Pooled Finance Development Scheme

Toolkits

PFDF

Ministry of Urban Development
Government of India

Contents

Preface

In India, national growth rates and reduction in national poverty levels are increasingly being determined by the efficiency of cities. Urban areas contribute much of this growth, driven not only by more than a 50% contribution to the country's gross domestic product (GDP), but also a significantly higher rate of growth of the services sector. It is expected that over the next two decades 40% of the country's population will be living in urban areas, resulting in increased strain on the already inadequate levels of infrastructure in these cities. The Government of India Jawaharlal Nehru National Urban Renewal Mission (JNNURM), launched in December 2005, aims to address some of these issues through the creation of a reform-based incentive scheme to improve and augment economic and social infrastructure in the country's cities and towns.

The majority of urban infrastructure projects currently being undertaken by the urban local bodies (ULBs) depends mostly on funds from state governments, the GoI-sponsored JNNURM (including the UIDSSMT), and other governmental agencies. Besides, most of the local bodies lack requisite capacities/expertise to prepare bankable urban infrastructure projects. Therefore, local bodies are not able to raise resources from the market/financial institutions for investment in infrastructure. The capability of the cities needs to be enhanced to enable them to finance in a sustainable way the infrastructure requirement that exists at the municipal level. Direct access to capital markets is now an accepted option for the country's larger financially viable ULBs. In this context the Government of India has allowed issue of tax-free municipal bonds. This facility has been availed by quite a few large municipal corporations. However, it is difficult for small- and medium-sized cities to raise resources from the market for infrastructure projects due to a lack of project structuring capabilities and creditworthiness.

There is, thus, a need for concerted efforts to ensure availability of resources to small- and medium-sized urban local bodies in order to improve urban infrastructure, service delivery and ultimately to achieve the goal of self-sustainability in these towns and cities. Ongoing programs of both the central and state governments may not be adequate to fill the resource gap, in light of the extent of the resource gap. To enable ULBs to bridge this gap through accessing market funds for their infrastructure projects, the Government of India has decided to launch, in the current fiscal year, the Pooled Finance Development Scheme (PFDS). The scheme is meant to provide credit enhancement grants to enable ULBs to access market borrowings through pooled finance municipal bonds for investment in urban infrastructure projects.

The main objectives of the PFDS are to: (i) facilitate ULBs to access capital and the financial market for investment in essential municipal infrastructure; (ii) facilitate development of bankable (structured with appropriate credit enhancements in such a way that they demonstrate the capacity for servicing the market debt to the satisfaction of the rating agencies and potential investors) urban infrastructure projects; (iii) reduce the cost of borrowing to local bodies with appropriate credit enhancement measures; and (iv) facilitate development/strengthening of the municipal bond market. The PFDS also creates an incentive structure to support urban reforms, which would also be driven by covenants of financial market lenders to ULBs.

With a budgetary provision of Rs.400 crores in the 10^{th} Five Year Plan, the Pooled Finance Development Fund (PFDF) would provide grants to the extent of 50% of the credit rating enhancement fund (CREF) or 10% of the bond issuance, whichever is less. In addition, up to 75% of the cost of project development would be reimbursed by the PFDF as a grant to the ULBs of approved pooled bond issues.

The PFDS encourages, on the one hand, state governments and mid- to small-sized ULBs to pool their projects together to achieve a marketable size and credit rating of the pooled bond issuance and, on the other hand, creates a risk mitigated environment for the capital and financial markets at large to invest in the development of urban infrastructure of the country's burgeoning towns and cities.

In order to apply for grant assistance to the credit rating enhancement fund required for a pooled bond issuance, the Government of India requires the following:

i. Creation of a state level pooled finance entity (SPFE), as the nodal agency of the state for coordinating pooled financing of urban infrastructure projects in the state;
ii. Identify a pool of projects, develop them and have the proposed pool bond rated by a credit rating agency, including assessment of the CREF required to make the pooled bond investment grade; and
iii. Commitment by the ULBs and the state government to create the first two levels of recourse/security to the bondholders.

Subject to the fulfillment of the above, the SPFE could submit its application for support under the PFDS to the state/union territory level sanctioning and monitoring committee (SMC).

In order to assist cities and SPFEs, the Government of India (Ministry of Urban Development) has developed Toolkits that outline the pooled finance development scheme in detail, the institutional framework, the process, and the detailed methodology for project preparation, pooling, credit rating and bond issuance. In addition, the Toolkits describe the reform agenda for accessing PFDF support and the criteria for appraisal.

The Ministry of Urban Development wishes to thank the Indo-USAID FIRE (D) project and its consultant, ICRA Management Consulting Services, for their support in preparing the Pooled Finance Development Scheme Toolkits.

We invite state governments and cities to pool together their bankable projects, seek support from the PFDS, and access the capital and financial markets to implement their urban infrastructure projects.

Ramchy
17/4/08
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Secretary
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Pooled Finance Development Scheme

Background and Toolkit Overview

PFDF

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1. Scope of this Document

1.1 Background/Preamble

In India, national growth rates and reduction in national poverty levels are increasingly being determined by the efficiency of cities. Urban areas will contribute greatly to improvements in both these indices. It is expected that over the next two decades 40% of the country's population will be living in urban areas.

The majority of urban infrastructure projects currently being undertaken by urban local bodies (ULBs) depend mostly on funds from state governments and other agencies. Besides, most local bodies lack the requisite capacities/expertise to prepare bankable urban infrastructure projects. Therefore, most local bodies have traditionally not been able to raise resources from the market/financial institutions for investment in infrastructure.

The capability of cities needs to be enhanced to enable them to finance infrastructure projects in a sustainable way. Direct access to capital markets has become an accepted option for the country's larger financially viable ULBs. In this context, government has promoted the issue of tax-free municipal bonds. This facility has also been availed by the larger municipal corporations.

However, it has been difficult for small- and medium-sized cities to raise resources from the market for infrastructure projects due to lack of capabilities and creditworthiness. There is, thus, need for concerted efforts to ensure availability of resources to urban local bodies in order to improve urban infrastructure, service delivery, and ultimately to achieve the goal of self-sustainability. Ongoing programs of both the Central and state governments may not be adequate enough to fill the resource gap given the extent of requirement. The Pooled Finance Development Scheme has been formulated to bridge this gap through which primarily smaller- and medium-sized cities will be able to access market funds for their infrastructure projects.

The objectives of the Pooled Finance Development Scheme include improving infrastructure facilities and helping in the creation of durable public assets in cities. In addition, it envisages decentralizing economic growth and employment opportunities, promoting dispersed urbanization, integrating spatial and socio-economic planning as envisaged in the Constitution (74th Amendment) Act, 1992, and promoting resource generating schemes for ULBs to improve their overall financial position.

The Government of India (GoI), therefore, set up the Pooled Finance Development Fund (PFDF) to enable urban local bodies to access alternative sources of funding for their bankable projects/schemes. The Ministry of Urban Development issued and notified the Guidelines for the PFDF vide Resolution No. K-14011/40/01-UD11 (Vol. III) dated October 25, 2006. The Ministry followed this Resolution with Notification No. K-14011/40/01-UD11 (Vol. IV) dated June 7, 2007 on "Guidelines for Issue of Tax-free Pooled Finance Development Bonds". The scheme and Guidelines are meant to provide credit enhancement grants to access market borrowings through pooled financing bonds on behalf of identified ULBs for investment in urban infrastructure projects.

The main objectives of the pooled finance mechanism, which will be implemented primarily at the state level, are as follows:

- Facilitate ULBs to access the capital and financial markets for investment in essential municipal infrastructure.
- Facilitate development of bankable urban infrastructure projects.
- Reduce the cost of borrowing to local bodies with appropriate credit enhancement measures and through restructuring of existing costlier debt.
- Facilitate development of India's municipal bond market.

The purpose of this document is to support GoI's Ministry of Urban Development in operationalisation of the PFDF scheme, which will take as its point of departure the GoI's Guidelines for PFDF. Further, the envisaged PFDF toolkit is being presented to the extent possible as a companion document to the GoI JNNURM toolkits and the Guidelines for GoI's Urban Infrastructure Development Scheme for Small and Medium Towns (UIDSSMT).

1.2 Organisation of this document

This document is organised along four separate toolkits covering the following areas:

- **Toolkit I – Institutional Framework and Processes**. This would provide a description of the proposed institutional framework and summarise the overall process for the scheme.
- **Toolkit II – Project Development, Pooling and Appraisal** would describe the aspects of the scheme relating to the processes involved in project development and pooling of projects. The toolkit would also provide guidelines for appraisal of projects.
- **Toolkit III – Credit Rating, PFDF Support and Bond Issue** would cover aspects of pooled financing relating to obtaining a credit rating for project pools and the steps in obtaining PFDF support and bond issuance for raising capital.
- **Toolkit IV – Reform Agenda, Performance Monitoring and Review** would describe the reform agenda to access support under the PFDF scheme and would provide guidelines for performance monitoring and review.

2. Structure of the Document

The Toolkit for PFDF will cover four sections as detailed below.

TOOLKIT I – INSTITUTIONAL FRAMEWORK AND PROCESS

1. **Overview of the Toolkit**
2. **Institutional Framework for PFDF**
   2.1 Definition of stakeholders/agencies involved
   2.2 Framework for policy oversight
   2.3 Framework for implementation/operationalisation
3. **Overall Process for PFDF Support**
   3.1 Project selection, development and appraisal
   3.2 Credit rating, application processing, bond issue and sanctioning
   3.3 Performance monitoring and post-disbursement review
   3.4 Reform agenda
   3.5 Flow of payments
   3.6 Business plan orientation for the SPFE
   3.7 Indicative timelines for various activities

TOOLKIT II – PROJECT DEVELOPMENT, POOLING AND APPRAISAL

4. **Overview of the Toolkit**
5. **Project Identification and Prioritization**
   5.1 Project identification
   5.2 Project prioritization
6. **Project Pre-feasibility and Preparation of Detailed Project Reports**
   6.1 Pre-feasibility analysis
   6.2 Preparation of Detailed Project Reports (DPRs)
7. **Viability Assessment and Independent Appraisal**
   7.1 Financial feasibility assessment by SPFE
   7.2 Independent appraisal of DPRs
8. **Pooling of Projects by SPFE**
   8.1 Guidelines for pooling
   8.2 Funding plan
   8.3 Determination of pooled bond issue
   8.4 Reform agenda for PFDF scheme support

TOOLKIT III – CREDIT RATING, PFDF SUPPORT AND BOND ISSUE

TOOLKIT IV –REFORM AGENDA FOR PFDF SUPPORT, PERFORMANCE MONITOR ING AND REVIEW

Pooled Finance Development Scheme

Institutional Framework and Processes 1

PFDF

Ministry of Urban Development
Government of India

1. Overview

The purpose of Toolkit I is to:

a) Provide an overall perspective of the Pooled Finance Development Fund (PFDF) scheme and detail the institutional framework for implementation of the PFDF scheme.

b) Outline the scope of the scheme in terms of eligible projects and other caps imposed as per the guidelines of Government of India.

c) Provide an overview of the process covering steps to be followed for: i) project development, structuring; pooling and independent appraisal; ii) credit rating and bond issue process; and iii) reform agenda for PFDF support, performance monitoring and review.

Toolkit I provides a complete overview of the PFDF scheme and captures the key elements of the scheme, each of which is then described in greater detail in the subsequent Toolkits (II, III and IV). Toolkit I is organised as follows:

2. Institutional Framework for PFDF

2.1 Definition of stakeholders/agencies involved

The stakeholders involved in implementation of PFDF include the following

- **Policy oversight** – Ministry of Urban Development, Government of India (MoUD), State Department for Municipal Administration (SDMA)
- **Implementation responsibility** – State-level Pooled Finance Entity (SPFE), Sanctioning and Monitoring Committee (SMC), Pooled Bond Trustee
- **Execution agencies** – ULBs/parastatals
- **Lenders/bond holders –** Agencies/investors subscribing to the bond issue
- **Others –** Credit rating agencies, independent project appraising agencies and citizens/customers

2.2 Framework for policy oversight

Exhibit 2.1 shows an illustrative institutional framework for operationalising pooled bond financing of urban projects. The framework is detailed below.

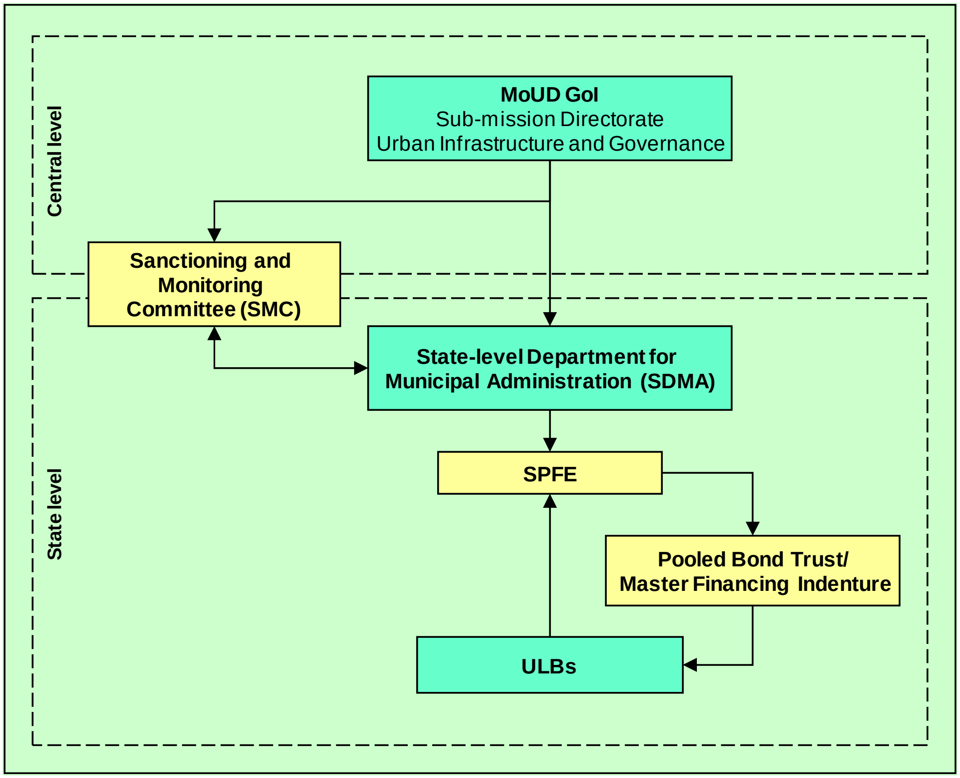
i. Ministry of Urban Development, Government of India (MoUD)

The **Ministry of Urban Development, Government of India (MoUD),** would provide the overall enabling policy support and incentivisation for operationalising pooled financing at the state and ULB level. To this effect, the MoUD has launched the Pooled Finance Development Fund (PFDF) scheme that envisages assistance in the form of support to the Credit Rating Enhancement Fund (CREF) and for project development. The PFDF scheme would be managed under the overall supervision of the Sub-mission Directorate for Urban Infrastructure and Governance, in conjunction with the Ministry's other programs for developing urban infrastructure projects, namely JNNURM and UIDSSMT, to facilitate greater synergies across these schemes with the PFDF scheme.

ii. State-level Department of Municipal Administration (SDMA)

At the state level, the Department of Municipal Administration (SDMA) would be responsible for setting up the State-level Pooled Finance Entity (SPFE) and for subsequently working with the SPFE through its participation in the Sanctioning and Monitoring Committee (SMC) towards operationalisation of PFDF and in facilitating access of ULBs to private capital through the PFDF scheme. While the SPFE shall be responsible for the day-to-day operations of the PFDF, the SDMA shall work with the SPFE in encouraging ULBs to consider pooled financing as an option for accessing capital and bridging resource gaps. The guidelines for setting up the SPFE and its role in operationalisation of PFDF are detailed below.

