




**AUDITOR-GENERAL'S
PERFORMANCE AUDIT REPORT
ON CONTRACTING OF
EXTERNAL LOANS FOR PUBLIC
DEVELOPMENT PROJECTS
BY THE NATIONAL TREASURY**

OCTOBER 2023

 THE NATIONAL ASSEMBLY PARDUS YAD	
DATE:	23 NOV 2023
	DAY: <u>Ikulu</u>
TABLED BY:	<u>Hon Kimani Ichungwaly</u> Leader of the Majority Party
CLERK-AT THE-TABLE:	<u>Miriam Mado</u>

VISION

Making a Difference in the Lives and Livelihoods of the Kenyan People.

MISSION

Audit Services that Impact on Effective Sustainable Service Delivery.

CORE VALUES

Integrity

Credibility

Relevance

Accountability

Independence

MOTTO

Enhancing Accountability

FOREWORD BY THE AUDITOR-GENERAL

I am pleased to present this Performance Audit Report on Contracting of External Loans for Public Development Projects by The National Treasury. My Office carried out the audit under the mandate conferred on me by Article 229 (6) of the Constitution of Kenya, 2010 and Section 36 of the Public Audit Act, 2015. The Act mandates the Auditor-General to examine the economy, efficiency and effectiveness with which public money has been expended pursuant to Article 229 of the Constitution of Kenya, 2010.

Performance, financial and compliance audits form the three-pillars of the audit assurance framework that I have established to give focus to the varied and wide scope of the audit work done by my Office. The framework is intended to provide a high level of assurance to stakeholders that public resources are not only correctly disbursed, recorded and accounted for, but their use results in positive impacts on the lives and livelihoods of the citizens. The main goal of our performance audit on public debt is to ensure effective use of public resources and promote service delivery to the citizens.

Our public debt audits establish if the Country's debt is raised to the required level of funding, done at the minimum financing cost taking account of risk and in a sustainable manner. It also establishes if other set Public Debt Management goals, such as developing and maintaining an efficient market for government securities are met. It further examines if funded activities are managed in a prudent way. I am hopeful that corrective action will be taken in line with our recommendations in the report.

The report is submitted to Parliament in accordance with Article 229 (7) of the Constitution of Kenya, 2010 and Section 39 (1) of the Public Audit Act, 2015. I have also remitted copies of the report to the Principal Secretary, The National Treasury and the Chief of Staff and Head of Public Service.



CPA Nancy Gathungu, CBS
AUDITOR-GENERAL
23 October, 2023

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LIST OF ABBREVIATIONS

Abbreviation	Full Name
CSDRMS	Commonwealth Secretariat Debt Recording Management System
DeMPA	Debt Management Performance Assessment
DPDM	Department of Public Debt Management
GoK	Government of Kenya
INTOSAI	International Organization of Supreme Audit Institutions
KeNHA	Kenya National Highway Authority
KISIP	Kenya Informal Settlement Improvement Project
KURA	Kenya Urban Roads Authority
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MTDS	Medium Term Debt Strategy
OAG	Office of The Auditor General
PAD	Project Appraisal Document
PAP	Project Affected Person
PDMO	Public Debt Management Office
PFM	Public Finance Management
PIM	Public Investment Management
TNT	The National Treasury

DEFINITION OF TERMS

Bilateral Debt: This is the portion of a country's external debt owed to a single creditor, usually another government.

Buyer Credit: This is a short-term loan extended to an importer by an overseas lender such as a bank or financial institution to finance the purchase of capital goods, services, and other big-ticket items.

Commercial Debt: This is the portion of a country's external debt owed to private commercial banks.

Commitment Fee: This is a penalty defined in an external loan agreement which is paid on funds that have not been drawn by the borrower, but was budgeted and committed by the lender within a financial calendar year. This happens when conditions precedent have not been fulfilled on time or when implementation is not progressing as per loan agreement.

Concessional: This is a measure of the "softness" of a credit facility, reflecting the benefit to the borrower compared to a loan at market rate.

Condition Precedent: This is a legal term describing a condition or event that must come to pass before a specific contract is considered effective.

Contracting: This is the process of entering into an agreement between two or more parties, especially one that is written and enforceable by law.

CS-DRMS (Commonwealth Secretariat Debt Recording and Management System): This is an integrated tool for recording, analyzing and reporting public sector debt. It is constantly evolving to match the ways in which debt management is reshaping itself. The software adopts a holistic approach through the extensive coverage of various types and categories of debt liability and debt related financial instruments for sovereign as well as sub-national governments.

Debt Crisis: This is a situation in which a country is unable to pay back its government debt as and when the debt falls due.

Disbursement: This means paying out money to an implementing entity or a service provider. Mostly used interchangeably with drawdown which means the delivery of loan amount to the borrower by the lender.

Domestic Debt: This is the portion of a country's debt that is incurred within its borders, in form of treasury bills and bonds.

Escrow Account: An escrow is an arrangement for a third party to hold the assets of a transaction temporarily. The assets are kept in a third-party account and are only released when all terms of the agreement have been met. The use of an escrow account in a transaction adds a degree of safety for both parties.

External Debt: This is the portion of a country's debt that is borrowed from foreign lenders, including commercial banks, governments, or international financial institutions.

Loan: This is a type of credit vehicle in which a sum of money is lent to another party in exchange for future repayment of the principal value with added interest and finance charges.

Multilateral Debt: This is the portion of a country's external debt owed to more than one creditor, usually international finance institutions such as The International Monetary Fund and World Bank.

Negotiation: This refers to a strategic discussion that resolves an issue in a way that both parties find acceptable.

Non – Disbursing Loan: This is an undrawn loan due to non-fulfillment of certain conditions in the loan agreement.

Public Debt as a percentage of GDP: This is an indicator of the ability of a government to meet its future obligations.

Public Debt Ceiling: This is a legally imposed upper limit on the stock of public debt of a country.

Public Debt Stock: This is the sum of public domestic debt and public external debt.

Public Debt: This means all financial obligations attendant to loans raised or guaranteed and securities issued or guaranteed by the national government. It can be raised both externally and internally.

Supplier Credit: This is a financing arrangement under which an exporter extends credit to the buyer.

EXECUTIVE SUMMARY

Background to the Audit

1. Article 229 (6) of the Constitution of Kenya, 2010 and Section 36 of the Public Audit Act, 2015 mandates the Auditor-General to examine and report on the economy, efficiency and effectiveness with which public money has been expended.
2. Public debt is primarily driven by fiscal deficit as the Country resorts to borrowing to fill the budgetary resource gaps to finance development needs of the two levels of government. This act of borrowing where government considers and negotiates the terms and conditions offered by different potential lenders, and formulates binding agreements defines loan contracting. The Public Debt Management Office under The National Treasury is mandated to carry out external loan contracting which is the formal process of formulating financing agreements with foreign lenders, such as foreign governments, foreign commercial banks, and international financial institutions. The sources of external loans include bilateral, multilateral, commercial banks, buyer credits and supplier credits.
3. Excessive levels of external debt combined with poor debt management can hamper a country's ability to invest in its economic future in terms of development projects and service delivery to citizens. It is important that public debt is managed efficiently and effectively to avoid debt crisis which can be triggered by factors such as exchange rate fluctuations, as external debt is usually denominated in the currency of the lender's country, not the borrower, and this means if the currency in the borrowing country weakens, it becomes costlier to service the debts.

