



# Report and Recommendation of the President to the Board of Directors

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Project Number: 42459-014  
Loan Number: 2790-SRI  
September 2016

## Proposed Loan for Additional Financing Democratic Socialist Republic of Sri Lanka: Local Government Enhancement Sector Project

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## CURRENCY EQUIVALENTS

(as of 5 September 2016)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	–	\$0.00687
\$1.00	–	SLRs145.65

## ABBREVIATIONS

ADB	–	Asian Development Bank
CKD	–	chronic kidney disease
GRM	–	grievance redress mechanism
IEE	–	initial environmental examination
MPCLG	–	Ministry of Provincial Councils and Local Government
NWSDB	–	National Water Supply and Drainage Board
O&M	–	operation and maintenance
PAM	–	project administration manual
PMU	–	project management unit
SPCU	–	subproject coordination unit

## NOTE

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

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## PROJECT AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 42459-014</b>	
<b>Project Name</b>	Local Government Enhancement Sector Project - Additional Financing	<b>Department /Division</b>	SARD/SAUW
<b>Country</b>	Sri Lanka	<b>Executing Agency</b>	Ministry of Provincial Councils & Local Government
<b>Borrower</b>	Democratic Socialist Republic of Sri Lanka		
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Water and other urban infrastructure and services</b>	Other urban services		3.00
	Urban policy, institutional and capacity development		2.00
	Urban solid waste management		1.00
	Urban water supply		15.00
<b>Agriculture, natural resources and rural development</b>	Rural market infrastructure		2.00
	Rural water supply services		35.00
<b>Health</b>	Mother and child health care		1.00
<b>Transport</b>	Road transport (non-urban)		1.00
	<b>Total</b>		<b>60.00</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Adaptation (\$ million)	10.00
Environmentally sustainable growth (ESG)	Global and regional transboundary environmental concerns	Climate Change impact on the Project	Medium
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Client relations, network, and partnership development to partnership driver of change	Effective gender mainstreaming (EGM)	✓
	Institutional development		
	Institutional systems and political economy		
<b>5. Poverty Targeting</b>		<b>Location Impact</b>	
Project directly targets poverty	Yes	Rural	Medium
Geographic targeting (TI-G)	Yes	Urban	Medium
<b>6. Risk Categorization:</b>	Low		
<b>7. Safeguard Categorization</b>	Environment: B Involuntary Resettlement: B Indigenous Peoples: B		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>60.00</b>	
Sovereign Project loan: Asian Development Fund		60.00	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>7.84</b>	
Government		7.84	
<b>Total</b>		<b>67.84</b>	
<b>9. Effective Development Cooperation</b>			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Democratic Socialist Republic of Sri Lanka for the additional financing of the Local Government Enhancement Sector Project.<sup>1</sup>

2. The project supports the improvement of local infrastructure and services delivered by local authorities in less-developed areas of Sri Lanka. The additional financing will expand the current project,<sup>2</sup> which is performing well. It includes (i) improving water supply systems to mitigate the risks of chronic kidney disease (CKD), (ii) improving local infrastructure and basic services delivery, and (iii) advancing policy reform and strengthening the capacity of local governments.<sup>3</sup>

## II. THE PROJECT

### A. Rationale

3. **ADB support to local governments.** Sri Lanka has three types of local authorities under nine provincial councils: (i) municipal councils constituted in cities and large towns, (ii) urban councils for less urbanized areas, and (iii) *Pradeshiya Sabhas* (local authorities) in peri-urban and rural areas.<sup>4</sup> To respond to the need to improve basic infrastructure and services provided by local authorities, the Asian Development Bank (ADB) approved the Local Government Infrastructure Improvement Project in 2005.<sup>5</sup> The infrastructure improvement project supported subprojects for water supply; roads; drainage and sewerage; and other municipal facilities such as public libraries, health care centers, and office buildings, under a bottom-up, demand-driven approach that follows the priorities set out by local authorities, and improves the financial management capacity of these authorities. One limitation of the infrastructure improvement project was that financial constraints prevented participation by poor and financially weak *Pradeshiya Sabhas*, which thus were unable to benefit.<sup>6</sup> The current project, which was approved in 2011 (footnote 2), expanded the infrastructure improvement project's interventions by targeting poorer *Pradeshiya Sabhas* to improve basic service delivery in less-developed areas in seven of the nine provinces (excluding the Northern and Eastern provinces). The subprojects selected under the current project reflect the needs of the local people and are implemented by local authorities, who will remain responsible for operation and maintenance (O&M) of the assets that are being built.

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<sup>1</sup> The design and monitoring framework of the project has been revised as Appendix 1.

<sup>2</sup> ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Local Government Enhancement Sector Project*. Manila (Loan 2790-SRI).

<sup>3</sup> Subproject design, preparation of bidding documents, costs in meeting safeguards requirements, and other due diligence for the additional financing were partially financed under the current loan.

<sup>4</sup> There are 22 municipal councils, 42 urban councils, and 271 *Pradeshiya Sabhas* in Sri Lanka as of 2016. Local authorities are established under the *Pradeshiya Sabhas* Act Number 15 of 1987, and are the smallest political unit in peri-urban and rural areas.

