

January 2014

Pilot Financing Instruments and Modalities: Proposed Extension of Pilot Period for the Project Design Facility with Modifications

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
COBP	–	country operations business plan
DMC	–	developing member country
OCR	–	ordinary capital resources
PDA	–	project design advance
PDF	–	project design facility
PPP	–	public–private partnership
RCOBP	–	regional cooperation operations business plan
TA	–	technical assistance

NOTE

In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. This paper seeks the approval of the Asian Development Bank (ADB) Board of Directors to extend the pilot period of the project design facility (PDF), with modifications, until 31 December 2017.

2. In 2011, the Board approved the PDF on a pilot basis for an initial period from 12 April 2011 to 31 December 2013. The PDF was established with a commitment authority of \$150 million.¹ A review of the PDF indicates that the PDF could offer a useful complement to other ADB financing modalities but that implementation issues impede its greater use. This paper therefore proposes to extend the pilot period of the PDF with a few modifications to address these issues. Before the extended pilot phase expires, ADB Management will report to the Board on the results achieved, and propose whether the PDF should be mainstreamed, further revised, or discontinued.

II. BACKGROUND

A. Improving Project Readiness and Cost Estimates

3. The PDF resulted from the 2009 comprehensive review of ADB business processes to improve ADB's client responsiveness and results orientation.² The review found that, for most infrastructure projects, the ADB loan typically finances the detailed engineering design, which commences late in the project cycle, and that this adversely affects project development and implementation.

4. Firstly, the detailed engineering design often commences upon loan effectiveness. In these cases, there is a significant time lag between the approval of a loan and the date that a contract can be awarded and construction and disbursements can commence. Secondly, in the absence of detailed engineering design, cost estimates at the time of Board approval are rough and based only on feasibility studies. This encourages the inclusion of large contingencies in project proposals, which leads to an inefficient use of ADB and developing member country (DMC) resources.³

B. The Project Design Facility

5. The PDF was developed to provide a new financing modality to support project preparation, particularly detailed engineering design.⁴ A project design advance (PDA) from the

¹ ADB. 2011. *Establishing the Project Design Facility*. Manila. [http://lnadbg1.asiandevbank.org/sec0023p.nsf/00000000000000000000000000000000/744003b90648ee5648257bab00054916/\\$file/r50-11.pdf](http://lnadbg1.asiandevbank.org/sec0023p.nsf/00000000000000000000000000000000/744003b90648ee5648257bab00054916/$file/r50-11.pdf). Use of the PDF in each DMC is financed from ADB's indicative resource allocation to the DMC concerned.

² Mandated by Strategy 2020 and the Asian Development Fund X Implementation Plan, business process reforms aim to improve ADB's responsiveness to developing member country clients and strengthen ADB's results orientation. Based on the recommendations of the 2009 review, ADB completed comprehensive reforms that resulted in the phased implementation of the streamlined business processes from January 2010.

³ In some cases, project cost estimates completed after the detailed engineering design are much larger than those in the original feasibility study. This causes further delays in project implementation and additional costs to the DMC, as the viability of the project must be reassessed and additional resources mobilized.

⁴ The PDF complements other ADB modalities that help finance project preparation, including detailed engineering design. These include (i) TA loans or (ii) an earlier loan that finances the preparation of subsequent loans, such as in the case tranches of a multitranche financing facility. DMCs may also request retroactive financing from a subsequent loan to finance project preparation costs, including detailed engineering design. Note, project preparatory TA (PPTA) may not be used to finance detailed engineering design unless financed by a cofinancier.

PDF provides quick-disbursing resources for project formulation and development, primarily for detailed engineering design. The PDA can also finance broader project and program preparatory work (e.g., feasibility studies, due diligence, preliminary designs, safeguard and pre-implementation work), including those for policy-based lending and nonsovereign operations; and transaction advisory services for public–private partnerships (PPPs).

6. The PDA will be repaid from the ensuing project or program loan, on terms based on the prospective financing source of the ensuing project or program, to be guided by the borrowing status of the DMC⁵ at the time of PDA approval.⁶

C. Pilot Status and Reasons for Minimal Uptake

7. While an indicative pipeline for PDF use was available at the time of PDF approval, to date only one project—the Bangladesh Coastal Towns Infrastructure Improvement Project—has used a PDA for \$3.5 million.⁷ The reasons behind the minimal uptake of the PDF are detailed in paras. 8–11.

8. **Legislative and regulatory hurdles.** In some DMCs, legislation, regulations, and rules impose onerous PDA processing requirements. A PDA is viewed as a separate loan, triggering loan review processes that may include parliamentary approval—in effect, requiring duplicative approval for the same loan. Some DMCs restrict the use of borrowings for design prior to the approval of project financing.

