

Table of Contents

| | | |
|---|---|-------|
| Preface | ... | xviii |
| Chapter One: The Integrated Analysis | | |
| 1.1 | Introduction | 1 |
| 1.2 | Targeted Users of the Book | 2 |
| 1.3 | Project Definition | 2 |
| 1.3.1 | Definition of a Project and Building Blocks for Evaluation | 3 |
| 1.3.2 | A Project as an Incremental Activity | 4 |
| 1.4 | An Integrated Approach | 5 |
| 1.4.1 | Financial Appraisal | 5 |
| 1.4.2 | Risk Analysis and Management | 8 |
| 1.4.3 | Economic Appraisal | 9 |
| 1.4.4 | Stakeholder Impacts | 12 |
| 1.5 | Cost-Effectiveness Analysis | 12 |
| 1.6 | Organization of the Book | 13 |
| Chapter Two: A Strategy for the Appraisal of Investment Projects | | |
| 2.1 | Introduction | 18 |
| 2.2 | Idea and Project Definition | 20 |
| 2.3 | Pre-feasibility Study | 22 |
| 2.4 | Feasibility Study | 29 |
| 2.5 | Detailed Design | 29 |
| 2.6 | Project Implementation | 30 |
| 2.7 | Ex-post Evaluation | 31 |
| Chapter Three: The Financial Appraisal of Projects | | |
| 3.1 | Introduction | 33 |
| 3.2 | Why a Financial Appraisal for a Public Sector Project? | 33 |
| 3.3 | Construction of Financial Cash Flows: Concepts and Principles | 34 |
| 3.3.1 | Investment Phase | 35 |
| 3.3.2 | Operating Phase | 40 |
| 3.3.3 | Cessation of Project Operations | 45 |
| 3.3.4 | Format for the Pro Forma Cash Flow Statement | 46 |
| 3.4 | Use of Consistent Prices in the Cash Flow Forecast | 49 |
| 3.4.1 | Definition of Prices and Price Indices | 49 |

| | | | |
|---|--|-----|-----|
| 3.4.2 | Nominal Interest Rate | ... | 54 |
| 3.4.3 | Expected Nominal Exchange Rate | ... | 56 |
| 3.4.4 | Incorporating Inflation in the Financial Analysis | ... | 58 |
| 3.5 | Analyses of Investment Decisions from Alternative Viewpoints | ... | 61 |
| 3.5.1 | Banker's Point of View | ... | 61 |
| 3.5.2 | Owner's Point of View | ... | 62 |
| 3.5.3 | Government's Point of View | ... | 62 |
| 3.5.4 | Country's Point of View | ... | 63 |
| 3.5.5 | Relationships among Different Points of View | ... | 63 |
| 3.6 | Conclusion | ... | 65 |
| Appendix 3A: Steps in Constructing the Pro Forma Cash Flow Statements | | | ... |
| Appendix 3B: Impacts of Inflation on Financial Cash Flows | | | ... |
| | | | 66 |
| | | | 70 |

Chapter Four: Discounting and Alternative Investment Criteria

| | | | |
|-------|-----------------------------------|-----|-----|
| 4.1 | Introduction | ... | 83 |
| 4.2 | Time Dimension of a Project | ... | 83 |
| 4.2.1 | Time Value of Money | ... | 84 |
| 4.2.2 | Compounding | ... | 84 |
| 4.2.3 | Discounting | ... | 84 |
| 4.2.4 | Variable Discount Rates | ... | 86 |
| 4.2.5 | Choice of Discount Rate | ... | 88 |
| 4.3 | Alternative Investment Criteria | ... | 88 |
| 4.3.1 | Net Present Value Criterion | ... | 89 |
| 4.3.2 | Internal Rate of Return Criterion | ... | 93 |
| 4.3.3 | Benefit–Cost Ratio Criterion | ... | 97 |
| 4.3.4 | Pay-Out or Pay-Back Period | ... | 98 |
| 4.3.5 | Debt Service Coverage Ratios | ... | 100 |
| 4.3.6 | Cost–Effectiveness Analysis | ... | 104 |
| 4.4 | Conclusion | ... | 106 |

Chapter Five: Scale, Timing, Length, and Interdependencies in Project Selection

| | | | |
|-----|---|-----|-----|
| 5.1 | Introduction | ... | 108 |
| 5.2 | Determination of Scale in Project Selection | ... | 108 |
| 5.3 | Timing of Investments | ... | 113 |
| 5.4 | Adjusting for Different Lengths of Life | ... | 118 |
| 5.5 | Projects with Interdependent and Separable Components | ... | 122 |
| 5.6 | Conclusion | ... | 126 |