Motivation for the Audit

4. The factors that motivated the Office to conduct the audit included: -
 - i. There has been an increase in the total public debt stock for the last five (5) years by 72% from KES.5.0 trillion in 2017/2018 to KES.8.6 trillion in 2021/2022. Further, there has been a corresponding increase in external debt stock by 67.41 % from KES.2.6 trillion in 2017/2018 to KES.4.3 trillion in 2021/2022.
 - ii. According to the Annual Public Debt Reports for the financial years 2019/2020 to 2021/2022, the Government of Kenya (GoK) paid commitment

- fees of KES.5,357,470,000 in the three (3) years on undisbursed external loans. This means that there were delays in commencement of projects which led to non-disbursement of contracted loans as per disbursement schedules, hence payment of commitment fees. This could have been occasioned by approval for financing of projects without proper planning and preparedness. Delays in implementation of intended projects further delays socio-economic benefits of the projects to the citizens. In addition, these nugatory costs incurred, could have been utilized in delivery of other essential public services.
- iii. According to the Hansard Report of 09 June, 2021, Members of Parliament raised concerns over stalled projects and termed non-adherence to The National Treasury circulars as one of the causes of stalled projects. They noted that new projects were initiated without proper scrutiny, while ongoing projects were not completed in time, yet these projects are funded through external loans.
 - iv. The UN Report on Financing for Sustainable Development Goals 2022, recommends, supporting the recovery and investing in sustainable development, while managing debt vulnerabilities will require comprehensive actions. Debt vulnerabilities need to be addressed in a holistic manner, with actions necessary across the Addis Ababa Action Agenda which seeks to align financing flows and policies with economic, social, and environmental priorities. A key domestic policy priority in this context is creating fiscal space through revenue mobilization, expenditure efficiency and better debt management. Further, the report states that strengthened loan contracting processes can contribute to responsible borrowing decisions.
5. The above factors made it necessary to conduct the audit on external loan contracting to determine if loans are contracted effectively to ensure that the costs and risks of borrowing are minimized.

Objective of the Audit

6. The main objective of the audit was to assess whether measures put in place by The National Treasury (TNT) ensures that external loan contracting is done effectively to minimize costs and risks of borrowing.

Scope of the Audit

7. The audit team examined the external loan contracting processes in Kenya conducted by The National Treasury (TNT). The audit covered financial years 2019/2020 to 2021/2022. The three (3) year period under review is based on the issuance of the Public Investment Management (PIM) Guidelines dated January 2020. The guidelines provide a framework for the efficient and effective management of public investments that include; project identification, conceptual planning, pre-feasibility, feasibility, selection for budgeting, implementation, monitoring, evaluation and reporting to ensure value-for-money and optimal use of public resources. The team carried out field verifications for inspections of sampled projects in six (6) counties namely; Mombasa, Kwale, Muranga, Nakuru, Kisumu and Nairobi.

Summary of Findings

8. The National Treasury (TNT) has implemented measures towards effective management of public debt. These measures include preparation and approval of Public Debt and Borrowing Policy 2020, Public Investment Management Guidelines 2020 and Mandatory Checklist for Loan Requirements. There is also a proposal to amend the Public Finance Management Act, 2012, to ensure that approvals of debt limit by Parliament is anchored on sustainability.
9. However, despite the above efforts towards effective management of public debt, audit findings indicate that loan contracting operations were not effectively carried out to minimize risks and costs of borrowing as detailed below:

A. Inadequacies in Project Identification, Planning and Approvals before Signing of Loans

Inadequate Public Participation During Project Identification

10. Interviews with project beneficiaries established that the intended beneficiaries were not involved during project identification in all the six (6) sampled projects. Although the implementing agencies stated that public participation was carried out, no evidence was provided to the audit team for requests for public participation, forums held, minutes and signed lists of attendees, and how views of any participants were considered in the project's identifications and designs.
11. Interviews with implementing agencies revealed that financiers approach ministries directly before projects are conceptualized by the users or project implementing ministries. The interviews further revealed that, depending on framework agreements or development cooperation agreements signed with GOK, the financiers indicate their intentions to finance selected projects from the ministries' strategic plans.

Delays in Fulfillment of Mandatory Loan Requirements Prior to Contracting External Financing

12. Review of loan correspondence files for the six (6) sampled loans revealed that all projects were approved and loan agreements signed based on commitment letters from implementing agencies to fulfil the mandatory requirements before the loans became effective, or within the required timelines. However, at the time of field verification, the projects had not commenced as planned due to non-fulfilment of the requirements by implementing agencies as committed in the letters.

Pro-Longed Approval Period that Led to Re-Designing of Feasibility Studies at Additional Expenses

13. Review of feasibility studies for the sampled projects revealed that five (5) projects had long time lapse between completion of feasibility study and signing of financing agreement which resulted to updating or redoing the feasibility study at additional cost to accommodate prevailing market conditions, changes over time, costs and local aspirations.

Approval of New Projects before Completion of Main Project

14. Review of loan correspondence files for the sampled loans revealed that in three (3) loans, subsequent projects whose operations depend on the main projects were approved before completion of main projects. This was contrary to The National Treasury (TNT) Circular No. 12/2018 dated 29 October, 2018 that requires all Accounting Officers to ensure that all ongoing projects are completed before initiating new projects and, the sanctioning of new projects must receive express authority from TNT.

B. Inadequate Creditor Evaluation and Negotiation

Insufficient Comparison of the Credit Terms

15. Review of loan correspondence files for all the sampled projects revealed that in analyzing concessionality of the loans, only one creditor is identified for each loan. The credit terms and conditions were evaluated without considering other potential creditors for the purpose of comparing credit terms and conditions necessary in obtaining the most cost-effective credit facility. This was observed in sourcing of both bilateral and multilateral loans, even where Development Partners have the same development objectives.
16. Further, interviews with the staff of the Debt Policy, Strategy and Risk Management Department, whose responsibility is to analyze the concessionality of the loans revealed that the reasons for analyzing only one credit term was due to receiving only one draft financing agreement for each project from the Resource Mobilization Department, which is mandated to mobilize financial resources. Further, the interviews revealed that comparative analysis is limited as a creditor will have been identified by the time a project proposal is forwarded to the Department and in some cases, the creditor would have financed the feasibility study. Consequently, there are risks that loans contracted may not be the most cost effective in the market.

Inadequate Evaluation of Credit Terms

17. Review of loan correspondence files for all the sampled projects revealed that only concessionality analysis were done, however, financial analysis such as currency, penalty fees and other charges, disbursement and maturity profiles and impact on

existing debt service profiles were not performed in order to obtain the lowest possible borrowing cost. This was attributed to inadequate staff and skills in the Debt, Policy, Strategy and Risk Management Department.

Inadequate Negotiation on Co-Financing Clauses

18. Review of financing agreements for the sampled projects revealed that two (2) out of six (6) sampled projects have co-financing clauses which have negative impact on the contracted loans. These two (2) projects are Mwache Dam Project and Nairobi Water Sanitation Project.
19. Mwache Dam Project is financed by International Development Association (IDA) and Agence Francaise De Development (AFD). Review of AFD financing agreement, revealed that one of the conditions precedents for the AFD agreement is that a drawdown request could not be submitted to the lender if a co-financier had suspended any payments on the project. In the circumstance, there are risks of paying costs on commitment fee and other related charges on loans where there is suspension on payments by a co-financier on the project.
20. Further, review of financing agreement for Nairobi Water and Sanitation Projects revealed that if the borrower prepays any amount due to a co-financier in full or in part, before the technical completion date, they must prepay the entire or a portion of the facility within 30 calendar days. Therefore, in the event a new financier is introduced and prepayment occurs, this clause may have a negative impact on liquidity position of the government.

Inadequate Negotiation and Non-Adherence to Legal Advice from the Attorney General

21. Comparison of legal clearances and signed financing agreements revealed that the Attorney General's (AG) legal advices were not followed in four (4) out of six (6) sampled loans.
22. Non-adherence to AG's advice on fulfilment of mandatory requirements before signing the loan agreements had contributed to stalling of projects at implementation phase, and payments of commitment fees on Kenol-Sagana-Marua Highway Improvement Project and Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project.

Inadequate Negotiation on the Use of Creditor's Procurement Policies and Guidelines

23. Review of signed financing agreements revealed that the creditors' procurement rules were to be used during procurement of consultants and contractors. According to interviews with the implementing agencies, the use of creditors' procurement policies, rules and guidelines have a requirement of prior review by the creditor at every stage of the procurement process before issuance of a No-Objection letter allowing the implementing agency to proceed to the next stage of procurement. The prior review processes take a long time leading to delays in procurement of consultants and civil works contractors. This leads to deferral in first drawdown of loan funds, necessitating payment of commitment fees on undisbursed loan amounts which could be avoided through adequate negotiations on favorable timeframes for prior review processes.

C. Delays in Fulfilment of Conditions Precedent Resulting to Incurring of Commitment Fees

24. Review of records obtained through Commonwealth Secretariat Debt Recording Management System (CS-DRMS) as provided by The National Treasury revealed that for the three (3) financial years under review, a total of 70 loans had been contracted out of which 17 were non-disbursing. The non-disbursing loans had accumulated commitment fees of KES.110,506,448.47.
25. The audit review revealed that all the sampled projects were disbursing. However, it was established that three (3) of the sampled disbursing loans had accrued total commitment fees of KES.158,750,956.82 as a result of non-disbursement as at the time of audit. This was mainly attributed to delays in land acquisitions and resettlement of persons affected by projects.

