

FINANCIAL ANALYSIS

A. Financial Sustainability of Pu'er Municipality

1. The Pu'er Municipal Government (PMG) will provide counterpart funding during implementation, pay debt service, and provide operation and maintenance (O&M) funds on all components¹ following the completion of the Yunnan Pu'er Regional Integrated Road Network Development Project in the People's Republic of China (PCR). The PMG will also be the executing agency for the Asian Development Bank (ADB) project. Financial due diligence was conducted by ADB on the PMG to:

- (i) review past revenue generation capacity and the share of PMG revenues from provincial and national sources from 2007 to 2012, as well as the level of expenditure that this has supported;
- (ii) assess its financial capacity to provide counterpart funding from 2014 to 2018, based on its revenue generating capacity;
- (iii) assess the PMG's ability to fund the O&M expenses of the project components in addition to its other obligations over the loan payback period, based on financial projections; and
- (iv) assess PMG's ability to meet debt service on the ADB loan.

2. Table 1 shows PMG's income and expenditures from 2007 to 2012. Fiscal revenue has grown rapidly. The majority of PMG's revenue has derived from central government transfers.

Table 1: Pu'er Municipal Government—Income and Expenditures, 2007–2012
(CNY million)

Item	2007	2008	2009	2010	2011	2012	Annual Average Growth Rate ^a (%)
Income (A+F+G)	5,818	6,687	9,813	14,002	15,425	17,537	24.7
Fiscal Revenues (Local Government) (A)	1,249	1,794	2,786	4,628	5,096	5,980	36.8
General Budget Revenue (B)	1,110	1,370	1,660	3,086	3,929	4,790	34.0
Revenue from Taxes (C)	782	992	1,215	2,470	3,136	3,733	36.7
Non-tax Revenue (D)	328	377	445	616	793	1,057	26.4
Fund Revenue (E)	139	424	1,126	1,542	1,167	1,190	53.6
Out-budget Revenues (F)	208	229	280	286	314	345	10.7
Central Government Transfers (G)	4,361	4,664	6,746	9,089	10,015	11,212	20.8
Expenditures	5,580	5,930	8,548	11,411	14,575	17,009	25.0
General public service	841	873	1,082	1,387	1,657	2,165	20.8
Education	931	1,111	1,457	1,740	2,102	2,852	25.1
Science & technology	26	32	42	84	117	88	27.3
Culture, sports, and media	72	99	145	284	412	389	39.9
Social insurance and employment	1,471	1,030	1,474	1,543	2,036	2,311	9.4
Medical & sanitation	448	540	896	1,069	1,360	1,475	26.9
Environmental protection	72	172	157	257	369	333	35.7
Urban and rural community affairs	124	216	267	323	461	527	33.5
Agriculture, forestry, & water	575	828	1,051	1,721	2,177	2,798	37.2
Transportation	384	228	890	713	1,070	1,048	22.3
Industry, commercial finance affairs	142	166	169	275	464	535	30.4
Other	158	245	388	596	1,948	2,488	73.6

^a The historic average annual growth rates of revenues and expenditures are higher than 20%.
Source: Pu'er Municipal Government statistics.

¹ The local government will also be responsible for financing any shortfall in the O&M costs and debt service.

3. The analysis could not identify the construction or investment component of the municipal budget because reporting is by sector and recurrent and investment expenditures are combined in a single line item. Therefore, the annual contribution needed for the project was compared with overall annual municipal expenditures and with spending on special infrastructure projects. These are municipal- or state-sponsored projects that are financed by higher levels of government.

4. A fiscal impact assessment was carried out by comparing annual revenues from the identified financing sources with the annual counterpart funds required for (i) capital expenditures during project implementation, and (ii) the recurrent costs of O&M and debt service of the project components. Interest and principal repayments for the ADB loan were estimated based on a grace period of 5 years and a maturity of 25 years.

5. **Historical revenues and expenditures.** Historical financial performance was analyzed to determine whether the PMG would be able to provide the required counterpart funds during the construction period and the funds necessary for O&M and debt service during the operating period. In addition, the annual average growth rate of revenues and expenditures during the project period were estimated. The sources of income include value-added tax, business tax, income tax, resource tax, and real property tax, as well as non-tax revenues and subsidies and direct transfers from other levels of government. Expenditures were categorized into general public services, education, public safety, personnel welfare, environmental protection, agriculture, forestry and water, and transportation.