<sup>5</sup> ADB. 2005. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Local Government Infrastructure Improvement Project*. Manila (Loan 2201-SRI). All local authorities (including *Pradeshiya Sabhas*) of the Northern and Eastern provinces are covered under the World Bank's North East Local Services Improvement Project. The infrastructure improvement project also supported 19 *Pradeshiya Sabhas* in these two provinces.

<sup>6</sup> Under the infrastructure improvement project, *Pradeshiya Sabhas* had to borrow as well as contribute a part of the subproject cost, which prevented financially weaker *Pradeshiya Sabhas* from fully benefiting.

4. **Project support for local infrastructure development.** The local authorities under the current project are implementing one to three subprojects each; these are chosen based on local priorities, with a ceiling of SLRs50 million (about \$0.4 million).<sup>7</sup> The focus of subprojects completed or under implementation includes (i) environmental infrastructure, (ii) economic infrastructure, (iii) public health infrastructure, and (iv) other local authority facilities. Although the scale of the investments is small, the interventions are having a tangible development impact in local communities because they address critical local needs. For example, the Huluganga bridge constructed in Panwila *Pradeshiya Sabha* in the Central Province enabled its inhabitants to commute to the adjacent town for basic services (e.g., health care, education, and markets); prior to construction of the bridge they had to take a circuitous road, which was 10 kilometers longer. Public health and other facilities built by the current project have enabled local authorities to provide better public services to their citizens.

5. **Local government reforms.** To receive support from the project, a *Pradeshiya Sabha* had to agree to undertake a set of reforms. This has proven effective in advancing reform in local authorities. All 108 *Pradeshiya Sabhas* supported under the current project have developed and implemented a reform plan addressing (i) improving service delivery, with a focus on local environmental improvement (including solid waste management); (ii) streamlining taxation, licensing, and approval systems and processes; (iii) ensuring the effective management of the government's assets; and (iv) improving the administration systems and management. Administration of *Pradeshiya Sabhas* has improved as a result of the reforms, facilitated by the use of information technology to unify and improve forms; produce computer-generated receipts and approvals; track applications; and manage grievances, property taxes, and libraries. These measures are increasing own-source revenues, speeding processing of citizen applications, reducing workloads for citizens and local officials in *Pradeshiya Sabhas*, and resulting in provision of additional, more efficient services to citizens.<sup>8</sup> Front office functions have been established in more than 90 *Pradeshiya Sabhas* to provide more efficient, citizen-friendly one-stop services.

6. **Safe drinking water supply in areas affected by the chronic kidney disease.** Sufficient supply of safe drinking water has become an urgent priority in the dry zones of the country, particularly in the North Central Province and in some areas in the Central, Eastern, Northern, North Western, and Uva provinces, where CKD of unknown etiology is becoming a major public health threat.<sup>9</sup> Scarcity of safe drinking water is considered as one of the most important risk factors leading to CKD. The government has accorded top priority to mitigate CKD, and established the Presidential Task Force on Prevention of Chronic Kidney Disease in 2015. The National Water Supply and Drainage Board (NWSDB) has been tasked to prepare and implement projects for safe drinking water supply in the affected areas through the installation of reverse osmosis plants, the procurement of water tankers to carry safe drinking water to remote areas, the extension of the existing water supply network, and rainwater harvesting.<sup>10</sup> The government requested ADB support for sustainable safe drinking water services in CKD-affected areas. Seven schemes with a total of \$3.9 million in funding are being

<sup>7</sup> For *Pradeshiya Sabhas* implementing water supply subprojects, this ceiling did not apply.

<sup>8</sup> For example, Bingiriya *Pradeshiya Sabha* in the North Western Province was able to (i) increase tax collection efficiency from 44% in 2013 to 81% in 2015, (ii) increase the amount of tax collection by 93% during 2013–2015, and (iii) reduce arrears by 60% during 2013–2016.

<sup>9</sup> There are an estimated 70,000 CKD patients in known high-risk areas, with a majority from the North Central Province. The annual death toll is about 2,000. The World Health Organization has recommended the provision of clean drinking water in CKD endemic areas, which can be done through central treatment facilities and a piped network.

<sup>10</sup> By December 2015, excluding ADB's financing, NWSDB implemented water supply systems improvement worth about SLRs1,000 million (\$7 million) in CKD-affected areas in the six provinces.

supported by the current project, but the need is much greater, for which additional financing is required.

7. **Demand for expanding the current project's successful model.** The current project is rated *on track*. It has managed the risks identified during processing and implementation, and successful implementation of the project is not threatened by major risks. Hence, expanding the current project's model for the additional financing modality is suitable because of (i) strong links of additional financing with the current project in terms of design and implementation arrangements, (ii) the urgency to support water supply improvement in areas affected by CKD, (iii) the opportunity to expand the benefits of the current project in terms of reforms and local infrastructure improvement, and (iv) the high degree of project readiness. Through provision of additional financing, the government is seeking to expand the successful investment and reform support provided under the current project and the preceding infrastructure improvement project to *Pradeshiya Sabhas* that did not receive prior support. As the capacity of *Pradeshiya Sabhas* in less-developed areas is generally very limited, the additional financing will continue supporting reforms, enabling the provision of citizen-centric basic services by *Pradeshiya Sabhas*, and strengthening their financial and administrative capacity. The additional financing will also expand support for improvement of water supply systems in CKD-affected areas, which will be the first large-scale intervention to reduce the risk of CKD. The additional financing is consistent with the ADB (i) Water Operational Plan, by addressing efficiencies in water use while improving access to safe drinking water supply; and (ii) Operational Plan for Health, by aiming to enhance health outcomes from water supply improvement.<sup>11</sup>