Exhibit 2.1 Institutional framework for PFDF



2.3 Framework for implementation/operationalisation

i. State-level Pooled Finance Entity (SPFE)

As a first step, the SDMA and the state government should set up a State-level Pooled Finance Entity (SPFE) as a nodal agency for pooled financing in the state. In setting up the SPFE, the SDMA should choose one of the following options:

a) Create the SPFE as a new entity, either as a company under The Companies Act or as a trust, under The Indian Trust Act, 1892. The SDMA could also consider setting up the SPFE as a joint venture along with other private sector financial institutions involved with similar interests and having capabilities in appraising and developing infrastructure projects.

b) Designate the State-level Nodal Agency (SLNA) in charge of operationalising JNNURM and UIDSSMT as the SPFE. This would enable greater synergies in project development and financing. However, this may be appropriate only if the SLNA is a financing intermediary with requisite skills in accessing capital markets and with adequate project development and appraisal skills.

The SPFE is envisaged to be structured as a lean organisation, keeping: a) project identification and pooling; b) project structuring; c) actual bond strategy, issuance and structuring; and d) post-project monitoring as core functions, which it will handle. A significant part of the project development (DPR and independent appraisal) activity should be outsourced to independent agencies empanelled by the SPFE through a transparent mechanism. Determination of the CREF would be done by a credit rating agency.

The MoUD actively encourages state governments to consider joint ventures/public private partnerships (PPPs) in setting up the SPFE. This would enable access not only to private capital, but also to specialized skills in project appraisals, understanding of capital markets, treasury and risk management, which are critical to the success of the PFDF. In the absence of a JV partner(s), the SDMA and the state government may require a substantial capacity building effort and time in getting the SPFE to acquire such specialized skills. The creation/designation of the SPFE should be done through a Government Order (GO) issued by the SDMA.

Role and responsibilities of the SPFE

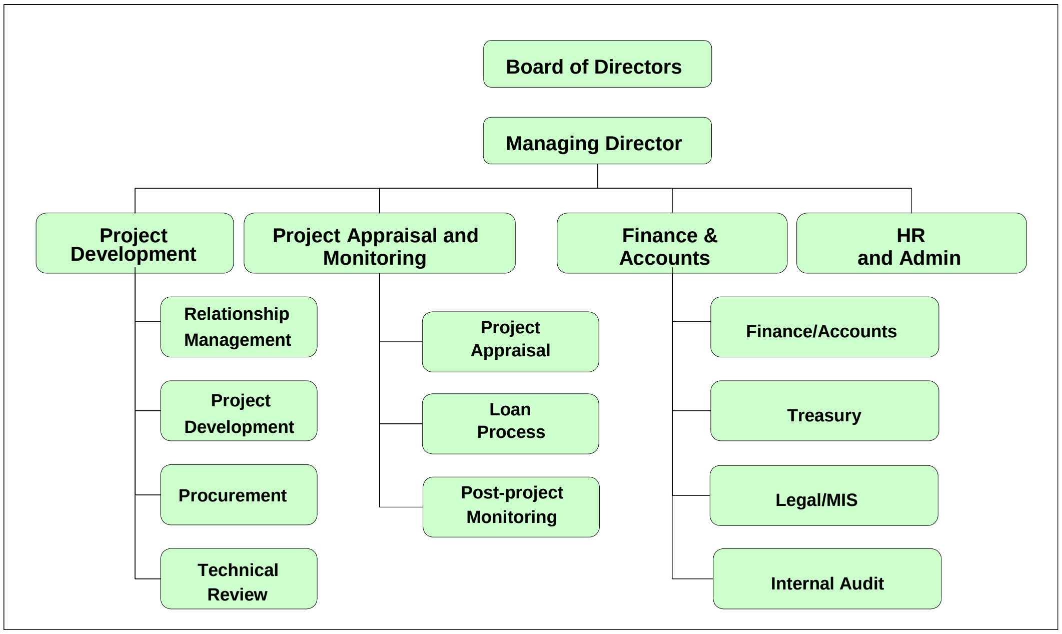
The SPFE would be the nodal agency in the state for pooled bond issues and development of pooled urban infrastructure projects. Assistance from the SPFE would be available to all ULBs with particular focus on developing projects through pooled financing in smaller and medium ULBs. While the SPFE would be the nodal agency for pooled financing, it does not prevent individual ULBs with capacity from accessing capital markets directly, though bond issues by individual ULBs will not be eligible to access support from the PFDF scheme for its credit enhancement or project development. The roles and responsibilities of the SPFE include the following:

a) **Project development –** The SPFE in coordination with SDMA and ULBs should identify, conceptualise and work towards creating a shelf of urban infrastructure projects that could potentially attract capital market financing.
b) **Project appraisal, structuring and credit rating of project pools –** Undertake an independent appraisal of the financial and economic viability of the projects. Identify projects amenable to pooling and carry out a credit rating of project pools to arrive at the Credit Rating Enhancement Fund required for obtaining a threshold credit rating for the pools identified.
c) **Working with the SMC and MoUD for obtaining CREF support and approval for bond issuance.** The SPFE as the nodal agency would be responsible for submitting applications to SMC in this regard.
d) **Bond issuance and related formalities -** The SPFE is responsible for working with merchant bankers and other stakeholders for bond issuance and completion of related legal and other documentation formalities covering opening of escrow accounts and repayment mechanisms, guidelines for operationalising credit enhancement features, etc.
e) **Project implementation, timely repayments to bond holders and post-project monitoring -** The SPFE will ensure timely implementation and ensure timely repayment to bond holders.

Governance and organization structure

Exhibit 2.2 provides an indicative organization structure for the SPFE.

Exhibit 2.2 Indicative organization structure of the SPFE



The organization structure of the SPFE should be geared to handle the roles and responsibilities highlighted earlier. Therefore, the organization of the SPFE should have/acquire skills in project development and appraisal, urban finance, accounting and treasury functions. The SPFE should ideally be governed by a Board of Directors, with at least 50% of the board comprising independent directors with expertise in the above areas. The organization should be headed by a Managing Director, who would be responsible for the operations of the SPFE, which can be structured along four functions as described below:

1. **Project development** should be responsible for the following:

    - **Relationship management -** Creating and managing relationships with ULBs and providing support to ULBs in developing the project concept and handholding them through the project development, financing and implementation cycle.

    - **Project development -** Planning and managing project development activities along specific themes in terms of project concept initiation, feasibility analysis, and conversion of ideas into bankable projects, pilot projects and wider replication.

    - **Procurement -** Managing procurement of services and works for various projects and developmental activities.

2. The **project appraisal and monitoring function** would be responsible for the activities relating to the appraisal of projects, managing the loan approval process, and the post-sanction and post-disbursement monitoring activities for the various projects financed. A list of consultants should be empanelled by the SPFE for conducting independent technical and financial appraisal of the pools identified by the SPFE.

3. The **finance and treasury function** plays a critical role in any financial intermediary, which would handle accounts, audit, compliance, legal and secretarial functions. The department should have focused accountability for resource mobilization and treasury management.
4. The **HR and admin function** would be responsible for managing the organizational aspect, including recruitment, compensation policy, training and other administrative aspects of the SPFE.

ii. Pooled Bond Trustee

Roles and responsibilities

A Pooled Bond Trustee would need to be selected to oversee the operation of the fund structure(s) created for financing and implementing a pool of identified projects. The Trustee would be responsible for overall supervision of the structure to ensure that the covenants and guidelines of the pooled financing scheme are being adhered to.

Setting up Pooled Bond Trustee

The Trustee services for the initial pooled finance schemes are to be outsourced to banks and financial institutions that provide these services.

iii. Sanctioning and Monitoring Committee

The Sanctioning and Monitoring Committee (SMC) is a joint panel that provides the overall direction and leadership for operationalisation of the PFDF scheme. It is responsible for review of applications sent by the SPFE for CREF support under the PFDF scheme and for requesting provision of tax-free status, if required, from the Ministry of Finance, Govt. of India, through the MoUD, Govt. of India. The SMC would operate at the state level as a single-window for clearing pooled financing proposals put up by the SPFE.

Structure

The SMC would comprise the following:

- State Secretary, Municipal Administration - Chairperson
- Joint Secretary, Urban Development, MoUD, GoI or) Representative - Member

- Representative of Planning Commission - Member
- Representative of Ministry of Finance, GoI - Member
- State Secretary, Department of Finance/Representative - Member
- State Commissioner/Director of Municipal Administration - Member
- MD/CEO of SPFE - Member Secretary

Roles and responsibilities

The SMC would be responsible for:

a) Review of all applications sent by the SPFE for support from Government of India in the form of CREF support and tax-free status.
b) Ensure compliance of various pooled schemes to the guidelines of the PFDF scheme.
c) Recommend and approve support under the PFDF scheme to various pooled finance programs of the SPFE; recommend tax-free status to MoUD/Min. of Finance, GoI, for approved pooled bonds by SPFE.
d) Monitoring and review of sanctioned pooled bond programs through reports sent to the SMC by the SPFE.
e) Overall policy support and coordination among MoUD, SDMA, SPFE and other key stakeholders to encourage and implement pooled bond programs in a sustainable manner.

iv. Role of other agencies involved

Apart from the SPFE, SMC and the Pooled Bond Trustee, there are a number of other stakeholders/ institutional arrangements that are critical to operationalising pooled financing programs at the state level including the following:

a) **Panel of independent experts/agencies** – The SPFE would need to empanel a list of consultants/ experts to provide services relating to undertaking pre-feasibility studies, preparing DPRs, and carrying out independent appraisal of projects/project pools identified by it. The SPFE would also need to develop guidelines for procurement of these services in a transparent, independent and efficient manner

b) **Merchant bankers and related service providers –** The SPFE would need to constantly liaise and work with merchant bankers for bond issues and related activities.

c) **Credit rating agencies** – Credit rating is mandatory for bond issues and is particularly critical in the case of pooled finance programs in order to determine the requirements of the Credit Rating Enhancement Fund (CREF).

d) **Legal services –** Addressing investor protection and credit risk is a critical aspect of pooled financing programs, which requires extensive legal review and documentation. The SPFE should have relationships with law firms to develop necessary covenants and agreements in this regard.

3. Overall Process for PFDF Support

The steps involved in the process of operationalisation of PFDF are listed below. Specific details of individual activities of this process are covered in greater detail in Toolkits II, III and IV that follow.

3.1 Project selection, development and appraisal

1. A State-level Pooled Finance Entity (SPFE) is created by the State-level Department for Municipal Administration (SDMA) to act as a nodal agency for coordinating pooled financing of urban projects in the state.
2. The SPFE will identify projects in coordination with the SDMA and the ULBs within the state. Project identification will be done through a combination of the policy priorities outlined by SDMA and the City-level Investment/Perspective Plans.
3. The SPFE undertakes project development activities and creates a shelf of projects that can be taken up for implementation and provides support to the ULBs preparing pre-feasibility reports and Detailed Project Reports. Given the importance of project development, the SPFE may be supported by the state government with an exclusive grant fund window for preparation of pre-feasibility reports and Detailed Project Reports.
4. From the shelf of projects created through its project development efforts, the SPFE then identifies projects that are amenable for pooled financing. The SPFE will identify pools of projects based on a few parameters, including financial discipline, size of bond issue, mix of projects to ensure adequate diversification, ULBs' ability to influence each other to adhere to bond servicing requirements, etc. The key objectives of pooling are to enable smaller and medium ULBs to access external capital at the same time having a diversified portfolio of projects that meets the risk-return expectations of potential investors.
5. Before finalising the pool of projects, the SPFE conducts an independent appraisal to validate the viability of the proposed pool of projects. This appraisal would form an input for the credit rating exercise that would follow. At this stage, the SPFE also establishes prima facie that pooled financing is the most cost effective financing option.
6. On completion of the independent appraisal, the SPFE engages with the respective municipal councils and enters into an MOA with the ULBs, which would adopt individual resolutions committing themselves to a reform agenda to access support under PFDF/improvements from baseline indicators and to participate in a pooled bond issue.
7. The SPFE then finalises the funding plan, including the size of the bond issue, and informs the SDMA and the state government regarding: (a) final project size; (b) commitment letter from state government regarding SFC devolution; (c) matching contribution of 25% for project development assistance (quantum of this may be open at this stage); and (d) if any multilateral or other guarantee is being contemplated, in addition, as part of the fund raising exercise.

3.2 Credit rating, application processing, bond issue and sanctioning

8. The SPFE then appoints a rating agency to carry out an independent credit rating of the pool in order to assess the credit enhancement requirements for the desired level of rating of the pool. At this stage, the SPFE may need to have informal discussions with a merchant banker to understand market acceptability of the structure, rating level, etc., and the coupon levels.

9. Based on the outcome of the credit rating exercise and other market information, the SPFE presents an application to SMC through the MoUD for approval of PFDF support and financial support from CREF. The application submitted by the SPFE also includes the application for tax-free status, if the same is envisaged for the bond issue.

10. The SMC reviews the application and clears the application if found conforming to the guidelines of the PFDF scheme. In the case of any non-conformance, the application is sent back to the SPFE with comments/queries. On approval by the SMC, the SPFE signs a MoA with MoUD and takes steps for bond issuance, including appointment of lead arranger, registrar, and trustee. SPFE then goes ahead and initiates steps for bond issue and disbursement. These include:
    a) Raising finance through bond issue.
    b) SPFE signs sub-loan agreements with ULBs.
    c) Signing of other legal documents – Trust Deed, Tripartite Agreement (SPFE, state government, guarantor), Guarantee Agreement (guarantor, SPFE), and Listing Agreement.
    d) Listing of bonds on NSE/BSE.
    e) Allotment letters for bonds in coordination with R&T agent.
11. The SPFE then completes the bond issuance program to raise resources for the projects in the pool and puts in place adequate monitoring mechanisms for ensuring timely completion of projects and achievement of subsequent operational milestones to ensure timely repayments of bond holders.

3.3 Performance monitoring and post-disbursement review

12. SPFE puts in place reporting requirements and monitoring mechanisms for: (a) project implementation monitoring and completion; (b) post-project monitoring covering achievement of operational and financial milestones envisaged; and (c) implementation of reform agenda as per the MoAs signed by the SPFE with MoUD and ULBs.

13. The reporting requirements should be developed to conform to the requirements of the Sanctioning and Monitoring Committee (SMC), independent bond trustee, stock exchanges, investors and rating agencies.

14. SPFE should provide details of compliance, coordinate surveillance of credit rating by credit rating agency, and provide periodic reports to the trustee and other agencies.