Chapter Six: Dealing with Uncertainty and Risk in Investment Appraisal

| | | | |
|-----|--|-----|-----|
| 6.1 | Introduction | ... | 127 |
| 6.2 | Importance of Risk Analysis in Investment Appraisal | ... | 128 |
| 6.3 | Definition and Measurement of Uncertainty and Risk | ... | 129 |
| 6.4 | Steps in Conducting Risk Analysis | ... | 130 |
| | 6.4.1 Sensitivity Analysis | ... | 131 |
| | 6.4.2 Scenario Analysis | ... | 132 |
| | 6.4.3 Monte Carlo Analysis | ... | 133 |
| 6.5 | Risk Management with Contracts | ... | 139 |
| | 6.5.1 Risk Reallocation | ... | 139 |
| | 6.5.2 Contracting Risk | ... | 143 |
| | 6.5.3 Incentive Effects | ... | 143 |
| 6.6 | Risks and Mitigating Measures in Project Financing | ... | 144 |
| | 6.6.1 Introduction | ... | 144 |
| | 6.6.2 Contractual Arrangements and Other Mechanisms for Mitigating Project Risks | ... | 146 |
| 6.7 | Conclusion | ... | 155 |

Chapter Seven: Principles Underlying the Economic Analysis of Projects

| | | | |
|-----|--|-----|-----|
| 7.1 | Objectives for Economic Investment Appraisal | ... | 157 |
| 7.2 | Postulates Underlying the Economic Evaluation Methodology | ... | 158 |
| 7.3 | Applying the Postulates to Determine Economic Evaluation of Non-tradable Goods and Services in an Undistorted Market | ... | 160 |
| | 7.3.1 Analysing Economic Costs and Benefits in an Existing Market (in the Absence of a New Project) | ... | 161 |
| | 7.3.2 Analysing the Economic Benefits of an Output Produced by a Project | ... | 163 |
| | 7.3.3 Analysing the Economic Cost of an Input Demanded by a Project | ... | 165 |
| 7.4 | Applying the Postulates to Determine Economic Evaluation of Non-tradable Goods and Services in Distorted Markets | ... | 166 |
| | 7.4.1 Sales Taxes Levied on Output of Project | ... | 167 |
| | 7.4.2 Subsidies on Production | ... | 172 |
| | 7.4.3 Environmental Externalities | ... | 174 |
| 7.5 | Other Distortions | ... | 176 |
| | 7.5.1 Economic Opportunity Cost of Capital | ... | 176 |
| | 7.5.2 Economic Opportunity Cost of Labour | ... | 177 |
| 7.6 | Conclusion | ... | 177 |

Chapter Eight: Economic Opportunity Cost of Capital

| | | | |
|-------|---|-----|-----|
| 8.1 | Why Is the Economic Cost of Capital Important? | ... | 180 |
| 8.1.1 | Choosing the Scale of a Project | ... | 181 |
| 8.1.2 | Timing of Investment | ... | 181 |
| 8.1.3 | Choice of Technology | ... | 182 |
| 8.2 | Alternative Methods of Choosing Discount Rates for Public Sector Project Evaluation | ... | 182 |
| 8.3 | Derivation of the Economic Opportunity Cost of Capital | ... | 184 |
| 8.4 | Determination of the Economic Cost of Alternative Sources of Funds | ... | 189 |
| 8.5 | Marginal Economic Cost of Foreign Financing | ... | 193 |
| 8.6 | Intergenerational and Risk-Adjusted Economic Discounting | ... | 196 |
| 8.7 | Country Study: Economic Cost of Capital for South Africa | ... | 196 |
| 8.7.1 | Estimation of the Economic Cost of the Three Diverted Funds | ... | 197 |
| 8.7.2 | Weights of the Three Diverted Funds | ... | 199 |
| 8.7.3 | Estimates of the Economic Cost of Capital | ... | 199 |
| 8.8 | Conclusion | ... | 200 |