D. Inadequate Monitoring and Evaluation of Contracted Loans

Inadequate Coordination, Review and Monitoring of Utilization of External Resources by Public Debt Management Office

26. Interviews with staffs from the Public Debt Management Office (PDMO) revealed that once a loan agreement is signed and disbursements progressively made to

projects, the PDMO does not directly monitor and evaluate the utilization of the project funds as per project loan requirements. However, PDMO relies on project progress reports from implementing agencies which may lack some material facts on the project's status, which may expose the government to financial risks. The interviews further revealed that inadequacy in monitoring and evaluation was due to inadequate staff number, knowledge and skills.

Inadequate Collaboration Between Stakeholders

27. Assessment of the six (6) sampled loans revealed that there is inadequate collaboration between different stakeholders whose inputs are required for efficient implementation of projects. The stakeholders include: National Lands Commission, National Environment Management Authority, County Governments and other authorities that issue approvals.

Inadequate Enforcement of The National Treasury Circulars and Guidelines

28. The PIM Guidelines issued through Circular No. 16/2019 of 24 January, 2020 provides a framework for efficient and effective management of public investments, that includes project identification and conceptual planning, pre-feasibility and feasibility studies, selection for budgeting, implementation, monitoring, evaluation and reporting, closure, sustainability and ex-post evaluations to ensure value-for-money and optimal use of public resources.
29. However, interviews with the PIM Unit revealed that, in May 2020 an Executive Order issued which, transferred the mandate of PIM Unit to the State Department of Planning which rendered the guidelines non-operational. The Executive Order No. 1 of 2022, reinstated the mandate of PIM Unit to The National Treasury. However, at the time of audit, the guidelines were not being adhered to. This was attributed to inadequate capacity in the PIM Unit and lack of awareness on the guidelines at the MDA levels.

Conclusion

30. The National Treasury had made several efforts in guiding the processes of loan contracting such as preparation and approval of Public Debt and Borrowing Policy, 2020, PIM Guidelines, 2020 and Mandatory Checklist for Loan Requirements.

However, the findings of the audit, indicate that The National Treasury has not carried out external loan contracting processes effectively, to minimize costs and risks of borrowing. This was evidenced by inadequate measures in:

31. Guiding the identification, planning and approvals of projects before loan signing, resulting to delays in commencement of the projects and re-designing of feasibility studies.
32. Ensuring assessment of credit terms and conditions adequately before signing of the loan agreements, which may result to contracting loans with unfavorable terms and conditions.
33. Ensuring all conditions precedent are met on time and funds are disbursed as per agreed schedules, resulting to payments of commitment fees.
34. Monitoring and evaluation mechanisms in ensuring project funds are utilized as per the project loan requirements, which may result to overlapping priorities and financing of non-feasible projects.

Recommendations

35. In view of the findings and conclusions of the audit, the following recommendations are made for implementation by The National Treasury;
To ensure that external loan contracting is done effectively to minimize cost and risk of borrowing, TNT should ensure that:
 36. Implementing agencies involve project beneficiaries during projects identification and designs through public participation in order to enhance ownership, social accountability and sustainability of the projects.
 37. Land acquisition, compensation and relocation of utility lines are financed in-advance through GoK development counterpart funding before signing of financing agreements.
 38. The time between feasibility studies and actual time for signing financing agreements is reduced to avoid costs of redoing feasibility studies and to hedge against foreign exchange fluctuations.

39. Additional loans are signed when the initial loan has been utilized and a detailed evaluation of remaining works have been done to establish the exact quantities of pending works.
40. The capacity and skills of DPDM are enhanced for adequate evaluation and negotiation of favorable credit terms and conditions and for adequate monitoring and evaluation of loan projects.
41. A framework for collaboration between all relevant stakeholders involved in debt-funded projects should be established for efficient coordination during project planning and approvals to avoid delays in implementation.
42. In collaboration with implementing agencies, have adequate measures to ensure all the conditions precedent are met within timeline to avoid non-disbursing of loans, which results to payment of commitment fees on undrawn amounts.
43. Enforce adherence to Circulars and PIM Guidelines by enhancing the capacity of PIM Unit and create awareness on the guidelines at the MDA levels for efficient and effective management of public investments, to ensure value-for-money and efficient use of public resources.

1.0 BACKGROUND OF THE AUDIT

Introduction

- 1.1. The Office of the Auditor-General (OAG) is established under Article 229 of the Constitution of Kenya, 2010. The Constitution mandates the Office to oversight the management of public resources within the three arms of government (the Executive, Legislature and the Judiciary), the Constitutional Commissions, the Independent Office of the Controller of Budget and any other entity that is funded from public funds.
- 1.2. In performing this role, we audit and report on the effective and lawful use of public resources. The audit reports of public entities are submitted to Parliament and the relevant County Assemblies for deliberations and action. Once discussed, Parliamentary and County Assembly Committees give appropriate recommendations for implementation. Thereafter, the Auditor-General follows up on the status of implementation of the recommendations before commencing the next cycle of auditing.
- 1.3. In Kenya, public debt is primarily driven by fiscal deficit as the Country resorts to borrowing to fill the budgetary resource gap to finance development needs of the two levels of government. This act of borrowing where government considers and negotiates the terms and conditions offered by different potential lenders, and formulates binding agreements, defines Loan Contracting.¹
- 1.4. The Public Debt Management Office (PDMO) under The National Treasury (TNT) is mandated to carry out External Loan Contracting which is the formal process of formulating financing agreements with foreign lenders, such as foreign governments, foreign commercial banks, and international financial institutions, by the National Government.² The sources of external loans include bilateral, multilateral and commercial banks which is in some instances referred to as supplier credits.
- 1.5. Prudent debt management ensures that debt is contracted at minimal cost and risk. Effective loan contracting ensures adequate project preparation and appraisal, evaluation of credit terms and conditions, and creditors' due

¹ Public Debt and Borrowing Policy 2020

² Corporate Finance Institute, 2021

diligence. This ensures that only viable projects are funded, other costs such as commitment fees, contractors' claims are avoided and citizens get value-for-their-money.

- 1.6. Excessive levels of external debt combined with poor debt management can hamper a countries' ability to invest in their economic future, in terms of development projects and service delivery to citizens. A debt crisis can be triggered by these factors because external debt is usually denominated in the currency of the lender's country, not the borrower, and this means if the currency in the borrowing country weakens, it becomes that much harder to service the debts.

Motivation for the Audit

- 1.7. The factors that motivated the Office to conduct the audit included: -
- (i). There has been an increase in the total public debt stock for the last five (5) years by 72% from KES.5.0 trillion in 2017/2018 to KES.8.6 trillion in 2021/2022. Further, there has been a corresponding increase in external debt stock by 65.38% from KES.2.6 trillion in 2017/2018 to KES.4.3 trillion in 2021/2022. This is shown in **Table 1**.

Table 1: Public Debt Stock Trend Over Last 5 Years

Fiscal Year	Public Debt Stock Annual 'KES. Millions"	External Debt (KES. Millions")	Domestic Debt (KES. Millions")
2017/2018	5,047,234	2,568,399	2,478,835
2018/2019	5,808,622	3,023,139	2,785,483
2019/2020	6,693,338	3,515,812	3,177,526
2020/2021	7,696,635	3,999,542	3,697,093
2021/2022*	8,588,281	4,299,948	4,288,333

Source: The National Treasury

- (ii). According to the Annual Public Debt Reports for the financial years 2019/2020 to 2021/2022, the Government of Kenya (GoK) paid commitment fees of KES.5,357,470,000 in the three (3) years on undisbursed external loans. This means that there were delays in commencement of projects which led to non-disbursement of contracted loans as per disbursement schedules, hence payment of commitment fees. This could have been

occasioned by approval for financing of projects without proper planning and preparedness. Consequently, this result into delays in implementation of intended projects, further delaying socio-economic benefits of the projects to the citizens. In addition, these nugatory costs incurred, could have been utilized in delivery of other essential public services.

