

## OPERATIONS MANUAL BANK POLICIES (BP)

*These policies were prepared for the use of ADB staff and are not necessarily a complete treatment of the subject.*

### COST SHARING AND ELIGIBILITY OF EXPENDITURES FOR ADB FINANCING

#### A. Introduction

1. This section sets out ADB's policy on cost sharing with respect to ordinary capital resources and Asian Development Fund (ADF) public sector loans (other than policy-based lending,<sup>1</sup> and limited or non-recourse financing to sub-sovereigns or non-sovereigns of the public sector), ADF grants, and technical assistance (TA) loans and grants. It also sets out ADB's policy on the expanded list of eligible expenditures.<sup>2</sup>

#### B. Definitions

2. The terms

- (i) "ADB's share in the project cost" means that portion of a project's cost that ADB will finance; and
- (ii) "country cost-sharing ceilings" are financing parameters that indicate the maximum share of aggregate costs ADB will finance with respect to the portfolio of projects in a developing member country (DMC), over the period of the prevailing country partnership strategy (CPS) for that DMC.

#### C. The Policy

3. **ADB's Share in the Project Cost.** ADB's share in the cost of a loan-financed project will always be less than 100% of the project cost. It will be based on specific sector, client, and project considerations, and will adhere to sound banking principles taking into account a project's cost recovery profile (i.e., ability to pay), sustainability configurations (i.e., adequate budget support), and currency mismatch risks.<sup>3</sup> ADB's share in the project cost may exceed or fall below the country cost-sharing ceiling, provided ADB's share in the aggregate cost of the portfolio of projects in a DMC does not exceed the country cost-sharing ceiling over the CPS period.

4. **Country Cost-sharing Ceiling.** Country cost-sharing ceilings for loans, ADF grants, and TA loans and grants will be set for each DMC in the course of CPS preparation. Loans will have one ceiling and TA and other grants will have a separate ceiling. The ceilings will be reviewed, and then may either be reset or confirmed, at subsequent CPS preparation processes.

<sup>1</sup> See OM Section D4/BP (Program Lending).

<sup>2</sup> This OM Section is applicable to projects approved on or after 15 March 2006.

<sup>3</sup> See OM Section G2 (Financial Management Systems, Financial Analysis, and Financial Performance Indicators).

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5. **Expanded List of Eligible Expenditures.** The following expenditures are no longer ineligible for ADB financing:<sup>4</sup> acquisition of land and rights-of-way, late payment charges imposed by suppliers and contractors, bank charges, food expenditures, interest during construction on non-ADB loans, secondhand goods, lease financing costs, taxes and duties, and local transport and insurance costs related to project expenditures.

6. **Guiding Principles.** In the implementation of the policy, the following guidelines will be observed: (i) expenditures covered under loan proceeds should promote development, and thus underpin the poverty reduction agenda, (ii) operations funded in the new and more flexible manner under this policy should not unduly burden the DMC's fiscal, debt and macroeconomic sustainability; and (iii) effective fiduciary and other oversight arrangements should be in place at all stages of the business cycle—at the country, executing agency, and project level. Reinforcement of these principles will be required through government commitment to, and ownership of, their development programs and projects financed by ADB.

**Basis:** This section is based on:

ADB. 2005. Doc. R193-05: *Cost Sharing and Eligibility of Expenditures for Asian Development Bank Financing: A New Approach*. Manila.

This OM Section is to be read with OM Section H3/OP.

**Compliance:** This OM section is subject to compliance review.

**For inquiries:** Questions may be directed to the Strategy and Policy Department and the Office of the General Counsel.

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<sup>4</sup> Other policies govern the extent to which particular expenditures may be financed. Thus, under OM Section D7/BP (Disaster and Emergency Assistance), ADB's mandate does not allow it to engage in peacemaking, peacekeeping, or humanitarian relief.

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### **COST SHARING AND ELIGIBILITY OF EXPENDITURES FOR ADB FINANCING**

#### **A. Introduction**

1. The procedures for applying ADB's policy on cost-sharing and expenditure eligibility are described below.

#### **B. Definitions**

2. The terms

- (i) "financing plan" means the plan which identifies the different sources<sup>1</sup> of financing for the project; if appropriate in relevant cases, it will also describe the different loan currencies and lending terms (i.e., short-term, medium-term, and long-term maturities);
- (ii) "project investment plan" means the summary of cost estimates of the project; and
- (iii) "due diligence" means (i) the process of investigating a potential investment; (ii) exercising that measure of prudence, activity, or assiduity as is properly expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances; it is not measured by any absolute standard, but depends on the relative facts of the special case; (iii) the conscientiousness with which proper attention is paid to a task; and (iv) giving the degree of care required in a given situation to ensure that one is fully aware of the assumptions and risks involved in an investment on which one is being asked to decide.