Chapter Nine: Shadow Price of Foreign Exchange and Non-tradable Outlays

| | | | |
|-------|---|-----|-----|
| 9.1 | Introduction | ... | 205 |
| 9.2 | Determination of the Market Exchange Rate | ... | 207 |
| 9.3 | Derivation of the Economic Price of Foreign Exchange | ... | 210 |
| 9.3.1 | A Partial Equilibrium Analysis | ... | 211 |
| 9.3.2 | <i>EOCFX and SPNTO</i> Using Funds in the Capital Market | ... | 214 |
| 9.4 | General Equilibrium Analysis: A Diagrammatic and Numerical Illustration | ... | 217 |
| 9.4.1 | Sourcing of Funds in the Domestic Capital Market | ... | 217 |
| 9.4.2 | Sourcing of Funds in the Foreign Capital Market | ... | 228 |
| 9.4.3 | Sourcing of Funds from Both Domestic and Foreign Capital Markets | ... | 232 |
| 9.5 | Country Studies: Shadow Price of Foreign Exchange and Non-tradable Outlays for South Africa | ... | 234 |
| 9.6 | Conclusion | ... | 235 |

| | | |
|--|-----|-----|
| Appendix 9A: A General Form for Estimating the Economic Value of Foreign Exchange and Non-tradable Outlays | ... | 237 |
|--|-----|-----|

Chapter Ten: Economic Prices for Tradable Goods and Services

| | | |
|---|-----|-----|
| 10.1 Introduction | ... | 241 |
| 10.2 Identification of Tradable Goods | ... | 242 |
| 10.2.1 Imported and Importable Goods | ... | 242 |
| 10.2.2 Exported and Exportable Goods | ... | 244 |
| 10.3 Economic Value of Tradable Goods and Services | ... | 246 |
| 10.3.1 Essential Features of an Economic Analysis | ... | 246 |
| 10.3.2 Valuation of Tradable Goods at the Border and the Project Site | ... | 248 |
| 10.3.3 Conversion Factors for Tradable Goods at the Border and the Project Site | ... | 253 |
| 10.4 An Illustrative Example | ... | 254 |
| 10.5 Conclusion | ... | 261 |
| Appendix 10A: Evaluating Projects Subject to Trade Protection | ... | 262 |

Chapter Eleven: Economic Prices for Non-tradable Goods and Services

| | | |
|--|-----|-----|
| 11.1 Introduction | ... | 264 |
| 11.2 The Case of Infinite Supply Elasticity | ... | 266 |
| 11.3 A Non-tradable Good in the Standard Supply and Demand Framework | ... | 268 |
| 11.3.1 Economic Value of a Non-tradable Output of a Project | ... | 268 |
| 11.3.2 Economic Value of a Non-tradable Input Purchased by a Project | ... | 275 |
| 11.4 Application of Economic Prices to Estimate the Economic Net Benefits of a Project | ... | 277 |
| 11.5 An Illustrative Example | ... | 279 |
| 11.6 Conclusion | ... | 283 |
| Appendix 11A: Choosing the Relevant Distortion | ... | 284 |
| Appendix 11B: Relationship between Tradable and Non-tradable Goods | ... | 288 |

Chapter Twelve: Economic Opportunity Cost of Labour

| | | |
|---|-----|-----|
| 12.1 Introduction | ... | 295 |
| 12.2 Alternative Approaches to Estimating the Economic Opportunity Cost of Labour | ... | 296 |
| 12.2.1 Value of Marginal Product of Labour Forgone Approach | ... | 296 |
| 12.2.2 Supply Price of Labour Approach | ... | 297 |

| | | | |
|--------|---|-----|-----|
| 12.3 | Structure of Analysis in the Labour Market | ... | 299 |
| 12.4 | Economic Opportunity Cost of Unskilled Rural Labour | ... | 300 |
| 12.5 | Economic Opportunity Cost of Skilled Labour | ... | 304 |
| 12.5.1 | Labour Market without Distortions or Regional Migration | ... | 304 |
| 12.5.2 | Workers Migrate to Project from Distorted Regional Labour Markets | ... | 305 |
| 12.6 | Economic Opportunity Cost of Labour When Labour Is Not Employed Full-Time | ... | 309 |
| 12.7 | International Migration and the Economic Opportunity Cost of Labour | ... | 312 |
| 12.7.1 | Retained or Returned Migrants | ... | 312 |
| 12.7.2 | Foreign Labour | ... | 313 |
| 12.8 | Effects of a Protected Sector on the Economic Opportunity Cost of Labour | ... | 315 |
| 12.8.1 | EOCL in the Protected Sector and No Migration | ... | 316 |
| 12.8.2 | EOCL with Two Protected Sectors | ... | 319 |
| 12.8.3 | EOCL in the Case of Search Unemployment With No Migration | ... | 323 |
| 12.8.4 | EOCL with No Open Sector and Labour Market Supplied by Migrants | ... | 326 |
| 12.9 | Conclusion | ... | 328 |