- (iii). According to a Kenya Human Rights Commission Press Release dated 05 May, 2022, the Kenya Human Rights Commission and National Coordinator of the Institute for Social Accountability filed a petition at the High Court seeking to compel The National Treasury and Attorney General to disclose information on Kenya's debt treaties, agreements, and contracts signed with other states and lending institutions, through a letter dated 07 February, 2022. The reasons for this petition was due to The National Treasury increasingly borrowing expensive bilateral loans in an opaque and shadowy manner.
- (iv). The increased need for borrowing has necessitated amendments of Regulation 26 (1)(c) of the Public Finance Management (PFM) Regulations, 2015 through Legal Notice No. 89 of 26 May, 2022 to shift the debt ceiling from KES.9 trillion to KES.10 trillion in order to create fiscal space required to restructure the debt stock and bring debt down to sustainable levels and support the budget for the FY2022/23.³ This amendment of the debt ceiling means that the GoK can contract more new loans, thus leading to accumulation of high stock of public debt.
- (v). According to the Hansard Report dated Wednesday 09 June, 2021, Members of Parliament raised concerns over stalled projects. They recognized the cause of stalled projects as non-adherence to project guidelines issued by The National Treasury. The Members noted that new projects were initiated without proper scrutiny, while ongoing projects are not completed in time due to a multiplicity of reasons. Cumulatively, this has

³ The National Assembly Hansard Report of 07 June 2022

created a vicious cycle with a bloated project portfolio, unpredictable funding for ongoing projects, limited fiscal space for new projects, low budget execution for ongoing interventions and ultimately delayed translation of the project outputs to benefits in terms of long-term economic growth and improved service delivery⁴. Considering that these projects are financed through external loans, the above challenges indicate inadequacies in external loan contracting processes such as planning and approvals for public development projects.

(vi). According to the UN Report on Financing for Sustainable Development Goals 2022, which addresses the Addis Ababa Action Agenda developed in 2015, that seeks to align financing flows and policies with economic, social, and environmental priorities, supporting the recovery and investing in sustainable development, while managing debt vulnerabilities, will require comprehensive actions⁵. Debt vulnerabilities need to be addressed in a holistic manner, with actions necessary across the Addis Agenda. A key domestic policy priority in this context is creating fiscal space through revenue mobilization, expenditure efficiency and better debt management. Further, the report states that strengthened loan contracting processes can contribute to responsible borrowing decisions.

1.8. The above factors therefore made it necessary to carry out an audit to assess whether the measures put in place by The National Treasury (TNT) ensures that external loan contracting is done effectively to minimize costs and risks of borrowing.

⁴ National Treasury Circular No. 16/2019 Guidelines on Public Investment Management for National Government and its Entities.

⁵ Financing for Sustainable Development Report (2022)

2.0 DESIGN OF THE AUDIT

Audit Objective

- 2.1. The main objective of the audit was to assess whether measures put in place by The National Treasury (TNT) ensures that external loan contracting is done effectively to minimize costs and risks of borrowing.
- 2.2. The specific objectives were:
 - (i) To assess whether the measures in place for guiding identification, planning and approvals of projects before loan signing are adequate.
 - (ii) To assess whether the measures put in place by TNT ensures adequate assessment of credit terms and conditions before signing of the loan agreements.
 - (iii) To assess whether the measures put in place by TNT ensure all conditions precedent are met on time and funds are disbursed as per agreed schedules.
 - (iv) To assess whether the monitoring and evaluation mechanisms put in place by TNT ensures that project funds are utilized accordingly as per the project loan requirements.

Audit Scope

- 2.3. The audit team examined the external loan contracting processes in Kenya conducted by The National Treasury (TNT). The audit covered financial years 2019/2020 to 2021/2022. The three (3) year period under review is based on the issuance of The Public Investment Management (PIM) Guidelines dated January 2020. The Guidelines provide a framework for the efficient and effective management of public investments that include; project identification, conceptual planning, pre-feasibility, feasibility, selection for budgeting, implementation, monitoring, evaluation and reporting to ensure value for money and optimal use of public resources.
- 2.4. The team carried out field verifications for inspections of sampled projects in six (6) counties namely; Mombasa, Kwale, Muranga, Nakuru, Kisumu and Nairobi.

Sampling

- 2.5. An extract of Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) listings for externally loan funded projects from FY 2019/2020 to 2021/22 provided the sampling frame of 70 loans. The audit team categorized the sampling frame into bilateral loans, multilateral loans, supplier credits and commercial loans. Under each category, the audit purposively selected individual projects based on loan amount, regional balance and the Big Four Agenda including infrastructure, water and housing. The six (6) projects sampled are shown in **Appendix I**.

Methodology for the Audit

- 2.6. The audit was conducted in accordance with the Performance Auditing Standards issued by the International Organization of Supreme Audit Institutions (INTOSAI) and audit policies and procedures established by the Office of the Auditor-General (OAG). These guidelines and policies fulfil the requirements of the International Standards of Auditing (ISA) issued by INTOSAI.
- 2.7. The methods used to gather audit evidence are outlined below: -

Documents Review

- 2.8. The audit team reviewed the loan correspondence files for the sampled loans to identify gaps in loan contracting processes and establish effectiveness of measures put in place by TNT with regard to planning and approval of projects for financing, negotiation of financing terms and conditions with the creditors, involvement of legal advisors before signing of the financing agreements, fulfilling conditions precedent and processing of the first disbursements. The audit team further reviewed an excerpt of non-disbursing loans for the year under review to assess the commitment fees incurred on them. The list of documents reviewed and the data obtained is shown in **Appendix II**.

Interviews

- 2.9. The audit team interviewed key personnel in the Directorate of Public Debt Management (DPDM), Macro and Fiscal Affairs Department in the Directorate of Budget Fiscal and Economic Affairs and the Public Investment Management

(PIM) Unit in order to understand the sampled loans in terms of how the projects were identified and approved for funding, how the creditors were identified and evaluated, negotiation of credit terms and conditions and any other challenges the loans are facing in terms of fulfilment of conditions precedent and disbursements.

- 2.10. The team further interviewed the implementing agencies responsible for the sampled projects to establish their involvement in project identification and preparations before projects are approved for financing, loan negotiation and, challenges they are facing in fulfilment of conditions precedent. The list of persons interviewed and the data obtained is shown in **Appendix III**.

Physical Verification

- 2.11. The team carried out field verification of the sampled projects to establish whether each project's beneficiaries were involved in project identification, the project commenced as per the project loan requirements, the utilization of the first disbursement, the implementation status of the project and the challenges faced.
- 2.12. The above methods helped the audit team to collect, organize and analyze data that helped achieve the set audit objectives. The evidence collected was presented using tables and graphs as appropriate.

Assessment Criteria

- 2.13. The main assessment criteria were drawn from The Constitution of Kenya 2010, Public Finance Management (PFM) Act, 2012, Public Finance Management (National Government) Regulations, 2015, National Treasury Budget Circulars, Public Investment Management Guidelines 2020, Loan Agreements, Public Debt Management Office - Office Manual Procedures, External Loan Operation Manual, Debt and Borrowing Policy 2020 and Good Debt Management practices like the UNCTAD Principles, Debt Management Performance Assessment (DeMPA tool) 2007 revised in 2021 and The Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) Public Debt Management Procedures Manual. Details of specific criteria used are shown in **Appendix IV**.

3.0 DESCRIPTION OF EXTERNAL LOAN CONTRACTING

- 3.1. External Loan Contracting is the formal process of formulating financing agreements with foreign lenders, such as foreign governments, foreign commercial banks, and international financial institutions. This process involves project identification, planning, creditor identification and evaluation, negotiation, signing of the financing agreement and disbursement. The Public Debt Management Office under The National Treasury is the key stakeholder in this process.

Regulatory and Institutional Framework

- 3.2. The legal framework governing external loan contracting includes Article 211 of the Constitution of Kenya, 2010, Sections 62 to 64 of the PFM Act 2012 and Regulations 183 to 196 of the PFM Regulations (National Government) 2015.
- 3.3. The institutional framework for managing public debt and borrowing includes Parliament, the Cabinet, Cabinet Secretary to The National Treasury (TNT) and The Directorate of Public Debt Management within The National Treasury. The overall management of external loan contracting is the function of the Resource Mobilization Department under the Directorate of Public Debt Management (DPDM) within The National Treasury.