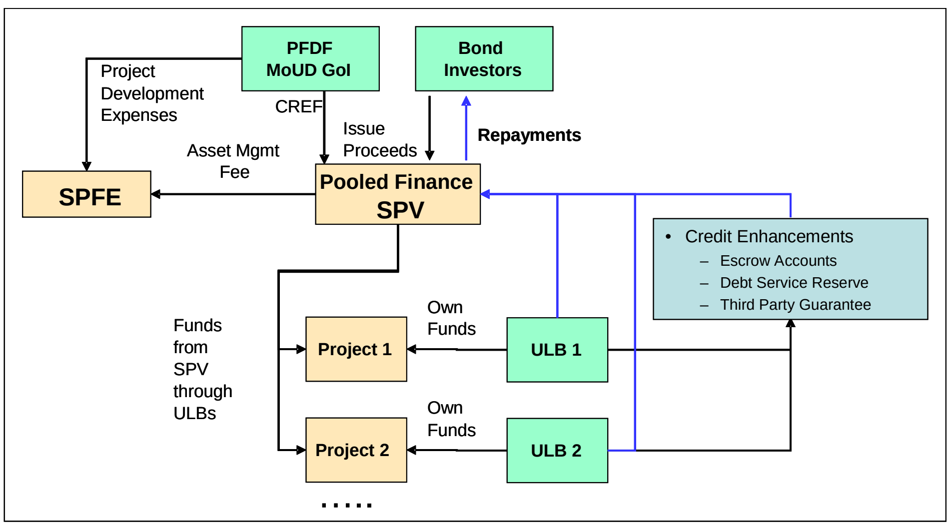
3.4 Reform agenda

In order to ensure synergy with other schemes of MoUD, the reform agenda agreed to by the ULB to access support under the PFDF scheme would require ULBs to conform to all the reforms specified for support under the MoUD's other schemes, namely JNNURM and UIDSSMT. The reform agenda outlined under JNNURM and UIDSSMT provides a fundamental level of reforms to be undertaken by the ULBs, as outlined in the respective toolkits of JNNURM and UIDSSMT, as well as briefly listed in Section 14.1 of the PFDF Toolkit IV. Additional reforms, particularly in the area of improvement in quality of accounting and financial information, reporting and dissemination practices, etc., would need to be undertaken for accessing support under the PFDF scheme. The capital market and the rating agency would require these reforms for raising finance competitively through pooled bonds. Some of these illustrative reforms are outlined in Section 14.1 of PFDF Toolkit IV.

3.5 Flow of payments

Exhibit 3.1 provides an illustrative flow chart showing the flow of payments across various entities.

Exhibit 3.1 Flow of payments across entities in pooled financing



3.6 Business plan orientation for the SPFE

Operationalising pooled financing is highly context specific and is dependent on a number of factors, including status of urban reforms and policy-level commitments at a macro level. Other factors at the local level include status of accounting reforms and quality of financial statements. Availability and capacity to develop and execute projects also play a vital role.

Therefore, at the time of inception, it may be useful for the SDMA and SPFE to jointly initiate an exercise to articulate and define a few tangible targets for the SPFE over a five-year horizon. These targets should flow out of an assessment of the urban investment needs in the state and the potential borrowing capacity of the urban sector based on its baseline revenues and potential for growth.

To provide a very generic broad-based target, a newly set up SPFE should preferably aim to go for its first pooled bond issue within two years of inception. This can be shorter in states with a relatively better record on reform orientation and with a shelf of well-defined viable project DPRs in place. It is more important, however, for the SPFE to set in motion focused project development activities to keep its shelf of potential projects filled for subsequent project pools. The medium- to long-term vision for a SPFE should be to evolve into a sustainable financing intermediary for developing and financing urban projects through periodic bond issues (say every half year or quarter).

3.7 Indicative timelines for various activities

Pooled financing is a fairly involved exercise involving multiple stakeholders with a number of inter-related activities. While some of these steps are sequential, for instance between finalization of a pool of projects to be considered for pooled financing to bond issuance, there are also a few other activities and steps that need to be pursued in parallel by the SPFE, including project development and project monitoring.

Project development would be an ongoing activity that would focus on creating a shelf of projects and would involve assistance to ULBs in conducting pre-feasibility studies and preparation of Detailed Project Reports. While the time frame for project development is based on the nature of the project and its complexity, a typical time frame for a pre-feasibility study would be two-four months, while preparation of a Detailed Project Report for most urban projects should not take more than six months. Given this long gestation of project development, it is important for the SPFE to have a clear project development strategy, implementation organization, and resources in place at inception.

Assuming that the SPFE has identified a preliminary pool of projects, it should target to hit the market with a bond issue within six months, with an outer boundary of one year. The intermediate steps and a typical time frame between conceptualization of a pool to bond issue by the SPFE are shown below.

Exhibit 3.2 Pooled bond issue cycle – steps involved and indicative timelines

Pooled Financing Cycle - Steps and Indicative Timelines	Timeline (in months)					
	2	4	6	8	10	12
Preliminary identification of pool						
Independent appraisal of the projects in the pool						
Funding plan and determination of bond issue						
MoA between SPFE and ULBs and obtaining council resolution						
Credit rating process						
Submission of application to SMC through MoUD						
Review and approval by SMC						
Obtaining tax-free status from MoF, GoI						
Appointment of merchant banker, legal counsel and trustee						
Bond issuance						

Pooled Finance Development Scheme

Project Development, Pooling and Appraisal 2

PFDF

Ministry of Urban Development
Government of India

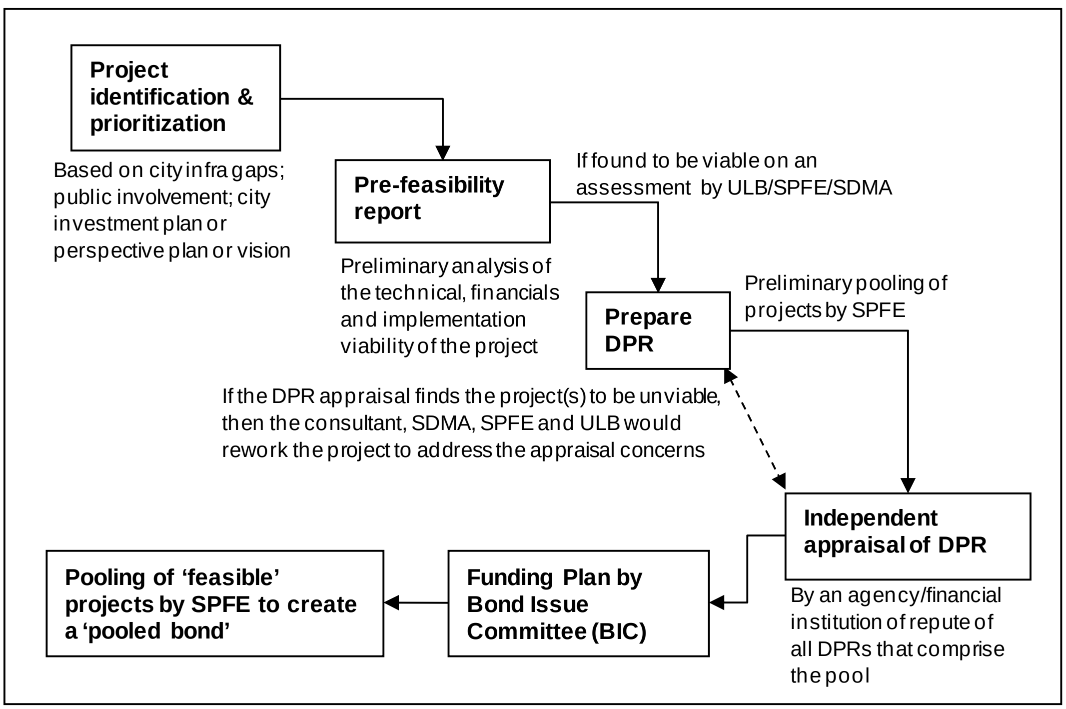
4. Overview of the Toolkit

The purpose of this toolkit is to outline the guidelines for project preparation, appraisal and selection, and pooling of projects. This toolkit would assist the urban local bodies (ULBs), the State Pooled Finance Entities (SPFEs), and the state governments to prepare and put forward projects in line with the requirements of the Fund. This toolkit focuses on the process that the ULBs and the SPFEs would follow to generate a proposal in line with the Fund's objectives and process requirements.

Project development is the preparatory phase of the project and the pooling of projects, which progresses to a pooled market borrowing supported by the PFDF. This phase comprises a number of steps, from the identification of the project to the finalization of a pool of projects ready to be rated by a credit rating agency.

Exhibit 4.1 provides a graphical representation of the project development process.

Exhibit 4.1 Project development process



Briefly, the project development phase comprises the following:

a) **Project identification and prioritization**

b) **Project pre-feasibility and preparation of the Detailed Project Reports (DPRs)**

c) **Viability assessment, financial structuring and independent appraisal of the DPRs**

d) **Selection and pooling of projects**

Each of these stages is detailed below in the following sections of this toolkit.

5. Project Identification & Prioritisation

5.1 Project identification

The origination of the project concept has to be done by the concerned ULB. The SPFE could assist the ULB in identifying the project concept and support the entire process of project identification and documentation.

The ULB shall initially identify the existing infrastructure situation and gaps through a process of envisioning the city's growth and development, including population growth, thereby projecting its needs for urban infrastructure facilities into the future.

This project identification process should be undertaken in a consultative manner involving all citizens and stakeholders. Such a consultative process should provide insight into the infrastructure status and needs of the city and assist in identifying infrastructure projects, in consultation with local stakeholders.

Projects identified through this process would of course have the "ownership" of all stakeholders and also form a part of a larger "vision" for the city.

5.2 Project prioritization

The need for the project, willingness to accept reforms, and the impact on the municipal budget would lead to prioritization of projects.

This list of prioritized projects, the vision of the growth and development of the city, the quality of infrastructure facilities proposed to be offered to its citizens, the proposed reforms, and the proposed financing plan may be documented in a City Investment Plan or Strategic or Perspective Plan. Further, this City Plan document should have the approval of the ULB's Standing Committee or General Body.

6. Project Pre-feasibility & Preparation of Detailed Project Reports

6.1 Pre-feasibility analysis

i. Need & approach for pre-feasibility analysis

Prior to undertaking a Detailed Project Report, which is both time and cost intensive, it is proposed that the ULB conducts a pre-feasibility assessment of the project. This pre-feasibility assessment would include detailing the project's specific scope (contours), phasing, and technical parameters, as well as an assessment of the financial feasibility for the ULB to implement this project. This pre-feasibility assessment would therefore establish the preliminary technical and financial feasibility of the project and also indicate whether the project would address the infrastructural gaps that it had been conceived to address.

Moreover, this pre-feasibility analysis would determine if the project could be implemented through a public private partnership ("PPP") framework or not. If it is believed at this stage that the project could be implemented under a PPP framework, the project development process henceforth would be quite different to the one detailed in this toolkit. In the PPP case, the project would be amenable to participate in a bond pool only if the ULB proposes to issue bonds to fund any financial commitment it has to make for the PPP project.

However, if a ULB already has a DPR prepared, and both the ULB and the SPFE believe that it is appropriate to include the project in a project pool, then this project and its DPR may go directly for an independent appraisal. It is further presumed that participation in a pooled bond issue has already been established as the most cost-effective funding approach for the project.

ii. Pre-feasibility assessment: consultant selection & appointment

ULBs may retain the services of specialist sectoral consultants for undertaking Detailed Project Reports (DPRs). However, it may be prudent to structure the assignment in two phases, wherein Phase 1 of the assignment would comprise the pre-feasibility assessment of the project and the second phase would comprise the preparation of the DPR. Such a mandate to the consultant would offer time and cost benefits to the ULB, in addition to the fact that the ULB would have to undertake the process of procuring a consultant only once. Finally, of course, this two-phased approach would have the benefit of continuity of thought and process in the preparation of the project.

The process of selecting and appointing the consultant to undertake the pre-feasibility assessment would typically involve the following steps:

- **Preparing Terms of Reference (ToR):** The ULB should prepare the ToR, which should clearly define: (a) the information or method by which the assessment needs to be conducted;

(b) the tasks required to be undertaken; and (c) the indicative time frame within which outputs are expected. Importantly, the ToR should define the minimum required man-month inputs or staffing requirements, output details including an indicative Table of Contents (ToC), etc.

- **Procurement and appointment of consultants:** The appointment of consultants by the ULB is expected to follow a fair and transparent process, where all consultants (within India, if the bid is restricted to domestic consultants only or otherwise globally) are given an equal opportunity to participate in the procurement process and are evaluated as objectively as possible.
- **Options for appointment of consultants:** Different options for the appointment of consultants are available depending on the consultancy requirements for the identified project. For example, (a) fixed budget selection (wherein the ULB specifies the budget and selects the consultant that has the best credentials and has submitted the best technical proposal, within this fixed budget); (b) quality and cost-based selection (where the ULB allocates weightages for the technical quality of the proposal and cost, and selects the consultant with the highest weighted average score); (c) quality-based selection (where the ULB selects the consultant who has submitted the best proposal, irrespective of the cost); or (d) cost-based selection (wherein the ULB selects the consultant who has quoted the lowest cost to conduct the assignment, amongst all the pre-qualified consultants, who have adhered to the ToR).
- **Prequalification:** As a best practice, ULBs seeking to implement a bundle of projects with PFDF assistance may prefer to maintain a database and pre-qualify consultants for various tasks. The SPFE should place this database on its website and also share it with MoUD so that other SPFEs can benefit. The qualifications of a pre-qualified shortlist of consultants should be validated periodically, say every two years. After such a list of pre-qualified consultants is available, the ULB could issue subsequent ToRs to these pre-qualified consultants only, seeking their technical and financial proposals.

iii. Scope of pre-feasibility assessment

The pre-feasibility assessment of the project should include both the technical and financial aspects of the project. Typically the scope of the assessment should include at least the following:

- **Project coverage**: The scope of the project should be clearly identified specifying not only the geographical area and population that the project would cover, but also the service levels, quality of service, etc. that the project proposes to offer.
- **Benefits from project**: The ULB should clearly identify the benefits that the project would deliver to the city and its residents.
- **Selection of technology**: The consultant should identify all the possible alternative technology options and conduct a thorough analysis of each based on the parameters of quality of service, time and cost of implementation, quantum of land required, life cycle costing, ease and cost of operations and maintenance, etc. This evaluation should throw up the most appropriate

technology for the city in a medium- to long-term time frame.

- **Basic engineering design**: The consultant should prepare the basic engineering design, based on the selected technology (above-mentioned point), to the detail required to enable estimation of costs and other parameters of the project.
- **Land requirement**: The basic engineering design would highlight the land requirement for the project. An assessment of land already owned by the ULB and/or to be acquired needs to be made, including an initial identification of specific feasible sites for the project.
- **Project implementation approach and likely time estimate for project completion**: The consultant and the ULB should evolve a mechanism to implement the project after evaluating all the possible alternative options, like Engineering Procurement Construction (EPC) bids or "Bill of Quantities" (BOQ)-based bidding for small packages of construction or any other alternative method that is best suited for quick and cost effective implementation of the project.
- **Estimate of project cost**: In light of the above, the consultant should be able to determine an estimated project cost that would probably not be precise, but is likely to be within ±10% of the actual project cost.
- **Estimate of operations and maintenance cost**: The consultant would also typically be in a position to offer estimated costs of operations and maintenance of the project over the long run.
- **Estimate of project-specific revenue**: The ULB would need to assess the extent of project-specific revenue that the ULB could potentially collect from the time the project commences operations, and incrementally as a result of the services provided by the project.

iv. Pre-feasibility report & SPFE review

All elements of the project as evolved and described in the preceding Section 3.1.iii would be documented and submitted to the ULB by the consultant as a pre-feasibility report. This report would be the key deliverable of the consultant in this phase of its involvement.

The preparation of the pre-feasibility report should typically take between two-four months, depending on the complexity of the project and the responsiveness and support extended by the ULB.

A committee comprising nominees of the ULB, SDMA and the SPFE would review the pre-feasibility report, which should comprise the following:

- Review of the project cost and operations and maintenance cost assessments.
- Review of the ULB's ability to sustain the funding support required by the project, both at the project construction stage, as well as for its ongoing operations and maintenance.
- If this funding support is found to be inadequate, then this review needs to evolve mechanisms, including change in user fees related to the services offered by the project, to provide the ULB with additional resources to be able to financially support this project.

- The ULB should undertake the appropriate steps to adopt the above-recommended "package" to make the project financially sustainable. This would imply securing a Council Resolution for the implementation of the "package".

The committee should complete this review of the pre-feasibility report within 21 days from the date that the consultant submits the pre-feasibility report.