8. **Additional financing eligibility criteria.** ADB eligibility criteria for additional financing have been met.<sup>12</sup> The project (i) remains technically feasible, economically viable, and financially sound; (ii) is accorded high priority by the government; (iii) is consistent with the current project's development objectives; and (iv) is consistent with the current country partnership strategy, which prioritizes inclusive and sustainable economic growth, including improving access to drinking water in lagging regions.<sup>13</sup> The current project is performing well in accordance with ADB's additional financing policy, and is on track to deliver the expected outputs.<sup>14</sup> As of 11 July 2016, cumulative current project contract awards total \$48.5 million (92.8% of the ADB net loan amount), and disbursements, \$34.2 million (65.1%). Subprojects are relatively small in scale, and safeguards compliance has been met.

## B. Impact and Outcome

9. The impact will be local authorities' capacity financially and technically strengthened in less-developed areas of seven provinces in Sri Lanka. The outcome will be improved local infrastructure and services delivered effectively by local authorities or NWSDB in less-developed areas of seven provinces in Sri Lanka. The impact statement is unchanged. The outcome statement was changed because most of the water supply schemes in areas affected by CKD will be operated by NWSDB. The original and aggregate targets are in the revised design and monitoring framework (Appendix 1).

<sup>11</sup> ADB. 2011. *Water Operational Plan, 2011–2020*. Manila; ADB. 2015. *Operational Plan for Health, 2015–2020*. Manila.

<sup>12</sup> ADB. 2011. *Operations Manual Section H5.BP*. Manila.

<sup>13</sup> ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka, 2015–2016*. Manila.

<sup>14</sup> ADB. 2010. *Additional Financing: Enhancing Development Effectiveness*. Manila; and Summary of Project Performance (accessible from the list of linked documents in Appendix 2).

### C. Outputs

10. The overall project with additional financing has three outputs. Output 1 has been added for the additional financing. The additions and modifications are in the revised design and monitoring framework.

11. **Output 1: Water supply systems in chronic kidney disease-affected areas improved.** The additional financing will support development and expansion of water supply systems in CKD-affected areas in the four provinces (Central, North Central, North Western, and Uva) to provide a continuous supply of safe drinking water. The schemes include the development of new water supply systems and the expansion of existing systems, mostly run by NWSDB. Facilities such as raw water intakes, water treatment plants, overhead tanks, and transmission and distribution networks leading to household connections are eligible for financing.<sup>15</sup> About 30 schemes will be developed or expanded, and will be implemented by the respective provincial councils with technical inputs and supervision support from NWSDB. Considering the nature and complexity of the schemes, the piped network will be operated by NWSDB, except for a few local authorities that have adequate operational capacity. If local authorities are identified to be the appropriate entity to implement the subprojects, such local authorities will first have to submit a reform plan, as practiced in the current project, prior to implementation of the subproject. The additional financing will also ensure efficient use of water through nonrevenue water reduction programs.

12. **Output 2: Local infrastructure and basic services delivery improved.** The additional financing will support improvement of social and economic infrastructure in 29 *Pradeshiya Sabhas* from five provinces (Central, North Western, Southern, Uva, and Western) that have not received support under either the infrastructure improvement project or the current project. The approach will remain the same; these *Pradeshiya Sabhas* will have to submit a reform plan approved through a council resolution, which will be reviewed and confirmed by the Ministerial Committee of the Ministry of Provincial Councils and Local Government (MPCLG) to ensure that the minimum reform requirements are met. They will then be eligible for provision of a capital grant for infrastructure improvement. Eligible subprojects include (i) environmental infrastructure such as water supply and sanitation (including sewerage), drainage, and solid waste management; (ii) economic infrastructure such as roads and bridges (including suspension bridges); (iii) public health infrastructure such as maternity and health care centers; and (iv) other local authority facilities such as public markets.

13. **Output 3: Local government policy reform advanced and capacity strengthened.** The additional financing will support advancing business process reengineering and additional capacity-building measures in the original and additional *Pradeshiya Sabhas*.<sup>16</sup> The activities will include (i) support for implementing the guidelines developed under the capacity development technical assistance;<sup>17</sup> (ii) establishment and implementation of information

<sup>15</sup> When providing drinking water through a piped network proves too costly, installation of reverse osmosis plants to purify groundwater and procurement of water tankers to supply the treated water may be necessary. These schemes will be fully financed by the government and are not included in the scope of the additional financing.

<sup>16</sup> The additional *Pradeshiya Sabhas* include the 29 under output 2, and those that will implement and operate water supply system improvements under output 1.

<sup>17</sup> Thirteen guidelines have been developed by ADB. 2011. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Local Government Enhancement Sector Project*. Manila, as follows: (i) tax enforcement and arrears recovery manual, (ii) information sources available for local authorities to increase coverage, (iii) standard agreement template for lease, (iv) service charge rationalization model, (v) extension of built-up locality in *Pradeshiya Sabhas*, (vi) incentive scheme for revenue collectors, (vii) standard request for proposal for selection of survey agency for conducting third-party surveys, (viii) process awareness, (ix)



technology solutions in the additional *Pradeshiya Sabhas*; (iii) continuation of support and improvement of information technology solutions in the original 108 *Pradeshiya Sabhas*, including the development and installation of additional software to simplify and increase the efficiency of local administration; (iv) support for implementing reform plans in the original and additional *Pradeshiya Sabhas*; and (v) capacity-building programs to strengthen technical, financial, and administrative capacity of the original and additional *Pradeshiya Sabhas*, provincial councils, and MPCLG.