Chapter Thirteen: Evaluation of Stakeholder Impacts

| | | | |
|--------|--|-----|-----|
| 13.1 | Introduction | ... | 330 |
| 13.2 | Nature of Distributive Analysis | ... | 331 |
| 13.3 | Reconciliation of Economic and Financial Values of Project Inputs and Outputs | ... | 332 |
| 13.3.1 | The Case of an Expansion in the Supply of a Non-tradable Good in an Undistorted Market | ... | 333 |
| 13.3.2 | The Case of Non-tradable Good Sold into a Market with a Unit Tax | ... | 334 |
| 13.3.3 | The Case of an Importable Input That Is Subject to Tariff | ... | 336 |
| 13.4 | Case Illustrations of Integrated Financial, Economic, and Distributional Analysis | ... | 337 |
| 13.4.1 | Case A: Workers' Transportation Project | ... | 338 |
| 13.4.2 | Case B: Tomato Paste Production Project | ... | 343 |
| 13.4.3 | Case C: The Jamuna Bridge Project | ... | 348 |
| 13.5 | Conclusion | ... | 351 |
| | Appendix 13A: Economic Aspects of Foreign Financing | ... | 353 |

Chapter Fourteen: Shadow Price of Government Funds, Distributional Weights, and Basic Needs Externalities

| | | | |
|------|---|-----|-----|
| 14.1 | Introduction | ... | 362 |
| 14.2 | Shadow Price of Government Funds | ... | 363 |
| 14.3 | Distributional Weights | ... | 366 |
| 14.4 | Basic Needs Externalities | ... | 369 |
| 14.5 | Basic Needs Externalities (Type B) Linked to Income | ... | 374 |

Chapter Fifteen: Cost-Effectiveness Analysis

| | | | |
|--------|---|------|-----|
| 15.1 | Introduction | ... | 378 |
| 15.2 | Education Projects | ... | 379 |
| 15.3 | Electric Power Projects | ... | 384 |
| 15.4 | The Use of Quality-Adjusted Life-Years for Medical Projects | | 385 |
| 15.4.1 | Nature of Health Projects | | 385 |
| 15.4.2 | An Example of Cost-Utility Analysis | ... | 387 |
| 15.4.3 | Issues Relating to the Application | ... | 388 |
| 15.5 | Water Projects | ... | 390 |
| 15.6 | Conclusion | ... | 393 |

Chapter Sixteen: Cost-Benefit Analysis of Transportation Projects

| | | | |
|--------|--|------|-----|
| 16.1 | Introduction | ... | 396 |
| 16.2 | The Case of Road Improvements | ... | 397 |
| 16.3 | The Case of Penetration Roads | ... | 401 |
| 16.4 | Externalities Connected with Road Projects | ... | 403 |
| 16.4.1 | Externalities Involving Traffic on Other Roads | ... | 404 |
| 16.4.2 | Externalities Involving Rail Traffic | ... | 408 |
| 16.5 | Some Implications and Generalizations | | 413 |
| 16.5.1 | Critical Traffic Levels | ... | 413 |
| 16.5.2 | Stage Construction | ... | 415 |
| 16.5.3 | The Timing Problem | ... | 417 |
| 16.5.4 | The Problem of Segment Construction | ... | 418 |
| 16.5.5 | The Road-Rail Problem | ... | 420 |

Chapter Seventeen: Appraisal of Upgrading a Gravel Road

| | | | |
|--------|---|-----|-----|
| 17.1 | Introduction | ... | 422 |
| 17.2 | Project Costs | ... | 423 |
| 17.3 | Analytical Framework | ... | 424 |
| 17.4 | Maintenance Costs | ... | 425 |
| 17.5 | Demand for Traffic on the Improved Road | ... | 427 |
| 17.5.1 | Traffic Level without the Project | ... | 428 |
| 17.5.2 | Traffic Level with the Project | ... | 431 |
| 17.6 | Savings in Vehicle Operating Costs | ... | 432 |
| 17.7 | Average Speeds of Vehicles | ... | 435 |

| | | | |
|---|---|-----|-----|
| 17.8 | Economic Appraisal | ... | 438 |
| 17.8.1 | Annual Savings in Maintenance Costs, VOC, and Time-Costs | ... | 439 |
| 17.8.2 | Economic Viability of the Project | ... | 445 |
| 17.9 | Impact on Stakeholders | ... | 448 |
| 17.10 | Dealing with Risk | ... | 449 |
| 17.10.1 | Sensitivity Analysis | ... | 450 |
| 17.10.2 | Risk Analysis | ... | 454 |
| 17.11 | Concluding Remarks | ... | 458 |
| Appendix 17A: Estimation of Vehicle Operating Costs | | ... | 459 |
| Appendix 17B: Estimation of Average Vehicle Speeds | | ... | 462 |

