

FINANCIAL ANALYSIS

A. Introduction

1. The financial analysis of the Khyber Pakhtunkhwa Cities Improvement Project has been performed according to Asian Development Bank (ADB) guidelines.¹ The project, estimated to cost €563.747 million (\$650 million equivalent),² is financed by an ADB loan of €329.575 million (\$380.0 million equivalent), an Asian Infrastructure Investment Bank (AIIB) loan of €173.461 million (\$200 million equivalent), a \$5 million grant from ADB's Special Funds resources (Asian Development Fund), and a counterpart contribution of €56.375 million (\$65 million equivalent) by the Government of Pakistan. The project, to be implemented from 2021 to 2027, will support the rehabilitation and reconstruction of water supply, sanitation, and solid waste management infrastructure, and improve public urban spaces in the five target cities of Abbottabad, Kohat, Mardan, Mingora, and Peshawar.

2. The Local Government, Elections, and Rural Development Department (LGE&RDD) of the Government of Khyber Pakhtunkhwa (GOKP) is the executing agency. For each city, the respective water and sanitation services company (WSSC) will be the implementing agency. These entities were established in 2015 by the GOKP for each target city and were entrusted with the responsibility to operate and maintain key urban services of water supply, wastewater, urban spaces, and solid waste management. Accordingly, the WSSCs entered into service and asset management agreements (SAMAs) with city municipal authorities for the transfer of assets and human resources to support delivery of the mandates assigned by the GOKP to the WSSCs.

B. Methodology

3. The project comprises 24 subprojects in water supply, sewerage, solid waste management, and urban green spaces. With the exception of the urban green space subprojects, these are designed to generate incremental revenues through enhanced coverage of serviced areas and volume-based metered service charge-out by the WSSCs. However, the existing tariffs are not structured for full cost recovery, while collection efficiency is weak, resulting in WSSCs relying heavily on GOKP grants for operational sustenance. Although the project will support metered water supply and volume-based tariffs for water supply, wastewater disposal and solid waste management services, the subprojects will not generate positive cash flows because of low tariffs and high operation and maintenance (O&M) costs. Accordingly, the financial analysis is based on the historical and projected financial performance of the WSSCs and analysis of GOKP's ability to fund the net incremental O&M costs of the project.

I. FINANCIAL PERFORMANCE AND PROJECTIONS OF WSSCs

A. Historical Financial Performance of Water and Sanitation Services Companies

4. During fiscal year (FY) 2017 to FY2020, the internally generated revenue of WSSCs increased at an average of 35% per annum, mainly because the number of residential customers increased. However, because of significantly lower-than-cost-recovery tariffs and high operating costs, the WSSCs' internally generated revenues provided annual operating ratios of only 10%–15% (Table 1).³ Net operating cash flows remained negative during this period, necessitating

¹ Asian Development Bank (ADB). 2019. *Financial Analysis and Evaluation: Technical Guidance Note*. Manila.

² €0.867303 = \$1.00 as of 15 October 2021

³ Operating ratio is the ratio of earnings before interest, taxes, and depreciation to internally generated revenue.

significant financing inflows from the GOKP. The financial position of the WSSCs remained stable, largely backed by government grants. While the WSSCs generated cash operating losses, the GOKP was able to provide adequate deficit financing during FY2017–FY2020, which indicates strong commitment and ability of the GOKP to ensure the operational and financial sustainability of the WSSCs.

Table 1: Consolidated Financial Performance of Water and Sanitation Services Companies

Item	FY2017 Actual	FY2018 Actual	FY2019 Actual	FY2020 Actual
A. Consolidated financial performance				
Operating costs (PRs billion)	2.39	2.80	3.50	3.99
Administrative costs (PRs billion)	0.27	0.37	0.51	0.57
Total costs (PRs billion) (a)	2.66	3.17	4.02	4.56
Revenue from services (PRs billion) (b)	0.27	0.43	0.61	0.62
Operating loss without government grants (PRs billion)	(2.40)	(2.74)	(3.41)	(3.94)
Government grants (PRs billion)	2.50	2.98	3.65	4.33
Depreciation and amortization (PRs billion) (c)	0.00	0.06	0.08	0.10
Total costs – adjusted (PRs billion) (d = a-c)	2.66	3.11	3.93	4.46
Operating ratio (b/d)	10%	14%	15%	14%
B. Consolidated cash flow				
Operating cash flows (PRs billion)	(0.33)	(1.16)	(1.06)	(1.31)
Investing cash flows (PRs billion)	(0.07)	(0.11)	(0.21)	(0.09)
Financing cash flows (PRs billion)	0.13	1.98	1.11	1.67
Net cash generated/(used) (PRs billion)	(0.27)	0.70	(0.16)	0.26
C. Consolidated financial position				
Long term assets (PRs billion)	0.24	0.31	0.44	0.45
Current assets (PRs billion)	1.40	2.66	2.96	3.59
Total liabilities (PRs billion)	1.44	2.79	3.21	3.78
Net assets (PRs billion)	0.2	0.18	0.18	0.26