#### D. Investment and Financing Plans

14. The overall project is estimated to cost \$128.84 million, with additional financing of \$67.84 million (Table 1). Detailed cost estimates by expenditure category and detailed cost estimates by financier are included in the project administration manual (PAM).<sup>18</sup>

**Table 1: Project Investment Plan**  
(\$ million)

Item	Current Amount <sup>a</sup>	Additional Financing <sup>b</sup>	Total
<b>A. Base Cost<sup>c</sup></b>			
1. Water supply systems in chronic kidney disease-affected areas improved	4.00	46.78	50.78
2. Local infrastructure and basic services delivery improved	55.20	11.87	67.07
3. Local government policy reform advanced and capacity strengthened	0.90	1.55	2.45
<b>Subtotal (A)</b>	<b>60.10</b>	<b>60.20</b>	<b>120.30</b>
<b>B. Contingencies<sup>d</sup></b>	<b>0.00</b>	<b>5.14</b>	<b>5.14</b>
<b>C. Financing Charges During Implementation<sup>e</sup></b>	<b>0.90</b>	<b>2.50</b>	<b>3.40</b>
<b>Total (A+B+C)</b>	<b>61.00</b>	<b>67.84</b>	<b>128.84</b>

<sup>a</sup> Refers to the net amount of the current project as changed. Includes taxes and duties of \$5.6 million financed from government resources.

<sup>b</sup> Includes taxes and duties of \$7.4 million to be financed from government resources by cash contribution and the Asian Development Bank (ADB). The amount of taxes and duties (i) is within the reasonable threshold identified during the country partnership strategy preparation process, (ii) does not represent an excessive share of the project investment plan, and (iii) will only be financed in respect of ADB-financed expenditures. Financing taxes and duties is material and relevant to the success of the overall project.

<sup>c</sup> In mid-2016 prices.

<sup>d</sup> Physical contingencies computed at 2.0%–3.0% for civil works equipment and consulting services; and 3.0% for consulting services. Price contingencies computed at 1.4%–1.5% on foreign exchange costs and 5.2%–6.5% on local currency costs; includes provision for potential exchange rate fluctuation under the assumption of a purchasing power parity exchange rate.

<sup>e</sup> Interest during construction for the ADB loan has been computed at 2.0% per annum.

Source: Asian Development Bank estimates.

15. The government has requested a loan in various currencies equivalent to SDR43,305,000 (\$60,000,000 equivalent) from ADB's Special Funds resources to help finance the project. The loan will have a 25-year term, including a grace period of 5 years, an interest rate of 2.0% per annum during the grace period and thereafter, and such other terms and conditions set forth in the draft loan agreement. The loan will finance civil works, consulting services, incremental recurrent costs, local transport and insurance costs, bank charges, and interest during construction on the loan.<sup>19</sup> The government will contribute \$7.84 million to cover (i) taxes and duties, (ii) part of contingencies, and (iii) environmental and social mitigation costs,

government information center templates, (x) application form process, (xi) rates rationalization, (xii) revised notice of assessment, and (xiii) common tendering process.

<sup>18</sup> Project Administration Manual (accessible from the list of linked documents in Appendix 2).

<sup>19</sup> Interest during construction will be capitalized and charged to the ADB loan.

which include administration costs for environmental clearance and costs for land acquisition and resettlement. The government has assured that it will meet any financing shortfall to ensure that project outputs are fully implemented.

16. The financing plan is provided in Table 2.

**Table 2: Financing Plan**

Source	Current <sup>a</sup>		Additional Financing		Total	
	Amount (\$ million)	Share of Total (%)	Amount (\$ million)	Share of Total (%)	Amount (\$ million)	Share of Total (%)
Asian Development Bank						
Special Funds resources (loan)	52.37	85.90	60.00	88.40	112.37	87.20
Government	8.63	14.10	7.84	11.60	16.47	12.80
<b>Total</b>	<b>61.00</b>	<b>100.00</b>	<b>67.84</b>	<b>100.00</b>	<b>128.84</b>	<b>100.00</b>

<sup>a</sup> Refers to the net amount of the current project.

Source: Asian Development Bank estimates.

## E. Implementation Arrangements

17. MPCLG will continue to be the executing agency, through its existing project management unit (PMU), supported by the project management consultant and the design and supervision consultants. Subproject coordination units (SPCUs) under the provincial councils of seven provinces will also continue to function as the implementation units at the provincial level.<sup>20</sup> Provincial councils will implement all subprojects under outputs 1 and 2 under the additional financing. NWSDB will prepare detailed designs, and provide technical assistance and supervision to the subprojects under output 1, for which it will assume O&M responsibility. It will also be represented in the procurement committee and technical bid evaluation committee of these subprojects. The close involvement of NWSDB will ensure technically sound design, implementation, and operation. For output 2, the PMU, through the design and supervision consultants, will support detailed design preparation and ensure work quality. *Pradeshya Sabhas* will manage the assets built under output 2, as is the case for the current project. All procurement of goods and civil works will follow ADB's Procurement Guidelines (2015, as amended from time to time), and consulting services will be engaged using ADB's Guidelines on the Use of Consultants (2013, as amended from time to time). The implementation arrangements are summarized in Table 3 and described in detail in the PAM (footnote 18). For both outputs 1 and 2, only the subprojects that meet the subproject selection criteria detailed in the PAM will be implemented.