The Role of The National Treasury

- 3.4. The National Treasury derives its mandate from Article 225 (1) of the Constitution of Kenya, 2010 which states that an Act of Parliament shall provide for the establishment, functions and responsibilities of The National Treasury. Further, Article 211 (1) of the Constitution of Kenya, 2010, states that Parliament may, by legislation prescribe the terms on which the national government may borrow; and impose reporting requirements. In addition, Section 49 (1) of the Public Finance Management Act (PFM) Act 2012 states that; the Cabinet Secretary may, on behalf of the national government, raise a loan only if the loan and the terms and conditions for the loan are set out in writing.
- 3.5. The roles of various Institutions under The National Treasury are discussed overleaf: -

Public Debt Management Office

3.6. The Public Debt Management Office (PDMO) derives its mandate from the PFM Act 2012, Section 62, which provides for its establishment under The National Treasury. The objectives of the PDMO are specifically given as: -

- (i) To minimize the cost of public debt management and borrowing over the long-term, taking account of risks;
- (ii) To promote the development of the market institutions for government debt securities;
- (iii) To ensure the sharing of the benefits and costs of public debt between the current and future generations.

The Role of the Resource Mobilization Department with Regards to Loan Contracting Process

3.7. The Debt and Borrowing Policy Section 5.4.2.1 paragraph 63(a)(d) outlines one of the functions of Front Office within the PDMO as “Undertake domestic and foreign borrowing including raising of grants in accordance with this policy, Kenya External Resource Policy and relevant laws and seeking legal opinions from the Attorney General on loan negotiations and liaising with implementation agencies to ensure that conditions precedent are fulfilled in time to save government from undue costs on commitment fees.”

Mandate of Public Investment Management Unit

3.8. The Public Investment Management (PIM) Unit was established at The National Treasury in the year 2018. The Public Investment Management (PIM) Guidelines were issued in the year 2020, though The National Treasury Circular No. 16/2019 for implementation by all Ministries, Departments and Agencies. The PIM Unit mandate is as follows:

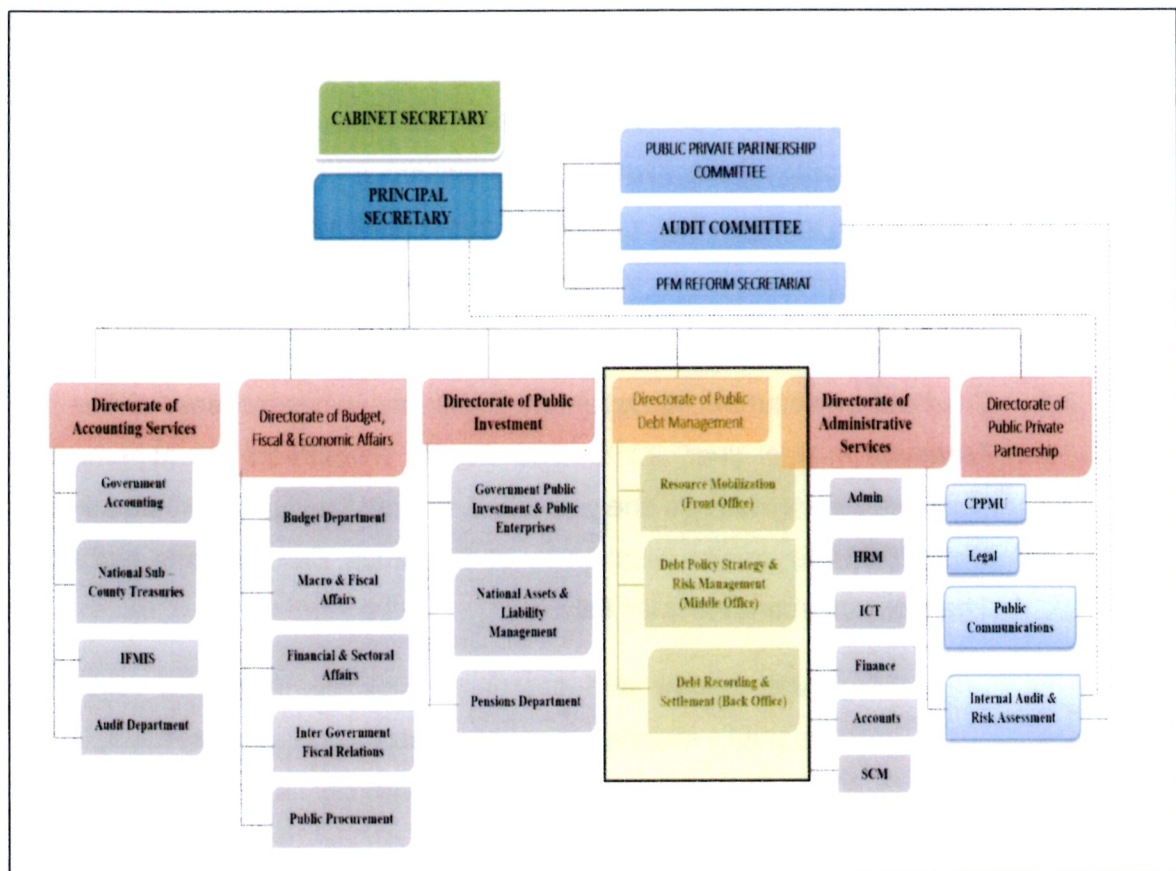
- (i) Formulate, review and coordinate policies, laws and regulations to improve public investment management across government;
- (ii) Building and strengthening PIM capacity in National and County Governments;
- (iii) Designing, developing and maintaining an efficient, effective and reliable Public Investment Management Information System (PIMIS);

- (iv) Developing standards, methodologies, and tools for appraisal of project concept notes, pre-feasibility and feasibility studies;
- (v) Gate keeping Role: Analyze, review and appraise proposed projects before approval.

Organizational Structure of The National Treasury

3.9. The National Treasury is headed by a Cabinet Secretary who is deputized by a Principal Secretary who heads six (6) Directorates of which External Loan Contracting falls under Directorate of Public Debt Management headed by a Director-General. This Directorate is further subdivided into three (3) sub-departments namely Resource Mobilization Department (Front Office), Debt Policy Strategy and Risk Management (Middle Office) and Debt Recording and Settlement (Back Office) as highlighted in the **Figure 1**.

Figure 1: The National Treasury Organogram



Source: The National Treasury Strategic Plan 2018/19 – 2022/23

Ministries and Implementing Agencies and their Functions in External Loan Contracting.

- 3.10. The Macroeconomic and Financial Management Institute of Eastern and Southern Africa Public Debt Management Procedures Manual Vol 1. Section 2.4.9 states that Line Ministries shall:
- (i) Prepare project proposals and submit them for approval to Ministry of Finance.
 - (ii) Provide regular progress reports on all programmes/projects to Ministry of Finance.
 - (iii) Prepare expected disbursements profiles.
 - (iv) Submit loan disbursements claims approval to responsible offices.
 - (v) Confirm disbursements received to the debt and treasury offices.
 - (vi) Make comments on draft loan agreement from the Ministry of Finance
 - (vii) Participate in all consultations and negotiations of all loan agreements for projects and programmes under their jurisdiction.
 - (viii) Implement, monitor and evaluate, in close collaboration with the body responsible for National Planning, all projects and programmes within their jurisdiction

National Government Budget and Deficit Financing

- 3.11. The National Government expenditure has increased steadily over the three (3) year period. Similarly, the revenue collected has increased. However, it is not able to meet this expenditure, causing fiscal deficit. This has necessitated increased borrowing over the years to finance this deficit, through external and domestic borrowing. External borrowing includes concessional loans, semi concessional loans and commercial loans, while domestic borrowing includes Treasury Bonds, Treasury Bills and CBK overdrafts. This is shown in **Table 2** outlined below:

Table 2: National Government Deficit Financing Sources

Fiscal Year	Official Budget Statement			Mode of Financing Deficit (Official Budget Statement)	
	Original Approved Budget (million)	Revenues (million)	Fiscal Deficit (million)	External (million)	Domestic (million)
2019/2020	2,800,000	2,100,000	607,800	324,300	283,500
2020/2021	2,790,000	1,890,000	840,600	347,000	493,400
2021/2022	3,030,000	2,100,000	929,700	271,200	658,500
2022/2023 ⁶	3,300,000	2,400,000	862,500	280,700	581,700

