



# Validation Report

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Reference Number: PVR-379  
Project Number: 39653-033  
Loan Number: 2611  
December 2014

## People's Republic of China: Guangdong Energy Efficiency and Environment Improvement Investment Program, Tranche 2

Independent Evaluation Department  
**Asian Development Bank**

## ABBREVIATIONS

|      |   |  |
|------|---|--|
| ADB  | – | Asian Development Bank                     |
| DMF  | – | design and monitoring framework            |
| EIRR | – | economic internal rate of return           |
| EPP  | – | efficiency power plant                     |
| FIRR | – | financial internal rate of return          |
| MFF  | – | multitranche financing facility            |
| MW   | – | megawatt                                   |
| PCR  | – | project completion report                  |
| PMO  | – | project management office                  |
| PRC  | – | People's Republic of China                 |
| RRP  | – | report and recommendation of the President |

## NOTE

In this report, “\$” refers to US dollars and CNY refers to yuan.

### Key Words

asian development bank, eirr, energy efficiency, energy sector, environment improvement, epp, firr, guangdong, mff, multitranche financing facility, people's republic of china, performance evaluation, project completion report

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## PROJECT BASIC DATA

|                                       |  |   |  |                               |
|---------------------------------------|--|---|--|-------------------------------|
| <b>Project Number:</b>                | 39653-033  | <b>PCR Circulation Date:</b>  | 27 Jun 2014  |                               |
| <b>Loan Number:</b>                   | 2611   | <b>PCR Validation Date:</b>   | Dec 2014   |                               |
| <b>Project Name:</b>                  | <b>Guangdong Energy Efficiency and Environment Improvement Investment Program, Tranche 2</b> |   |  |                               |
| <b>Country:</b>                       | People's Republic of China   |   | <b>Approved</b><br>(\$ million)                    | <b>Actual</b><br>(\$ million) |
| <b>Sector:</b>                        | Energy   | <b>Total Project Costs:</b>   | 66.14  | 70.74                         |
| <b>ADB Financing:</b><br>(\$ million) | <b>ADF:</b> 0.00   | <b>Loan:</b>  | 22.06  | 22.06                         |
|                                       |  | <b>Borrower:</b><br>Guangdong Provincial Government                                 | 5.00   | 4.63                          |
|                                       | <b>OCR:</b> 22.06  | <b>Beneficiaries:</b><br>Subproject Entities  | 39.08  | 42.26                         |
|                                       |  | <b>Others:</b><br>Revolving Fund  | 0.00   | 1.79                          |
| <b>Cofinancier:</b>                   |  | <b>Total Cofinancing:</b>   | 0.00   | 0.00                          |
| <b>Approval Date:</b>                 | 4 Jun 2008 (MFF)<br>16 Dec 2009 (2611)   | <b>Effectiveness Date:</b>  | 28 Jun 2010  | 28 May 2010                   |
| <b>Signing Date:</b>                  | 30 Mar 2010  | <b>Closing Date:</b>  | 31 Dec 2012  | 8 Oct 2012                    |
| <b>Project Officers:</b>              | H. Yang  | <b>Location:</b><br>ADB headquarters<br>People's Republic of China Resident Mission | <b>From:</b><br>Dec 2009                           | <b>To:</b><br>Oct 2011        |
|                                       | X. Liu   |   | Oct 2011   | Oct 2012                      |
| <b>Validator:</b>                     | P. Choynowski,<br>Consultant   | <b>Peer Reviewer:</b>   | F. Ahmed, Lead Results Management Specialist, IED2 |                               |
| <b>Quality Reviewer:</b>              | B. Nguyen, Senior Evaluation Specialist. IED2  | <b>Director:</b>  | B. Finlayson, IED2                                 |                               |

ADB = Asian Development Bank; ADF = Asian Development Fund; IED2 = Independent Evaluation Department, Division 2; MFF = multitranche financing facility; OCR = ordinary capital resources; PCR = project completion report.