6. **Projections of revenues and expenditures.** In projecting the revenues and expenditures, the analysis did not consider funds from land sales. The financial forecasts have assumed that revenues and expenditures are likely to increase at 10%² per annum. Based on past trends, this is conservative. The PRC's central government provides annual subsidies for routine maintenance of rural roads. Under its current policy, it provides CNY7,000, CNY3,500, and CNY1,000 per kilometer per annum for county, township, and village roads.

7. **Fiscal impact and affordability assessment.** The assessment of projected annual revenues showed that the PMG has the necessary counterpart funds for implementation of the project components. The analysis indicated that sufficient counterpart funds would be available, based on the fund sources identified during project preparation. These included new budgets, subsidies, and allocations that will be earmarked by the PMG. The annual counterpart funding required will peak in 2016 at only 1.41% of projected revenues during implementation. The construction and ensuing O&M will not affect the PMG's financial position (Table 3).

8. The PMG's contributions were analyzed in terms of affordability given projected revenues and expenditures from 2014 to 2018. Table 2 shows that counterpart contributions will be highest in 2016, when CNY361.05 million will be required to support project investments. PMG's municipal finance bureau is not expected to experience difficulty making the counterpart funds available in this year or in the other years when the financial demand will be lower. As the PMG has adequate time to make counterpart funding provisions, with the main contributions scheduled from 2014 to 2018, the analysis concluded that the PMG can afford to finance the project.

9. The results of the fiscal analysis are presented in Table 2 and Table 3.

² The historic average annual growth rates of revenues and expenditures are higher than 20%.

Table 2: Pu'er Municipal Government—Annual Project Counterpart Funding, 2014–2018

Annual Counterpart Funding	2014	2015	2016	2017	2018	Total
Amount (CNY million)	56.30	261.55	361.05	264.90	114.99	1,058.78
Amount as portion of total revenue (%)	0.27	1.12	1.41	0.94	0.37	0.82

Source: Asian Development Bank estimates.

Table 3: Pu'er Municipal Government—Annual Operation and Maintenance Funding for Project, 2019–2034

O&M Funds Required	2019	2020	2021	2022	2023	2034
Amount (CNY'000)	5,409	5,571	5,738	5,911	6,088	5,409
Amount as portion of total revenue (%)	0.03	0.02	0.02	0.02	0.02	0.03

O&M = operation and maintenance.

Note: O&M cost were forecast to increase at 3% per annum.

Source: Asian Development Bank estimates.

Table 4: Pu'er Municipal Government—Debt Service Requirements of ADB Project Loan, 2010–2025

Debt Service	2020	2021	2022	2023	2024	2025
Debt service amount (CNY million)	3,851.01	4,233.28	4,653.78	5,116.34	5,625.15	6,184.86
Debt services as portion of total revenue (%)	5.80	5.80	5.85	5.93	6.04	6.20

Source: Asian Development Bank estimates.

B. Financial Management Arrangement and Assessment

10. The borrower will be the Government of the PRC, and the final borrower will be the Pu'er Municipal Government. The ADB loan will be made to the government, and the funds will be relented by the government's Ministry of Finance to the Yunnan provincial government's financial department, which will in turn onlend the funds to the PMG's municipal financial bureau. All of these loans will be on the same terms. The PMG's municipal financial bureau will transfer both the ADB loan funds and government counterpart funds to the Pu'er Municipal Transport Bureau (PMTB). The final borrower will bear responsibility for repaying the loan, including principal and interest. Loan repayment to ADB will be done level-by-level via the same parties through which the ADB loan funds have passed en route to the PMTB.

11. The PMG will be the executing agency and have overall responsibility for project preparation and implementation. The PMTB will be the implementing agency and will establish a project management office (PMO) that will assume day-to-day responsibilities for the implementation of all components.