Source: OAG Analysis of 2019/2020 National Government Financial Statement

Process Description for External Loan Contracting in Kenya⁷

(i). Project Identification, Planning and Approvals for financing

- 3.12. All projects are identified through stakeholder consultation process using a bottom-up approach, which identifies projects in response to stakeholder needs through relevant stakeholder consultations, or a top-down approach, which identifies projects in response to policy objectives highlighted in national and county development plans, sectoral and strategic plans and other policy documents including Budget Policy Statements. No other project concept note is initiated for a project that is being implemented by any other national or county government agency.
- 3.13. The National Treasury Launches Sector Working Groups (SWG) with key representatives from Ministries, Departments and Agencies tasked to identify, prioritize and allocate resources to areas that will have the greatest impact to the National Government priorities.
- 3.14. Once the resources are allocated in the annual budget to finance the projects, the line ministries prepare project proposals in accordance with Public Investment Management guidelines which provide a framework for the efficient and effective management of public investments that includes project identification and conceptual planning, pre-feasibility and feasibility, selection

⁶ The National Treasury and Planning, Budget Statement 2022/2023

⁷ Draft External Loans Operations Manual, April 2019

for budgeting, implementation, monitoring, evaluation and reporting to ensure value for money and optimal use of public resources. Project proposal is forwarded to TNT for approval and financing.

- 3.15. The PIM Unit at The National Treasury receives proposal, review, scrutinize and analyze to ensure it meets the Government objectives and is in line with Kenya Vision 2030 and authorizes the project for approval.

(ii).Evaluation of Funding Alternatives and Creditor Identification

- 3.16. The Resource Mobilization Department in PDMO then chooses the preferred creditors which have obtained the highest average evaluation scores as the possible sources of financing for government. The Resource Mobilization Department evaluates funding prospects and their impact on the debt portfolio in terms of compliance with the approved strategy. Evaluation should be made of the technical, financial and legal terms and conditionalities of the external loan proposals, including the loan purpose, conditions for disbursing loans and the degree of Concessionality.

(iii). Loan Negotiation and Signing of the Agreements

Loan Negotiation

- 3.17. This involve Selection of the loan negotiating team which is based on the role played by individual institutions in the debt management cycle. The Government negotiating team should be composed of well-trained professionals who can meaningfully engage the experienced negotiating teams of creditor institutions/countries. There must be representation from the sector involved, the parent Ministry, The National Treasury, the Public Debt Management Office and the Attorney General's Office. Negotiation strategy needs to be agreed upon by the team during preparations so as to ensure that guiding principles are developed and conformed to. Extensive preparations for negotiations need to be done and this should lead to formulation of a game plan, which will be a basis for negotiations.
- 3.18. Pre- negotiations-involve obtaining and analyzing all loan information based on the standard strategy. A negotiating team reviews the project documents such as appraisal documents, draft agreements, disbursement and procurement procedures and many others including the legal obligations. Importantly, this

review helps to ensure that the proposed obligation's clauses are not in conflict with the objectives and laws of the state.

- 3.19. Post-Negotiations is where both parties must go through the entire document to satisfy themselves that everything in it and other negotiated documents is accurate.
- 3.20. Renegotiations- There are instances where the need to re-negotiating terms of existing debts by either rescheduling or refinancing arises. In such instances, the practice is to go through the whole process as if dealing with a new loan.

Signing of the Loan Agreement

- 3.21. Once both parties are satisfied with the agreement, the agreement is signed between the development partner and The National Treasury on behalf of the GOK in three originals. The Cabinet Secretary, National Treasury signs on behalf of the government as per the Constitution of Kenya and PFM Act 2012.

(iv). Fulfilment of Condition Precedent and Effectiveness of Loan

- 3.22. These are conditions set forth which must be complied with by the borrower before the loan is available for disbursement. These conditions vary from creditor to creditor, and the common ones include; legal opinion from Attorney General's Office, opening of an escrow account, satisfactory evidence that all Project Affected Persons (PAPs) have been compensated and setting up a project implementation unit. Once all condition precedents are met by both The National Treasury and implementing agency, a Loan becomes effective and it is now available for draw-down.

(v). Disbursement and Utilization

- 3.23. Disbursement begins when the committed loan amount is released from the lender to the borrower through the following three methods:
 - a) Revenue Mode of Disbursement: The creditor deposits money directly into the borrower's bank account according to a set schedule for project expenditures.
 - b) Appropriation in Aid (AIA): The borrower receives goods and the creditor pays the provider of goods or services directly.

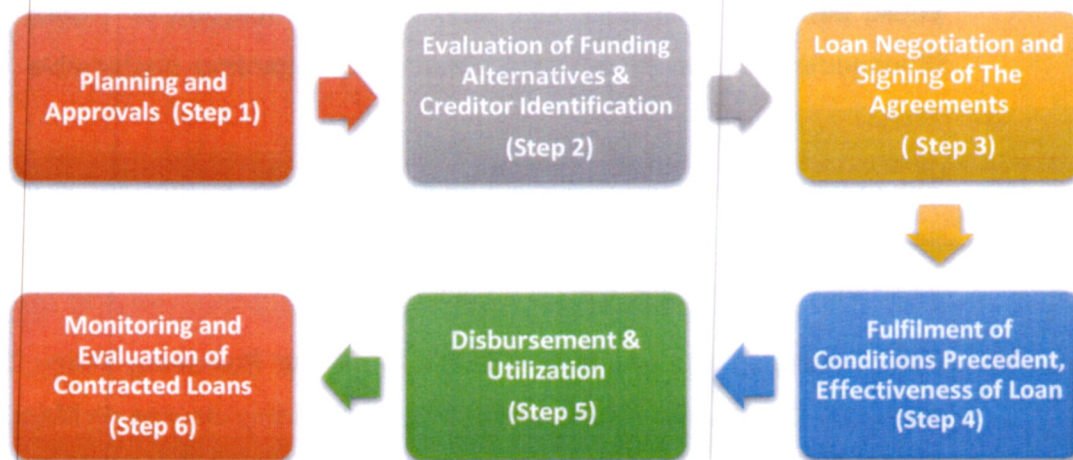
c) Reimbursement Method: The borrower finances expenditure and seeks reimbursement at a later date from the creditor.

3.24. Once the loan is available for drawdown then expenditure or Utilization to finance the development projects as per the purpose of the loan as stated in loan agreement occurs.⁸

(vi). Monitoring and Evaluation of Contracted Loans

3.25. This involves implementing agencies and PDMO carrying out coordination, reviewing and monitoring the utilization of external resources through joint programming, joint work plans, joint visits and joint implementation to ensure that projects are evaluated against plans, targets, and milestones set out in the Project Implementation Plan, the signed project contract or project implementation document⁹.

Figure 2: External Loan Contracting Processes by The National Treasury



Source: OAG Figure of the External Loan Contracting Process

⁸ MEFMI Public Debt Management Procedures Manual, Vol. 1

⁹ Public Investment Management Guidelines, 2020

4.0 AUDIT FINDINGS

4.1. The National Treasury has implemented measures towards the effective management of public debt as follows: -

- (i) There has been an increase in the supply of information through sufficient publication of Monthly Debt Bulletins, Annual Public Debt Management Reports, the Annual Borrowing Plan, the External Public Debt Register and Budget Books on the website;
- (ii) In the interest of management of debt sustainably, draft Public Finance Management (Amendment) Bill, 2023 and legal notices proposing amendments of the Public Finance Management Act, 2012, and its Regulations, 2015, for National and County Governments have been drafted. The proposed amendments sought to have the debt limit approved by Parliament anchored on sustainability as advised by public debt management office so as to provide proper definition of national and county public debt. The proposals also seek additional function for Public Debt Management Office in advising Parliament regarding sustainable debt levels.
- (iii) The formulation and preparation of budget guidelines as provided in Annual National Treasury circulars contributed to the timely achievement of expenditure targets and market confidence.
- (iv) The formulation and approval of Public Debt and Borrowing Policy, 2020 enhanced the process of loan contracting by providing clauses on Managing Costs and Risks, Mandatory Checklist and Conditions Precedent to Debt Contracting and Transparency in Contracting Debt Financing.