**Table 3: Implementation Arrangements**

Aspects	Arrangements
Implementation period	October 2016–December 2019
Estimated completion date	31 December 2019 (loan closing date is 30 June 2020)
<b>Management</b>	
(i) Oversight body	National Steering Committee consists of Secretary of MPCLG (Chair); members: Senior Members of MPCLG, Ministry of Finance, Ministry of National Policies and Economic Affairs [External Resources Department, National Planning Department, Department of Project Management and Monitoring, and National Budget Department], Ministry of Health and Indigenous Medicine, National Physical Planning Department, Finance Commission, Provincial chief secretaries, Urban Development Authority, National Water Supply and Drainage Board, Central Environmental Authority, National Solid Waste Management Support Center,

<sup>20</sup> There will be no infrastructure improvement subprojects (outputs 1 and 2) in Sabaragamuwa Province. Its SPCU, after rationalizing its staff, will support output 3 only.

Aspects	Arrangements		
	Presidential Task Force on Prevention of Chronic Kidney Disease, provincial project directors, and project director [member secretary]); Provincial Steering Committee consists of the Provincial Chief Secretary (chair), Senior officials of National Water Supply and Drainage Board, Central Environmental Authority, Urban Development Authority, secretary of the provincial local government ministry, Provincial Director of Health Services and subproject coordination unit.		
(ii) Executing agency	MPCLG		
(iii) Key implementing agencies	Provincial councils		
(iv) Implementation unit	Project management unit in Colombo, subproject coordination units in provincial capitals of seven provinces		
Procurement	National competitive bidding	60 contracts	\$52 million
Consulting services	Quality- and cost-based selection	36 person-months	\$0.3 million
	Single-source selection <sup>a</sup>	561 person-months (537 national and 24 international)	\$3.0 million
	Individual consultant selection	114 person-months	\$0.2 million
Retroactive financing and/or advance contracting	Advance contracting will be used for procurement of works and recruitment of consultants. Retroactive financing is allowed for expenditures for works, goods, and services incurred prior to the loan effective date but no earlier than 12 months before the loan signing date, and not exceeding 20% of the loan amount.		
Disbursement	The loan proceeds will be disbursed in accordance with the Asian Development Bank's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and detailed arrangements agreed upon between the government and the Asian Development Bank.		

MPCLG = Ministry of Provincial Councils and Local Government.

<sup>a</sup> Approved by the procurement committee of MPCLG, the present consultants who have demonstrated satisfactory performance will be continued as the additional financing project is continuing with the original project activities.

Source: Asian Development Bank.

### III. DUE DILIGENCE

#### A. Technical

18. NWSDB will be responsible for design and supervision of most water supply schemes in CKD-affected areas, as well as O&M of the schemes. These subprojects are technically straightforward and within the existing capacity of NWSDB. Technical viability has been confirmed for four water supply schemes in the North Central and North Western provinces, and will be confirmed for the remaining schemes during subproject preparation. As in the current project, the technical viability of subprojects under output 2 will be confirmed during feasibility studies, with due consideration of local capacity to undertake O&M.

#### B. Economic and Financial

19. **Economic analysis.** The government identified water supply subprojects under output 1. Subprojects under output 2 will be selected through a participatory consultation process. The economic analysis was carried out for two sample water supply subprojects, chosen from among the identified subprojects in the North Central Province, and for which detailed designs have already been completed: an extension of the distribution network in Bendiwewa and capacity enhancement of the Minneriya water treatment plant. The estimated economic internal rates of return of the two sample subprojects range from 16.4% to 23.0%, higher than the economic opportunity cost of capital (estimated at 12.0%), indicating sufficient economic return. The results of the sensitivity analysis are also satisfactory (except when all downside risks are combined), against (i) capital costs overrun of 20%, (ii) O&M costs overrun of 20%, (iii) benefit decrease of 20%, and (iv) 1-year implementation delay.

20. **Financial analysis.** Some subprojects expected under output 2—such as roads, bridges, and drainage improvements—do not generate cash revenues, while water supply subprojects under output 1 do generate cash revenues. Therefore, a financial analysis was conducted for two sample representative water supply subprojects under output 1. The financial internal rates of return were estimated at 4.4% for the network extension in Bendiwewa and 7.8% for the capacity enhancement of the Minneriya water treatment plant, higher than the weighted average cost of capital of 2.8%, indicating sufficient financial return. The results for both subprojects are also satisfactory against downside risks, including (i) 10% increase in capital expenditure, (ii) 10% increase in O&M costs, (iii) 10% decrease in revenues, and (iv) a 1-year implementation delay. All water supply subprojects under output 1 are expected to be financially viable as a result of a 25% water tariff increase every 3 years, and 100% grant funding for the capital cost. Moreover, confirming the financial viability of revenue-generating subprojects under outputs 1 and 2 is one of the subproject selection criteria. For nonrevenue-generating subprojects under output 2, the PMU will assess the capacity and commitment of local authorities to allocate adequate O&M funding to sustain service delivery when it reviews the subproject request from local authorities.