9. **Limited familiarity with the instrument.** Limited familiarity of ADB staff and DMCs with the PDF undermines demand. Use of a new financing modality requires staff to take the time to understand how the modality works and to develop DMC ownership. Furthermore, a review of the experience with PDF so far indicates that its scope has been construed too narrowly. It should be clarified that the PDF not only finances detailed engineering design but can generally support activities aimed at increasing project readiness.⁸

10. **Project design facility design constraints.** The PDF does not adequately address the cost of detailed designs; this has discouraged its use. The original ceiling for an individual PDA was set at \$5 million or 1% of the estimated cost, whichever is larger, of the ensuing loan from ADB's ordinary capital resources (OCR) or Special Funds resources.⁹ Consultations with operations departments highlight that this ceiling is too low, especially for large or complex infrastructure investment projects.

11. The average cost of preparing standard detailed engineering designs comprises 3%–4% of overall project costs. Project preparation for complex projects (including PPPs)

⁵ The borrowing status comprises the country classifications under the Graduation Policy and debt distress classification under the ADF Grant Framework. ADB. 2013. Classification and Graduation of Developing Member Countries. *Operations Manual*. OM A1/BP. Manila; ADB. 2013. Performance-Based Allocation of Asian Development Fund Resources. *Operations Manual*. OM A3/BP. Manila.

⁶ PDA grants do not need to be repaid.

⁷ ADB. 2012. *Project Design Advance: Bangladesh—Coastal Towns Infrastructure Improvement Project*. Manila (Project Number 44212).

⁸ This includes the possibility to engage consulting services for a period longer than the initial PDA period and to use proceeds from the ensuing loan to continue financing these consulting services, e.g. for construction supervision.

⁹ While this Board paper discusses PDAs and ensuing loans mainly in the context of OCR and ADF resources, a PDA and ensuing loan can also be financed from other Special Funds resources than ADF.

generally cost about 5% of the total project investment and can increase to 10% in some cases.¹⁰

D. Rationale for Pilot Extension

12. Several DMCs are considering using the PDF to finance project preparation, pending approval of the extension of the PDF pilot and proposed modifications.¹¹ Greater use of the PDF will help DMCs better design projects, thereby improving project planning, financing, and implementation efficiency. The PDF will help address project performance concerns raised in the 2012 Development Effectiveness Review and the 2012 Annual Portfolio Performance Report.¹² ADB is increasing efforts to help DMCs achieve better project outcomes by: (i) reviewing and improving ADB modalities, including the PDF, to strengthen project readiness, and (ii) more rigorously monitoring project performance and proactively addressing implementation issues as they arise.

13. ADB has also embarked on an ambitious PPP program, setting a target of 50 PPP transactions through 2016.¹³ The PDF can be an important source of financing to prepare these transactions as better prepared projects will help DMCs attract private sector participation. Traditional TA resources are limited to support development of such transactions.

14. Section III sets out design modifications for the PDF that are aimed at addressing some of the constraints identified in Section II above and at increasing uptake during the extended pilot period. To address the limited familiarity with the PDF, ADB will take further initiatives to improve awareness of PDF benefits, to clarify its scope, and to identify and address possible other constraints to its use.¹⁴

III. PROPOSED MODIFICATIONS TO THE PROJECT DESIGN FACILITY

A. PDA Master Agreement

15. ADB will attempt to alleviate the concerns of DMCs that experience legislative and regulatory hurdles in processing individual PDAs by introducing the concept of a master agreement for PDAs. This PDA master agreement will not commit a DMC to request a PDA or ADB to provide a PDA. Instead, it will set out the general framework within which a DMC may avail of PDAs and the general terms and conditions that apply each time that ADB provides a PDA to the DMC. The master agreement will specify the maximum aggregate amount of PDAs that the DMC may request. The PDA master agreement would clarify the DMC's plans to use the PDA for future ADB projects and programs as identified in the rolling country operations business plan (COBP) or the regional cooperation operations business plan (ROBP) with an

¹⁰ 2011. *Infrastructure Action Plan*. Submission to the G20 by the MDB Working Group on Infrastructure. http://www.boell.org/downloads/MDBs_Infrastructure_Action_Plan.pdf

¹¹ Discussions are ongoing in Bangladesh, India, Pakistan, Papua New Guinea, and Sri Lanka.

¹² ADB. 2013. *Development Effectiveness Review 2012 Report*. Manila; ADB. 2013. *2012 Annual Portfolio Performance Report*. Manila.

¹³ ADB. 2012. *Review of the ADB Results Framework*. Manila (page vii, level 3, indicator 12).