4.2. However, despite the above efforts towards effective management of public debt, audit findings indicate that, loan contracting operations were not effectively carried out to minimize risks and costs of borrowing as detailed below:

A. Inadequacies in Project Identification, Planning and Approvals Before Signing of Loans.

4.3. Effective project identification and planning are crucial initial steps before approval of projects for financing. Ineffective identification and planning may lead to challenges including wastage of budgetary resources on projects that are not aligned to national priorities, delays in commencement due to incomplete, inadequate or missing engineering designs, poor costing and budgeting, cost and time overruns and ultimately incomplete or stalled projects resulting to increased costs and risks of borrowing.¹⁰

4.4. The following observations were made:

1. Inadequate Public Participation During Project Identification

4.5. Regulation 205(d) of the PFM Regulations, 2015, states that the accounting officers of a national government entity should be responsible for ensuring that during the project identification and design, the intended beneficiaries are involved through the public participatory approach to planning through public forums to enhance leadership, ownership, social accountability and sustainability of the project.

4.6. Interviews with project beneficiaries established that the intended beneficiaries were not involved during project identification in all the six (6) sampled projects. Although the implementing agencies stated that public participation was carried out, no evidence was provided to the audit team on requests for public participation, forums held, minutes and signed lists of attendees, and how views of any participants were considered in the projects identifications and designs.

4.7. Interviews with implementing agencies revealed that financiers approach ministries directly before projects are conceptualized by the users or project implementing ministries. The interviews further revealed that, depending on framework agreements or development cooperation agreements signed with GOK, the financiers indicate their intentions to finance selected projects from the ministries' strategic plans.

¹⁰ Public Investment Management (PIM) Guidelines, Section 7, 2020

- 4.8. The involvement of beneficiaries during project identification was limited as projects were identified through top to bottom approach which is highly centralized and has a disconnect from grassroots beneficiaries unlike demand-driven where a project is identified through a bottom to top approach which is highly decentralized and people centric.
- 4.9. Consequently, the audit observed the following inadequacies in project design in the sampled projects:

Kenol-Sagana-Marua Highway Improvement Project:

- 4.10. Interviews with beneficiaries of the project revealed that the design did not consider the need of footbridges in four sections being at Katipanga, Kamorori Primary School, Kenol and Kamari, which were considered very crucial due to increased human and motor traffic, and speeding vehicles transporting Khat (Miraa) along that road. Further, the project affected the existing markets, boda-boda stages and sheds at Kenol-Makuyu Junction and Kenol Town. The affected beneficiaries need relocation of these facilities to safer places for free movements and interactions with their customers.
- 4.11. The beneficiaries of the project stated that they had requested the implementing agency, KeNHA to address their concerns. At the time of audit, the consultant handling the Project explained that the concerns were important and new design proposals had been submitted to KeNHA with additional cost implications. These costs could be avoided with proper identification and planning.

Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project:

- 4.12. Interviews with beneficiaries of the project at Shanzu area revealed that they were not involved during project identification phase but were involved during project implementation. At the time of audit, the construction of the road at this section had not commenced due to land acquisition challenges. Further, the interview revealed that the County Government had approved construction of buildings on the land parcels adjacent to this road reserve years before the commencement of the project, only to later demolish the structures thrice, negatively affecting livelihood of these beneficiaries. Additionally, the interview revealed that a scheme to regularize land ownership documents for the

beneficiaries owning land parcels adjacent to this road reserve was formed in 2002. However, at the time of audit this had not been effected.

- 4.13. This will further delay implementation of the project in that section as bank policy requires all affected persons to be compensated and their livelihood enhanced before project start, resulting to payment of commitment fees and other costs such as interests and claims on delayed payments.

Mwache Dam Project and Related Infrastructure:

- 4.14. The financing agreement for Coastal Region Water Security and Climate Resilience Project was signed on 13 January, 2015 where Mwache Dam and Related Infrastructure is the main component of the project.
- 4.15. The construction of this dam was expected to begin on 11May, 2015. However, at the time of audit, it had not commenced due to land compensation and resettlement challenges. Interviews with project beneficiaries revealed that they were not engaged at the identification stage, therefore, the resettlement action plan did not consider their needs such as relocation of Fulugani Primary School which borders the project. While households were moved from the neighborhood to distant location, the school was not relocated, which has negatively affected school attendance. Interview with the Deputy Principal of the school and the Chair of School Board of Management revealed that the school population had dropped by about 22%, from 1,230 to 960 students. The drop was attributed to young learners being unable to walk long distances and parents' concern about heavy vehicles plying the road which may result to accidents. Further, the parents were also concerned about students' health arising from frequent clouds of dust emanating from the project site, and their safety due to possible incidences of under-age sexual abuse and gender-related violence.
- 4.16. The interview further revealed that due to these circumstances, it was later decided that the new school should be constructed closer to the new settlements, which had not begun as at the time of audit.

Second Kenya Informal Settlement Improvement Project (KISIP2):

- 4.17. Interviews with both Nakuru and Kisumu County Project Coordination Team revealed that although counties were given responsibility to implement the project, they were not involved in project design, formulation of the project appraisal document and creation of the project operation manual. Further, the interviews revealed that this limited project knowledge by the county governments had negative impact on their capacity to implement the project, which may increase the risk of poor costing and time overruns, ultimately resulting into incomplete or stalled projects.

Nairobi Water and Sanitation Project:

- 4.18. Interview with Nairobi City Water and Sewerage Company (NCWSC) management revealed that they were neither informed of the Nairobi Water and Sanitation project nor involved in its identification or design. This is despite NCWSC being direct users of the infrastructure and hence, they should be actively engaged in planning sewerage projects as they are better positioned to identify service gaps.
- 4.19. According to an interview with the implementing agency, Athi Water Works Development Agency (AWWDA), once the project is completed, it will be handed over to the NCWSC for service provision. This may affect effective operationalization of the project as they have limited knowledge on its operation and maintenance.

2. Inadequate Fulfillment of Mandatory Loan Requirements Prior to Contracting External Financing

- 4.20. Section 4.6 (43) of the Public Debt and Borrowing Policy (2020) requires that in order to mitigate the Government against any potential financial risks of paying commitment fees and other charges on loan amounts due to delays in commencement of project implementation, a checklist of the mandatory requirements must be provided to The National Treasury by Ministries, Departments and Agencies (MDAs), National Government entities and County Governments before contracting external financial support. This checklist includes but not limited to; feasibility study report, confirmation of land and way

leave acquisition for the project, commitment to relocate public utilities and prioritization and commitment of the counterpart funding where necessary.

- 4.21. Review of loan correspondence files for the six (6) sampled loans revealed that all projects were approved and loan agreements signed based on commitment letters from implementing agencies to fulfil these mandatory requirements before the loans became effective, or within the required timelines. However, at the time of field verification, the projects had not commenced as planned due to non-fulfilment of these requirements by implementing agencies as committed in the letters. The causes of these delays is as analyzed in **Table 3** overleaf.

Table 3: Delay in Commencement of Sampled Projects

Projects	Planned Project Start Date	Actual Project Start Date	Delayed by	Reasons for Delay
Second Informal Settlement Improvement Project (KISIP 2)	06 August 2020	At the time when the audit collected data in February 2023 no works had started.	2 years 6 months	Incomplete and conflicting designs which will further delay land acquisition.
Kenol-Sagana-Marua Highway Improvement Project	20 July 2020	07 October 2021	1 year 3 months	Inadequate counterpart funding to relocate and compensate PAPs
Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project	26 November 2020	21 December 2021	1 year 1 month	Lack of ownership documents for land acquisition, inadequate counterpart funding for relocation of utilities.
Establishment of Bus Rapid Transit Line 5 Project	27 May 2021	24 May 2022	1 year	Incomplete design which will further delay land acquisition for bus depot.
Nairobi Water and Sanitation Project (NWSP)	1 December 2020	At the time when the audit collected data in February 2023 no works had started.	2 years 4 months	Incomplete designs which means land and wayleave acquisition cannot begin, Incomplete implementation of main project.
Additional Financing for Coastal Region Water Security and Climate Resilience Project (Mwache Dam Project)	Initial agreement signed on 11 May 2015. Additional Financing signed on 4 March 2022.	At the time of the audit field work in February 2023 no works had started.	Cumulative 7 years	Inadequate counterpart funding for land acquisition and relocation of PAPs.

