sup>

43. DA and MDFO audited consolidated financial statements for years ending 31 December 2006, 2007 and 2008 were qualified, For 2008, audit qualifications included, among others:

- MDFO: the difference of PHP 484.21 million (\$9.94 million) pertaining to the balance of advances to LGUs per MDFO books when compared to LGU SSAFs;
- MDFO: non-submission of SSAFs by six LGUs totaling PHP 77.44 million (\$1.61 million); and
- DA: receivables of PHP 29.31 million (\$0.61 million) – primarily PHP 24.18 million (\$0.60 million) un-liquidated advances to national government agencies presumed expended on InfRES - that were between 90 days to two years overdue, and considered uncollectable, but included in the balance.<sup>45</sup>

44. The PPRR Team has observed that SEAE has limited its assessment of InfRES audited financial statements to satisfactory compliance with required submission dates; it appears not to have assessed if audited InfRES accounts are “acceptable”, a criteria ADB uses to assess if compliance with this loan covenant is satisfactory.<sup>46</sup> PAI 5.10 Appendix 1 indicates that

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<sup>44</sup> PAI 5.19, paragraph 27.

<sup>45</sup> As these remain un-liquidated, it is unclear if these are to be funded by ADB loan proceeds or otherwise.

<sup>46</sup> PAI 5.10, Appendix 1 describes assessment procedures for audited accounts.

satisfactory compliance with the relevant loan covenant requires not only timely submission, but acceptable quality.

45. It is crucial that SEAE reviews audited financial statements it receives for acceptability to be able to more effectively monitor projects under their supervision. For example, it was not able to explain the PHP 10.17 million and PHP 76.80 million 'Donations' expense included in the DA and MDFO consolidated financial statements for 2008. OAI subsequently established that these line items represent liquidations made by the LGUs to the DA and MDFO respectively, to account for advances received for InfRES activity.

46. SEAE has indicated that the issue of unsatisfactory timeliness and audit qualifications will be discussed with the relevant government agencies and ADB's Philippines Country Office (PHCO). It has also attempted to meet with CoA to discuss audit qualifications, but this has so far not taken place.

*Bank reconciliations not done properly or on a timely basis*

47. Bank reconciliations were not prepared for the Dollar Imprest account maintained by the DA.<sup>47</sup> Three LGUs also either did not prepare bank reconciliations for InfRES-related bank accounts or were significantly delayed in this effort. Bank reconciliations that were reviewed by the PPRR Team included long outstanding reconciling items, unadjusted stale cheques, and incorrect accounting.

48. The DA indicates that it is now regularly preparing the monthly bank reconciliation of the Dollar Imprest Account. The DA further indicates that LGUs often receive bank statements from the relevant banks late.

*Co-mingling of ADB loan proceeds with Government and LGU funds*

49. The Loan Agreement specifies that amounts withdrawn from the ADB loan may only be used for the purposes of financing eligible expenditures or other goods and services under the project.<sup>48</sup> It also requires that all goods and services financed from the proceeds of the loan shall be used in accordance with the provisions of Schedule 3 (Procurement and Withdrawal of Loan Proceeds) and 4 (Consultants) of the loan agreement. ADB may refuse to finance a contract where goods and services have not been procured under procedures substantially in accordance with those agreed.<sup>49</sup>

50. Note that findings relating to LGU financial transactions do not necessarily mean that these have been withdrawn or reimbursed from ADB funds. The Project Office and MDFO scrutinize all LGU InfRES-related claims, and MDFO does not lodge a withdrawal application with ADB for these if it is not satisfied that claims are properly supported and eligible.

51. ADB proceeds were used – or borrowed temporarily – at five LGUs to pay ineligible expenses of at least \$26k that should have been borne by the Government or LGU. ADB loan proceeds were transferred out, rather than paid directly to the contractor, in two LGUs.<sup>50</sup> It is

<sup>47</sup> This was brought up-to-date by the DA during the visit by the PPRR Team.