() = negative, FY = fiscal year.

Source: Audited financial statements: up to FY2020 for the Kohat and Swat water and sanitation services companies (WSSCs); up to FY2019 for the Peshawar and Mardan WSSCs.

B. Projected Financial Performance of Water and Sanitation Services Companies

5. In line with existing trends, the projected financial performance does not indicate substantial improvement in net operating results despite customer growth. This is due to a stagnant tariff regime and increasing incremental costs. The operating ratio for WSSCs is projected to range from 16% to 18% from FY2022 to FY2026 (Table 2). The WSSCs have maintained stable financial positions, largely backed by government grants. The financial position of the WSSCs is not expected to deteriorate in a “with-project” scenario, as the project assets will be transferred to the respective WSSCs in the form of government grants.

Table 2: Projected Operating Results of Water and Sanitation Services Companies

Item	FY2022	FY2023	FY2024	FY2025	FY2026
Consolidated projected operating results					
Operating costs (PRs billion)	1.55	1.83	2.06	2.19	2.30
Administrative costs (PRs billion)	0.27	0.34	0.37	0.40	0.42
Total costs (PRs billion) (a)	1.82	2.17	2.43	2.59	2.73
Revenue from services (PRs billion) (b)	0.24	0.28	0.30	0.34	0.40

Item	FY2022	FY2023	FY2024	FY2025	FY2026
Operating loss without Govt. grants (PRs billion)	(1.58)	(1.89)	(2.13)	(2.25)	(2.33)
Government grants (PRs billion)	2.06	2.39	2.33	2.47	2.62
Depreciation and other adjustments (PRs billion) (c)	0.50	0.50	0.50	0.50	0.50
Total costs – adjusted (PRs billion) (d = a-c)	1.34	1.67	1.93	2.09	2.23
Operating ratio (b/d)	18%	17%	16%	17%	18%

() = negative, FY = fiscal year, GOKP = Government of Khyber Pakhtunkhwa.

This table covers the Abbottabad, Kohat, Mardan, and Mingora water and sanitation services companies (WSSCs).

Source: WSSCs.

II. FISCAL POSITION OF THE GOVERNMENT OF KHYBER PAKHTUNKHWA

Fiscal Position of the Government of Khyber Pakhtunkhwa

6. In a historical context, the ability and continued policy-level commitment of the GOKP to provide timely and adequate financial support to the WSSCs is demonstrated by consistent growth in provincial resources (Table 3) and budget allocations to the LGE&RDD (Table 4). The deficit financing by the LGE&RDD of the WSSCs is evidenced through the WSSCs' financial performance (Table 1). Furthermore, current expenditure allocations consistently increased during FY2017–FY2020, evidencing enhanced budget cover over O&M costs.

Table 3: Provincial Fiscal Performance, Fiscal Years 2017–2021

Item	FY2017 ^a	FY2018	FY2019	FY2020	FY2021
	Actual	Actual	Actual	Actual	Budget
A. Total GOKP revenues (PRs billion) (a)	404.2	493.2	513.9	763.2	923.0
B. Total GOKP expenditures (PRs billion) (b)	458.2	504.2	520.8	763.2	923.0
Current expenditure (PRs billion)	338.6	348.0	369.0	532.6	593.1
Development+Capital expenditure (PRs billion)	119.6	156.2	151.8	230.7	329.9
C. Fiscal deficit (PRs billion) (c) = (a-b)	(54.0)	(11.0)	(6.9)	0	0
D. Fiscal deficit (c/a)	(13%)	(2%)	(1%)	0%	0%
E. Growth in current expenditure allocation		3%	6%	44%	11%

() = negative, FY = fiscal year, GOKP = Government of Khyber Pakhtunkhwa.

