BRIEFING NOTE

Foregoing Competition to Secure Funding for Public Infrastructure

One third of funding secured was non-concessional

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Foregoing Competition to Secure Funding for Public Infrastructure

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Introduction

As Sri Lanka shifted to lower middle-income status and access to traditional concessional financing sources dwindled, the government sought new ways to fund its growing infrastructure needs following the conclusion of the nearly three-decade long civil conflict in 2009. At the time, export credit instruments emerged as a key alternative source of finance. However, these instruments often funded projects that required deviation from the competitive bidding process to select contractors. Furthermore, they often funded projects that originated as unsolicited proposals (USPs) from a contractor in the country of the lender and the loans frequently required the borrower to purchase goods and services, including the selection of the contractor, from the country of the lender. However, Sri Lanka's public procurement framework established in 2006 favoured competitive bidding and lacked provisions for accommodating USPs, and deviations from the competitive bidding process were only allowed in exceptional situations with Cabinet approval.

To overcome this obstacle, in 2010, Sri Lanka's Cabinet of Ministers approved an amendment to the country's procurement guidelines of 2006 by creating a special framework to permit deviations from the standard procurement process. The new framework enabled the procurement entities to forego competition when selecting the contractors. This framework assigned the Standing Cabinet Appointed Review Committee (SCARC) the task of reviewing USPs and recommending to the Cabinet of Ministers whether or not to proceed with projects that bypassed the standard competitive procurement process.[1] The new framework became operational in August 2010, and the guidelines for processing Unsolicited/Standalone Proposals (USPs) were issued in May 2011 through Supplement 23 to the procurement guidelines.[2] The SCARC functioned from 2010 to 2016 until it was repealed by Supplement 30 to the procurement guidelines in December 2016.[3]

The objective of this brief is to assess the level of concessionality of the funding secured via the special framework by foregoing competition. It does so by using two measures of concessionality. First, the criteria outlined in the special framework of 2010 to determine whether the funding to be secured was favourable compared to alternative funding sources. Second, the criteria used by international organisations such as the International Monetary Fund (IMF) to assess the concessionality of a loan.

This analysis was undertaken using the information provided by the Department of Public Finance (DPF) in response to a Right to Information (RTI) request filed by Verité Research. The alternative funding source used for comparison in this brief is the average borrowing rate of international sovereign bonds issued by Sri Lanka during this period.

[1] Department of Public Finance, 'Supplement 23 to the PROCUREMENT GUIDELINES PART II REFERENCE: 237', (2011), at https://www.treasury.gov.lk/api/file/5c891efb-a1cb-4098-aba5-4d4360a5cedb [Last accessed on 16 May 2022], Preamble.

[2] Supplement 30 to the Guidelines on Government Tender Procedure – Part II (December 2016), available at https://www.treasury.gov.lk/api/file/040fa3ab-2f79-4c7b-89ce-dfc48e550999, [Last accessed on 16 May 2022]

[3] For more information on this special framework please refer to previous Verité Research publication: Verité Research, 'The Lure of Chinese Loans', 2022, at https://www.veriteresearch.org/publication/the-lure-of-chinese-loans/, [Last accessed 15 June 2023].

Of the 48 projects approved by SCARC, Verité identified 20 projects as public sector-funded development projects. Detailed loan information was unavailable for two projects; thus, this analysis focuses on the 18 projects funded via 21 loans worth USD 3,416 million. (Refer Annex 1 for the list of the 48 projects approved by SCARC.)

Summary Findings

The analysis finds the following observations and implications of Sri Lanka's attempt to forego competition in procurement in order to secure funding at favourable terms:

1) A bulk of the funding (91%) secured by foregoing competition came from lending institutions in China. However, lending institutions in China were not alone in funding projects that originated as USPs. The remaining funds secured by SCARC came from lending institutions in six developed countries.
2) SCARC was set up to improve the evaluation of USPs to determine whether awarding contracts by foregoing a competitive bidding process was beneficial to the country. However, SCARC's evaluation criteria that determined the suitability of funding secured was weak. Further, in practice, SCARC frequently neglected its own guidelines as well as international benchmarks established to evaluate the concessionality of a loan.
    a. Eight loans secured by SCARC by foregoing competition did not even meet the minimum suitability criteria outlined in the special framework of 2010. These loans were from lending institutions in the Netherlands, Belgium, Spain, and Australia.
    b. Eleven loans accounting for 30% of the value of the funding secured by SCARC by foregoing competition did not meet the international benchmark of concessionality. These included three loans from China and the eight loans referred to above.
3) Foregoing competition in procurement risks increasing the cost of infrastructure projects. The public infrastructure procurement process should ideally uphold the competition principle to ensure that public money is well spent. The cost escalations that result from the lack of competition can be accommodated or even justified if the level of concessionality of the loan (measured by the grant element) is higher. However, the low levels of concessionality of some of the loans approved by the SCARC (for example, below 10%) suggest that the country may have been better off borrowing at commercial rates and going for competitive bids instead of taking loans that required it to forego competition in the bidding process.