<sup>48</sup> Loan Agreement, section 3.03 (a)

<sup>49</sup> Loan Agreement, section 3.05

<sup>50</sup> This practice is not allowed per Philippines Financial Management Advisory Section IV – Financial Recording and Reporting, Item B – Reporting bullet (g) of Requirements, SORD and SSAF.

important to emphasize to the LGUs that the use of ADB funds – even temporarily – for ineligible expenses is strictly disallowed.

52. Other financial-related findings:

- There were delays noted in updating financial records involving three LGUs.
- For one particular LGU, there was no audit trail that enabled identification of individual transactions.
- LGU statement of source and application of funds (SSAF) and receipts and disbursements (SORD) were not properly prepared or delayed for four LGUs.
- Accounting for proceeds of bid documents cannot be established at EA level (for the internationally bid consultancy contract) and six LGUs.
- Supporting documentation was inadequate for supervision costs incurred by three LGUs.
- Manual erasures and corrections to financial documents were not countersigned in three LGUs, bringing their authenticity into question.
- Across all LGUs, financial documentation was not completely signed off and authorized as required.<sup>51</sup>

### ***Recommendations***

53. It is recommended that:

- ADB should seek reimbursement from the Government for the un-liquidated advances and ineligible expenses as identified in this report before InfRES can be closed;
- SEAE should promptly acknowledge receipt, and thoroughly review received audited accounts,
- SEAE must take corrective action to improve the timeliness and quality of InfRES audited accounts, and/or actions to be taken should this not improve, including ensuring it does meet with the relevant government agencies to resolve the matter;
- DA<sup>52</sup> and LGUs must ensure that bank reconciliations are performed and reconciling items addressed and dealt with promptly and accurately; SEAE should ensure this is undertaken;
- The Borrower should strictly comply with ADB's policy on not funding ineligible payments from loan proceeds;
- LGUs must update InfRES financial records promptly and accurately;
- LGUs should ensure that expenses are legitimate and eligible, and fully supported and authorized by the LGUs;
- LGUs should be required to complete and properly maintain financial documentation; and
- All parties must contribute to ensure internal controls in LGUs are significantly improved and tightened.

<sup>51</sup> Loan Agreement, section 4.01 requires that sound administrative and financial practices be applied. These include evidence that the financial transaction has been appropriately checked and authorized.

<sup>52</sup> We note that the DA imprest fund has been dormant since 2008, and that the remaining funds will be returned to ADB.

The EA has undertaken to adhere to the timelines as set in the Loan agreement, to issue advisories pertaining to un-liquidated advances and ineligible advances to all concerned LGUs, and indicated that it is more actively assisting LGUs with financial matters.

54. For future similar decentralized projects, parties involved in project inception should consider the following:

- Establish a central repository for original project documentation, for accountability purposes;
- Ensure satisfactory capacity at all levels, particularly with respect to liquidation of advances to LGUs, and financial management generally;
- Require that completed LGU bank reconciliations for InfRES bank accounts be submitted to the project office, along with other financial reports; and
- Focus on training to align with individual LGU capacity;
- Develop and maintain a project level financial management manual with simple to easy follow instructions to ensure not only consistency but to support weak implementation capacity.

The EA has responded that a central repository could only store photocopies of originals that should be maintained by each LGU (or respective CoA office).

### **C. Asset Inspection**

55. The Loan Agreement requires that civil works under InfRES should be carried out with due diligence, efficiency, and in conformity with sound construction, engineering and environmental practices.<sup>53</sup> The PPRR Team visited 15 completed civil works sites across southern Philippines. Sites that were completed were chosen for inspection, so an assessment could be made as to satisfactory delivery according to contract terms and conditions. A quantity surveyor was part of the Team that conducted the visits.

56. The PPRR Team assessed civil works based on two main criteria, namely detailed engineering, and construction implementation. Criteria were based on national standards issued by the Department of Public Works and Highways (DPWH). Beneficiaries were randomly interviewed during site visits, to seek their views on the impact of the construction.