¹⁴ For example, a comprehensive training program for ADB staff on project finance that will highlight the benefits of the PDF in improving development effectiveness is being developed along with a related awareness programs for DMCs, complemented by support from project officers familiar with the PDA to provide hands on training during project preparation.

indicative amount (overall and for each proposed PDA).¹⁵ Once a DMC requests and ADB approves, a PDA under the master agreement, the DMC can avail of the PDA upon the execution of a short form letter agreement for which a format will be attached to the master agreement.

16. It is envisaged that this type of master agreement could offer relevant DMCs sufficient basis to seek a one-off approval under its regular loan approval procedures for PDAs up to the maximum aggregate amount set out in the master agreement, and that, as part of this approval process, the DMC will delegate the further processing of such PDAs to relevant executing and implementing agencies. The pilot period will serve to explore whether this concept will work to make the PDF more viable.

17. The use of a master agreement is optional. ADB can continue to provide PDAs on a stand-alone basis to those DMCs that do not wish to avail of a master agreement. Each PDA requires approval of ADB Management, regardless whether or not ADB has entered into a PDA master agreement with the DMC concerned.

B. Ceiling Amount

18. To better reflect the cost of detailed engineering designs, it is proposed that the maximum aggregate amount for PDAs for a single ensuing project is increased to \$10 million or 4% of the estimated cost of the ensuing OCR or Asian Development Fund (ADF) loan, whichever is larger. With appropriate justification and provided that prior no-objection from the ADB Board has been obtained,¹⁶ Management may approve an amount of PDAs for a single ensuing project in excess of this ceiling.

C. Repayment Terms

19. The PDA implementation period is estimated at 2 years, at which time the related project or program loan should have been processed. Some DMCs have raised issues with the imposition of commitment charges, which they associate with a separate lending instrument and have requested ADB to initially waive such charges. To encourage PDF use and in view of the fact that such charges are minimal for the initial two year period of the PDA, it is thus proposed to waive these commitment charges for a period of 2 years from PDA signing. If the ensuing loan does not materialize after 2 years from PDA signing, commitment charges are applicable thereafter.

20. Other than this, the PDA carries standard interest and commitment charges applicable to OCR and ADF loans.¹⁷ In principle, a PDA is repaid by the proceeds of the ADB loan for the ensuing project or program. The payment of interest and commitment charges, where

¹⁵ At the request of a DMC, a PDA that was not included in the COBP or RCOBP can be processed exceptionally. However, in such a case, information on the envisaged PDA should be reported to the Board at least 21 calendar days before Management approval of the PDA.

¹⁶ The Board will be provided with 10 business days to object to any such proposal.

¹⁷ The PDA and ensuing loan constitute separate financing instruments. For OCR, this means that maturity premium will only apply to an ensuing loan, not to the PDA. For ADF, this means that the aggregate maturities and grace periods for the PDA and the ensuing loan combined will exceed the standard ADF loan terms while the maturity and grace period for a PDA alone will be shorter than those under the standard ADF loan terms. Given the low amounts involved, the terms and conditions for OCR-financed PDA will not include the conversion options available for regular OCR loans.

applicable, is deferred until the PDA is repaid from the loan proceeds or other repayment terms take effect.¹⁸

IV. CONCLUSION

21. PDF use would help DMCs ensure project readiness and improve project outcomes. Sound preparatory work is more likely to catalyze additional funds from other sources. PDF use will enable more robust cost estimates to address the challenges detailed in paras. 3–4. During the PDF pilot phase, staff instructions were developed for processing the PDF and Management approved one PDA. Overall demand was low due to the PDF design, which did not effectively address DMC internal processing requirements, reflect the cost of detailed engineering design, and included less than optimal lending terms as compared with the counterfactual.

22. The proposed extension of the pilot period and modifications to the PDF to address the aforementioned concerns should encourage greater DMC demand for the PDF, while providing ADB with more experience for evaluating the suitability and effectiveness of the PDF in meeting DMC needs. It will provide ADB Management and the Board with a stronger basis to conclude whether, and on what terms, the PDF should be mainstreamed.

23. As stated in para. 2, the PDF was established with a commitment authority of \$150 million. In case PDF demand in the extended pilot period exceeds this amount, Management will request the Board to increase the amount of commitment authority.

V. RECOMMENDATION

24. The President recommends that the Board approve
- (i) the extension of the pilot period for the project design facility until 31 December 2017; and
 - (ii) the modifications to the project design facility, as described in paras. 15–20.

¹⁸ Appendix 1 to the original Board paper (cf. footnote 2) will be superseded by updated staff instructions incorporating the modifications proposed in this Board paper.