## I. PROJECT DESCRIPTION

### A. Rationale

1. According to the report and recommendation of the President (RRP), Guangdong province was the largest and fastest-growing province in the People's Republic of China (PRC),<sup>1</sup> with gross domestic product growing at 14% per annum since 1995. Electricity consumption was dominated by energy-intensive industries, such as cement, iron and steel, petrochemical, chemical, clay and porcelain, glass, paper and paper products, metals, and textiles, which represented 73% of total electricity use. The demand for power grew 13% annually since 1995, outpacing capacity addition. Thus, Guangdong experienced severe power shortages since 2002, with supply curtailed to many industrial consumers. The rapid

<sup>1</sup> ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Multitranche Financing Facility and Administration of Grant from the Clean Energy Fund to the People's Republic of China for the Guangdong Energy Efficiency and Environment Improvement Investment Program*. Manila.

increase in electricity demand also increased the reliance on imported energy, thus, affecting the overall energy security in the country.

2. About 75% of generation capacity in Guangdong was coal-fired, which caused serious air pollution and acid rain, with ambient air quality increasingly failing to meet national air quality standards. The energy intensity of Guangdong's economy was also relatively high by international standards at 3.4 times the average of member countries of the Organization for Economic Cooperation and Development (OECD). Improvements in energy efficiency in Guangdong were expected to lower energy consumption and the need for additional power generation capacity, thereby saving energy, reducing adverse environmental impacts, relieving energy shortages, and improving energy security.

3. The Government of the People's Republic of China prioritized energy efficiency and environmental protection in the Eleventh Five-Year National Plan (2006–2010), including targets for improving energy intensity by 20% and reducing major pollutants by 10%. Under this plan, Guangdong targets to improve its energy efficiency by 16% and reduce its sulphur dioxide emissions by 15% by 2010. Subsequently, the provincial Government of Guangdong approved strategies to support the energy efficiency and pollutant reduction targets. A policy framework was also established for energy efficiency improvement and pollution reduction in key sectors. The proposed investment program was consistent with the Asian Development Bank (ADB) Medium-Term Strategy II for 2006–2008 and with the strategic development objectives of the country strategy and program.<sup>2</sup> It was also aligned with ADB energy sector policies.<sup>3</sup>

## **B. Expected Impact**

4. The expected impact of the multitranche financing facility (MFF) investment program was improvement of energy security and environmental conditions in Guangdong province. The project design and monitoring framework (DMF) provided the following indicators to measure the achievement of the expected impact—Guangdong's overall energy efficiency improved by 16% and emissions of sulphur dioxide reduced by 15% by 2012.

## **C. Objectives or Expected Outcome**

5. The expected outcome of the investment program was improvement in energy efficiency in the industrial and commercial sectors in Guangdong province. The DMF provided the following indicators for measuring the achievement of the expected outcome: (i) energy savings of 532,767 megawatt-hours per year; (ii) electricity bills for subprojects reduced by \$42.6 million by the end of the investment program; and (iii) substitution of 175,813 tons per year of coal, including emission reduction of 415,560 tons per year of carbon dioxide, 1,785 tons per year of total suspended particulates, 4,795 tons per year of sulphur dioxide, and 1,066 tons per year of nitrogen oxides by 2012.

## **D. Outputs**

6. The investment program was to generate the following outputs: (i) an efficiency power plant (EPP) onlending model that enables annual savings of 532 gigawatt-hours of energy and

<sup>2</sup> ADB. 2006. *People's Republic of China: Country Strategy and Program Update (2007–2008)*. Manila.

<sup>3</sup> ADB. 1995. *The Bank's Policy Initiatives for the Energy Sector*. Manila; ADB. 2000. *Energy 2000: Review of the Energy Sector Policy of the Asian Development Bank*. Manila; and ADB. 2007. *Special Evaluation Study on Energy Policy 2000 Review: Energy Efficiency for a Better Future*. Manila.

107 megawatts (MW) capacity by 2011, along with \$200 million subloans extended within 15 years; (ii) an energy services company sector established in Guangdong, and financial support provided for at least six energy services companies; (iii) capacity-building activities undertaken to promote and assess energy efficiency projects, with two workshops held on EPPs, 20 end users trained on the Clean Development Mechanism, and a public education program implemented by 2012; and (iv) the EPP model has been replicated, with programs for reducing power demand introduced in two other provinces by 2009.

7. Based on the project completion report (PCR),<sup>4</sup> under Tranche 2 of the MFF, the following were the expected outputs: (i) energy efficiency projects implemented with an equivalent EPP capacity of 27.6 MW, (ii) an energy services company sector developed in Guangdong province, and (iii) the capacity for promoting and assessing energy efficiency projects had been developed.