57. All sites were found to be in place as recorded. Beneficiaries interviewed were generally positive, indicating improved incomes and improved quality of living conditions, with improvements in agricultural productivity and land development. FMRs were strategically located near farmland and main highways. Land development along newly construction roads was noted.

#### *Design did not totally meet standard requirements*

58. The PPRR Team assessed the detailed engineering design of each site. The design is included in the FS, SPAR and DED documents prepared as a prerequisite of each LGU's participation in InfRES. The Team also referred to drawings prepared as part of contract documentation.

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<sup>53</sup> Loan Agreement, Section 4.01(a).

59. Only one of the 15 sites was found to have met the standard requirements for detailed engineering. The remaining 14 sites (all FMRs) did not appear to totally meet the requirements, indicating that some aspects could have been improved. This implies that the design and preparatory aspects of LGU participation in InfRES did not always meet national standards and best practice.

60. Of particular concern is the PPRR Team's finding that in some instances, road plans did not include contour lines. This may render the drawings unhelpful as topography has a significant impact on estimating materials, logistics and costs involved. This may account for the inadequate slope protection in some instances, to prevent erosion and flooding, causing blockage to spillways and canals.

61. The DA has indicated that it took action to address the design concerns with initiatives that began around mid 2009 onwards, which cover sustainability, feasibility and cost effectiveness. An SEAE review mission conducted in November 2009 subsequent to the PPRR fieldwork found that, where resources are available, corrective measures would be taken to improve design for current construction.<sup>54</sup>

*Construction implementation not of acceptable quality*

62. The PPRR Team also assessed construction implementation. It compared the specifications as agreed in the contract, to actual construction. Again, only one site appeared to have completely met the requirements as per the contract. Eight sites were found to have substantially met the requirements as per the contracts, while the remaining six sites (FMRs) were found to be of unacceptable quality. Deficiencies noted are as follows:

- Roads were experiencing segregation (inadequate compacting which causes the base material to separate), indicating the road had a short life span;
- Road depression is evident in some instances;
- Materials used were not of the quantity or type as specified in the contract;
- Road surfaces were not properly drained, which compromises longevity; and
- Roads were undergoing repairs already (although some are conducted at no cost as it is still within the retention period).

63. The PPRR involved ocular inspection of sites. It did not include either collection of samples for testing of materials used, or a close inspection of the contract or associated bill of quantities to form an assessment of reasonableness of the cost involved.

64. Lack of maintenance of the project-financed infrastructure was also noted. Vegetation was encroaching the roads and drainage/irrigation channels. Erosion also caused blockage to drainage and canals. Maintenance of construction assets is an LGU responsibility;<sup>55</sup> it must be in place to preserve the benefits InfRES infrastructure.

65. The DA notes that the six sites passed satisfactory technical inspections and was in good condition before these were handed over to the LGUs. It identified typhoon damage as the most probable reason for the poor construction quality in the six sites mentioned. If so, it is even more critical that design and construction are of a standard to withstand typhoon conditions, which InfRES sites in Southern Philippines are particularly susceptible to on an

<sup>54</sup> BTOR 27 November 2009, Appendix 1, paragraph 11.

<sup>55</sup> RRP, paragraphs 82-86.

annual basis. Other probable reasons identified relate to poor LGU operational management, maintenance and quality control, combined with financial and cost-benefit restrictions.

66. Subsequent to PPRR fieldwork, SEAE conducted a review mission in November 2009, and also identified consistent deficiencies across all five sites visited relating to camber, side drainage, compaction and materials.<sup>56</sup> An outcome from that mission was that the DA and SEAE agreed that corrective measures would be taken to improve design and construction deficiencies where funds are available.

