

FINANCIAL ANALYSIS

A. Introduction

1. The financial analysis of the proposed Punjab Intermediate Cities Improvement Investment Project was carried out in accordance with the Financial Management and Analysis of Projects of the Asian Development Bank (ADB).¹ The financial analysis examines the projected fiscal situation of the municipal corporation of the project cities of Sahiwal and Sialkot. The project involves the rehabilitation and reconstruction of water supply and sanitation infrastructure, and improvement of urban transport infrastructure and public spaces in both cities. Both cities directly provide the services of water supply and wastewater management and disposal to their residents.

B. Methodology and Major Assumptions

1. Project Components

2. The project, estimated to cost \$250 million, is financed by an ADB loan of \$200 million and counterpart contribution of \$50 million by the Government of Pakistan. The project, to be implemented from 2017 to 2023, will rehabilitate and reconstruct the water supply and sanitation infrastructure, and improve public transportation and public spaces in both cities. The executing agency is the Government of Punjab and the implementing agencies are the cities of Sahiwal and Sialkot (municipal corporations). A project management unit (PMU) will be established by the Government of Punjab, and each city will establish a city implementation unit (CIU) for project implementation within its jurisdiction. The Government of Punjab has taken a decision to establish an urban services company for each city, and entrust to them the responsibility to operate and maintain key urban services of water supply, wastewater, urban spaces, and solid waste management. While the network assets will remain the property of the municipal corporations, the urban services companies will enter into a service and asset management agreement to operate and maintain the network, and deliver these principal urban services. The municipal corporations will directly operate and maintain the infrastructure for public transportation and public spaces.

2. Approach and Assumptions

3. The water tariff in both cities is fixed, based on the area of land occupied by a resident, the ferrule size of the water connection, and the nature of occupation (residential, commercial, or industrial). Water supply is not metered in either city, and the services of wastewater disposal and solid waste management are provided without any volumetric user charges. Revenue from the operation of bus terminals (comprising fees from bus operators, shop rentals, and related activities) is limited. Both cities have earned a small revenue surplus in the preceding four financial years (2012–2015), which was largely consumed in capital investment or improvement projects. However, if the revenue from the three principal urban services is compared with the cost, both cities are incurring a deficit. The ADB loan is being transformed into a grant for both cities to implement the projects to improve the essential urban services. In the absence of a comprehensive cost recovery tariff, coupled with lack of metering, a conventional financial evaluation based on cash flow analysis leading to the computation of a financial internal rate of return is not considered appropriate. A fiscal analysis has instead been performed, assessing the fiscal capacity of both cities, and their ability to finance the whole or part of the incremental

¹ ADB. 2005. *Guidelines for the Financial Management and Analysis of Projects*. Manila.

operating costs for the services once the project commences operation. The major financial modeling assumptions are as follows:

- (i) The historical financial performance of the cities for the preceding four financial years has been analyzed.
- (ii) The revenues and costs relating to key urban services, namely water supply, wastewater, urban spaces, and solid waste management, have been identified to the extent information is available, and future earnings projected based on anticipated growth in both costs and revenues.
- (iii) The underlying projected inflation is 5.2% in 2017 and 2018, and 5.5% thereafter in the country.
- (iv) The Government of Punjab will conduct a thorough consumer survey in both cities, to identify households that have connected illegally to the water network but that are not on the list of consumers. As a result of this survey, it is anticipated that the revenue from the key urban services will be significantly increased in Sahiwal and Sialkot over years. This assumption is considered reasonable in view of the strong measures being proposed by the government to streamline and strengthen the administration of these services. The time-bound action plan to ensure project sustainability is provided in Table 10 of Project Administration Manual.
- (v) Affordability rate has been calculated based on international standards for water supply of 4% (United Nations Development Programme 3%; World Bank 5%) and applied to annual domestic income data for calculating user charges from fiscal year 2019.
- (vi) As part of the exercise in professionalizing the delivery of the principal urban services, the urban services companies will be required to achieve an annual improvement in collection efficiency of at least 3%.
- (vii) The cities of Sahiwal and Sialkot will introduce inflation-linked tariff increases in 2018. Though volumetric tariffs are also expected for water, with a surcharge for wastewater, insufficient evidence is available to estimate the likely tariff levels for this financial analysis.

C. Fiscal Analysis

1. Current Situation

4. The historical financial statements of the municipal corporations for 2012–2015 are in Table 1.

Table 1: Operational Income and Expenses of Both Cities
(PRs million)

Item	Sialkot				Sahiwal			
	2012	2013	2014	2015	2012	2013	2014	2015
Own-source income	397.13	426.20	489.30	463.03	142.84	174.36	237.14	258.00
Urban immovable property tax	62.06	72.98	84.91	122.77	24.15	38.01	49.26	52.51
Grants and transfers	282.12	234.89	257.23	282.08	202.57	237.90	206.16	229.37
Total Income	741.31	734.07	831.44	867.88	369.56	450.27	492.56	539.88
Establishment expenses	279.83	320.09	337.54	348.76	175.12	213.82	222.52	233.29
Other expenses	221.99	246.69	352.91	307.78	137.57	206.98	255.75	240.94
Total expenses	501.82	566.78	690.45	656.54	312.69	420.80	478.27	474.23
Surplus/(Deficit)	239.49	167.29	140.99	211.34	56.87	29.47	14.29	65.65

Item	Sialkot				Sahiwal			
	2012	2013	2014	2015	2012	2013	2014	2015
Own-source revenue (% of total income)	54%	58%	59%	53%	39%	39%	48%	48%

Sources: Asian Development Bank and the Local Government and Community Development Department.