Chapter Eighteen: The ABCs of Electricity Project Analysis

| | | | |
|------|--|-----|-----|
| 18.1 | Background | ... | 465 |
| 18.2 | The Simplest Case — A Homogeneous Thermal Alternative | ... | 467 |
| 18.3 | Run-of-the-Stream Hydro Projects | ... | 469 |
| 18.4 | Daily Reservoir Hydro Projects | ... | 471 |
| 18.5 | Seasonal Hydro Dams | ... | 473 |
| 18.6 | Heterogeneous Thermal Capacity — A Vintage Approach | ... | 476 |
| 18.7 | Thermal Capacity That Differs by Type of Plant | ... | 482 |
| 18.8 | Some Notes on Solar and Wind Power | ... | 491 |
| 18.9 | Conclusion | ... | 493 |

Chapter Nineteen: An Integrated Appraisal of Combined-Cycle Versus Single-Cycle Electricity-Generation Technologies

| | | | |
|--------|--|-----|-----|
| 19.1 | Introduction | ... | 495 |
| 19.2 | Background | ... | 495 |
| 19.3 | Project Costs and Parameters for the Appraisal of the Single-Cycle Plant | ... | 497 |
| 19.3.1 | Project Parameters and Assumptions | ... | 497 |
| 19.3.2 | Power Purchase Agreement (PPA) | ... | 500 |
| 19.3.3 | Project Financing | ... | 501 |
| 19.4 | Financial Appraisal of the Proposed IPP | ... | 501 |
| 19.4.1 | Financial Viability of the IPP | ... | 502 |
| 19.4.2 | Financial Sensitivity Analysis of the IPP | ... | 506 |
| 19.5 | Financial Appraisal of Alternative Electricity- Generation Technology | ... | 508 |
| 19.5.1 | Financial Feasibility of the Single-Cycle Plant from the AEC's Perspective | ... | 508 |
| 19.5.2 | Financial Feasibility of a Combined-Cycle Plant from the AEC's Perspective | ... | 510 |
| 19.5.3 | Financial Investment in Alternative Technologies from the AEC's Perspective | ... | 513 |

| | | | |
|--------|---|-----|-----|
| 19.5.4 | Financial Sensitivity Analysis from the AEC's Perspective | ... | 515 |
| 19.5.5 | Estimation of the Levelled Financial Costs of the Single-Cycle and the Combined-Cycle Plant | ... | 517 |
| 19.6 | Economic Appraisal | ... | 518 |
| 19.6.1 | Economic Valuation of the Project's Costs | ... | 519 |
| 19.6.2 | Economic Evaluation of Selecting an IPP | ... | 522 |
| 19.7 | Stakeholder Impacts | ... | 527 |
| 19.7.1 | Identification of Stakeholders and Externalities | ... | 527 |
| 19.7.2 | Distributive Impacts | ... | 529 |
| 19.8 | Conclusion | ... | 529 |

Chapter Twenty: Restructuring the Water and Sewer Utility in Panama

| | | | |
|--------|--|-----|-----|
| 20.1 | Introduction | ... | 532 |
| 20.2 | Programme Description | ... | 533 |
| 20.3 | Programme Costs and Financing | ... | 535 |
| 20.4 | Financial Appraisal of the Programme | ... | 536 |
| 20.4.1 | Programme Parameters and Assumptions | ... | 536 |
| 20.4.2 | Financial Feasibility | ... | 540 |
| 20.4.3 | Financial Sensitivity Analysis | ... | 546 |
| 20.5 | Economic Appraisal | ... | 550 |
| 20.5.1 | National Parameters | ... | 551 |
| 20.5.2 | The Economic Value of Water | ... | 551 |
| 20.5.3 | Conversion Factors of Programme Inputs | ... | 557 |
| 20.5.4 | Economic Viability | ... | 559 |
| 20.5.5 | Economic Sensitivity Analysis | ... | 560 |
| 20.6 | Stakeholder Analysis | ... | 564 |
| 20.6.1 | Identification of Stakeholders and Externalities | ... | 565 |
| 20.6.2 | Distributive Impacts | ... | 567 |
| 20.6.3 | Concerns with Current Non-paying Customers | ... | 569 |
| 20.7 | Risk Analysis | ... | 570 |
| 20.8 | The Economic Cost of Foreign Financing | ... | 574 |
| 20.9 | Conclusion | ... | 575 |