#### **C. Application of the Policy**

##### **1. Setting the Country Cost-Sharing Ceilings**

3. Regional departments are responsible for processing and proposing, for the approval of Management and the information of the Board, the cost-sharing arrangements applied to individual developing member countries (DMCs). The country cost-sharing ceiling for a DMC will be established in the context of the DMC's overall development program, and the DMC's funding capabilities over the short to medium term. Specifically, ADB will take into account the following:

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<sup>1</sup> This includes (a) the DMC, (b) other multilateral and bilateral agencies, (c) commercial banks, (d) private equity groups, (e) capital markets, and (f) ADB.

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- (i) level and quality of the DMC's public expenditure program and its balance-of-payments;
- (ii) DMC's public finance strategy and preferences (e.g., the DMC's strategy for financing of sub-national governments, financing of recurrent costs by user charges or other non-debt sources, partial financing by users and/or beneficiaries or the private sector in some sectors; preferences for different levels of ADB financing across sectors or types of projects);
- (iii) quality of budget management (i.e., the DMC's mechanisms for budget preparation, execution,<sup>2</sup> and monitoring);
- (iv) performance track record of ongoing projects;
- (v) proportion of the DMC's overall development program that it finances from its own resources and the proportion financed by development partners, including ADB (both from a historical perspective and for the period of the latest country partnership strategy [CPS]);
- (vi) degree to which ADB-financed projects align with the DMC's overall development plans; and
- (vii) extent to which ADB-financed projects are integrated into the DMC's budget and budget processes.

4. When processing proposals for the country cost-sharing ceiling, the regional departments will work closely with the DMC and other development partners, with the objective of adopting similar criteria and methodologies and avoiding duplicating assessments. Joint assessments may be undertaken to ensure consistency, accelerate harmonization, and reduce costs for DMCs.

5. Country cost-sharing ceilings will generally be set for each DMC in the course of CPS preparation. For DMCs where the CPS was endorsed before the date of this section, or where CPS preparation is already in an advanced stage of processing as of the date hereof, the country cost-sharing ceilings may be established as a stand-alone exercise before the next CPS preparation process. Until new country cost-sharing ceilings under this section are established for a DMC, the cost sharing limits applicable to the said DMC as of 25 August 2005 will constitute the country cost sharing ceiling.

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<sup>2</sup> Budget execution refers to the process of implementing an approved budget, including aspects such as budget releases and funds flow; treasury cash management; procurement; and internal and management controls including on payroll and assets, accounting and reporting, and auditing.

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### 2. Setting ADB's Share in the Project Cost

6. Regional departments will also be responsible for applying the new cost sharing and expenditure eligibility policy in respect of projects planned and implemented by their divisions and offices over the course of the CPS. In determining ADB's share in the project cost the regional department will take into account, among other things, (a) the country cost-sharing ceiling and any other relevant financing parameter<sup>3</sup> that may be adopted by the regional department for the CPS period; (b) information gathered in the course of due diligence reviews, covering, as appropriate, technical, commercial (revenue streams, if any, and revenue assumptions), financial (financial model and pro forma financial statements, as appropriate), legal, capacity, governance and fiduciary, regulatory, social, environmental, and other safeguards; (c) the cost recovery profile and sustainability capacity of the project; (d) sector characteristics; (e) specific client characteristics, including its cofinancing capacity and track record with the type of project and/or activity areas; and (f) the developmental nature of the project and its impact on the sector, industry, and economy.

### 3. Determining Eligibility of Certain Project Expenditures for ADB Financing

7. **Acquisition of Land and Rights-of-Way.** The acquisition of land and rights-of-way may be financed by ADB. The amount eligible for financing will be determined in the course of project preparation and processing, based on the magnitude of the estimated costs, the DMC's budget conditions,<sup>4</sup> and specific assessments undertaken as part of the project due diligence. These assessments will focus on (a) confirming the expected productive nature of the acquisition; (b) the suitability of land market conditions,<sup>5</sup> including the definition of strategies to deal with any foreseen distortions; (c) the adequacy of the administrative arrangements, to ensure transparent and efficient channeling of funds; (d) the definition of the risk profile of the transaction, and the type of risk mitigation measures required; and (e) the soundness of the monitoring and evaluation arrangements for the purchase and payment of the land and right-of-way.<sup>6</sup> When the acquisition of land and rights-of-way involves involuntary resettlement and/or if the acquisition affects indigenous people, the cost of acquisition may be financed by ADB provided all requirements under ADB's policies on Involuntary Resettlement<sup>7</sup> and Indigenous

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<sup>3</sup> E.g., cost sharing ceilings on a sector basis, and financing parameters with respect to taxes and duties, recurrent costs and land and right of way acquisition.

<sup>4</sup> Factors affecting budget conditions include such things as the expected timing of expenditure, and the ability of the DMC to provide the required financing on time.

<sup>5</sup> Factors affecting the suitability of market conditions would include, among other things, rules and arrangements on land titling, registration and publication of interests in land and other real property, registration and publication of transfers of land and interests therein, enforcement procedures, the availability of market prices, and other transactional or administrative costs associated with land and land matters.