## **E. Provision of Inputs**

8. The total cost of the investment program was estimated at \$142.00 million at appraisal and the cost of the project financed under Tranche 2 was estimated at \$66.14 million. Actual cost under Tranche 2 was \$70.74 million, almost 7% more than the amount estimated at appraisal. The increase was attributed to the yuan appreciation.

9. ADB approved a \$100 million MFF in 2008 from its ordinary capital resources for financing the investment program. The government was allowed to choose from eligible currencies and interest rate regimes for each loan under the MMF. The specific terms of each tranche were to be based on the periodic financing request, with interest determined in accordance with the London interbank offered rate lending facility of ADB. The actual ADB financing for Tranche 2 was \$22.06 million, Guangdong provided a counterpart funding of \$4.63 million, subborrowers provided a total of \$42.26 million, and funds from the investment program revolving fund equaled \$1.79 million.

## **F. Implementation Arrangements**

10. The Guangdong provincial government was the executing agency and established a project management office (PMO) to implement the energy efficiency subprojects. The PMO was responsible for the nonfinancial and technical assessment of applications and the supervision of subprojects. A steering committee comprising senior provincial government officials provided policy directions and operating guidance, and approved subloans. The Guangdong Finance Trust Company was to establish a separate unit to administer the trust. Its responsibilities included (i) assessing the financial viability of subprojects; (ii) disbursing funds and managing the subloan portfolio, including collateral and guarantees; and (iii) preparing financial statements. In addition to nonfinancial and technical assessment of applications and supervision of subproject implementation, the PMO engaged third-party agencies to perform independent measurement and verification of energy savings achieved by subprojects. Implementation arrangements for overall implementation of the investment program were largely as anticipated at appraisal. The project was to be implemented from June 2010 to December 2012. By the end of December 2012, the project was physically and financially completed as envisaged. The loan account was closed on 8 October 2012, with the loan of \$22.06 million fully disbursed.

<sup>4</sup> ADB. 2014. *Completion Report: Guangdong Energy Efficiency and Environment Improvement Investment Program, Tranche 2 in the People's Republic of China*. Manila.

11. All covenants were complied with and no loan covenants were modified, suspended, or waived. Project progress reports and financial reports were submitted on a quarterly basis. The project audit was conducted by the Guangdong Provincial Audit Office and annual audit reports were submitted on time. The reports were useful in identifying and correcting issues and weaknesses in project implementation.

## II. EVALUATION OF PERFORMANCE AND RATINGS

### A. Relevance of Design and Formulation

12. The PCR rated Tranche 2 *highly relevant*. It stated that the project was closely aligned with the government's long-term strategic objectives, and those of the ADB country partnership strategy. The project's objective of promoting energy saving matched those of the energy saving and emission reduction strategy and policy of the PRC. The Twelfth Five-Year Plan (2011–2015) identified the promotion of energy efficiency financing and the energy services company industry as development objectives. The project was consistent with these government priorities and with ADB priorities at both appraisal and completion. The PCR also noted that the heavy use of coal to produce energy caused substantial harm to the environment and that the use of fossil fuel to produce energy was neither environmentally sustainable nor economically desirable. The government's commitment to improving energy efficiency, diversifying the energy supply mix by developing renewable energy sources, cutting emissions, slowing global warming, and reducing the effects of climate change would address these environmental issues. This validation rates the project *highly relevant*.

### B. Effectiveness in Achieving Project Outcome and Outputs

13. The PCR rated Tranche 2 *highly effective*. All six subprojects under Tranche 2 were completed and energy savings were measured and verified by third-party agencies. The PCR estimated that Tranche 2 subprojects achieved annual energy savings of 176 gigawatt-hours. This prevented the consumption of 58,175 tons of coal equivalent per year and reduced emissions by 137,505 tons per year of carbon dioxide, 1,587 tons per year of sulfur dioxide, 353 tons per year of nitrogen oxide, and 6,172 tons per year of total suspended particulates. Savings in electricity costs from the subprojects were estimated at about \$20 million annually from 2013. The project achieved the expected results of improved energy efficiency in selected industrial and commercial sectors in Guangdong province and exceeded targets for energy savings and emission reductions.