### C. Governance

21. Project-specific governance risks were identified through the financial management assessment of MPCLG, provincial councils, *Pradeshiya Sabhas*, and NWSDB.<sup>21</sup> All entities are established organizations with appropriate accounting, reporting, internal control, and audit mechanisms. Based on the assessment, the overall fiduciary risk is considered moderate, and the proposed risk-mitigating actions include (i) strengthening the internal audit divisions by recruiting new staff in provincial councils and providing adequate training with the support of MPCLG; and (ii) procurement of an appropriate accounting package, and training staff in provincial councils on use of the package. The current project has implemented capacity-building programs, including the development of financial accounting and asset-management systems of *Pradeshiya Sabhas*. The additional financing will provide further support for improving the financial management capacity of entities concerned.

22. An updated procurement assessment confirmed that the MPCLG has a sound procurement system in line with ADB guidelines. The procurement system is accountable and transparent, and the overall procurement risk is low. The PMU and the SPCUs have experience in procurement in accordance with ADB requirements and have a satisfactory track record. Procurement for civil works and equipment will be handled either at the central or at the provincial level to reduce procurement risks, as the PMU and SPCUs have higher capacity and more experience than do local authorities. Transparency in procurement, financing, and other matters will be maximized under the project through such measures as development by the PMU of a website to disclose project information and thereby reduce corruption risk and improve governance. Implementation of reform plans by local authorities will improve governance, through measures such as enhancing citizens' participation, improving financial management, and establishing a grievance redress mechanism (GRM), as proven in the current project.

23. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government. The specific policy requirements and supplementary measures are described in the PAM.

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<sup>21</sup> Financial Management Assessment (accessible from the list of linked documents in Appendix 2).

## D. Poverty and Social

24. The project is classified as *effective gender mainstreaming*. While Sri Lanka has a good track record in gender equality, and in particular in education and health, many women are disadvantaged owing to poor roads, water supply, sanitation, and other public services, particularly in less-developed areas of the country. Limited access to safe drinking water requires household members, primarily women and children, to spend considerable time and effort on fetching water. Inadequate and poor-quality roads limit access by poor communities to markets, health care centers, and schools, and create safety and security issues for women and girls. Subprojects implemented under the current project addressed the immediate needs of these communities, including women. Construction of maternity centers and day care centers directly benefited women, and improvement of water supply systems eased the workload of women in fetching water. Under the additional financing, all local authority facilities, including libraries, public markets, and health care centers, will have a separate toilet for women and for the disabled, as in the current project. More than 100,000 women will receive treated water that meets drinking water quality standards. An updated gender action plan will ensure that the inclusive and participatory approach will be followed to address the needs of women and socially marginalized groups. Resources are allocated for the implementation and monitoring of the gender action plan.

## E. Safeguards

25. The safeguard categories are the same as for the current project: category B for the environment, involuntary resettlement, and indigenous peoples. Compliance with safeguard requirements in the current project has been satisfactory and risks well-managed. The project-specific GRM has been established and functional, with no pending grievance cases reported.<sup>22</sup> The additional financing will have no significant impacts on the environment, involuntary resettlement, and indigenous peoples, as subprojects with significant impacts will be excluded in accordance with the subproject selection criteria. The environmental assessment and review framework, resettlement framework, and indigenous peoples planning framework prepared for the current project were updated to provide guidance in screening, categorizing, and preparing subprojects, and for impact mitigation planning in the event unanticipated environmental, resettlement, and/or indigenous peoples impacts arise during implementation. Three initial environmental examinations (IEEs) with environmental management plans prepared for sample subprojects confirmed there were no significant environmental impacts, because the subprojects are small in scale, with very limited impacts. Subproject sites are located outside sensitive areas, and any impacts during construction and operation can be avoided and/or mitigated through proper design and high-quality construction and O&M practices. IEEs will form part of the bidding and contract documents and will be submitted to ADB for review, no objection, and disclosure prior to contract awards. Due diligence reports on land acquisition and resettlement were prepared for the same three sample subprojects to confirm there are no impacts on involuntary resettlement and indigenous peoples. Consultation and public participation will continue throughout project implementation, and any safeguard-related grievances will be handled in accordance with the existing GRM. The three framework documents, IEEs, and due diligence reports were disclosed on ADB and MPCLG websites. The project has developed institutional capacity on safeguards, with safeguard managers in place in PMU and SPCUs, supported by specialists in project management and design, and supervision. The semiannual safeguard monitoring reports will be submitted and disclosed on ADB website.

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<sup>22</sup> A total of nine grievance cases were recorded, and all cases have been satisfactorily resolved.

## F. Risks and Mitigating Measures

26. Major risks and mitigating measures are summarized in Table 4 and are described in detail in the risk assessment and risk management plan.<sup>23</sup> Intended benefits are expected to outweigh costs.