### **Recommendations**

67. FMRs for InfRES cost between PHP 2 million to PHP 4.5 million (\$40,000-\$90,000) per kilometer.<sup>57</sup> This justifies investing substantial time and effort to plan, closely monitor and supervise construction to preserve the long-term benefits and also provide continuous support and training to LGUs. We understand that through initiatives taken by the EA from mid 2009 onwards, many of the above shortcomings are being addressed, and that full technical assistance to LGUs is now being provided. The EA also indicates that it has included in its initiatives again from mid 2009 onwards, to remind LGUs promptly of the importance of maintaining InfRES infrastructure. This is commendable, and we strongly urge that this high level of support and supervision be maintained until the close of InfRES.

68. For future projects the EA should:

- Improve the quality and relevance of preparatory studies and appraisals to enable better estimation of materials and costs required – this may require increased funding and management assistance by the project; and
- Provide strong engineering support to LGUs to assist with contract supervision.

### **D. Project Management & Framework**

69. Inherent risks are very high for a project such as InfRES. It:

- *is highly decentralized*, with a total of 148 sites chosen across 97 LGUs - from an eligible 779 municipalities across 40 provinces - for infrastructure construction or rehabilitation;
- *is implemented concurrently* across the targeted regions, which does not afford the InfRES team to learn from experience; and
- *has high expectations of LGUs*, with varying levels of capacity.

*EA and Project Office could have been more effective*

70. The DA as EA is responsible for project coordination and management. In line with the initial project design,<sup>58</sup> a project consultant<sup>59</sup> was engaged to provide operational management, advice and support through a project office (PO). In 2008, during a period of intense InfRES

<sup>56</sup> BTOR 29 November 2009, Appendix 1, paragraphs 11.

<sup>57</sup> The PPRR Team calculated the cost of roads across contracts reported in the June 2009 quarterly progress report to range from PHP 2m (\$43k) to PHP 4.5m (\$87k), significant enough to justify regular and rigorous monitoring and supervision.

<sup>58</sup> *Loan Agreement*, Schedule 1 (paragraph 3) & Schedule 4; *RRP*, paragraph 98.

<sup>59</sup> PCSS 001.

activity, the DA did not have a full-time Project Manager.<sup>60</sup> Field engineers were employed, but spent very little time in the field.<sup>61</sup> Bid evaluation reports and contracts awarded were not submitted to ADB on a timely basis.<sup>62</sup> The EA did not or could not take timely corrective action or step in when necessary.<sup>63</sup> It is believed that the inherent risks in InfRES could have been mitigated if there was better coordination and management between the EA and PO during this time.

71. The DA indicates that corrective steps have been taken since mid 2009 to address the above issues.

*No standard record keeping procedures for InfRES exist*

72. Section 4.08 of the Loan Agreement stipulates that Government shall enable ADB to inspect any relevant records and documents. The PPRR Team was unable to look at original documentation in most instances, despite its best efforts.

73. There is no standard system of maintaining InfRES documents. As a result, the PPRR Team had great difficulty locating originals or even photocopies of documents for selected contracts whether at the EA, Project Office or LGU. This was further complicated by the fact that InfRES disbursement vouchers and supporting documents are submitted to the resident Commission on Audit (COA) team leader for review, who then has final custody of these, in accordance with Government regulations.<sup>64</sup> Copies of these are not automatically retained at the EA, LGU or PO. This has significantly compromised over the PPRR Team's accessibility to InfRES-related transactions.

74. The DA recognizes that there was unclear division of responsibilities at central and local levels. The high volume of LGUs and sites to be processed in a short time was a factor. Another factor is that LGUs are autonomous from the DA and separately accountable to the Government.

*ADB could have been more proactive in monitoring InfRES*

75. ADB staff are required to ensure prompt submission of bid evaluation reports and signed contracts in English by the EA.<sup>65</sup> Bid evaluation reports were not submitted to ADB along with the contracts, and were only being received by ADB from December 2008,<sup>66</sup> after two full years of active procurement. It is unclear if ADB persistently sought prompt submission of bid evaluation reports by the EA before that.<sup>67</sup> Prompt review of these and adequate supervision by ADB may have resulted in clearer directions to – and compliance by - LGUs on bid evaluation techniques and ADB requirements.