At this stage, the ULB, with the assistance of the consultant, SDMA and the SPFE, should assess whether this project, along with the implementation of the recommended financial "package", should be implemented on a PPP basis or not. If it is indeed possible to undertake this project on a PPP framework, and the ULB decides to move ahead on that basis, then the project development process to be adopted hereafter is detailed in Section 6.1.v hereunder.

If the review of the pre-feasibility report by the committee of the ULB, SDMA and the SPFE indicates that the project is technically and financially viable, and will not be undertaken on a PPP basis, then the consultant would be asked to go ahead and undertake the second phase of his assignment, i.e., preparation of the DPR.

v. PPP project development & PFDF support

If the ULB decides to undertake the project on a PPP basis, then the ULB would engage either the same consultant or another consultant, selected and appointed through a fair and transparent process (outlined in Section 6.1.ii, Pre-feasibility assessment: consultant selection and appointment), with the appropriate expertise in attracting private sector participation to urban infrastructure projects.

The key terms of reference of the consultant for this phase of project development would comprise the following:

- Evolve the various options and recommend the appropriate mechanism of engaging the private sector in this project.
- Prepare draft concession or other contractual agreement outlining the detailed terms and conditions of private sector participation in the project.
- Determine the appropriate bid variables and prepare bid documents accordingly, with all required support information and resolutions, to select an appropriate private sector partner(s).
- Handle the entire bid process management on behalf of the ULB.
- Assist the ULB in evaluating all the bids received in a fair and transparent manner and recommend the bid most suited for the project. (The bid evaluation parameters are typically determined prior to the commencement of the bidding process and are unambiguously detailed in the bid documents.)

If as part of this bid process, the best private sector offer that the ULB receives is one that requires the ULB to contribute viability gap funding ("VGF"), and the ULB decides to mobilize this VGF through a bond issuance, then the ULB can approach the SPFE to pool its VGF requirement for a pooled bond issuance. In such a situation, the following needs to be finalized prior to the project becoming part of a pool:

- Receipt of final binding bids from private sector parties.
- Selected bidder (where the ULB issues a conditional letter of intent to the selected bidder).
- Negotiation of the contractual arrangements, including the concession agreement or any other project-specific contractual document, and finalisation of the VGF amount.

6.2 Preparation of Detailed Project Report (DPR)

If the project is not to be undertaken on a PPP basis, then the ULB would ask the consultant to undertake the second phase of the assignment, i.e., the preparation of the DPR.

The DPR would typically comprise the following:

- Detailed description of the project, as outlined in the pre-feasibility report.
- Design & detailed engineering – Review the basic design of the pre-feasibility report and undertake detailed engineering of the same.
- Environmental Impact Assessment (EIA) – Undertake an EIA to address any adverse impact on the environment as a result of the project.
- Bill of quantities – With the detailed engineering in place, specify the bill of quantities for project construction.
- Land required and status of land acquisition – Clearly outline the land required for implementation of the project; specify the selected project site; assess the quantum of land already in possession of the ULB and the detailed status of the land to be acquired for the project; and indicate the estimated time and costs for such acquisition in the DPR.
- Definitive cost estimates – Based on the bill of quantities, the DPR should estimate the project cost using firm, negotiated quotations of materials, and also build in expected inflation in the cost of key materials.
- Implementation methodology - The DPR should specify the agreed implementation methodology after evaluation of all possible alternatives.
- Methodology of undertaking operations and maintenance of the project – The DPR should specify whether the construction bids would include O&M for the initial years or whether O&M would be bid out separately or undertaken directly by the ULB.
- Cost estimate for operations ands maintenance - This should be undertaken using a bottom-up calculation, as well as projections based on actual O&M costs of similar projects in nearby areas.
- Projections of incremental project-specific revenues, supported by appropriate ULB Council Resolution (project revenues to cover at least the O&M costs).
- Financial structuring and funding plan for the project and the associated fund mobilisation costs**,** including that the proposed bond issue is the most cost effective mechanism for

mobilising financial resources for the ULB.

- Projections of ULB's financials and an assessment of ULB's ability to service the above-outlined funding plan, such that the minimum Debt Service Coverage Ratio ("DSCR") is at least 1.25.
- Undertake sensitivity analysis of the financial projections to assess best case, worst case and realistic case scenarios.

In light of the fact that the DPR is the second phase and a continuation of the pre-feasibility report, it should probably take between four-six months, depending on the complexity of the project and the responsiveness and support of the ULB.

7. Viability Assessment & Independent Appraisal

7.1 Financial feasibility assessment by SPFE

If the ULB has a ready DPR, and the SPFE has not assessed this project earlier, then the DPR shall be reviewed by the SPFE along the following parameters:

- Assessment of the financial viability of the project, including the ULB’s ability to sustain the financial commitments for implementing the project, as well as the costs of operations and maintenance.
- Based on the above assessment, the SPFE would recommend a financial structure/package, including changes to be made to the user charges for the service to be augmented/provided by the project.
- ULB shall take appropriate steps to adopt all or some of the SPFE recommended “package”, resulting in General Body or Council Resolutions to this effect.
- Based on the DPR and the subsequent ULB-adopted “package”, SPFE would ascertain the viability of taking this specific ULB project as a part of a pool for a pooled bond issue.

7.2 Independent appraisal of DPRs

At this stage of project development, the SPFE has undertaken an assessment of all the pre-feasibility reports or “already prepared” DPRs, and would therefore be in a position to prepare preliminary project pools, based on its assessments of the financial viability and financial structure of the various projects.

Once such a preliminary project pool is prepared by the SPFE, and is acceptable to the respective ULBs and the SDMA, the SPFE will arrange for an independent appraisal of all the DPRs of this project pool. This independent appraisal of the DPRs would be on the following parameters:

- Technical design and detailed engineering solution of the project.
- Bill-of-quantities and estimated project cost.
- Guidelines for operations and maintenance (“O&M”) of the project and the proposed plan of undertaking O&M and cost estimates thereof.
- Proposed plan for project implementation and procurement documentation for contractors.
- Financial structure and plan.
- Debt servicing capability of the ULB.

Any consultant or bank or financial institution of national repute, empanelled with the Ministry of Urban Development, Government of India, for this purpose, will undertake the independent appraisal of all the DPRs. The consultant will provide a report of the appraisal of the DPRs to the respective ULBs, the SPFE and the SMC.

This appraisal of the DPRs for the entire proposed project pool should typically take not more than two months.

The independent appraisal report would provide a consolidated view on the overall viability of the portfolio of projects in the pool and would also comment on the individual projects within the pool. In the case where the consultant or bank or financial institution undertaking the independent appraisal finds one or more DPRs of the pool to be unviable, either technically or financially, the concerns raised by the independent appraisal must be addressed by the ULB, the DPR consultant, the SPFE and the SDMA to the satisfaction of the independent appraiser. The SPFE would finalise the pool of projects through an iterative process that would take into account queries and issues raised by the independent appraiser and the ability of respective ULBs to satisfactorily address them.

8. Pooling of Projects by SPFE

8.1 Guidelines for pooling

On completion of the independent appraisal of the DPRs, the SPFE will finalise the bond pool or pool of projects, based on the following parameters:

- Consider only those ULBs that accept all conditionalities stipulated by the credit rating agencies/SPFE for participating in the pooled bond issuance.
- Appropriate size of bond issue (neither too small to make the issuance costs prohibitive nor too large to make closure difficult).
- Mix of projects/ULBs that include, at a minimum, some financially stronger projects/ULBs and others that might not be so strong, such that the bond pool gets a credit rating that is attractive (at least investment grade) for the investors.
- ULBs that would be able to "influence" each other to adhere to their respective bond servicing requirements

A pool of projects so created would be an agglomeration of distinct projects, promoted by different ULBs, with their own appraised DPRs, including the identified funding gap to be met from the proposed pooled bond issue. The projects are proposed to be pooled to enable the creation of a certain minimum size of the bond issuance and sufficient creditworthiness that would make the issue attractive enough for subscription by investors.

8.2 Funding plan

For each one of the projects in the pool, the SPFE will follow the process outlined below for operationalising the funding plan as contained in the final DPRs:

- The SPFE shall form a committee, which may be called the "Bond Issue Committee" (BIC), comprising the heads of the finance function of each ULB and the SPFE. The chief financial officer of the SPFE shall head the BIC.
- Circulate the final DPRs, which will contain not only the final project costs, but also the proposed funding plan for the project, amongst the members of the BIC. The consultant preparing the DPR would evolve this funding plan in close consultation with the ULB, by: (a) making a realistic assessment of the ULB's available operating surplus to partially fund the project during project implementation and any cash reserves; and (b) any other "internal" sources of funding or grants from state government or other sources. The difference between the final project cost and the internally generated funds would be funded by the pooled bond issue.
- BIC should meet to:
  - ❖ Review the funding plan for each one of the ULBs.
  - ❖ Review projections related to: (a) project-specific revenue/expenditure and assumptions;

and (b) ULB financials and assumptions.

- ❖ Review sources of funding – determine final funding mix – proportion through debt and equity.
- ❖ Discuss sources of debt and equity.
- ❖ Debt – it would already have been established by the DPRs that the PFDF bonds are the most cost effective option for debt financing. If the consultant has factored in further credit enhancement of the PFDF bonds through a guarantee(s) from multilateral funding agencies/banks/FIs, etc., the BIC shall additionally evaluate different options for obtaining such a guarantee(s). Any gaps in raising the full quantum of debt through the PFDF bond route may be discussed and options like Megacity loans, term loans from bank, etc. may be evaluated. The issues related to accessing a diversified funding mix may be evaluated.
- ❖ Equity – grants and internal accruals. Evaluate likelihood of obtaining the quantum of grant funding from the state government, including the process and time frame for the same. Evaluate the quantum of surplus (accruals) likely to be generated by the constituent ULBs after detailed evaluation of the projected financials of the ULBs in the most likely scenario.
- ❖ Ensure that all General Body/Council Resolutions required to implement the above-outlined funding plan are in place.
- ❖ BIC shall then draw up an activity chart, which shall outline the steps required for accessing the various sources of finance, assign key responsibilities, and set a broad time frame for completion of the fund raising process. This shall be tied to the cash flow requirement of the project and timeline for completion of the project.

8.3 Determination of pooled bond issue

On creation of the bond pool and the funding plan for each ULB project, the SPFE would have ascertained the bond issue parameters, i.e., the size of the bond issuance, the tenor of the bonds to be issued, the timing of the funds requirement, the servicing of bonds by each ULB participating in the bond pool, repayment schedule, the cost of undertaking the bond issuance, etc.

On finalization of the bond pool, the SPFE will sign draft agreements with each ULB (approved by the ULB Council of elected members or Standing Committee or other appropriate body of elected members of the ULB), which will on completion of the bond issuance process be the sub-loan agreements from the SPFE to the participating ULBs. The draft agreement with each participating ULB will comprise clauses on the following:

- Payment of initial costs associated with the bond issuance.
- Bond servicing payment schedule, including annual costs of bond maintenance, like costs of trustee bank, etc.
- Repayment amount and schedule.
- Implementation of the agreed "reform package" by the ULB, as outlined in the following section and detailed in Toolkit IV.

- Creation of escrow accounts and maintenance of adequate reserves in escrow accounts.
- Interception of state grant to the ULB.

8.4 Reform agenda for PFDF scheme support

In order to ensure synergy with other schemes of MoUD, the reform agenda agreed to by the ULB to access support under the PFDF scheme would require ULBs to conform to all the reforms specified for support under the MoUD's other schemes, namely JNNURM and UIDSSMT. Both these programs have outlined a reform agenda covering mandatory reforms at the state and ULB levels, apart from certain optional reforms. The coverage of this reform agenda is detailed in the JNNURM and UIDSSMT toolkits, and also highlighted in Section 14.1 of Toolkit IV of the PFDF scheme.

The reform agenda outlined under JNNURM and UIDSSMT provides a fundamental level of reforms to be undertaken by the ULBs. Additional reforms, particularly in the area of improvement in quality of accounting and financial information, reporting and dissemination practices, etc., would need to be undertaken for accessing support under the PFDF scheme. The capital market and rating agency would require these reforms for raising finance competitively through pooled bonds. Some illustrative additional reforms that may be sought by financial investors include:

- Greater granularity and periodicity in reporting and dissemination of financial and operational information.
- Reporting on credit enhancement measures, including escrow account status and flows from each one of the pre-agreed specific revenue items that are being escrowed.
- Reporting on governance information, including attendance, decisions and minutes of municipal council meetings.
- Other specific independent audit and disclosure requirements relating to environmental and social safeguard requirements.

Pooled Finance Development Scheme

Credit Rating, PFDF Support and Bond Issue Process 3

PFDF

Ministry of Urban Development
Government of India

9. Overview of the Toolkit

The purpose of this toolkit is to outline the steps that the SPFE and ULBs need to take in order to determine the funding plan, prepare for and complete the credit rating process, submit proposals for CREF support, complete the bond issue process, and achieve financial closure on the project.

The toolkit is organized as follows.

10. Credit Rating Process

The credit rating process shall commence with the appointment of a rating agency by the SPFE followed by conducting the rating process. Midway through the rating process, discussions with leading merchant bankers, independent bond trustees and legal counsel may be initiated since the rating agency may need to interact with these entities before finalisation of the rating structure and concluding the rating. However, in case sufficient capacity exists within the SPFE to interact on these aspects with the rating agency, the same may be conducted in house. The final appointment of the merchant banker, independent bond trustee and legal counsel may be concluded after obtaining sanction of CREF support from the SMC.

10.1 Terms of Reference for rating agency

The SPFE shall define the Terms of Reference (ToR) for appointment of the credit rating agency. The suggested draft ToR is provided in Exhibit 10.1

Exhibit 10.1 Terms of Reference

Background

The growth rate of the Indian economy has been increasing over the last few years. Sustaining these growth rates is, however, critically dependent on correcting the infrastructure bottlenecks which exist across various sectors of the economy. One of these bottlenecks is the quality of city infrastructure including roads, water and sanitation. The pressure on city infrastructure has been multiplying on account of the rapid growth in urban population. In the past, municipalities have traditionally relied on state government for funding urban infrastructure projects. Although some of the larger municipalities have started building capacity, most lack the capacity for sustained long-term planning and preparation of bankable urban infrastructure projects. The size of projects for smaller municipalities has also not been adequate to constitute a marketable size for bond issues. They also lack internal systems for accessing market borrowings. The sharp growth in infrastructure requirement coupled with pressure on state governments' own finances has led to a situation where municipalities may not be able to sustain infrastructure creation solely relying on state government funding. There is, therefore, a need to access alternate sources of funds for bridging municipal infrastructure gaps.

Direct access to capital markets for funding urban infrastructure projects, often leveraging government grants, is an established option in global markets. However, capital market investors require well structured projects with a clear understanding of inherent risks, appropriate pricing of such risks, and an established system for ensuring timely payment of dues.

In this context, the Government of India (GoI) launched its Pooled Finance Development Fund (PFDF) scheme. The Guidelines of the scheme were issued by the Ministry of Urban Development and notified vide its Resolution No. K-14011/40/01-UDII (Vol. III) dated October 25, 2006. This Resolution was followed by the Ministry's Notification No. K-14011/40/01-UDII (Vol. IV) dated June 7, 2007 on "Guidelines for Issue of Tax-free Pooled Finance Development Bonds". Both the

Guidelines are annexed to this ToR.

The PFDF scheme is meant to provide credit enhancement grants to a pool of (primarily) medium and smaller municipalities to enable them to access the capital market through pooled finance municipal bonds for investment in urban infrastructure projects. The PFDF scheme is meant for creation of essential municipal infrastructure, with priority on water and sanitation projects. In case access to the PFDF scheme is being sought for projects in other areas, it must be first demonstrated that adequate service quality exists in the water and sanitation sectors in areas under the jurisdiction of the respective municipalities. The main objectives of the PFDF scheme are four-fold:

- Facilitate ULBs to access the capital and financial market for investment in essential municipal infrastructure.
- Facilitate development of bankable urban infrastructure projects.
- Reduce the cost of borrowings to local bodies with appropriate credit enhancement measures and through restructuring of existing costly debts.
- Facilitate development of municipal bond market.