**Table 4: Summary of Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigating Measures</b>
Audits by the Auditor General's Department are delayed.	ADB's Sri Lanka Resident Mission is engaged in ongoing dialogue with the Auditor General's Department to undertake audits on time. Both the PMU and the SPCUs have experience with ADB-funded projects. Strengthening the internal audit divisions and training; and Procure appropriate accounting package and train staff
Amendments to acts and ordinances governing the local government are not approved as planned and in a timely manner.	The government constituted a committee to study all pending amendments, including the ones recommended under ADB's capacity development technical assistance associated with the current project, and propose final draft amendments to enhance democratic governance. Follow-on advisory support will be provided under output 3, if required. Policy dialogue with the MPCLG will continue.
Change in leadership in local authorities may derail reform plan implementation.	Each reform plan requires local authority approval through a council resolution. The PMU and SPCUs will closely monitor the implementation of reform plans. The successful implementation of reforms under the reform plans is a key factor in determining budgetary support for local authorities.

ADB = Asian Development Bank, MPCLG = Ministry of Provincial Councils and Local Government, PMU = project management unit, SPCU = subproject coordination unit.

Source: Asian Development Bank.

## IV. ASSURANCES

27. The government has assured ADB that implementation of the project shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and loan documents.

28. The government has agreed with ADB on certain covenants for the project, which are set forth in the loan agreement.

## V. RECOMMENDATION

29. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan in various currencies equivalent to SDR43,305,000 to the Democratic Socialist Republic of Sri Lanka for the additional financing of the Local Government Enhancement Sector Project, from ADB's Special Funds resources, with an interest charge at the rate of 2.0% per annum during the grace period and thereafter for a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao  
President

5 September 2016

<sup>23</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

## REVISED DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned with			
<b>Current project</b> Local authorities' capacity financially and technically strengthened in less-developed areas of seven provinces in Sri Lanka (defined by project). <b>Overall project</b> Unchanged			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
<b>Outcome</b> <b>Current project</b> Improved local infrastructure and services delivered effectively by local authorities in less-developed areas of seven provinces in Sri Lanka.  <b>Overall project</b> Improved local infrastructure and services delivered effectively by local authorities or the National Water Supply and Drainage Board in less-developed areas of seven provinces in Sri Lanka.	<b>Current project</b> By the end of the project (2016): a. Travel time to markets is reduced by 20% on average in local authorities implementing road subprojects (2011 baseline: 27 minutes in the sample local authorities). <sup>a</sup>  b. Population served by piped water systems increased by 20% on average in local authorities implementing water supply subprojects (2011 baseline: 27% in sample local authorities). <sup>a</sup>  c. New systems and processes introduced for taxation, licensing, and approval as a result of business process reengineering (2011 baseline: old and inefficient systems).  d. Final accounts of participating local authorities are audited within 6 months of the end of fiscal year (2011 baseline: delay in preparation of final accounts and audits).  <b>Overall project</b> By the end of the project (2020): a. to d. Unchanged  e. Drinking water that meets quality standards benefited 200,000 people (100,000 women) in CKD-affected areas.	a. Project-specific evaluation survey at the completion of each road subproject  b. Project-specific evaluation survey at the completion of each water supply subproject  c. Project quarterly progress reports and one completion report issued by MPCLG  d. Annual audit reports issued by the Auditor General's Department  e. Project quarterly progress reports and one completion report for each subproject and total project issued by MPCLG	Audits by the Auditor General's Department are delayed.
<b>Outputs</b>  <b>Output 1</b> <b>Current project</b> None	<b>Current project</b> None	<b>For all output indicators:</b> Project quarterly progress	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
		reports and one completion report for each subproject and total project issued by MPCLG	
<b>Overall project</b> 1. Water supply systems in CKD-affected areas improved <sup>b</sup>	<b>Overall project</b> By the end of the project (2019): 1a. 40,000 new household connections (including 90,000 women) provided in CKD-affected areas. (Baseline: 0)  1b. 800 km of water distribution network laid. (Baseline: 0)		
<b>Output 2</b> <b>Current project</b> 2. Local infrastructure and basic services delivery improved	<b>Current project</b> By the end of the project (2016): 2a. Improved water supply schemes in 10 local authorities (6,000 households newly served).  2b. Improved solid waste management systems, including composting in 40 local authorities.  2c. Constructed or improved 15 km of local roads.  2d. Constructed or improved 25 public primary health care facilities.  2e. Constructed or improved 40 public markets  2f. Local authorities have implemented subprojects particularly benefiting women, such as maternity centers.  2g. Public facilities financed by the project have separate toilets for men and women.  2h. Women representation in the planning committee of local authorities in 50% of participating local authorities.		
<b>Overall project</b> Unchanged	<b>Overall project</b> By the end of the project (2019): 2a. Improved water supply schemes in 10 local authorities (6,000 households including 14,000 women newly served).		



Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	<p>2b. Improved solid waste management systems, including composting in 50 local authorities.</p> <p>2c. Constructed or improved 25 km of local roads.</p> <p>2d. Constructed or improved 30 public primary health care facilities.</p> <p>2e. Constructed or improved 45 public markets.</p> <p>2f. Unchanged.</p> <p>2g. Unchanged.</p> <p>2h. Women representation in the planning committee of local authorities in 95% of participating local authorities (2016 baseline: 75%).</p>		
<p><b>Output 3</b> <b>Current project</b> 3. Local government policy reform advanced and capacity strengthened</p> <p><b>Overall project</b> Unchanged</p>	<p><b>Current project</b> By the end of the project (2016):</p> <p>3a. Bylaws and regulations are prepared in accordance with the amendments of acts and ordinances related to the local government (2011 baseline: No bylaws and regulations).</p> <p>3b. Bottlenecks in current tax, licensing, and approval systems of local governments are analyzed and necessary improvements proposed (2011 baseline: old system).</p> <p>3c. Information technology system is developed, including the updating and computerization of databases on taxes, licenses, and financial accounting; and an asset management system in select local authorities in seven provinces (2011 baseline: manual system).</p> <p><b>Overall project</b> By the end of the project (2019):</p> <p>3a. Unchanged.</p> <p>3b. Bottlenecks in current tax, licensing, and approval systems of local governments</p>		<p>Amendments to acts and ordinances governing the local government are not approved as planned and in a timely manner.</p>