*Lack of coordination in formulation and implementation of InfRES between DA, MDFO and LGUs*

<sup>60</sup> Back-to-office Report (BTOR), SEAE, 2 December 2008, paragraph 6.

<sup>61</sup> Ibid, paragraph 7.

<sup>62</sup> The EA and project office have confirmed this.

<sup>63</sup> This could be due to the lack of internal engineering capacity at the EA.

<sup>64</sup> The PPRR Team tried to coordinate with COA at the commencement of the PPRR to try and ensure that documents pertaining to contracts selected were made available for review, but was unsuccessful.

<sup>65</sup> PAI 3.04, paragraphs 13 and 14.

<sup>66</sup> This was confirmed by the EA and project office.

<sup>67</sup> There were changes to key InfRES staff during 2008 and 2009.

76. Active collaboration from all government bodies is needed to minimize occurrence of issues as identified in this report.

77. MDFO requirements were not adequately reflected in procedural guidelines issued by DA/Project Office to LGUs, initial training for LGUs did not incorporate specific MDFO requirements for financial documents, resulting in subsequent delayed LGU payments to contractors, jeopardizing completion of contracts.

78. The template for the Implementing Management Agreement (IMA) between the DA and LGU was not cleared with MDFO by InfRES before the commencement, resulting in required documentation required by MDFO not being incorporated in the IMA. The PPRR Team understands however, that the DA/Project Office has recently been updating LGUs directly with their requirements.

*Continuous training and support of LGUs is required*

79. Technical training pertaining to construction supervision (engineering) and financial requirements was found to be inadequate for LGU needs. While training was conducted during the preparatory stage, the benefits were lost when there was turnover of LGU staff between training and commencement of project implementation. The delay in the recruitment of project management consultants also compromised opportunities to strengthen LGU capacity.

80. This is the first time LGUs were tasked with project implementation of foreign-funded projects. For some LGUs, the cost of civil works they were tasked to implement was far in excess of their annual revenues. LGUs needed more time to enhance capacity.

81. It is considered that continuous training and support of LGUs is required to address the lack of capacity in LGUs.<sup>68</sup> While technical staff may have been available at the latter stages of InfRES, these were not necessarily deployed on the field. The DA indicates that for LGUs with less capacity, supplementary training and support has been provided since mid 2009.

## **Recommendations**

82. For the remaining life of InfRES, it is recommended that:

- The EA ensure that deliberate and dedicated on-site supervision and support to LGUs with ongoing contracts is provided<sup>69</sup>.

The DA indicates that was being done from mid 2009.

83. The following operational recommendations are proposed for similarly designed projects in the Philippines:

*For the Borrower:*

- The EA should have greater oversight and play a more active role in project coordination and management;

<sup>68</sup> This is reiterated in BTOR, SEAE, 2 December 2008, paragraph 11.

<sup>69</sup> Indications are that InfRES engineers are now regularly deployed on the field.

- The EA should establish clear guidelines for maintenance of project documents;
- The EA should assess the procurement and financial management capacity of LGUs as part of the assessment of LGU eligibility, and conduct mandatory training that is aligned to LGU assessed capacity prior to commencement of the bidding process;
- The EA should ensure that a system for filing original project documents that facilitates accessibility is in place; original documents could be stored in a central repository<sup>70</sup>;
- All government bodies must actively collaborate to ensure project objectives are met, and to minimize re-occurrence of similar issues; and
- The EA and project office must provide continuous, strong supervision and support to the LGUs, both on-site and off-site.

*For ADB:*

- ADB should strictly require the timely submission of contracts, bid evaluation reports and audit reports;
- ADB should carefully review audited consolidated financial statements and SSAFs, and work more closely with the Government and EA to address internal control shortcomings identified; and
- ADB should provide more frequent and regular monitoring of the project, including the conduct of regular visits to the LGUs.

SEAE has indicated that it will address the above issues, and that since April 2009, it has instituted more regular monitoring of InfRES.