Tasks

The State Pooled Finance Entity (SPFE), a cost neutral pass through entity, will issue bonds in the capital market on behalf of the participating ULBs in the pool. A credit rating agency shall be appointed by the SPFE to carry out the following tasks:

a) Rate the PFDF bond issue taking into consideration the finalised DPRs, funding mix and the proposed structure of the issue.
b) Determine the size of the Credit Rating Enhancement Fund (CREF).
c) Evaluate the impact on the rating due to alternate structures proposed by the SPFE.
d) Communicate the rating in writing along with a detailed structured payment mechanism (SPM) on which the rating is based. The SPM will also define the process/mechanism for investment of CREF (which will be in line with the PFDF Guidelines) and also for re-investment of CREF released during the tenure of the bonds.
e) Provide a detailed rating rationale to be included in the offer document.
f) Evaluate and comment on the legal documents supporting the structure – Tripartite Agreement [between SPFE, state government and guarantor (if any)], Trustee Agreement (between SPFE and independent bond trustee), Deed of Guarantee (if any), Commitment Letter from state government for SFC devolution at source (if used).
g) Undertake surveillance of the bonds on an annual basis (or earlier if warranted) and renew the rating until redemption of the bonds. The surveillance process will also comment on release of CREF at the appropriate time linked to redemption of the bonds.
h) Participate in pre- and post-issue meetings with SPFE, legal counsel to the bond issue, trustee, guarantor, state government, Ministry of Urban Development, and Sanctioning and Monitoring Committee (SMC), as and when required.
i) Provide standardized reporting templates, which, while covering the information requirement for credit rating surveillance, will also incorporate the reporting needs of MoUD, SMC, Steering Committee, Project Review Committee, trustee and guarantor. A comprehensive reporting format may be evolved for the same.

Deliverables

The rating agency will provide the following deliverables:

a) Rating communication letter, including SPM, defining the detailed operation of the structure (within four weeks of SPFE providing information required by rating agency).
b) CREF requirement (along with a) above).
c) Detailed rating rationale (within one week of acceptance of rating).
d) Standardized reporting templates (within two weeks of acceptance of rating).
e) Annual surveillance rating communication letter and rationale (not later than one year from the previous rating exercise, subject to SPFE providing required information in a timely manner).

Payment Schedule

Initial rating fees shall be payable along with the mandate letter by the SPFE to the rating agency on submission of a pro forma invoice by the rating agency. Surveillance fees shall be payable by SPFE on an annual basis.

The expenses of the SPFE will be reimbursed by PFDF under its reimbursement of project development expenses.

10.2 Process of appointment of rating agency

The SPFE shall invite bids from all four existing rating agencies for rating of the PFDF bonds based on the above ToR. In the case where state regulations ask for open tender, the same shall be issued in leading newspapers/website of the SPFE. Otherwise, a limited tender may be issued. The draft tender format is provided in Exhibit 10.2

Exhibit 10.2 Tender format for appointment of credit rating agency

CREDIT RATING OF POOLED FINANCE BONDS TO BE ISSUED BY …….. (Name of SPFE)

(SPFE) plans to issue pooled finance bonds in order to finance urban infrastructure project(s) for providing water supply/sanitation/solid waste management infrastructure (brief description of project). This project(s) will be executed across a pool of xx municipalities/ULBs. The beneficiary ULBs, which comprise the pool, are …. (Names of municipalities).

(SPFE) requires the services of a credit rating agency to rate the proposed Rs. xx crore bond issue. The Terms of Reference (ToR) for the rating agency are enclosed/available on our website…

The rating agency is required to submit a detailed proposal including the following:

1. Background.
2. Experience in rating debt issues of state governments, municipalities, pooled finance issues and structured finance issues along with some sample rationales.
3. Methodology for rating debt issues by state governments, municipalities and pooled bond issues.

4. Agreement to complete the exercise as per the ToR.
5. Time frame for completing the exercise.
6. Specific deliverables (to comply with ToR, mentioning exclusions, if any).
7. Fees – both for initial rating and for annual surveillance.

The detailed proposal shall be submitted in two parts. The technical proposal shall cover item Nos. 1 to 6 above and the commercial proposal shall cover item No. 7 above. The two parts shall be submitted in two separate covers clearly marked ……. Both parts must reach the office of (SPFE) at …. by …

(SPFE) shall open the technical bids for evaluation on …. Commercial bids of successful bidders shall be opened on …

(SPFE) reserves the right to accept or reject any proposal. The decision on appointment of a rating agency shall be based on both technical competence and commercial competitiveness, and (SPFE)'s decision in this regard shall be final.

Based on the evaluation of bids, SPFE shall finalise selection of the rating agency and issue the mandate letter along with fees to the agency.

10.3 Outline of rating process with a case study

The rating agency will assign a rating to the bonds issued by Pooled Finance SPV (Special Purpose Vehicle, a trust/company promoted by the SPFE specifically for issuance of such pooled bonds). The issuer of the bond is the SPV, which has extended/will extend loans to the ULBs (or a PPP entity where the project is implemented through the PPP route).

Rating for the bonds will be driven by the following:

a. The credit quality, diversity and concentration of the loans in the pool. The credit quality of the loans is essentially the credit quality of the ULB/PPP entities, which are the underlying and eventual obligors for the SPV.
b. The underlying loan documents that provide for a structured payment mechanism (SPM) envisaged for securing the loan repayment by the ULB/PPP. These mechanisms include a) interception of state grants and b) escrow mechanisms to ring fence ULB/PPP cash flows for servicing the underlying loan.
c. The structure of the SPV provides for credit enhancements to the pooled finance bond in various forms such as senior-subordinate bond structures, third party guarantees, escrow, and interception mechanisms in aid of the pooled finance bonds.
d. The quality of the servicer, who will collect the repayments from the ULB/PPP, is also a key rating consideration. In many states, the SPFE is a lender to the ULBs and will take on the role of servicer/collection agent. The past track record of the SPFE in originating and collecting loans to the ULBs in the state would then become a rating consideration.

i. Issuer credit quality

Assessment of the credit quality of the borrowing ULB/PPP is the starting point. The assessment would be on the lines of credit ratings for ULBs currently being carried out under JNNURM where the ratings provide feedback about the operational and financial profile of ULBs. In the Indian context, ULBs are heavily dependent on the state government – their responsibilities (and hence expenditure commitments) flow from legislation passed by the state; and their taxation powers are delegated by the state and, even where they are vested with taxation powers, the ULBs generally act only with state government approval. Ratings for ULBs therefore are heavily influenced by the credit rating/assessment of the state government. An ULB's rating would also be influenced by its standalone strengths as reflected in own revenues and overall revenue balance.

ii. Diversity and concentration of pool

The diversity and concentration of a pool makes an important difference to the credit quality of the pooled finance bond. Keeping the credit quality of the underlying loan pool unchanged, the greater the diversity of the loan pool, the better the credit quality of the senior-most bond in the pooled finance bond hierarchy. Diversity of the loan pool is directly related to the number of ULBs/PPPs in the pool, the distribution of loan sizes (for example, if a single loan accounts for a dominant share of the pool, then the diversity would be poor, even if there were many other smaller exposures to other ULBs in the pool), and the default correlation between the ULBs/PPPs in the pool. The dominant role played by a single common entity, the state government, in the affairs of the ULBs within a state reduces the possibility of significant divergence in the credit profile of the state's ULBs. This should ordinarily mean higher default correlation between ULBs of a single state on account of the high dependence on the state government. There are exceptions to this rule when a ULB/PPP has shown a track record of independent resource generation and possesses a revenue base robust and independent enough from state government control.

iii. Existing rated pooled finance bonds in Indian context

The Karnataka Water & Sanitation Pool Fund (KWSPF) and the Tamil Nadu Water & Sanitation Pooled Fund (TWSPF) can serve as an example.

	Karnataka WSPF	Tamil Nadu WSPF
Size of bond issue	Rs 1bn	Rs 320m
Issuer	KWSPF Trust	WSPF Trust
Number of ULBs	7 erstwhile city municipal corporations and 1 erstwhile town municipal corporation.	1 municipal corporation, 4 municipalities and 8 Adjacent Urban Areas.
Tenure	15 years	Balance maturity of loans
Rating of the bond	LAA(SO) by ICRA	LAA(SO) by ICRA

	Karnataka WSPF	Tamil Nadu WSPF
Credit enhancement	1. 50% of outstanding principal guaranteed by USAID 2. Rs. 255m pre-funded bond service fund	1. 50% of outstanding principal guaranteed by USAID 2. Rs. 69m pre-funded bond service fund
SPM	1. Escrow mechanism to be funded in 10 EMIs before annual bond service due date 2. Interception of State Government grants to support repayment of bonds	1. Escrow mechanism to be funded in 9 EMIs before the annual bond service due date 2. Interception of State Government grants to support repayment of bonds
Structure	Pooled bond issue used to on-lend to underlying ULBs	Pooled bond issue used to refinance existing high-cost loans taken by ULBs

iv. Loan credit quality

As mentioned, the pooled bonds can either be used to on-lend to pool constituents (as in KWSPF) or refinance existing loans borrowed by constituents (as in TWSPF). In the latter case, the pooled bonds will be serviced out of repayments of the constituent loans in the pool. Here, the primary input to the rating of the pooled finance bond would be the constituent loans' ratings. The starting point for this rating would be the rating of the individual ULBs/PPPs. The rating for the constituent loans, however, could possibly be notched up from this base line in the presence of SPMs/credit enhancements. These could take the form of interception of state government grants, debt service reserve funds, and escrow mechanisms created from ULB/PPP cash flows for securing the loan's repayment. The level of comfort from such mechanisms (which determine the notching of the loan's rating from the base line credit quality of the ULBs/PPPs, if at all) will also depend on the quality of monitoring mechanisms put in place to invoke/administer the SPM (for example, drawing on DSRF or calling on the state government to intercept the grant as and when required). Further, elements of the SPM such as state government grants are already factored in while rating the ULBs/PPPs. A grant interception mechanism is only an SPM, rather than an external source of credit enhancement (such as a state government or a multilateral guarantee). Indeed, in the current Indian Constitutional arrangement, state government devolutions of tax to ULBs are mandatory. The quantum of devolution and its sharing by local bodies in the state is advised by the quinquennial State Finance Commissions (SFC) and becomes binding on the state government once the SFC report is accepted by the state legislature. However, state governments continue to retain flexibility in year-to-year allocations and even the timing of distribution to the local bodies. Hence, devolution of state grants could be seen as an application of revenue, rather than an obligation with rigid timelines (as in the case of a debt obligation of the state government).

v. Loan credit quality mapped to default likelihood

Once the constituent loans have been rated, the credit ratings are translated to default likelihood. Rating agencies have mapped their ratings to default rates using historical ratings and default experience. It can be argued that default likelihood and recovery post-default in the municipal sector would be linked to the next higher tier of government, given the resources of the state governments (to whom the ULBs are closely tied) and the essential nature of the services provided by ULBs.

vi. Analysis of structure

The analysis of the structure of the SPV is the next step. The capital structure of the SPV could take various forms – there are often multiple layers of seniority-based tranching amongst the SPV's obligations. The higher the seniority, the better the rating of the instrument concerned. In both the WSPF structures discussed above, there was only one class of bond, but there was credit enhancement in the form of a bond service fund, which would be funded upfront. Further, there was a guarantee of 50% of the outstanding bond principal from USAID. Apart from these, the State Government also promised to intercept the devolution of its grants to the ULBs concerned, if the escrow account was not funded by the timelines provided (3 months before bond due date in the case of TWSPF and 2 months before in the case of KWSPF).

vii. Review of documentation

The rating agency will review legal documentation such as:

- Trust deed governing the setting up of the SPV trust, classes of bond holders, constitution of pool, details of credit enhancement and SPM, and the duties and rights of the trustee.
- Assignment agreement and deed of assignment of the loans to the SPV trust (where the loans to the ULBs/PPPs have already been made).
- Loan agreements between SPV and ULBs/PPPs and associated agreements such as tripartite escrow agreements.
- Guarantee agreements.
- Agreement/government order from state government regarding interception of devolution funds
- Legal opinions on the legality of the transaction.

viii. Conditional rating to precede the final rating

As outlined in the preceding point, review of the legal documentation is essential to obtain comfort from various credit enhancement forms and SPMs. Since the rating process precedes the finalisation of the bond issuance process by a few stages (after the rating, withdrawal from the CREF needs to be sanctioned, followed by legal documentation of MoA and sub-loan agreements and appointment of intermediaries for the bond issuance), the rating that is assigned initially is often *conditional* and is subject to confirmation of the structure, the pool composition, and completion of the formalities and legal documentation related to the ULB, SPM and credit enhancements.

ix. Servicer quality

Where the SPV is taking over loans that have already been made to the ULBs from the originator of those loans, the rating process would consider the selection filters and track record of the originator. It is also important to evaluate the quality of servicing of the loans after their securitisation. Recovery of loans from ULBs is generally an intensive process given the presence of loan-level SPMs like interception of state grants, DSRF and escrow accounts. Presence is required at the field level to interact and follow up with the ULBs and the state government to ensure timely repayments. The role of servicing and collecting the loans will have to be vested with the entities that have such capabilities. Different states have varying institutional arrangements. In Tamil Nadu for instance, Tamil Nadu Urban Development Fund (TNUDF) and Tamil Nadu Urban Infrastructure Financial Services Limited have experience in lending to (and recovering from) the ULBs.

x. The rating framework

As discussed previously, inputs to the rating of the pooled finance bond are the credit quality of the underlying loans, their diversity, default correlation, the structure and credit enhancements, review of legal documentation, and the quality of the servicer/collection agent. As can be seen, the analysis is a mixture of quantitative and qualitative aspects. These aspects are incorporated into a cash flow model. The rating for the pooled finance bond is based on an expected loss (EL) approach.

The steps in assessing EL for a pooled finance bond are:

- Drawing up various cash flow scenarios for the pool. This analysis must incorporate standalone likelihood of default of an ULB/PPP (how likely is an individual ULB to default given its credit standing and the availability of SPMs), timing of default (when is the default likely?), frequency of joint default (how likely are two or more ULBs to default together, given their default correlations), and the recovery post-default of an ULB/PPP. All these aspects have been discussed in preceding sections on the rating approach.
- Each of these cash flow scenarios captures the cash flows derived from the pool. To these are added the credit enhancements provided at the level of the SPV, such as guarantees, interception mechanisms and cash collaterals. The resulting cash flows are presumed to be available to service the rated pooled finance bonds.
- The adequacy of these aggregate cash flows vis-à-vis the bond service requirements is measured across all possible scenarios for cash flows collected from the pool. A scenario-probability-weighted average cash flow expected to be available to the bond holders can now be computed. The average expected loss (EL) to the investors in the bond can thus be calculated.
- EL benchmarks have been set for various rating levels. These benchmarks can be interpreted

as the loss that can be expected by investors in the rated instrument. As a rule, the higher the rating, the lower the EL benchmark. These benchmarks have been partly drawn from historical experience of losses taken by investors in debts rated at various levels.

- The rating for the pooled finance bond would therefore be based on mapping the EL to the investors of the EL benchmarks. The higher the EL to the investor, the lower the rating,

Practical implementation of the cash flow modelling approach described above is commonly done through Monte Carlo (MC) simulation given the ready availability of simulation tools and ease of implementation. The steps involved in drawing up the probabilities for the default scenarios mentioned above include modelling each asset value as a standard normally distributed variable with certain correlation. The default cut-off point for asset value is defined and simulations are run to generate different scenarios. Default in each or either of these assets is flagged if the simulated asset values are below the respective default cut-off points. Joint default scenarios in a pool of loans are simulated using this method.