14. The DMF also indicated that the investment program achieved 35.3 MW in EPP by the end of Tranche 2 project, compared to a target of 27.6 MW. Financial support was provided to three energy service companies, compared to two expected at appraisal. Three workshops were held on EPP by 2012, compared to two expected at appraisal, with more than 30 end users participating. This validation assesses the project *highly effective*.

### C. Efficiency of Resource Use in Achieving Outcome and Outputs

15. The PCR rated the project *highly efficient*. It began by discussing the project's financial internal rate of return (FIRR). In this validation's view, the inclusion of the FIRR discussion in the Efficiency in Achieving Outcome and Outputs section is not appropriate. The FIRR is an indicator of sustainability, not efficiency, and should have been discussed in the Preliminary Assessment of Sustainability section.

16. The PCR recalculated the subprojects' economic internal rates of return (EIRR); all were above 46% if without environmental benefits, and above 60% if with environmental benefits. The overall project EIRR was recalculated at 65.5% (without environmental benefits) and 81.9% (with environmental benefits), compared to appraisal estimates of 21.7% and 28.1%, respectively. The recalculated EIRR was higher than anticipated because of greater energy savings and environmental benefits. A sensitivity analysis—based on a scenario in which the energy saving and environmental benefits were lowered by 50%—indicated that the EIRR would have been 25.4% if without environmental benefits and 29.1% if with environmental benefits.

17. However, the PCR should have provided a clear comparison of the assumptions used in comparing the RRP EIRR with the PCR EIRR. This validation notes that the PCR did not provide sufficiently detailed information on the assumptions behind the EIRR recalculation. This validation also notes the following: (i) Although the currency of analysis was local currency, the numeraire was not stated nor the value of the standard conversion factor (in the case of border prices) or the value of the shadow exchange rate factor (in the case of domestic prices); (ii) Inputs and outputs were not disaggregated into tradables and non-tradables; (iii) It was not clear whether taxes, duties, and others were deducted in the shadow pricing of inputs and outputs; (iv) It was also not clear how government subsidies (mentioned in the FIRR discussion) were treated in the EIRR recalculation; and (v) Energy cost savings were calculated as energy savings of the end users multiplied by the energy price. However, the energy price is a financial quantity and inappropriate in an economic analysis. The EIRR recalculation should have used the economic long-run marginal cost of electricity production. Moreover, energy savings did not include savings to the power company from system losses and in-plant usage that were avoided. Natural gas cost savings were based on the quantity of natural gas saved multiplied by the natural gas price. Similarly, the price of natural gas is a financial quantity and inappropriate in an economic analysis. The EIRR recalculation should have used the economic cost of natural gas production or its imported price. This validation again notes that avoided transmission and distribution system losses should have been included as an economic benefit.

18. The PCR stated that ADB internal processing and support during implementation was efficient and satisfactory. Since this was the second tranche of the MFF investment program, experience accumulated during the implementation of the first tranche allowed the executing agency to improve the regulation and operation handbooks for the MFF investment program, such as (i) revising the financial management and energy savings measurement and valuation handbooks; (ii) issuing a retained earnings interim management handbook to introduce incentive measures for companies to participate in the EPP program; and (iii) adopting flexible subloan guarantee and collateral measures for subproject subborrowers.

19. Despite the shortcomings in the EIRR recalculations and discussion of process efficiency, this validation rates the project *efficient*, given the high level of economic benefits generated by the project.

#### **D. Preliminary Assessment of Sustainability**

20. The PCR rated the project *highly likely sustainable*. The high EIRRs and FIRRs indicated that the total energy saving benefits produced by the project were sufficient to cover the loan repayments. Regulations and policies adopted by the PRC government and the Guangdong provincial government supported demand-side power management and energy management. Guangdong is expected to provide an annual budget support for the project's

operation and management costs from the provincial energy efficiency fund, and also risk reserves, which are expected to be used for loan defaults. By the end of 2012, the accumulated risk reserve fund reached CNY14.7 million. All subborrowers of the MFF investment program repaid their subloans on time with no default. A part of the retained earnings from the investment program is also expected to be used to provide a risk reserve fund and supplement operational expenses. Therefore, the project will have sustainable, long-term policy and financial support. The Guangdong provincial government formulated a series of project management regulations and handbooks for the MFF investment program, which are revised regularly to support project implementation. The project's revolving funding mechanism is operational and proceeds from loan repayments of earlier subborrowers were being rolled over to provide loans for new subborrowers. The investment program's management team is qualified and stable and is expected to continue to perform adequately.