<sup>6</sup> The valuations by external independent professional valuation experts (or if there are no professional valuation experts, other professionals with relevant expertise acceptable to ADB and the borrower), made either as part of the formal project due diligence process or separately, will be considered in determining the cost of acquisition.

<sup>7</sup> ADB. 1995. Doc. R179-95. *Involuntary Resettlement*. 12 September. Manila.

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People<sup>8</sup> are complied with, and the acquisition is undertaken and implemented in compliance with the ADB-approved resettlement planning documents and/or indigenous peoples plan.<sup>9</sup>

8. **Taxes and Duties Related to Project Expenditures.** During the CPS preparation process, a reasonable threshold will be identified for the financing of taxes and duties related to project expenditures. This threshold will be based on assessments of the transparency, competitive neutrality, and sustainability of the DMC's fiscal and tax regime. In making the assessments, comparisons may be made with regional and international emerging market benchmarks.

9. The following principles will be used to determine the amount of taxes and duties to be financed in a project: (a) the amount will be within the reasonable threshold identified during the CPS preparation process, (b) the amount will not represent an excessive share of the project investment plan, (c) the taxes and duties apply only with respect to ADB-financed expenditures, and (d) the financing of the taxes and duties is material and relevant to the success of the project.

10. **Resettlement Expenses, Recurrent Costs, Severance Pay, Local Transport and Insurance Costs; Late Payment Charges Imposed by Suppliers and Contractors; Bank Charges; Food Expenditures, and Interest During Construction on ADB and non-ADB Loans.** These expenditures qualify for ADB financing. However, resettlement expenditures are eligible for ADB financing only if they are incurred in compliance with ADB's policy on involuntary resettlement and, if relevant, ADB's policy on indigenous peoples, and the ADB-approved resettlement planning documents and indigenous peoples' plans.

11. **Secondhand Goods.** Expenditures for the acquisition of secondhand goods may be financed if they meet the basic criteria of economy, efficiency and appropriateness, e.g., when there are sufficient goods from enough sources to enable competitive bidding; and when the procurement of secondhand goods provides better economies of scale or when, in comparison, the acquisition of new goods would lead to excessive costs to the borrower.

12. **Lease Financing.** The cost of leasing assets may be financed if (a) it is shown to be less costly than available alternatives, considering the value of the asset, the comparative cost of a straight purchase, and the net present value of the lease contract (whether a capital lease<sup>10</sup>

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<sup>8</sup> ADB. 1998. Doc. R55-98. *The Bank's Policy on Indigenous Peoples*. 17 April. Manila.

<sup>9</sup> The resettlement planning documents include the (i) resettlement plan, (ii) resettlement framework, and (iii) updated resettlement plan. The indigenous peoples plan includes the (i) indigenous peoples development plan, and (ii) updated indigenous peoples development plan. See OM Section F2 (Involuntary Resettlement) and OM Section F3 (Indigenous Peoples).

<sup>10</sup> Capital leasing is used to finance an asset for a major part of its useful life. During the term of the lease, although the lessor continues to be the legal owner, substantially all the benefits and risks inherent in the ownership of the asset are transferred to the lessee. At the end of the lease term, the lessee typically obtains full ownership of the asset.

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or an operating lease<sup>11</sup>); and (b) special accounting and financial management and reporting arrangements are in place to ensure sufficient fiduciary oversight during project implementation. For purposes of project sustainability, the necessity for and ability of the lessee to acquire title to the asset should be considered and appropriately addressed.

13. The eligibility of these items must be assessed, documented, and justified in the report and recommendation of the President (RRP).

### **D. Foreign Exchange and Local Currency Cost Estimates**

14. Project investment plans presented in the RRP will show a summary of the project cost estimates priced in a single currency, and will not distinguish between direct or indirect foreign exchange costs, and local currency costs.

### **E. Imprest Accounts**

15. Imprest accounts may be in any currency, including the borrower's local currency, so long as the currency is freely convertible and stable.

### **F. Fiduciary Oversight**

16. To give due attention to fiduciary oversight, country systems, including financial management systems, fiduciary controls, and audit capacity, will be assessed upfront. They will be used to help establish the country cost-sharing ceiling.

17. In addition, due-diligence reviews will be undertaken in the preparation of projects and will be reflected in the project design, particularly in the design of fiduciary, monitoring, and evaluation mechanisms. Among other things, the reviews will be used to assess in detail the financial management systems, fiduciary controls, auditing arrangements, and procurement capacities of the project executing and implementing agencies. This will include the agencies' capacity to provide audited financial statements and project accounts in a timely manner.

18. During project execution, regular monitoring and review of these matters, including the appropriateness of expenditures, will be undertaken by ADB staff and external auditors. The DMC and the executing agencies will ensure that expenditures financed and to be financed by ADB will be strictly for the purposes of the project.

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<sup>11</sup> Operating leasing is similar to renting of assets; and is typically for a shorter period than the asset's useful life. The lessor typically retains ownership of the asset both during and after the end of the term of the lease. At the end of the lease term, the lessee typically returns the assets to the lessor without further obligation.

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