Bond Structure

Typical pooled bond structures would incorporate tenures ranging from 10 to 15 years. The underlying ULBs would make payments on a monthly basis into a separate bank account, which would be pooled into an escrow account used for repayment of pooled bond investors. Generally speaking, prepayments are undesirable from an investor viewpoint and issue conditions typically incorporate clauses where ULBs cannot prepay without bond holder consent. However, if such clauses do not exist or there is nothing to prohibit prepayment, ULBs with surplus cash could make a prepayment and the same would be passed on to investors as and when they occur. Alternatively, prepayment can be deposited in a separate bank account (opened exclusively for this purpose) and passed on to bond holders as and when due. This alternative, however, poses the problem of negative carry and comingling of funds. The situation of a "cleanup call option" may also be envisaged, wherein the SPFE buys back performing loans from the SPV, if the total outstanding in the pool has dropped to 10% (or lower) of the initial pool size, with purchase consideration paid by the SPFE to the SPV distributed amongst the bond holders. In such a situation, the underlying ULB would be able to exit the pool. However, these conditions must be expressly documented in the legal agreements and specifically provided for.

Case Study – Karnataka Water and Sanitation Pooled Fund

In 2005, the Government of Karnataka (GoK) accessed market borrowings through the pooled finance mechanism to finance the Greater Bangalore Water and Sewerage Project (GBWASP) proposed to be implemented across (erstwhile) seven CMCs and one TMC adjoining the Bangalore Municipal limits. These CMCs and TMC have since been merged with the Bangalore Mahanagar Palike in 2006-07. The overall cost of the project was approximately Rs 340 crore, which was proposed to be funded by a variety of sources including a pooled bond issue of Rs 100 crore.

In order to access the municipal bond market, the GoK constituted the Karnataka Water and Sanitation Pooled Fund (KWSPF) as a SPV, specifically created to tap the market borrowings. KWSPF was constituted as a trust under the Indian Trusts Act, 1882. Karnataka Urban Infrastructure Development and Finance Corporation (KUIDFC), which is the nodal agency in Karnataka for implementation of externally aided projects, acted as the asset management company for the trust.

KWSPF (the issuer) issued Rs. 100 crore of fixed coupon tax-free pooled finance bonds in July 2005. The bond issue was rated LAA (SO) by ICRA, indicating high credit quality, and was fully subscribed. The issue had a tenor of 15 years with a 3-year moratorium and did not carry any put/call option. Repayment would start from the fourth year with the principal redeemed in twelve equal instalments. The bonds carried a coupon rate of 5.95%.

Timely repayment is being ensured through a structured payment mechanism monitored by Canara Bank, which was appointed as an independent trustee to the bond holders. The KWSPF structure incorporates many credit enhancements. The KWSPF Trust issued loans out of the pooled bond proceeds. Each of these underlying loans was backed by a structured payment mechanism whereby the erstwhile city municipal corporations (CMCs) concerned will fund $1/10^{th}$ of their annual repayment instalment by depositing equivalent funds in a designated bank account. These balances will then be pooled together to fund an escrow account opened in the name of the KWSPF trust. The bond holders will be serviced from the funds lying in this escrow account. Such an arrangement reduces the risks associated with a large annual repayment having to be funded at one time by the CMCs. Further, well before the bond holders due date, the independent trustee will check the adequacy of funds in the escrow account and issue notice to the GoK to top up the deficit, if any. GoK will be obliged to top it up to the extent of deficit. If there is a deficit even after this top up, the WSPF trustee will utilise the BSF (sized at Rs 25.5 crore). The BSF will be topped up within 60 days of the utilisation by a combination of a USAID guarantee (50% of bond principal) and the GoK.

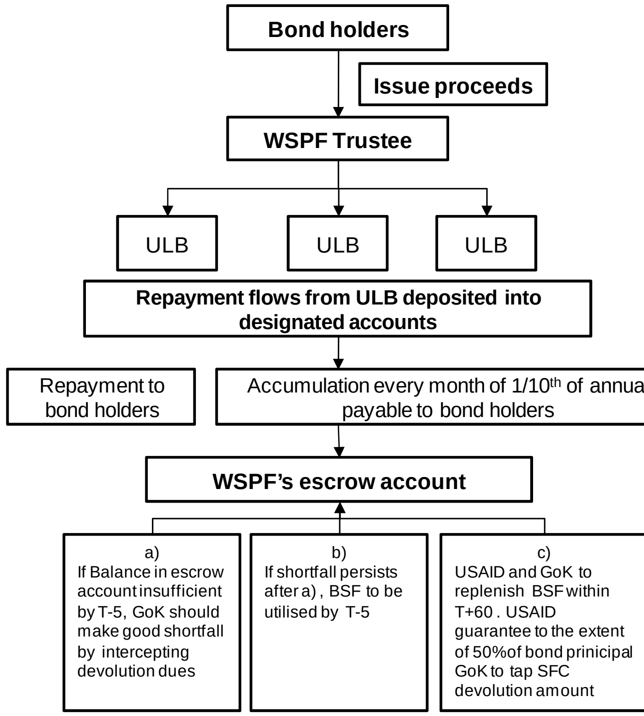
The BSF was sized by the rating agency (ICRA) at Rs 25.5 crore in order for the bonds to achieve the target LAA (SO) rating. This BSF was funded upfront and hence acted as a source of credit enhancement. Also acting as credit enhancement was a guarantee from USAID (a departmental undertaking of the US government) to the extent of 50% of the bond principal.

The rating agency initially made an assessment of the standalone credit quality of the CMCs. Though not strictly a credit enhancement, the GoK promise to intercept devolution funds (the devolution funds are an essential component of the financial strength of the CMCs duly reflected in their standalone credit quality assessment) provided comfort to the extent it imposed an element of discipline in debt servicing. The pre-funded BSF and the USAID guarantee are designed to provide support in the event of default by the CMCs and the inability of the State Government to provide the requisite top-ups from devolution funds.

The Value Chain	Remarks
Standalone credit strength of the CMCs	Based on financial & operating parameters of the CMC and reflecting the credit standing of the GoK
+	
Structured Payment Mechanisms 1. GoK commitment to utilise devolution funds for debt service 2. Systematic pre-funding of escrow account by the CMCs	Notching of rating of the underlying CMC exposures
+	
Credit Enhancements 1. USAID Guarantee 2. Pre-funded Bond Service Fund *Supported by a time invocation of credit enhancement by trustee*	External sources of credit enhancement
=	
Credit Quality of the Bonds	LAA(SO)

The overall framework for sizing the quantum of credit enhancement is one of expected loss (EL) to investors in the rated bond. As mentioned previously, EL refers to the probability-weighted-average loss arising to investors in various default scenarios. These various scenarios were constructed assuming various timings of default, number of defaults (amongst the 8 CMCs), and availability of funds from the State Government. The probabilities for the different default scenarios were constructed after considering the standalone default likelihood over time and the default correlations between the CMCs and the State as also amongst the CMCs themselves.

Structured Payment Mechanism: Karnataka Water & Sanitation Pooled Fund Structure



10.4 Key information requirement for rating

While each rating agency has its own information requirements for conducting the rating exercise, SPFE may indicate to the ULBs to keep ready the following information, which may be required for the rating purpose and will help in expediting it.

Typical Information Requirement for Credit Rating from ULBs

1. Organisation structure and names of key personnel.
2. History of elections to council.
3. Copy of the Act under which the municipality has been incorporated.
4. Last five years budget documents and audited financial statements.
5. Break-up of main items of revenue and capital receipts/expenditure.
6. Main state government notifications relating to the municipality, which affect its revenue raising capability (like property tax rates, etc.) or its expenditure responsibility.
7. Projections along with assumptions (as submitted to consultant for preparation of DPR).
8. Annual financial statements of the state government for last five years, highlighting State Finance Commission (SFC) devolution trends.
9. Formula recommended by the SFC for devolution and state government's adherence to the same.
10. Procedure for disbursement of devolution funds by the state government to the ULBs, and timeliness of receipt of devolution funds by the ULB in the past.

Any additional information requirement beyond this may be arranged by the SPFE.

10.5 Conducting the rating process

For better coordination, SPFE may appoint one of its key personnel as a one-point contact for the credit rating process, which would coordinate amongst the rating agency, state government and the constituent ULBs for expediting the information requirement. The BIC may meet periodically to assess the progress of the rating exercise and streamline any bottlenecks. The rating agency may be invited to attend the meeting of the BIC to expedite the process.

During the rating process, various options for structuring the bond issue would be discussed and the rating agency may be asked to evaluate the same from the rating standpoint. The SPFE, in conjunction with the guarantor/merchant banker, may provide alternate pools that the rating agency may evaluate from the point of view of sizing the CREF. After evaluating all options, the rating agency may then conclude the process of rating based on the final structure.

10.6 Appointment of merchant banker, independent bond trustee and legal counsel

The SPFE may follow a similar process as outlined above for appointment of a merchant banker, independent bond trustee and legal counsel for the bond issue. It is advisable to enable interaction amongst these agencies before finalization of the rating unless adequate capacity exists within the SPFE to conduct discussion on these aspects in house with the rating agency. This would ensure that the structure finally offered for rating is marketable by the merchant banker. However, given the uncertainty on obtaining CREF support until the proposal is evaluated and accepted by the SMC, SPFE may enter into informal discussions with leading merchant bankers/trustees during the rating process and complete the appointment of these entities after SMC approves its proposal for CREF support. If the SPFE has its own legal counsel, the services of the counsel may be used for the bond issue and a separate legal counsel need not be appointed. The legal counsel would draft the legal documents as mentioned in above item No. f) of the Tasks of the draft ToR of the credit rating agency.

11. Submission of Proposals for Seeking Support under PFDF Guidelines

This chapter outlines the process for submission of documents to the relevant authorities for seeking support under the PFDF scheme. The support shall be at two levels – CREF support and reimbursement of project development expenses.

11.1 Proposals seeking CREF support

i. Application format

The SPFE shall submit an application to MoUD. MoUD would then forward the application to all members of the SMC and convene a meeting of the SMC to review the application. The application may incorporate the following:

- Introduction outlining the name of the SPFE, participating ULBs, the DPRs, size of the project (total project cost), and extent of CREF support being sought, rating for the same and preparation for bond issue.
- Brief description of projects proposed to be financed, need for the same and ULBs' willingness to participate in the pool (enclosing Council Resolutions).
- Copy of the DPRs establishing the adequacy of service quality in water and sanitation (in case project is not in these sectors), demand assessment and results of willingness to pay study, design and detailed engineering, including evaluation of alternative technologies, cost estimates, financial viability, and rationale for PFDF bonds as most cost effective option and funding plan.
- Final project cost and means of finance, giving PFDF bond issue terms being proposed (amount of bond issue, tenure, repayment schedule till redemption and interest rate assumed).
- Rating agency's letter communicating rating assigned to the bonds, details of the SPM (a graphical description of the SPM, indicating trigger timelines, timing of guarantor support and state government support may be annexed) and sizing of the CREF; rating rationale may be enclosed.
- Funding plan (ULB-wise) as per above item No. 8 from Typical Information Requirement for Credit Rating, matching cash flow requirements of the project giving estimated time frame for completion of the project(s).
- Reform agenda for support under PFDF scheme - details of proposed reform package segregated into sections on management, operations, accounting, MIS and reporting systems, tariff reform and collection process, etc.; timelines for achieving the above reforms may also be indicated.
- Commitment letter from state government for deducting SFC devolution at source; letter from guarantor (if any).

- Standardized reporting formats as per item No. i) of the ToR of the rating agency, including commitment from the SPFE to coordinate with the ULBs to ensure such MIS is submitted on a regular basis until redemption of the bonds.

The proposals for CREF support shall be reviewed by the SMC. Subsequent to this review, the SMC shall communicate to MoUD the recommendation regarding items to be supported, quantum of CEFF support, and any other conditions to be imposed on the borrowing entities. Post approval by SMC, the SPFE and the MoUD will execute a Memorandum of Agreement (MoA) (details of MoA covered in Section 11.1 (iii) below). In case the SMC does not recommend CREF support, the same shall be communicated to the SPFE.

The contribution by the MoUD to the CREF shall be the lower of 10% of the bond amount or 50% of the CREF as determined by the credit rating agency. The SPFE shall be free to fund the balance portion of the CREF from any other source.

The MoUD shall disburse CREF support in full on achievement of certain milestones. These include:

- Formal MoA to be signed between MoUD and SPFE.
- Appointment of merchant banker and independent bond trustee.
- Preparation of final offer document for bond issue.
- Opening of escrow accounts for receipt of bond proceeds, for CREF as well as any other accounts to be mutually decided between the trustee and rating agency.
- Formal opening of bond issue.
- Any other conditions to be mutually decided between SMC and MoUD.

CREF would ideally be disbursed immediately after the opening date for the PFDF bond issue.

ii. Review process

The application for CREF support shall be reviewed as per Exhibit 11.1.

iii. MoA between SPFE and MoUD

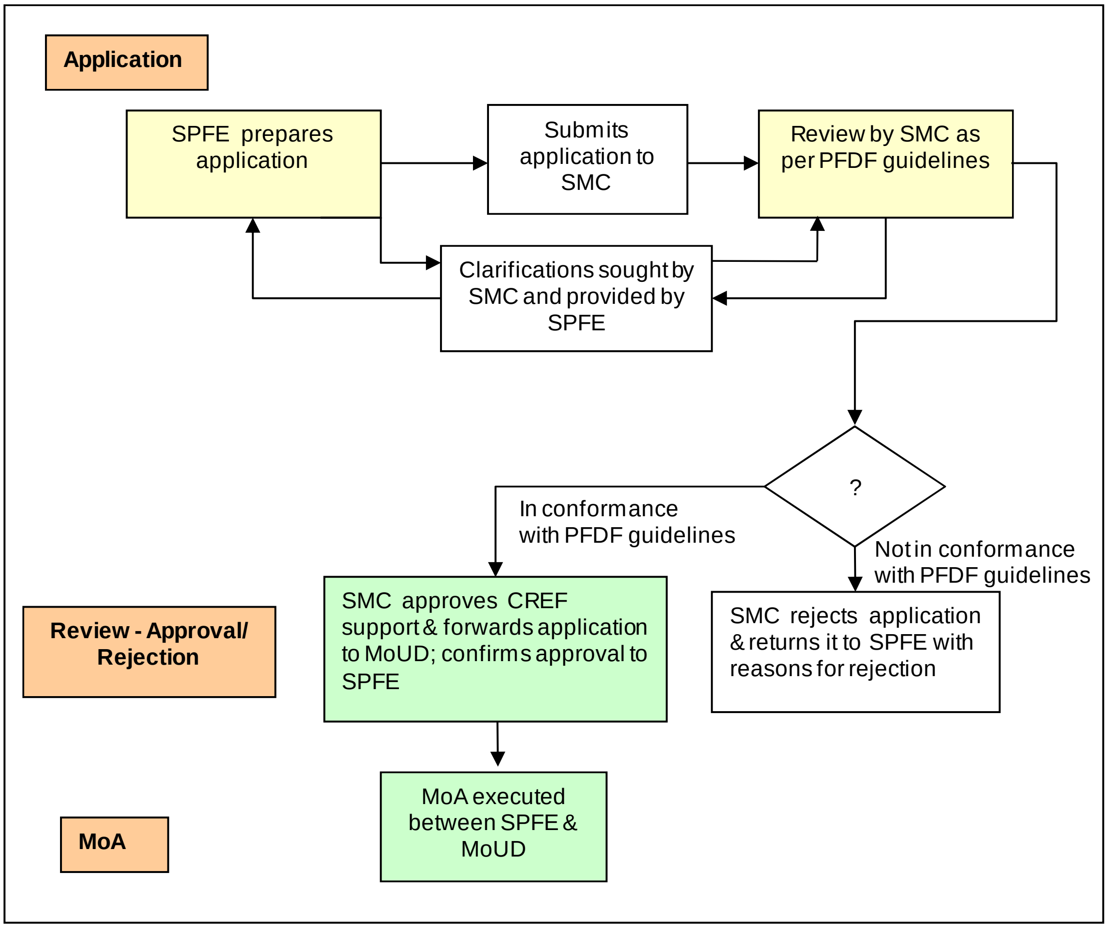
In the case where the SMC approves the application for CREF support, the SPFE (on behalf of the ULBs) and MoUD will enter into a MoA. The MoA shall be drafted by the legal counsel and incorporate the following:

- Means of financing project costs for each ULB and combined for all ULBs.
- PFDF bond issue size, repayment terms and SPM.
- Extent of CREF support.
- Terms of disbursement - including any preconditions imposed by MoUD.
- Milestones for bond issue and repayment giving timelines (depicted graphically).
- Milestones for project implementation/intended use plan, giving timelines (depicted

graphically).