84. The following, listed here for the consideration of the DA, SEAE/SERD and the Government, are some suggestions aimed at maximizing development impact:

- Consider alternatives for enhancing internal engineering capacity within the EA.
- Minimize administrative layers required for funds and documents flow;<sup>71</sup>
- Assess LGU capacity when delegating project responsibilities and formulating training and support needs;
- Phasing the project by geographical clusters;
- Establish a roving/satellite PO that follows geographical clusters;<sup>72</sup> and
- Consider assisting LGUs with funding and management of feasibility studies and design centrally, at the same time enhancing the quality and relevance of same.
- The autonomous character of LGUs should be taken into account in strengthening accountability mechanisms. Specifically, the Loan Agreement should include separate covenants to address LGU's obligations under the Project.

<sup>70</sup> Subject to Government regulations.

<sup>71</sup> Options to consider are direct payments from ADB to contractors, and parallel funding (ADB pay for 100% of certain contracts) rather than concurrent funding (ADB, Government and LGU pay a portion of each and every contract).

<sup>72</sup> Per DA, the Regional Field Units of the DA are meant – increasingly – to represent the roving PO function. It is considered better, however, if roving PO officers are dedicated to the project.

85. Highly decentralized projects which aim to build capacity of LGUs such as InfRES would benefit from:

- Carefully devolving selected responsibilities to LGUs rather than delegating wholesale, taking into account the existing capacity of the LGU;
- Increasing resources and providing continuous training to really support and build LGU capacity and preserve longevity of intended benefits;
- Consider options such as waiving the requirement for substantial LGU financial contribution, so that poorest communities may benefit;<sup>73</sup> and
- ADB and the EA conducting centralized and/or focused assessment on bid evaluations done especially at the beginning of each phase, to ensure LGUs provide sufficient justification for their procurement decisions.

#### IV. RED FLAGS

86. The PPRR Team identified irregularities or ‘red flags’ - which may indicate the occurrence of fraudulent or corrupt practices<sup>74</sup>. These irregularities pertain to individual project events/transactions, and may or may not be common across LGUs. The PPRR Team noted that the ‘red flags’ tended to be clustered around particular LGUs.

87. In LGU X, there were a series of deviations to the procurement process that appeared to benefit Firm A, who was subsequently awarded both the contracts handled by that LGU. Irregularities noted include the following:

- Firm A’s bid was the only one received before the bid submission deadline, and therefore the only one opened. Six other bids were received, but they were *all* submitted late. Affidavits of non-collusion – stating that no delaying arrangement was entered to with other bidders - were submitted to the LGU by Firm A and five of the six other bidders. No explanation was provided as to why so many bidders submitted late;
- The bid evaluation did not address the ineligible bid security submitted by Firm A, or inadequate financial requirements; and
- Performance securities submitted by Firm A were already expired prior to the completion of the contract.

88. Also in LGU X:

- Disbursements attributed to ‘supervision costs’ of PHP 0.56 million – paid to LGU employees and the city mayor - were not supported;
- Liquidation of travel advances issued to employees was outstanding;

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<sup>73</sup> The PPRR Team noted that the Government requires all LGUs to provide counterpart financing as a precondition for participation in foreign-funded projects. Poorer LGUs have difficulty sourcing the funds. ADB may wish to consider how to address this limitation so as to facilitate ADB-financed decentralized projects in the Philippines to reach the poorest LGUs.

<sup>74</sup> ADB may conduct further inquiries subsequent to this PPRR to follow up on the ‘red flags’ observed. At this stage, no conclusions are being made in this report that fraudulent and corrupt practices have occurred.

- ADB funds were improperly used to pay travel advances, local taxes and other ineligible expenses;<sup>75</sup>
- Financial records that were submitted were not updated in sufficient detail to enable tracking of individual transactions;
- Inconsistencies were noted in financial documentation submitted by the LGU;
- Validity and authenticity of documents produced by the LGU for PPRR review cannot be established;<sup>76</sup> and
- Several blank but signed duplicates of disbursement vouchers with same reference number were found, with corresponding checks issued as partial payments to Firm A.