21. The project's FIRR was recalculated based on actual project costs and energy savings. FIRRs for all Tranche 2 subprojects ranged from 35.3% to 109.6%. The recalculated FIRR for the overall project was 50.7%, compared to the 15.7% estimated at appraisal. The higher FIRR resulted mainly from (i) significantly higher-than-anticipated energy savings, (ii) lower operational costs, and (iii) government subsidies. The after-tax weighted average cost of capital of the Tranche 2 project was recalculated at 6.4%, compared to 3.1% estimated at appraisal. The increase in the weighted average cost of capital resulted from a change in the actual financing cost of the subborrower counterpart fund. A sensitivity analysis indicated that the FIRR would be 20% if the energy saving benefits of the overall project were reduced by 50%. Therefore, the project was considered financially robust.

22. The Guangdong Finance Trust Company served as the financial intermediary from the outset of the MFF investment program and demonstrated a sound and stable financial performance. During 2010–2013, the total income of the Guangdong Finance Trust Company was about CNY500 million and the profit rate was above 66%. Income and profit growth rates were above 20%, demonstrating sound operation ability and good business development. The company's average equity ratio was 3% for 2010–2013, with a nonperforming debt ratio of nil. The ratio of bad debt losses was close to nil, reflecting a highly competent project management. Given the performance of the Guangdong Finance Trust Company and high FIRRs, this validation rates the project *most likely sustainable*.

## **E. Impact**

23. The PCR did not rate the impact of the Tranche 2 project. The project focused on retrofitting existing facilities of subproject borrowers with new energy-saving equipment. Potential environmental impacts were limited to the disposal of the replaced equipment. Subprojects under Tranche 2 had no adverse environmental impacts and achieved substantial energy savings and emissions reductions in Guangdong.

24. Based on the annual energy savings, Tranche 2 subprojects had led to energy cost reductions of about \$20 million annually from 2013, which enhanced the competitiveness of subborrower companies and promoted overall economic development in Guangdong. The project upgraded existing equipment and facilities and involved no land acquisition, resettlement, or adverse impact on indigenous peoples. By reducing the consumption of coal, the project reduced the threat that coal emissions pose to public health, freed resources, and lowered safety risks associated with coal mining and transport. Improvements in energy security and environmental quality benefited the poor in particular because they were more vulnerable than the general population to health risks. Project implementation also created



jobs in the energy efficiency sector. The project demonstrated the benefits of improving energy efficiency through subproject use of energy efficiency technologies, which created technical and vocational job opportunities in manufacturing and sales. Energy service companies expanded services for end users and recruited more technical and operational personnel. In this validation's view, the impact of the project was *significant*.

### III. OTHER PERFORMANCE ASSESSMENTS

#### A. Performance of the Borrower and Executing Agency

25. The PCR rated the performance of the borrower and the executing agency *highly satisfactory*. The borrower and the Guangdong provincial government supported project implementation and signed and delivered the onlending and trust agreements on time. The loan agreement and project agreement became effective on schedule. The EPP steering committee effectively coordinated and enabled efficient subproject selection, approval, and issuance of interim management handbooks that outlined guidelines for implementing the MFF investment program. Adequate counterpart funds were provided in a timely manner. Tranche 2 was awarded as best performing project in the PRC by ADB in 2013. This validation assesses the performance of the borrower and the executing agency *highly satisfactory*.

#### B. Performance of the Asian Development Bank

26. The PCR rated ADB performance *satisfactory*. During project processing, ADB provided technical assistance to assist in the feasibility study and endorsed subproject selection criteria and evaluation. During implementation, ADB conducted project missions to subproject sites to resolve project implementation issues and to maintain close communication with the borrower and executing agency. ADB supported efforts to promote the investment program and helped improve EPP management procedures. This validation rates the performance of ADB *satisfactory*.

### IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

#### A. Overall Assessment and Ratings

27. The project was rated *highly successful* in the PCR. The project was highly relevant to the government's development strategy and to the ADB energy sector policy in the PRC, was successfully and efficiently implemented, and achieved its objective of energy efficiency improvement and emission reduction in Guangdong. Energy savings and emission reductions substantially exceeded appraisal targets. The environmental impact was positive. The project is expected to continue to benefit the province and play a demonstration role in the financing of energy efficiency projects in the PRC.

28. The table below compares the PCR ratings with those given by this validation. This validation rates the project *highly relevant*, *highly effective*, and *most likely sustainable*. However, this validation rates the project efficiency *efficient* because of issues related to the recalculation of EIRRs and the inadequate discussion of process efficiency. Nevertheless, the overall rating remains *highly successful*.

### Overall Ratings

| Criteria   | PCR                       | IED Review               | Reason for Disagreement and/or Comments   |
|--|---------------------------|--------------------------|---|
| Relevance  | Highly relevant           | Highly relevant          |   |
| Effectiveness in achieving project outcome and outputs | Highly effective          | Highly effective         |   |
| Efficiency in achieving project outcome and outputs    | Highly efficient          | Efficient                | EIRR recalculations did not follow ADB guidelines and the discussion of process efficiency was inadequate (para. 17). |
| Preliminary assessment of sustainability               | Highly likely sustainable | Most likely sustainable  |   |
| <b>Overall assessment</b>                              | <b>Highly successful</b>  | <b>Highly successful</b> |   |
| Borrower and executing agency                          | Highly satisfactory       | Highly satisfactory      |   |
| Performance of ADB                                     | Satisfactory              | Satisfactory             |   |
| Impact   | Not rated                 | Significant              |   |
| Quality of PCR   |                           | Satisfactory             | Refer to para. 32.  |

ADB = Asian Development Bank, EIRR = economic internal rate of return, IED = Independent Evaluation Department, PCR = project completion report.

Source: ADB Independent Evaluation Department

## B. Lessons

29. The PCR provided four lessons. First, it noted that a strong government ownership was critical to the successful implementation of the project. It also noted the importance of management handbooks on procurement, financial management, and energy savings measurement and verification that ensured the smooth and sustainable project implementation. Second, effectiveness of the financial intermediary loan modality was supported by independent evaluations of the financial viability of candidate subborrowers and the project's revolving funding mechanism. Third, actual energy savings achieved were higher than anticipated at appraisal. More accurate methods of estimating energy saving should have been used by (i) establishing an accurate baseline, (ii) designing a customized measurement and verification method to verify energy savings from the outset, and (iii) using the same methodology for pre- and post-project energy saving calculations. Fourth, third-party measurement and verification agencies ensured accurate assessment of energy savings and emissions reduction for the subprojects. This validation agrees with these and has no additional lessons to offer.

## C. Recommendations for Follow-Up

30. The PCR suggested two recommendations. First, ADB should continue to monitor and review the project's operational performance during implementation of the MFF investment program. Second, ADB should continue financing energy efficiency projects in the PRC that use innovative mechanisms, such as public-private partnerships. This validation has no other recommendations to offer.

## **V. OTHER CONSIDERATIONS AND FOLLOW-UP**

### **A. Monitoring and Evaluation Design, Implementation, and Utilization**

31. The RRP stated that the PMO was to establish a performance and monitoring system within 6 months of the effective date of the first loan agreement under the investment program. This requirement was included in the loan covenants. The PCR indicated that the performance and monitoring system was established in 2011. It did not provide an assessment of this performance and monitoring system.

### **B. Comments on Project Completion Report Quality**

32. The PCR quality is assessed *satisfactory*. It followed the guidelines and was well written. The ratings were sound and the lessons were adequate. The major shortcoming was its analysis and assessment of the efficiency criterion, where these could have been improved with adequate shadow pricing of subproject inputs and outputs, and with the valuation of benefits. The FIRR should also be discussed in the sustainability section.

### **C. Data Sources for Validation**

33. Data sources included the RRP, PCR, and loan review mission reports.

### **D. Recommendation for Independent Evaluation Department Follow-Up**

34. The PCR recommended that the ADB project performance evaluation review for the project be undertaken in 2015. Given that there were few issues and the MFF investment program was generally successful, a project performance evaluation review may not be required.