Corruption and poor governance related to infrastructure procurement have been key concerns of the public for a considerable period. The recently signed IMF programme also highlighted that fixing governance is key to putting the country on a sustainable growth path. To prevent the potential mismanagement of public funds as highlighted in this research, the following two vulnerabilities in the procurement process need to be fixed. First is the ability of the Cabinet of Ministers to bypass procurement guidelines and introduce special frameworks that enable circumventing the competitive bidding process without parliamentary oversight. Second is the ability of the appointed committees to approve projects that do not meet the minimum criteria outlined in the governing framework without facing any adverse consequences.

Research Overview

Chinese lending institutions were not the only ones that backed unsolicited proposals.

The analysis revealed that of the 18 public sector development projects, eight projects were financed by Chinese lending institutions, and the remaining 10 projects were financed by lending institutions from six developed countries.

Of the projects funded by Chinese lending institutions, five were funded by the Export and Import Bank of China (EXIM China), and three by the China Development Bank (CDB). Of the projects funded by non-Chinese institutions, four were funded by Austrian lending institutions, two by Belgian institutions, and one each by institutions in Spain, the Netherlands, Australia, and France.

The size of the projects funded by Chinese lending institutions makes them far more visible when compared to others. While the total funds raised for these 18 projects amounted to USD 3,416 million, the eight projects from China accounted for 91% of this value. The remaining 9% accounted for ten projects funded by lending institutions from the six other countries.

These findings indicate that a bulk of the funding secured by foregoing competition came from Chinese lending institutions (91%), but that they were not alone in funding projects that originated as unsolicited proposals.

The special framework failed to weed out non-concessional funding in its evaluation of unsolicited proposals.

According to Public Finance Circular 444, a primary rationale motivating the creation of the SCARC to forego competitive bidding and award contracts to entities that submitted USPs was to take advantage of the purportedly highly concessionary terms of the associated loans. However, the evaluation standards outlined in the special framework to determine whether the funding was concessional or not were far from ideal.

As per section (e) of Supplement 23, SCARC could consider the funding as suitable if the following two conditions were met: 1) a minimum repayment/maturity period of 15 years and, 2) a minimum grace period of 3 years.[4]

However, the concessionality of a loan cannot be judged purely on its duration of maturity and grace periods. The globally understood method of assessing the concessionality of a loan is the loan's grant element. The grant element is defined as the difference between the loan's nominal value (face value) and the sum of the discounted future debt-service payments to be made by the borrower (present value), expressed as a percentage of the loan's nominal value. A concessional loan is one where this grant element is positive. A positive grant element implies that the cost of servicing the loan is less than the cost of servicing a commercial loan of the same

[4] Department of Public Finance, 'Supplement 23 to the PROCUREMENT GUIDELINE PART II REFERENCE: 237', (2011), at https://www.treasury.gov.lk/api/file/5c891efb-a1cb-4098-aba5-4d4360a5cedb [Last accessed on 16 May 2022], Paragraph 3.3.

value. As per the IMF, the grant element should exceed a benchmark rate of 35% for a loan to be considered concessional.

Thus, a key shortcoming of the SCARC framework was its failure to incorporate the cost of borrowing or the grant element when determining loan suitability. Calculating the grant element is crucial for understanding a country's capacity to accommodate project cost escalations that often result from a lack of competition, particularly in the context of unsolicited proposals where cost escalations are prevalent.[5] The higher the grant element, the greater the capacity to accommodate cost escalations. For example, if a loan has a grant element of 10% and the project cost escalation compared to the total cost estimated is over 10%, the loan becomes effectively non-concessional. In such cases, the country may be better off securing a commercial loan to fund the project if it can raise funds at market rates and call for internationally competitive bids.[6]

This analysis was applied to assess the concessionality of 21 loans taken to fund the 18 projects under consideration in this research, both in terms of whether they met the standards applied by the SCARC based on the duration of the loans as well as the international standards of concessionality based on the grant element.