^a Expenditure classifications were revised in FY2018.

Source: GOKP's Actual Revenue and Expenditure Report 2018–2019; Source for FY2020 and FY2021: GOKP Annual Budget Statement 2020–2021.

Table 4: Local Government, Elections and Rural Development Department Budget and Actual Expenditure, Fiscal Years 2017–2021

Item	FY2017	FY2018	FY2019	FY2020	FY2021
	Actual	Actual	Actual	Actual	Budget
A. Total LGE&RDD budget (PRs billion) (c=a+b)	13.2	23.3	13.5	14.2	17.8
- current and development budget (PRs billion) (a)	12.8	22.4	12.5	13.2	17.0
- TMAs budget for WSSCs (PRs billion) (b)	0.4	0.9	1.0	1.0	0.8
B. Total LGE&RDD expenditure (PRs billion) (f+g)	11.5	22.1	13.1	13.5	17.0
- Current expenditure (PRs billion) (d)	3.8	3.3	3.3	5.3	10.3
- TMAs budget utilization—WSSCs (PRs billion) (e)	0.4	0.9	1.0	0.9	0.7
- Total current expenditure (PRs billion) (f=d+e)	4.2	4.2	4.3	6.2	11.0
- Development expenditure (PRs billion) (g)	7.3	17.9	8.8	7.3	6.7
Year-on-year change—annual budget	-	77%	(42%)	5%	26%
Year-on-year change—current expenditure	-	0%	0%	61%	94%

() = negative, FY = fiscal year, LGE&RDD = Local Government, Elections, and Rural Development Department, TMA = Tehsil Municipal Administration, WSSC = water and sanitation services company.

Item	FY2017 Actual	FY2018 Actual	FY2019 Actual	FY2020 Actual	FY2021 Budget
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Source: Accountant General Government of Khyber Pakhtunkhwa (GOKP) Appropriation Accounts for FY2017–FY2020; GOKP Annual Budget Statement 2020–21 for FY2021.

7. The GOKP's 2020–2023 medium-term budget estimates for service delivery specify planned budget allocation to the LGE&RDD of PRs26.5 billion (current expenditure: PRs11.5 billion) for FY2022 and PRs28.5 billion (current expenditure: PRs12.9 billion) for FY2023.⁴ While the budget outturn might be lower than the planned budget allocation, this demonstrates the GOKP's commitment to allocating budget resources to the LGE&RDD.

8. The coronavirus disease pandemic has negatively affected Pakistan's economy. The GDP growth rate for FY2020 remained at -0.5%. The International Monetary Fund (IMF) projects real GDP growth at 1.5% for FY2021, with gradual improvements over the subsequent 5 years and projected GDP growth of 5% in FY2026,⁵ a level aligned with the 5.2% GDP growth rate in FY2017 and coinciding with the planned completion of project implementation.

III. FINANCIAL SUSTAINABILITY OF INCREMENTAL OPERATION & MAINTENANCE COSTS

9. The net incremental O&M costs of the project are projected to average 0.45% of the total GOKP budget. The total LGE&RDD budget is projected to increase from 1.93% to average 2.39% of the total GOKP budget (Table 5). This indicates likely financial sustainability of the project assets since the incremental costs do not result in significant increase of the GOKP budget and fiscal resources. The following key assumptions have been used in the preparation of the financial sustainability analysis:⁶

- (i) The LGE&RDD's budget as a percentage of the total GOKP budget would remain at 1.93% (based on the FY2021 approved budget) in the "without-project" scenario;
- (ii) Service rates are based on existing tariffs, with volumetric charge-out.
- (iii) Irrecoverable revenue is estimated at 20% of gross revenue from FY2026 onward;
- (iv) Inflation is assumed at 8.76%, based on IMF estimates (footnote 4); and
- (v) Nonrevenue water is factored in the water consumption assumptions (water supply).