5. The operational parameters and the projected volumes of operation of the two cities for water supply and wastewater services are in Table 2.

Table 2: Operational Parameters of Both Cities

Item	Volumes in '000 cubic meters per annum							
	2017	2018	2019	2020	2021	2022	2023	2024
Sahiwal water supply	43,435	43,580	43,726	43,872	44,018	44,165	44,895	45,990
Sahiwal wastewater collection	26,280	26,772	27,274	27,784	28,305	28,835	29,565	29,930
Sialkot water supply	94,900	97,590	100,356	103,201	106,127	109,135	111,690	114,245
Sialkot wastewater collection	57,670	59,259	60,892	62,570	64,294	66,065	67,890	69,350

Source: Asian Development Bank and the Local Government and Community Development Department.

6. The projected income statements of Sialkot and Sahiwal for the principal urban services including public transport after proposed Government measures and project implementation are in Tables 3.1 and 3.2.

Table 3.1: Income for Sialkot from Principal Urban Services^a
(PRs million)

Item	2017	2018	2019	2020	2021	2022	2023	2024
Income	149.79	275.36	699.30	759.30	831.94	903.10	980.39	1064.34
Expenditure	(916.59)	(978.68)	(1,046.61)	(1,117.96)	(1,207.23)	(1,289.86)	(1,380.14)	(1,475.21)
Surplus/(Deficit)	(766.80)	(703.32)	(347.30)	(358.66)	(375.30)	(386.76)	(399.74)	(410.86)

() = negative. ^a (including water and sanitation, and public transport).

Sources: Asian Development Bank and the Local Government and Community Development Department.

Table 3.2: Income for Sahiwal from Principal Urban Services^a
(PRs million)

Item	2017	2018	2019	2020	2021	2022	2023	2024
Income	16.77	43.80	260.18	283.13	364.60	522.58	566.21	613.58
Expenditure	(461.23)	(489.60)	(521.28)	(553.40)	(697.90)	(867.63)	(924.79)	(980.85)
Surplus / (Deficit)	(444.46)	(445.79)	(261.09)	(270.27)	(333.30)	(345.04)	(358.58)	(367.27)

() = negative. ^a (including water and sanitation, and public transport).

Sources: Asian Development Bank and the Local Government and Community Development Department.

7. Projected income statements of combined operations of the urban services including water, sanitation, and public spaces under the project were also prepared for the two cities. A comparison of the projected income statements of these services in a with- and without-project situation was conducted and the projected savings in government grant or subsidy in the two cities for the first 3 years of full operations starting in 2022 are indicated in Table 4. This table reflects the projected savings that will accrue due to reduction in the grant/subsidy which the provincial government is expected to provide to fill the revenue gap generated due to increased volume of the urban services in each of the three years after commencement of project operations.

Table 4: Projected Savings in Government Grant or Subsidy from 2022 to 2024^a
(PRs million)

Year	Sialkot	Sahiwal
2022	564	226
2023	594	241
2024	632	269

^a (including water and sanitation, and public transport and spaces).

Sources: Asian Development Bank and the Local Government and Community Development Department.

8. On the establishment of the urban services companies, the municipal corporations will enter into an agreement with the companies for management of the assets, and transfer the salaries and non-salary expenditure budgeted in their own books. The agreements are being drafted, and are expected to include arrangements to allow the urban services companies to recover the salaries of staff hired from the market, as well as the higher variable costs (e.g., for electricity and fuel) resulting from the enhanced levels of service they will be mandated to achieve. As the municipal corporations have limited capability to raise additional resources on their own account, the Government of Punjab has assured that it will provide any incremental funds required to ensure the design level of service from both the water and sanitation companies.

9. The Government of Punjab has embarked on a significant reform measure, by constituting the urban services companies to deliver the principal urban services and focusing accountability on a corporate entity. It is essential that the initial consumer survey is performed to identify all illegal connections and convert them into legal connections that pay the nominal charges imposed for these services. It is also essential that both municipal corporations implement the reform program, providing annual inflation-linked tariff increases, and that the urban services companies achieve the annual improvements in collection efficiency. Further reform measures to be taken include the introduction of prepaid metering for select consumers, followed by wider implementation of water meters to cover the entire consumer network eventually, accompanied by measures to reduce nonrevenue water. Simultaneously, professional management is proposed to be recruited at market-based remuneration. The urban services companies will identify the cost of providing the services and recommend affordable tariffs, which will help to lower the subsidy burden on the government. In the medium term, the combined impact of these measures is expected to improve the quality of service as well.