To assess the grant element of these 21 loans, a discount rate of 6.5% – that is, the commercial rate at which Sri Lanka could borrow during the period under consideration – was applied. The calculation revealed that 11 of the loans were non-concessional based on international standards, i.e., the grant element of these loans was below 35%. These 11 loans amount to up to USD 1 bn and account for 30% of the total value of the 21 loans approved by SCARC.

Four of these loans had a grant element of between 5-10%: two of these were from lending intuitions in the Netherlands, one from Spain and one from China. Two of the loans from the China Development Bank (CDB) had a grant element below 5%. (Refer to Exhibit 1). These low grant elements are highly problematic as these projects originated as USPs and were to be awarded outside the competitive bidding process. As mentioned above, if the cost escalation that results from lack of competition exceeds 10%, the country would have been better off borrowing at commercial rates and going for competitive bids rather than taking these loans. For example, a study by Verité Research revealed that one of the CDB funded projects that originated as a USP and was approved by SCARC was awarded at a price 33.4% higher than the original total cost estimate and the grant element of the loan was only 3.6%. The project was Gampaha, Attanagalla, Minuwangoda Integrated Water Supply Scheme. The high-cost escalation compared to the grant element insinuates a high trade-off of choosing to forgo competition.[7]

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[5] A study by the OECD finds that such 'tied' loans can increase the costs of a development project by 15 to 30%. (Catrinus J. Jepma - OECD 'The tying of aid', 1991, page: 15, at https://www.oecd.org/dev/pgd/29412505.pdf, [last accessed 22 June 2020].

[6] For more information on assessing the concessionality of foreign loans please refer to previous Verité Research publication: Verité Research, 'Financing Infrastructure: The (non) Concessionality of Concessional Loans', 2020, at https://www.Veritéresearch.org/publication/financing-infrastructure-the-non-concessionality-of-concessional-loans/ . [last accessed 15 June 2023].

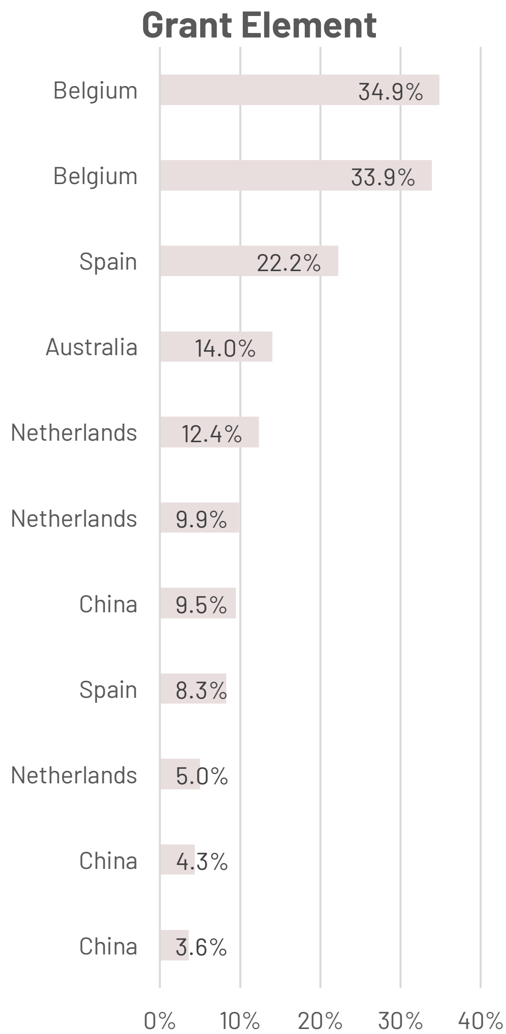
[7] Verité Research, 'The Lure of Chinese Loans', 2022, at https://www.veriteresearch.org/publication/the-lure-of-chinese-loans/. [Last accessed 15 June 2023].