Table 5: Incremental Operation and Maintenance Costs, Fiscal Years 2026–2031
(PRs million)

Item	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
A. Water supply						
Incremental cash inflow	228.7	257.5	309.1	367.1	432.5	506.4
Incremental O&M costs	1,213.9	1,320.3	1,436.0	1,561.8	1,698.6	1,847.4
Net incremental O&M costs	985.2	1,062.8	1,126.9	1,194.7	1,266.1	1,341.0
B. Sewerage						
Incremental cash inflow	17.7	16.0	18.9	22.3	26.3	31.1
Incremental O&M costs	789.3	858.4	933.7	1,015.5	1,104.4	1,201
Net incremental O&M costs	771.6	842.4	914.8	993.2	1,078.1	1,170.1
C. Solid waste-management						
Incremental cash inflow	740.4	799.4	864.2	935.3	1,013.6	1,099.8

⁴ GOKP, Finance Department. 2021. Medium Term Budget Estimates for Service Delivery (2020–2023). Peshawar. [Budget Estimates 2020–2021—Finance Department Government of Khyber Pakhtunkhwa \(gkp.pk\)](#).

⁵ IMF. Pakistan country page: [Pakistan and the IMF](#) (accessed 11 May 2021).

⁶ Detailed assumptions are provided in the consolidated and project-level financial models.

Item	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
Incremental O&M costs	5,424.8	5,900.1	6,417.0	6,979.2	7,590.7	8,255.8
Net incremental O&M costs	4,684.4	5,100.7	5,552.8	6,043.9	6,577.1	7,156.0
D. Urban green spaces						
Incremental cash inflow	-	-	-	-	-	-
Incremental O&M costs	345.2	375.4	408.3	444.1	483.0	525.3
Net incremental O&M costs	345.2	375.4	408.3	444.1	483.0	525.3
Total net incremental O&M costs	6,786.3	7,381.3	8,002.7	8,675.8	9,404.3	10,192.4
Add: uncollectable receivables	197.4	214.6	238.4	264.9	294.5	327.5
Total incremental funding required	6,983.7	7,595.9	8,241.2	8,940.7	9,698.8	10,519.9
LGE&RDD budget, without project	28,731.5	31,604.6	34,765.1	38,241.6	42,065.8	46,272.4
LGE&RDD budget, with project	35,715.2	39,200.5	43,006.3	47,182.4	51,764.6	56,792.2
GOKP budget (PRs billion)	1,486.6	1,635.2	1,798.7	1,978.5	2,176.4	2,394.1
% of total GOKP budget -						
- total incremental funding required	0.47%	0.46%	0.46%	0.45%	0.45%	0.44%
- total LGE&RDD budget, w project	2.40%	2.40%	2.39%	2.38%	2.38%	2.37%

FY = fiscal year; GOKP = Government of Khyber Pakhtunkhwa; LGE&RDD = Local Government, Elections and Rural Development Department; O&M = operation and maintenance.

Source: Project financial projections.

10. The scenario analysis, assuming a 10% increase in total incremental funding required, which takes into account potential adverse variances in incremental revenues, uncollectable receivables and incremental gross O&M costs, to cover the project O&M costs. The scenario analysis did not indicate material impact on the percentage of total incremental funding required on the fiscal capacity of the GOKP.

IV. CONCLUSION

11. The project is considered financially sustainable. The net incremental O&M costs of the project are projected to average 0.45% of the total GOKP annual budget, which is considered to be within the absorptive capacity of the GOKP. The fiscal position of the provincial government has improved in previous three years, partly because of increased revenues and reduced developmental expenditure. Conversely, the budget allocations and actual releases for current expenditure, which will cover project O&M costs, have consistently increased. The budget allocations and deficit financing by the GOKP to the WSSCs has remained sufficient to ensure the operational and financial sustainability of these entities. Furthermore, the GOKP has commenced with institutional reforms, including implementation of financial sustainability action plans and capacity building of the WSSCs, with the aim of improving their financial sustainability and operational efficiency. Some aspects of these reforms, such as revision of tariff structures and rationalizing the operating and administrative costs of the WSSCs, are expected to face socioeconomic or change-management hurdles. However, the GOKP has demonstrated strong commitment toward implementing these reforms and shifting to targeted subsidies and cross-subsidization options using other sources. In view of these considerations, the project is considered financially sustainable. While the institutional reforms are underway, a formal tariff differential subsidy mechanism is needed to ensure secured and adequate funding of WSSC financial deficits. The loan agreement includes specific covenants in this respect.