12. The existing accounting departments and accounting staff of the implementing agency are experienced with project implementation and management of domestic projects. All accounting staff members in the implementing agency are experienced with PRC government accounting procedures and receive appropriate accounting training at least once a year. Detailed position descriptions exist for all accounting positions, and turnover is not frequent.

13. The implementing agency's current accounting procedures are adequate. Such accounting procedures as transaction recording, chart of accounts, controls, and cost allocation are well-established and effective. The general ledger and subsidiary ledgers are always reconciled and balanced. In line with the accounting regulations in the PRC, all accounting and supporting documents and financial statements are retained on a permanent basis. The PRC's government accounting standard and related policies, regulations, and procedures currently

adopted by implementing agency can satisfactorily service ADB's project accounting requirements.

14. The implementing agency follows the PRC's standard business accounting and general accounting systems for their normal business and the country's construction accounting standard and systems for their construction projects (footnote 3). The accounting systems are computerized. All financial statements are produced from the automated accounting systems. The financial staff members also receive training from the accounting software company and understand electronic accounting.

15. The implementing agency prepares balance sheets, revenue and expenditure statements, total revenue statements, total expenditure statements, detailed revenue statements, detailed expenditure statements, payroll statements, and office expenditure statements monthly and annually. It also prepares fixed asset statements and basic information at the end of each year. The current reporting system is effective for the existing organizations. At the end of each year, the implementing agency finalizes the financial statements and compares them with the physical data and budget. The current reporting system, however, does not routinely produce all the financial reports that would be required by the ADB (eg. a summary of sources and uses of funds).

16. The financial management risk is considered moderate rather than low because (i) the implementing agency has no experience with ADB loan disbursement and withdrawal procedures, and (ii) the PMTB staff members who are familiar with financial management have limited ability to communicate in English. This will require early implementation support and focused capacity development interventions. Pu'er Highway Management and Maintenance Company provides support for the PMTB's daily work, and will appoint key staff to the PMO.

17. **Internal auditing.** The PMG and the implementing agency will maintain separate project accounts and records by funding source for all expenditures incurred on the project. Consolidated project financial statements will be prepared annually in accordance with applicable guidance and regulations, where these are generally consistent with internationally recognized accounting principles and practices.³ The implementing agency maintains an internal auditing system, but it is inadequate. Internal audits are implemented through a task force on an exceptional basis. Financial audit teams are recruited from inside the organization, and the results of the internal auditing are submitted to the director of the PMTB. The implementing agency does not have internal auditing resources, and accordingly no routine internal auditing is performed. The PMTB's current internal control system involves only the head of the agency, who makes the final decision on all types of expenditures.

18. **External auditing.** Under the current PMG external auditing system, an auditing department at the same level or higher level within the municipal government audits PMG departments. Yunnan Provincial Audit Office will be responsible for the external audit. The audit is conducted based on the national standards on auditing issued by the central government. No major accountability issue has been found in the audit reports of the past years.

19. The PMG and the PMTB will cause the annual consolidated project financial statements to be audited in accordance with national and government auditing standards, where these are

³ Applicable laws, regulations, and guidelines include: (i) The Accounting Law of the PRC (2000); (ii) State-owned Construction Enterprise Accounting Control Regulations; (iii) Capital Construction Financial Control Regulations; and (iv) Accounting Methods for Projects Financed by the World Bank.

found to be consistent with ADB's auditing requirements as detailed in the project agreements. As required, the PMO and the PMTB will submit to ADB:

- (i) the annual consolidated project financial statements,
- (ii) an audit report that includes a separate audit opinion on the use of the imprest accounts and the State Owned Entity procedures, and
- (iii) an audit management letter.

C. Financial Management Capacity Building

20. The following actions will be implemented under the project to mitigate the identified risks:

- (i) To avoid delay in the disbursement process, the ADB project team will provide training at loan inception to build implementing agency accounting staff capacity to administer the ADB loan disbursement procedures and meet project accounting requirements.
- (ii) The project training component will finance capacity-building support to strengthen the internal auditing capacity of the implementing agency.
- (iii) The project management consultant will provide technical support to upgrade the existing information management system to develop monitoring and evaluation capability in the implementing agency.
- (iv) Provide continuous support and a focus on financial management practices during review missions.