Interestingly, the eight non-concessional loans that came from four of the developed country lending institutions did not even meet the conditions listed in the special framework of a 3-year grace period and a 15-year maturity period. While the three CDB loans did meet the SCARC'S duration criteria, albeit marginally (see Exhibit 1), they had significantly lower grant elements (i.e., low levels of concessionality), highlighting the shortcoming of the special framework's standard of assessing concessionality.

Exhibit 1:11 of the 21 loans with grant elements below 35%

The loans highlighted in red also failed to meet the concessionality criteria of the SCARC (i.e., 3-year grace period and 15-year maturity period).

Host Country	Lending Institution	Grace Period (yrs)	Mat urity (yrs)	Interest Rate
Belgium	KBC Bank of Belgium	3.5	10	1.20%
Belgium	Fortis Bank NV/Fortis Banque SA	3	12	0.80%
Spain	Banco Bilbao Vizcaya Argentaria S.A.	1.9	10	Euribor 6 months 2.25%
Australi a	Export Finance & Insurance Corporation and HNB	1.5	11	Libor 6 months 1%
Netherla nds	Co-op Centrale Raiffeisen-Boerenleenbank (Netherlands)	3	13	4.65%
Netherla nds	Co-op Centrale Raiffeisen-Boerenleenbank	3	13	4.94%
China	China Development Bank	3.2	15	Libor 6 months 2.9%
Spain	Banco Bilbao Vizcaya Argentaria S.A.	1	3	Euribor 6 months 2.75%
Netherla nds	Co-op Centrale Raiffeisen-Boerenleenbank	2	3	5%
China	China Development Bank	4	15	Libor 6 months 2.9%
China	China Development Bank	3	15	Libor 6 months 2.95%



Source: Calculations made by Verité Research based on information sourced from the Ministry of Finance, External Resources Department and the Department of Public Finance.

These findings reveal the weaknesses in the concessionality evaluation methods introduced by the special framework, which states that the key objective of setting up the framework was to improve the evaluation process of USPs. The three CDB loans met the special framework's concessionality criteria despite the very low grant elements compared to loans from other countries that did not meet the duration criteria; however, they charged significantly higher interest rates, which negated the benefits of their longer durations compared to other loans(see Exhibit 1). This suggests that SCARC's reliance on the duration criteria while ignoring interest rates allowed the approval of high-interest, non-concessional loans as long as they meet grace period and maturity requirements. As a result, highly non-concessional loans, such as those from the CDB, can easily pass SCARC's evaluation criteria.

Conclusion

The SCARC-led special framework was essentially designed to forego competition in the procurement process to secure export credit at favourable terms. The research reveals that SCARC was able to secure funding by foregoing competition from lending institutions in China as well as lending institutions in six other developed countries: Belgium, Spain, the Netherlands, France, Austria and Australia. In terms of value, however, the funding from developed countries accounts for 9% of the total loan value, and pales in comparison to the funding from Chinese lending institutions (91%).

The research found that SCARC, on multiple occasions, failed to secure concessional funding due to two reasons. First, it bypassed established definitions of concessionality, allowing highly non-concessional loans with high-interest rates to be approved as long as they met the special framework's duration criteria. Second, SCARC was selective in applying its guidelines to the evaluation process, leading to the approval of projects funded by loans that did not meet even its own criteria. By doing so, SCARC failed to meet consistently the stated objectives of the special framework: specifically, to establish a more rigorous evaluation process and to facilitate access to funding on favourable terms.

At a time when the country is mired in a debt crisis caused by irresponsible public sector borrowing and is in the process of creating better governance frameworks to prevent the same from occurring again, it is important to fix procurement-related problems such as these that leave ample room for the mismanagement of public money.

The findings of this research highlight two key vulnerabilities in the existing procurement framework governed by the Procurement Guidelines established in 2006, that need to be urgently addressed. First, is the Cabinet's ability to modify the prevailing procurement guidelines, to introduce special frameworks that forego the competitive bidding process for procurement without parliamentary oversight. This enables the Cabinet to undermine the principle of competition embedded in the 2006 Procurement Guidelines at a whim. Second, is the ability of the ad-hoc Committees like SCARC established with the approval of the Cabinet of Ministers to overstep their mandate and to approve projects that do not meet even the minimum criteria outlined without being subject to any investigation or facing any consequences. Going forward, it is imperative that the government and policymakers address these shortcomings. Eliminating opportunities for abuse and misuse in procurement will help ensure that the country can obtain the best value for public money spent on development projects.