- Financial and operating performance benchmarks for ULBs (derived from projected financials and assumptions made in the DPRs) giving timelines (tabular format).

Exhibit 11.1 Review process for CREF support



- Reform agenda and timelines (tabular format).
- Rights and obligations of SPFE.
- Rights and obligations of state government – Urban Development Department.
- Rights and obligations of Central Government - MoUD, clearly outlining its role in monitoring implementation of the project(s) and utilization of the CREF grant.
- Conditions under which MoUD may suspend grant support and recall disbursed portion.
- Remedies applicable to parties (MoUD and SPFE) in case either party does not comply with the terms of the MoA.
- SPFE must agree to full public disclosure of any and all information relating to this grant assistance.

iv. Sub-loan agreements between SPFE and ULBs

Based on the above, SPFE will enter into sub-loan agreements with the participating ULBs. The sub-loan agreements shall be drafted by the legal counsel and incorporate the following:

- Means of financing project costs separately for each ULB and combined for all ULBs.
- PFDF bond issue size, repayment terms and SPM.
- Break-up of each ULB's share of the PFDF bond issue and its individual repayment obligation.
- Process to be followed by the ULBs for opening of escrow accounts as per SPM suggested by the rating agency.
- Process to be followed by ULBs for transferring funds into escrow accounts towards their repayment obligations as per SPM suggested by rating agency.
- Process to be followed for deducting SFC at source; reference to state government commitment letter for SFC devolution shall be made here.
- Commitment from ULBs to adhere to all conditions applicable to the ULBs as per above MoA.
- Commitment from ULBs to adhere to stated financial and operating performance benchmarks (derived from projected financials and assumptions made in the DPRs), giving timelines.
- Commitment from ULBs to adhere to stated reform agenda and timelines for the same.

The SPFE may include in a single agreement, for administrative ease, terms for repayment obligation(s) on other borrowings (if any) made by the ULB for the same project. However, such terms may be clearly segregated into a separate section of the agreement.

11.2 Proposals seeking project development expense reimbursement

Proposals that are approved by the SMC would be eligible for securing reimbursement of project development expenses.

i. Application format

The SPFE shall submit an application to the SMC incorporating the following aspects:

- Introduction - outlining name of the SPFE, participating ULBs, progress achieved in terms of appointment of consultant for preparation of DPRs, progress achieved in terms of other project- related activities and appointment of other agencies, timeline for completion of project, etc.
- Brief description of projects proposed to be financed.
- Schedule of project development expenses for which reimbursement is being sought, along with supporting bills for each activity, including expenses towards formation of SPFE (if SPFE is newly created), appointment of consultant for preparation of DPRs, appointment of rating agency, merchant banker, trustee, legal counsel (if separately appointed), and any other

project development-related expenses. The total expense shall be clearly bifurcated into two parts – 75% of total for which Central Government support is being sought and 25% for which state government support is being sought.

- Confirmation regarding satisfactory completion for each of the above activities.

Two copies of the above application shall be submitted to SMC - one for Central Government support (75%) and balance for state government support (25%).

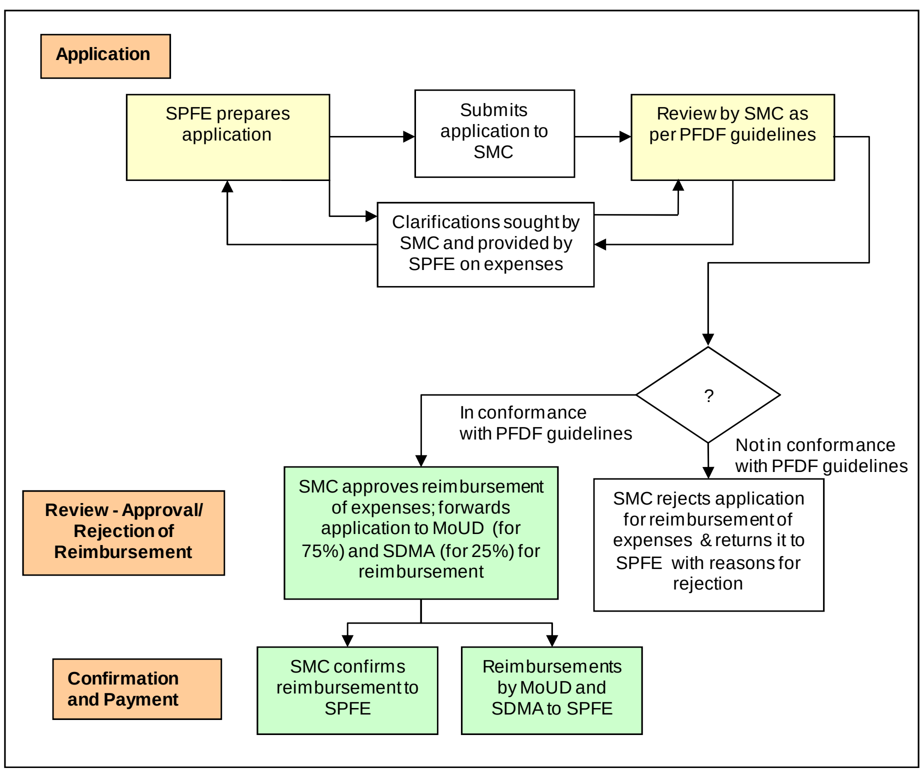
The application for seeking project development expense reimbursement can be made immediately after submission of the application for CREF support or along with the same application.

All applications must be clearly numbered and dated for reference.

11.3 Review process

The application for seeking project development expense reimbursement shall be reviewed as per following process:

Exhibit 11.2 Review process for project development expenses reimbursement



11.4 Sanctioning and disbursement of PFDF support

The process for sanctioning and disbursement of PFDF support is depicted in Exhibits 11.1 and 11.2 above.

i. Application/disbursement of CREF support

The SMC may from time to time seek clarification from the SPFE on applications made for CREF support. In cases involving clarification on DPRs and rating-related structures, SPFE may need to involve the respective consultant/rating agency for formulating its reply. Necessary clauses incorporating timeliness of response from these agencies must be built into the agreement executed with these agencies. Post approval of the application, SPFE shall ensure compliance with disbursement conditions described in Section 11.1 above to ensure timely disbursement. The applications, which are rejected, may be reworked/resubmitted one time (only) after addressing the deficiencies highlighted by the SMC.

ii. Application/disbursement of project development expense

The SPFE shall have internal processes to ensure detailed documentation of project development expenses incurred by the SPFE. All applications for reimbursement of project development expenses are to be submitted along with actual copies of all expenses incurred directly on the development of the projects. No costs for reimbursement of manpower costs of the SPFE would be reimbursed as project development costs. The SMC may seek further backup/supporting documents during its review process, and SPFE shall ensure timely submission of the same. Applications that are formally rejected (after resubmission) may still be considered for reimbursement of valid/approved project development expenses.

12. Bond Issuance Guidelines

The SPFE shall follow the following process for PFDF bond issue:

- Opening of escrow accounts - as required by rating structure.
- Formalise legal documentation - drafting of all legal documents (Trust Deed, Tripartite Agreement, letter of support from state government for SFC devolution, any other FI/multilateral guarantee, agreement between SPFE and ULBs, etc.); compliance with all legal requirements. The legal counsel shall check and report on legal compliance.
- Compliance with listing requirements – the merchant banker shall check and report on compliance with all listing requirements.
- Drafting of Information Memorandum (IM) – the merchant banker is responsible for preparing the IM for the issue and finalising the same in discussion with the ULB and the credit rating agency.
- Issue formalities - any other issue formalities shall be as per merchant banker’s advice and shall incorporate compliance with all regulatory guidelines.
- Apply for tax-free status to MoUD enclosing following documents:
    - ❖ Introduction - outline name of the SPFE, participating ULBs, progress achieved in terms of appointment of consultant for preparation of DPRs, size of the project and extent of CREF support being sought, completion of rating and preparation for bond issue.
    - ❖ Brief description of projects proposed to be financed, need for the same and ULBs’ willingness to participate in the pool (enclosing Council Resolutions).
    - ❖ Copy of the DPRs establishing the demand assessment and results of willingness to pay study, technical evaluation, cost estimates, financial viability, PFDF bonds as most cost effective option and funding plan.
    - ❖ Final project costs and means of financing, giving PFDF bond issue terms being proposed (amount of bond issue, tenure, repayment schedule until redemption and interest rate assumed).
    - ❖ Rating agency’s letter communicating rating assigned to the bonds, details of the SPM (a graphical description of the SPM indicating trigger timelines, timing of guarantor support and state government support may be annexed), and sizing of the CREF; rating rationale may be enclosed. Funding plan (ULB-wise) as per Section 8.2 above, matching cash flow requirements of the project giving estimated time frame for completion of the project(s).
    - ❖ Reform agenda - details of proposed reform package segregated into sections on management, operations, accounting, MIS and reporting systems, tariff reform and collection process, etc.; timelines for achieving the above reforms may also be indicated.
    - ❖ Commitment letter from state government for deducting SFC devolution at source; letter from guarantor (if any).
    - ❖ SMC’s confirmation on acceptance of application for CREF support.
    - ❖ Copy of MoA with MoUD.

- Bond issuance: The bond issuance or investor subscription to the bonds would be undertaken within a certain period of time, i.e., bond subscription would open and close on specified dates, as stipulated in the IM. The merchant banker would be responsible for ensuring that all potential investors in the marketplace are adequately informed about the issue, through the IM, as well as through direct interactions with managers of the merchant banker. Based on his/her expertise, experience, direct contacts and relationships with potential investors, the merchant banker would attract potential investors to subscribe to these bonds.
- Post-issue monitoring - rating surveillance process, reset of CREF, etc. shall be the responsibility of the SPFE trustee. Towards this, the SPFE shall:
  - ❖ Convene a meeting of the BIC, inviting the rating agency, merchant banker and trustee to draw up a detailed action plan for implementation of the SPM suggested by the rating agency and other steps as suggested by the merchant banker and legal counsel, which are required for the bond issue.
  - ❖ Action plan to identify activities like opening of escrow accounts, completion of legal documentation, drafting of the IM, appointment of R&T agent, opening of bond issue, creation of charge, compliance with listing requirements, etc. Key responsibilities to be allocated and timelines to be decided.
  - ❖ BIC to periodically meet to assess progress and ensure reporting to SMC and MoUD.
  - ❖ BIC to ensure post-issue monitoring in conjunction with trustee and rating agency.

12.1 Reinvestment of CREF

The rating agency would conduct its annual surveillance exercise during which the CREF requirement would be re-assessed in light of periodic redemption of the bonds. Any CREF thus released would be re-invested in an escrow account called “CREF Reinvestment Account” (CRA) on which the SPFE will have exclusive charge. The SPFE may form an Investment Committee (IC) for this purpose comprising the MD/CEO of the SPFE, head of finance of the SPFE, and two state government functionaries: Principal Secretary, Finance, and Principal Secretary, UDD.

Funds in CRA will be invested in Central Government securities, highest rated short-term debt instruments, or in highly liquid debt instruments having the highest rating, as approved by the IC. The maturity date of such investment shall be decided by the SPFE in consultation with UDD of the state government taking into consideration the SPFE’s plans for the forthcoming pooled bond issue under the PFDF scheme.

The transactions in CRA will form part of the standard reporting requirement, which will be submitted to MoUD for reporting purposes every six months. The proceeds realized from sale/renewal/encashment of such investments, including returns thereon, shall forthwith be credited into the CRA.

Pooled Finance Development Scheme

Reform Agenda, Performance Monitoring and Review 4

PFDF

Ministry of Urban Development
Government of India

13. Overview of the Toolkit

This toolkit covers the reform agenda for support under the PFDF scheme and provides guidelines for the reform focus required for PFDF access. This toolkit further summarises linkages of the PFDF scheme with other schemes of MoUD and explains the responsibilities of the SPFE and other agencies with respect to performance review and monitoring.

Toolkit IV is organised as follows:

14. Reform Agenda for Support under PFDF Scheme

14.1 Focus of the reform agenda

In order to ensure synergy with other schemes of MoUD, the reform agenda to access support under the PFDF scheme would require ULBs to conform to all the reforms specified for support under the MoUD's other schemes, namely JNNURM and UIDSSMT. Both these programs have outlined a reform agenda covering mandatory reforms at the state level and ULB level, apart from certain optional reforms. The coverage of this reform agenda is detailed in the JNNURM and UIDSSMT toolkits. The areas covered under these reforms are listed below:

a) Mandatory reforms – ULB Level

- **Accounting reforms**
- **E-Governance applications**
- **Property tax reforms**
- **Levy of user charges**
- **Services to urban poor**

b) Mandatory reforms – State Level

- **Implementation of 74th Constitutional Amendment Act**
- **Rent control reforms**
- **Stamp duty rationalisation**
- **Community Participation Law**
- **City planning function**

c) Optional reforms

- **Revision of byelaws for approval of construction of buildings and development of sites**
- **Simplification of legal requirements for conversion of land from agri-purposes to non-agri purposes**
- **Property title certification**
- **Computerised land registration**
- **Revision in byelaws to make rainwater harvesting compulsory**
- **Administrative reform**
- **Structural reform**
- **Public private partnerships**

The reform agenda outlined under JNNURM provides a fundamental level of reforms to be undertaken by the ULBs. Additional reforms, however, particularly in the area of improvement in quality of accounting and financial information, reporting and dissemination practices, etc. would also be influenced by capital market requirements and the rating required for raising finance competitively for the proposed pools brought forth to the market by the SPFE. Some illustrative additional reforms that may be sought by financial investors include:

- Greater granularity and periodicity in reporting and dissemination of financial and operational information.
- Reporting on credit enhancement measures, including escrow account status and flows from each one of the pre-agreed specific revenue items that are being escrowed.
- Reporting on progress of the reform agenda agreed upon at the time of bond issue.
- Reporting on governance information, including minutes and attendance of municipal council meetings and decisions of municipal council.
- Other specific independent audit and disclosure requirements relating to environmental and social safeguard requirements.

In this regard, it is critical for the state government to implement all the reforms recommended under the list of reforms at the state level mandated under JNNURM and UIDSSMT, as this would send a strong positive signal for external investors looking to invest in urban infrastructure projects in the state.

14.2 MoA between SPFE and MoUD

An illustrative draft MoA format to be entered into between the SPFE and MoUD is enclosed below.

Pooled Finance Development Fund Scheme

(PFDF)

Draft Memorandum of Agreement (MoA)

between

The Ministry of Urban Development

and

The State Pooled Finance Entity (SPFE) of________________

Dated ___________________

Draft Memorandum of Agreement (MoA)

THIS AGREEMENT is made on this ______________ day of __________, 200______ between the Government of India, through the Ministry of Urban Development, of the Part I

AND

The State Pooled Finance Entity of ____________ (*mention the name of the state*) through its authorized person, of the Part II.