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	<p>are analyzed and training provided to 140 local authorities (2011 baseline: old system; no local authorities trained).</p> <p>3c. Unchanged.</p> <p>3d. 80% of actions in reform plans implemented in 75% of the project local authorities (2016 baseline: No reform plans in additional local authorities).</p> <p>3e. Sex-disaggregated data pertaining to project activities are collected and reflected in the project performance management system (baseline: No sex-disaggregated data collected).</p>		<p>Change in leadership in local authorities may derail reform plan implementation.</p>
<p><b>Key Activities with Milestones</b></p> <ol style="list-style-type: none"> <li>1. <b>Water supply systems in CKD-affected areas improved.</b> <ol style="list-style-type: none"> <li>1.1 Screening and selection of subprojects (Q1 2016) (changed).</li> <li>1.2 Subproject financial and economic analysis and safeguard reports (Q4 2016) (changed).</li> <li>1.3 Complete detailed design and bid documents (Q4 2016) (changed).</li> <li>1.4 Bidding and contract award (Q2 2017) (changed).</li> <li>1.5 Complete construction works (Q4 2019) (changed).</li> </ol> </li> <li>2. <b>Local infrastructure and basic services delivery improved.</b> <ol style="list-style-type: none"> <li>2.1 Participating new local authorities make a reform plan and identify priority subprojects (Q2 2016) (changed).</li> <li>2.2 SPCUs and PMU review reform plans and subprojects (Q3 2016) (changed).</li> <li>2.3 Public consultation, identification and finalization of new projects (Q2 2016) (unchanged).</li> <li>2.4 Review and approval of subprojects by SPCU/PMU (Q3 2016) (unchanged).</li> <li>2.5 Undertake feasibility and safeguard analysis (Q4 2016) (unchanged).</li> <li>2.6 Complete detailed design and bid documents (Q4 2016) (changed).</li> <li>2.7 Bidding and award of all works (Q2 2017) (changed).</li> <li>2.8 Complete construction works (Q4 2018) (changed).</li> </ol> </li> <li>3. <b>Local government policy reform advanced and capacity strengthened.</b> <ol style="list-style-type: none"> <li>3.1 Support reform plan implementation (Q2 2019) (changed).</li> <li>3.2 Develop and install information technology system (Q2 2019) (changed).</li> <li>3.3 Implement capacity development programs for MPCLG, provincial councils, and local authorities (Q2 2019) (changed).</li> </ol> </li> </ol> <p><b>Project Management Activities</b>  PMU and SPCUs fully staffed.  Engaged consultants and contractors.  Implemented gender action plan.  Undertaken project-specific evaluation survey.</p>			

<b>Inputs</b>	
<b>Loan</b>	<b>Technical Assistance Grant</b>
<b>ADB</b>	<b>ADB</b>
\$52.37 million (current)	\$540,000 (current)
\$60 million (additional)	\$0 (additional)
\$112.37 million (overall)	\$540,000 (overall)
<b>Government</b>	<b>Government</b>
\$8.63 million (current)	\$100,000 (current)
\$7.84 million (additional)	\$0 (additional)
\$16.47 million (overall)	\$100,000 (overall)
<b>Assumptions for Partner Financing</b>	
<b>Current project</b>	
Not applicable	
<b>Overall project</b>	
Unchanged	

ADB = Asian Development Bank, CKD = chronic kidney disease, km = kilometer, MPCLG = Ministry of Provincial Councils and Local Government, PMU = project management unit, Q = quarter, SPCU = subproject coordination unit.

<sup>a</sup> Baseline survey of 1,000 households in 10 local authorities were undertaken under the current project preparatory technical assistance. ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Local Government Enhancement Sector Project*. Manila (TA 7877).

<sup>b</sup> New output 1 scales up activities that are under output 2 (performance indicator 2[a]) of the current project.

Source: Asian Development Bank.

### **LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/RRPs/?id=42459-014-3>

1. Loan Agreement: Special Operations
2. Sector Assessment (Summary): Water and Other Urban Infrastructure and Services
3. Project Administration Manual
4. Summary of Project Performance
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Financial Analysis
8. Economic Analysis
9. Country Economic Indicators
10. Summary Poverty Reduction and Social Strategy
11. Gender Action Plan
12. Initial Environmental Examination: Uththupitiya Water Supply Subproject
13. Initial Environmental Examination: Bendiwewa Water Supply Subproject
14. Initial Environmental Examination: Capacity Improvement of Minneriya Water Treatment Plant Subproject
15. Environmental Assessment and Review Framework
16. Resettlement Framework
17. Indigenous Peoples Planning Framework
18. Risk Assessment and Risk Management Plan

### **Supplementary Documents**

19. Local Authority and Subproject Selection Criteria
20. Financial Management Assessment
21. Project Climate Risk Assessment and Management Report