Annexure

Annex 1: List of projects approved by SCARC.

The 18 projects highlighted in red below were the public-sector-funded development projects which have been shortlisted for the study.

No.	Project Name
1	Clinical waste management system in the needy hospitals in Sri Lanka under the government's assistance
2	Construction of the Expressway from Hambantota Seaport to Mattala Airport
3	Construction of headworks of Moragahakanda reservoir
4	Extension of Southern Expressway from Beliatte to Wetiya
5	Extension of Southern Expressway from Matara to Beliatte
6	Gampaha, Attanagalla, Minuwangoda Integrated Water Supply Scheme
7	Greater Matale Water Supply Project
8	Kirama Katuwana integrated water supply scheme
9	Kolonna and Balangoda Water Supply Scheme - Phase II Extension of distribution networks - Part II
10	Loan Facility US$.500 Million from China Development - "CATIC"
11	Mahiyanganaya Water Supply Scheme
12	Matara-Hambantota Highway and other Four Road Sections in the Hambantota Hub Development Project
13	Monaragala and Buttala Integrated Water Supply Scheme
14	National blood transfusion service of Sri Lanka with state of the art technology giving special emphasis to North and East1
15	Outer circular highway from Kadawatha to Kerawalapitiya
16	Reconstruction of BridgeNo.38/3- Peliyagoda - Puttalam Road (Kochchikade Bridge)
17	Sewerage infrastructure for Katharagama Sacred City
18	Veyangoda Railway Crossing Flyover
19	Wastewater infrastructure for greater Hambantota
20	196 Rural Bridges in Sri Lanka
21	Development of greater Ratnapura Water Supply Project Phase II
22	Hunan Road and Bridge Construction Corp for the construction of Outer Circular Road in Trincomalee
23	Kattankudy Division sewerage disposal project
24	National emergency response project - III
25	Relocation and development of Institute of Technology University of Moratuwa
26	Supply and Construction of 141 Bridges - Mabey Bridge Ltd, United Kingdom
27	Construction of housing units at Edmonton Road, Colombo 05
28	Construction of housing development project at Werellawatta, Yakkala
29	Construction of housing development project at Mount Clifford, Homagama
30	Setup a housing development project at Slave Island, Colombo 02 by M/s TATA, India
31	Construction of 12 housing units at Yakkala Siyane Uyana
32	Construction of 135 low cost housing units in Jaltara - Homagama
33	Construction of housing development project at Iskagarawattam Pallekele, Kandy
34	Construction of 103 housing units at Hantana Watte, Kandy
35	Development & Construction of Housing Project at Kavirathna Place Pamankada

36	Construction of Commercial area & Housing Project at Kalugala Land, Pallekele, Kandy
37	Construction 130 housing units at Galkaduwa Watta, Rathnapura
38	Construction of 23 housing units at Hantana Land, Kandy (Stage 3)
39	Construction of 19 housing units at Hantana Landy, Kandy (Stage 4)
40	Flagship Investment in the City of Colombo (Shangri La Hotel)
41	Offer to purchase land for a multinational mixed development project in Colombo (John Keells)
42	'Glennie" Street development project - Integrated multi-use mixed development project
43	Mixed development project - "CCC development project"
44	Construction of 400 room star class hotel & residential apartments (ITCL, India)
45	"Mixed Development Project at Transworks Square Land at Colombo 01 (The One Transworks Square (Pvt) Ltd"
46	Colombo Port City – Phase 1
47	Luxury Eco-Friendly Villas Hotel - Palatupana, Yala
48	Setting up an integrated resort in Colombo
49	Mattala International Airport*

* 49 projects have been approved by the SCARC as per the list received by Verité Research through the Department of Public Finance (DPF), however, the Mattala International Airport which appears in the list of projects approved by the SCARC has been excluded from this study. This is because the commercial contract for the construction of the Mattala Airport was signed with China Harbour Engineering Company Ltd on the 27th of November 2009 and the Loan agreement to fund the project with China EXIM Bank was signed on the 5th of March 2010. These events occurred before August 2010 (i.e., the month SCARC was established through the Public Finance Circular No:444). This project is thus excluded from this study as it's clear that the proposal for the project was not approved by SCARC and it is unclear which aspects of the project the SCARC approval refers to.

Source: RTI filed on the 14th of February 2022 with the Department of Public Finance