WHEREAS the Part II seeks financial assistance from the Part I under the Pooled Finance Development Fund Scheme (PFDF);

WHEREAS the Part II, in pursuance of the requirements for assistance, has developed a Pooled Bond Issue (PBI), fully detailed in Annexure I;

AND WHEREAS the Part II has formulated a detailed information memorandum and detailed project reports of all the projects that comprise this pool, with details on its feasibility, fully detailed in Annexure II;

AND WHEREAS the Part II and the ULBs or parastatal agencies participating in the PBI have undertaken to implement the reform agenda, as per the timeline indicated therein, fully detailed in Annexures III and IV;

AND WHEREAS the Part I has considered the documents mentioned in Annexures I, II, III, and IV and found them consistent with the goals and objectives of PFDF;

AND WHEREAS the Part I agrees to release a grant of Rs. ______________/-, in accordance with the terms and conditions specified in this agreement.

NOW THE PARTIES WITNESSED as follows:

1. That the Part I shall release the funds towards the Credit Rating Enhancement Fund (CREF) of Rs. …………………../- upon:
    a. SPFE signing the Memorandum of Agreement (MOA),
    b. Opening of the PBI for subscription, and
    c. The State Government releasing its fifty percent (50%) share of the CREF.

2. That the Part I or an institution nominated by it, may periodically undertake site visits to ascertain the progress of the ongoing projects and also the reform agendas through designated representatives.

3. That apart from Progress Reports, the Part II shall submit Quarterly Reports of the status of the CREF to Part I. In case Part II fails to submit such a report, CREF support for any further PBI from Part II may be denied/withheld until such submission.

4. Similarly, the Part II shall submit Half-yearly Reports of the progress in respect of the implementation of the reform agendas as detailed out in Annexure III.

5. That Part II shall submit a complete report regarding the outcome of the PFDF support on the completion of the project.

6. That the Parties to the Agreement further covenant that in case of a dispute between the parties the matter will be resolved by arbitration within the provisions of the Arbitration and Conciliation Act, 1996, and the rules framed there under and amended from time to time. The matter in dispute shall be referred to ________________ (*Insert a name of an arbitrator*) as arbitrator. However, in case such person refuses to act as arbitrator, or is rendered, unable because of sickness or otherwise, or dies, ___________________ (*name of the second person for arbitrator*) shall act as arbitrator between the parties and the dispute shall be referred to such person. In case this second person is not available for any reason to act as arbitrator between the parties, both parties shall name one person of their choice as arbitrator and decision of such arbitration shall be final and binding on the parties.

7. That in case there is any delay in the implementation of the reform agendas or submission of any required periodic reports, etc. at the state level by the Part II due to circumstances beyond the control of Part II, i.e., *Force Majeure* or any other reason, the decision on the matter of extension of time for the implementation of the goals and objectives of the PFDF shall be at the discretion of Part I.

8. That in case of any breach regarding the terms and conditions of the PFDF scheme, the Part I shall be entitled to withhold release of instalments of the grant on giving 30 days notice to the Part II. However, in this regard the decision taken by the Part I shall be final and binding on the Part II, though, before making such orders, opportunity of a hearing shall be given to the Part II.

IN WITNESS HEREOF all the parties have put their hands on these presents of Memorandum of Agreement in the presence of witnesses.

WITNESSES:

1. __________________ Ministry of Urban Development

2. __________________ State Pooled Finance Entity of _________

15. Other Linkages and Requirements

15.1 Linkage with other schemes

Given the availability of grants available from the JNNURM and UIDSSMT schemes, it is important to ensure appropriate linkages to synergize the role of these grant-based schemes and the market access approach of PFDF to ensure effective and sustainable infrastructure creation and service delivery.

For effective realization of synergies at the project level, ULBs should be allowed to access grant funding from UIDSSMT/JNNURM for the portion of finance that they would have to contribute on their own for partial financing projects under the pooled finance program. The resources available from a pooled bond would cover the debt portion, while the equity/grant portion could be accessed from UIDSSMT and JNNURM.

15.2 Government support

Apart from playing an active role in facilitating implementation of the state-level reform agenda, the state government needs to play a vital role in capacity building at the local level in terms of understanding the need for external financing. Some of the specific areas of support and interventions from state government and SDMA that would particularly boost capital market access of ULBs through the pooled financing route are listed below:

a) **Project development –** The SPFE is expected to play a significant role in project development and, thus, needs to have in place a system to create and periodically replenish a shelf of well-defined projects that can be subsequently taken up for market-based financing. This could be incentivised by making available a separate grant window for meeting project development activity initially. The contribution to the grant window could be reduced progressively as the SPFE moves to periodically access the market with a continuous stream of project opportunities.

b) **Accounting reforms –** Quality of accounting and financial information is a critical driver of the success of bond issues. While the JNNURM and other schemes are already incentivising states to go in for accounting reforms, it is important that this is undertaken in both letter and spirit. Apart from moving to accrual accounting, the SDMA should insist on moving towards real-time availability of accounting information and finalisation of audited accounts within a fixed time frame.

c) **Capacity building –** Accessing capital markets is an involved exercise and requires a significantly higher level of capacity among ULBs in terms of generating projects and practicing financial and operational discipline. The state government should initiate a formal exercise for ULBs to educate and train them on issues relating to capital market access and the steps that need to be taken by them in this regard.

16. Performance Review and Monitoring

An effective performance review and monitoring framework is critical for ensuring implementation of projects financed under pooled financing and timely repayments by the respective ULBs in the pool to the bond holders/investors. The SPFE has to put in place reporting information at two levels:

a) ULBs → SPFE

b) SPFE → a) SMC b) bond trustee and c) credit rating agency

Sections 16.1 and 16.2 provide guidelines/illustrative reporting formats for effective flow of information for levels a) and b), respectively.

16.1 Reporting by ULBs → SPFE

The SPFE should put in place reporting requirements and monitoring mechanisms for managing the entire cycle from project financing and implementation to post-project implementation to ensure timely repayments and adherence to reform agenda milestones. The SPFE's reporting requirements and monitoring mechanisms are to be defined for two stages:

a) Stage I - Project implementation and completion

b) Stage II - Post-project monitoring including implementation of reform agenda

During stage I, reporting should be designed to track progress of construction, both in financial and physical terms, vis-à-vis the work plan agreed upon at the commencement of the project. During stage II, the focus of supervision and monitoring by the SPFE would be to track beneficiary level impact, progress toward ULB reform agenda milestones, and adequate investor protection.

i. Stage I - Project implementation and completion

The role of the SPFE during implementation covers the following:

1. Review physical and financial progress based on a plan prepared at the time of signing the loan agreement. (Lenders may insist on retaining an independent project review engineer, in which case this independent engineer will be responsible for monitoring timely implementation of the project.) The review should be based on a work plan prepared prior to the commencement of the project in the form of a Gantt chart that lists the activities, milestones and timelines.
2. Ensure timely release of milestone-linked payments to local bodies.

3. Ensure smooth implementation including support in any dispute resolution as required.
4. Ensure quality and progress of implementation through periodic reviews.
5. Ensure beneficiary participation through appropriate dialogue, including their participation in review meetings

Given its role in project implementation, the SPFE would need to have a strong information flow on projects and finances of the ULB and the project. Specifically, this includes:

- Quarterly reporting on physical and financial progress of the project by the ULB and evaluated by the SPFE.
- Careful monitoring of the quality of project implementation and adherence to technical specifications through site visits by SPFE personnel and independent audits as required.
- Policy norms on the basis of project size and complexity for:
  - ❖ Physical inspection and site visit frequency for ensuring completion according to work plan.
  - ❖ Procurement and contracting procedures.
  - ❖ Schedule of meetings for monitoring progress with the SDMA and ULBs.
  - ❖ Periodic reporting on project implementation to the board of the SPFE.

A project is considered to be complete when the contractor/independent engineer submits the Completion Certificate of the works to the ULB. The contractor shall also provide the following in addition to the Completion Certificate:

- All bills and vouchers of purchases and other payments.
- The contractor shall provide exact information on the quantity of work done and as-built drawings of the works done.
- On submission of the drawings, the local body shall physically verify the completion of the project and satisfy itself before making final payment to the contractor.
- The contractor shall also furnish in writing detailed information on the operation and maintenance of the system.

Critical documents and reports needed during the project implementation stage and their periodicity are described in Exhibit 16.1 below.

Exhibit 16.1 Illustrative reporting framework - project implementation

Sl. No.	Document/Report	Periodicity/ Stage	Purpose
1	Work plan (physical and financial)	Start of project	To ensure that the ULB and SPFE have a shared understanding of the project in terms of the activities, milestones and timelines and to enable them to track progress and correct deviations, if any.
2	Report on physical and financial progress	Quarterly	To enable the SPFE to track project progress during implementation.

Sl. No.	Document/Report	Periodicity/ Stage	Purpose
3	Site inspection visit reports	After visits	Validation of reports submitted by ULBs to SPFE on a periodic basis.

Illustrative formats of these reports/documents are presented in Annexure I.

ii. Stage II - Post-project monitoring and review

The SPFE should evolve a policy for post-project monitoring and develop a framework for identifying projects for independent post-project impact assessment, depending on size, segment and complexity of projects to ascertain actual versus intended impact on end beneficiaries. The SPFE should also evolve procedures for monitoring of projects directly by the SPFE.

The SPFE should receive a quarterly status report from the ULBs involved in a pool. Annexure II provides illustrative reporting formats. While the exact reporting requirements could vary depending on the nature of the ULB and the cost and complexity of the project financed, the SPFE should define its reporting requirements to cover the three dimensions described below:

- **Operational performance** (for example, in the case of a water supply project, the ULB should report quantum of supply, losses, net supply at household level, number of incremental connections, etc.) and **financial performance** of the project (covering revenues, O&M costs, etc.**)** should be reported on a quarterly basis. Financials of the ULB should be reported to the ULB every six months.
- **Debt servicing** – compliance with covenants and repayment details should be reported to the SPFE at the end of every month.
- **Implementation of reform agenda -** Since the implementation of the reform agenda agreed by the ULB is likely to be critical to its long-term financial sustainability, the SPFE should monitor progress on the reform agenda agreed by the ULB. The ULBs in a pool should report progress on the commitments made as part of the reform agenda to the SPFE every six months

16.2 Performance review and monitoring – reporting by SPFE

In addition to providing updated information on the pool of projects to its own Board of Directors, the SPFE should disseminate information on the pool of projects to the SMC, the bond trustee and the credit rating agency that are responsible for monitoring and overseeing the functioning of the SPFE and the pool(s) of projects managed by the SPFE.

The SPFE would need to compile information at the pool level based on reports submitted by various ULBs that are part of the pool (as explained in Section 16.1 - Reporting by ULBs → SPFE) and its own site visits to provide periodic MIS to **a) Sanctioning and Monitoring Committee, b) credit rating agency, and c) independent bond trustee**.

The reporting of information by the SPFE to these three entities would be along similar lines to the reporting formats described in Annexures I and II, the only difference being that the reports submitted by the SPFE would present information at the level of the pool of projects rather than individual ULBs. In addition to the information presented on the projects/ULBs in the pool, the SPFE should also report the status of investments of the funds kept under the Credit Rating Enhancement Fund (CREF) to these entities on a quarterly basis.

The SPFE should ideally report progress and status of the projects in the pool along the same lines of information reporting by the ULBs. Compliance with the debt servicing and loan covenants position of every pool should be reported to the bond trustee every month and every quarter to the SMC. All other information pertaining to the pool should be presented by the SPFE to the SMC and the independent bond trustee on a quarterly basis. A detailed report on the financial and operational performance of the projects/ULBs in the pool should be submitted to the credit rating agency every six months along with a report on compliance to debt servicing and loan covenants.

Annexure I - Reporting formats – ULBs → SPFE - project implementation

A. Project level work plan (prior to commencement of project)

Physical Plan	Elapsed Time (in months)																	
	1	2	3	4	5	6	7	8	9	…	…	…	…	…	…	…	…	n
Pre-construction stage ….. ….. **Construction stage** …. *Milestone I* …. …. *Milestone II* …. **Completion**																		

Financial Plan	Planned Date of Completion	Own Funds	Grants	Loan	TOTAL
Milestone 1 - ….					
Milestone 2 - ….					
….					
…..					
TOTAL					

B. Report on project level physical and financial progress (quarterly)

Report No.	
For the quarter	
ULB name	
Project code	
Project description	

PHYSICAL PROGRESS

Activity	Plan vs. Actual	Elapsed Time (months)												
		1	2	3	4	5	6	7	8	9	…	…	…	n
Pre-construction stage	Plan													
	Actual													
Construction stage	Plan													
	Actual													
…. *Milestone I* …. *Milestone II* …. **Completion**	….													

Remarks/reasons for delay/mid-course corrections required:

FINANCIAL PROGRESS

Total project cost	
Financing mix	
Loans	
Grants	
ULB own funds	

Financing Mix	Month		Project Till Date		Remarks/Reasons for Delay, etc.
	Plan	Actual	Plan	Actual	
Loan					
Grant					
Own funds					
TOTAL					

C. Site inspection report (within a week of site inspection by SPFE personnel)

ULB	
Project code	
Project description	
Visit report filed by	

Date of visit	

Purpose of visit
Stage of project
Observations on physical and financial progress of the project
Recommended actions/responsibility

Signature - SPFE personnel **Signature - ULB commissioner**

Annexure II - Reporting formats – ULBs → SPFE – post-project monitoring

A. Operational and financial performance report on the project (half-yearly)

ULB	
Project code	
Project description	
Report reference no.	
Date of report	

1. *Project-related operational performance (illustrative, for a water project)*

Sl. No.	Performance Parameter	Baseline	Target	HY 1	HY 2	…	HYn
1	Gross water supply (MLD)						
2	Gross water supply per capita (LPCD)						
3	Losses (%)						
4	Net water supply per capita (LPCD)						
5	Distribution network/road length (%)						
6	Connections/properties						

2. *Project-related financial performance*

Sl. No.	Performance Parameter	Baseline	Project Target	HY 1	HY 2	…	HYn Till Repayment of Loan is Completed
1	User charges (Rs. Lakh)						
2	Collection efficiency (%)						
3	O&M costs						
4	Debt servicing costs						
5	Cost recovery (%) – (3+4)/(1)						

3. *Financial performance of the ULB*

Particular	Half-yearly		Annual	
	Oct-Mar 07	Oct-Mar 06	Apr-Sep 07	Apr-Sep 06
Opening balance				
1. Revenue receipts				
2. Revenue expenditure				
3. Revenue surplus/deficit (1 – 2)				
4. Capital receipts				
5. Capital expenditure				
6. Capital surplus/deficit (4-5)				
Total surplus/deficit				
Closing balance				

B. Debt servicing and loan covenants related information (monthly)

ULB	

Project code	
Project description	
Report reference no.	
Date of report	

1. ***Escrow account status***

Bank Name & A/c Number	Scheduled Funding		Actual Funding		Remedial Action Taken
	Amount	Date	Amount	Date	

2. ***Details of loan and interest repayment***

Bank Name and A/c Number	Scheduled Payment		Actual Payment		Remedial Action Taken
	Amount	Date	Amount	Date	

C. Adherence to reform agenda

ULB	
Project code	
Project description	
Report reference no.	
Date of report	

Reform Parameter	Oct-Mar 07		Reasons for Deviation, if any
	Committed	Actual	
Collection efficiency (%)			
Property tax			
Professional tax			
Water user charges			
Water connections/properties			
E-Governance initiatives			
.....			
....			