89. In LGU Y, an official receipt issued by the contractor did not tally with the actual amount released by the LGU by PHP 0.49 million. The LGU indicated that this was due to contractor error, and it would request another official receipt from the contractor for the full amount.<sup>77</sup>

90. In LGU Z, no procurement documents could be provided at EA (project office) level to support the bid evaluation report for any of its contracts issued under InfRES. For these contracts, neither corresponding feasibility studies nor bid attendance records were found. This is exacerbated by the fact that the bidding took place late 2007, early 2008, but bid evaluation reports were only forwarded to ADB in December 2008.

91. Information on bidders disqualified on grounds of collusion by one LGU was not disseminated across other LGUs, with the consequence that other LGUs awarded contracts to the same bidders. Four of these disqualified bidders were allowed to participate in other InfRES-related bids, and three of them were subsequently awarded contracts in two other LGUs.

OAI plans to investigate some of these red flags in accordance with ADB's *Integrity Principles & Guidelines*.<sup>78</sup> In the meantime, however, it is strongly recommended that

- the EA escalate these findings to the appropriate Government agencies, to conduct its own investigations and take corrective action as appropriate; and
- ADB assure itself of the propriety of the bidding process conducted by LGU Z through a review of InfRES documents it retains, and ensure InfRES funds were used as intended.

## V. CONCLUDING COMMENTS

92. From the PPRR Team's observations at the 15 sites visited, all sites chosen for site visits were at recorded locations. Farm-to-market roads (FMR) – the major deliverable from InfRES - were found to be strategically located near farmland and accessible to major highways. Beneficiaries met during site visits gave positive feedback, citing improved transportation leading to improved living conditions.

93. However, it cannot be concluded that InfRES funds were used effectively or efficiently overall, given the quality of design and construction at sites visited was generally found not to

<sup>75</sup> The PPRR Team could not establish if these amounts had been returned to the ADB pool of funds from which it had been taken, due to non-availability of the LGU's 2007 bank statements.

<sup>76</sup> 25 sets of documents appear to have been newly prepared/printed and signed.

<sup>77</sup> In April 2010, the LGU provided OAI with a copy of the replacement official receipt.

<sup>78</sup> ADB. December 2007. <http://www.adb.org/Documents/Policies/Anticorruption-Integrity/>

be in substantial compliance with DPWH standards, and due to the difficulty in obtaining procurement and financial documentation for review. In spite of the scope limitations, but based on a review of 41% of procurement, it can be concluded that at least in a number of cases, ADB's procurement guidelines have not been consistently followed. The wide geographical spread of the InfRES and the many LGUs involved, of varying capacity, makes this a complex project.

94. Although the PPRR was restricted to examining mainly photocopied documents as were made available to the PPRR Team, and included site visits to only 15 of the 142 locations, numerous significant deficiencies and concerns were identified. While many of the 'red flags' were clustered around certain LGUs, the majority of the LGUs had similarly weak internal controls. It is therefore reasonable to infer that similar problems are likely to be occurring at sites not visited, and for contracts either not selected for review or which could not be properly reviewed due to scope limitations. The PPRR Team has identified non-compliance with at least two loan covenants.

95. It is therefore recommended that ADB and the Borrower fully consider and address issues and risks identified in this report when designing future similar decentralized projects being considered for the Philippines. It is also recommended that these be designed to take into account the findings in this report on (i) the LGUs, and incorporate appropriate front-ended risk mitigation measures including capacity development and training and effective monitoring mechanisms; and (ii) the impact of a complex project implementation structure on the delivery of desired outcomes and development impact.

96. It is also recommended that the EA share LGU-specific findings with the LGUs involved, to use this as an opportunity to improve their capacity in procurement, financial management and construction implementation.

97. The PPRR Team is grateful for the cooperation of the DA, the InfRES project office, MDFO, regional, local government officials, and SEAE, SERD. It is particularly appreciative of the time and hospitality accorded it by the InfRES project office. ADB values the courtesies and support extended to the PPRR Team.