Source: OAG Analysis of Delays in Commencement of Sampled Projects

- 4.22. Further, review of Mwache Dam Project financing agreements and correspondences revealed that the initial loan agreement for Mwache Dam was restructured to request for additional financing and extend the end-date of the project. According to the internal memo of reference number EA/FA62/240/85/E'TY (35) and dated 22 April, 2021, The National Treasury, through the Directorate of Public Debt Management and Resource Mobilization Department requested the World Bank for restructuring of Project loan because the construction had stalled, as a result of the complex nature of acquisition of land from the community residing on the project site.
- 4.23. In June 2019, the World Bank, at the request of The National Treasury, approved restructuring of the project loan which involved partial cancellation of US\$80 Million. This cancellation, together with foreign exchange losses, resulted to a significant financing gap approximated to US\$137 Million (KES 20,337,650,000).
- 4.24. This gap necessitated additional financing which was processed alongside the restructuring of the project to extend the closing date by five years, from 31 December, 2021 to 31 December, 2026. This could have been avoided through adequate planning.

3. Pro-Longed Approval Period that Led to Re-Designing of Feasibility Studies at Additional Expenses

- 4.25. A guide to good practice by Scottish Community Project Fund indicates that Feasibility studies are likely to contain elements that change with time, for example cost, market conditions or even local aspirations. It is inefficient use of client and contributor's money if feasibility study is carried out and there is no plan to take it forward. Similarly, if there is a protracted delay, this may render the study out of date, and therefore unattractive to financiers unless it is re-assessed.
- 4.26. Review of feasibility studies revealed that five (5) out of the six (6) sampled projects had long time lapse between completion of feasibility study and signing of financing agreement, which resulted to updating or redoing the feasibility study at an additional cost to accommodate prevailing market conditions,

changes over time, costs and local aspirations. The time-lapse is as analyzed in **Table 4**.

Table 4: Time-lapse Between Completion of Feasibility Studies and Signing of Financing Agreement

PROJECT NAME	DATE OF FEASIBILITY STUDY	DATE OF SIGNING FINANCING AGREEMENT	TIME LAPSE DURATION
Additional Financing for Coastal Region Water Security and Climate Resilience Project (Mwache Dam Project)	September 2011	27 March 2020	9 years
	August 2014	3 March 2022	8 years
Nairobi Water and Sanitation Project (NWSP)	December 2011	2 March 2020	9 Years
Bagamoyo-Horohoro-Lunga Lunga -Malindi Road Project	2009	10 June 2020	11 years
Kenol-Sagana-Marua Highway Improvement Project	2009	9 January 2020	11 years
Establishment of Bus Rapid Transit Line 5 Project	2018	29 January 2021	5 years

Source: OAG Analysis of Time-lapse Between Feasibility Study and Signing Financing Agreements

4.27. Further evaluation on the impact of delay in signing loan agreements after completion of feasibility studies showed that the exchange rates indicated in the feasibility studies varied from the rates at the time of signing financing agreement, as shown in **Table 5** overleaf. It would therefore imply that the loan signed at a later date is more expensive as the exchange rate has also increased immensely.

Table 5: Cost Implication of Delay in Signing Financing Agreement

Project	Feasibility Study Stage		Signing of Loan Agreement		Difference in USD/KES Rate	%Change in USD/KES Rate
	Date	USD/KES Rate *	Date	USD/KES Rate *		
Kenol	1-Jan-09	78.27	9-Jan-20	101.47	23.2	29.64
Bagamoyo	1-Jan-09	78.27	10-Jun-20	106.43	28.16	35.98
Mwache	1-Sep-11	93.68	27-Mar-20	105.11	11.43	12.20
NWSP	1-Dec-11	89.59	2-Mar-20	101.16	11.57	12.91
Mwache	1-Aug-14	87.84	3-Mar-22	113.89	26.05	29.66
BRT Line 5	1-Jan-18	103.29	29-Jan-21	110.14	6.85	6.63

Source: OAG Analysis of Cost Implications on Delayed Contract Signing Over Time

4. Approval of New Projects Before Completion of Main Project

- 4.28. The National Treasury Circular No. 12/2018 dated 29 October, 2018 requires all Government Accounting Officers to ensure that all ongoing projects are completed before initiating new projects and, the sanctioning of new projects must receive express Authority from The National Treasury.
- 4.29. However, review of loan correspondence files revealed that subsequent projects whose operations depended on the main projects were approved before completion of main projects. The impact of this were as follows;

Nairobi Water and Sanitation Project:

- 4.30. The Nairobi Water and Sanitation Project, a downstream project of the Northern Collector Project (NCP), was started before the completion of NCP. A review of the Northern Collector Project progress report dated February 2023 revealed that its credit became effective in 2014 and was valid up to 2020. However, an addendum was signed for extending the credit timelines to 31 January, 2022 which was further extended to 31 January, 2024. In addition, the project is still ongoing despite revision of initial completion date of 24 June, 2018 to 31 April, 2021.
- 4.31. Interview with Athi Water Works Development Agency (AWWDA) revealed that the Northern Collector Project was at 95% complete. However, it is not in use as a primary transmission pipeline to Gigiri reservoir is still at 70% completion.

- 4.32. Indications are therefore that the Nairobi Water and Sanitation Project was approved for funding despite NCP facing implementation challenges, further affecting the implementation of NWSP. In the circumstance, the viability and thus value for money on the Nairobi Water and Sanitation Project could not be ascertained.

Second Kenya Informal Improvement Project

- 4.33. Review of a letter referenced MTIHUD/HUD/ADM/1/1/1/VOL.III (218) dated 3 June, 2019 revealed that The National Treasury approved KISIP 2 on 17th May 2017 before completion of KISIP1 which was closed on November 30, 2019.
- 4.34. Further, field verification carried out on 08 February, 2023 and 13 February, 2023 in Nakuru and Kisumu respectively established that some of the infrastructure components designed under KISIP1, were never implemented. However, they were planned to be implemented under KISIP2, which was scheduled to start in the F/Yr.2021/2022, but had not commenced as at the time of audit. In addition, a review of the KISIP 1 undated project closure report revealed that operation and maintenance of upgraded infrastructure remains a challenge. According to the report, most counties have not yet taken up operation and maintenance of completed projects and as a result, there is heavy solid waste and wastewater discharge into the drains. Without addressing these challenges faced in KISIP1, viability and effective implementation of KISIP2 could not be ascertained.

Mwache Dam Project:

- 4.35. Mwache Dam Project was signed on 21 June 2018 to improve drinking water and sanitation systems in Mombasa County through Coastal Region Water Security and Climate Resilience Project. However, at the time of audit, civil works and infrastructure related to Coastal Region Water Security and Climate Resilience Project had not yet commenced. Therefore, the viability of the successive project is uncertain as its value can only be achieved upon completion of Coastal Region Water Security and Climate Resilience Project. The resulting effect of signing another credit facility contributes to ineffective use of taxpayers' money and delays in social-economic return of the project.

B. Inadequate Creditor Evaluation and Negotiation

4.36. Section 50(1) of the Public Finance Management Act, 2012 requires that in guaranteeing and borrowing money, the national government shall ensure that its financing needs and payment obligations are met at the lowest possible cost in the market, which is consistent with a prudent degree of risk, while ensuring that the overall level of public debt is sustainable. The audit revealed inadequacies in creditor evaluation and negotiation as discussed below: -

1. Insufficient Comparison of the Credit Terms

- 4.37. Section 51 of The Public Debt and Borrowing Policy 2020 states that the Government will consider and negotiate the terms and conditions offered by different potential lenders when contracting debt.
- 4.38. Further, DeMPA (2021) DPI 9.1 requires that PDMO staff monitors market conditions on a continuous basis and assesses potential creditors and markets to obtain the most beneficial or cost-effective terms and conditions for external borrowing before the start of each loan negotiation.
- 4.39. Review of loan correspondence file for all the sampled projects revealed that in analyzing concessionality of the loans, only one creditor is identified for each loan. The credit terms and conditions were evaluated without considering other potential creditors for purposes of comparing their credit terms and conditions necessary in obtaining the most cost-effective credit facility. This was observed in both bilateral and multilateral loans even where the development partners have the same development objectives.
- 4.40. Further, interviews with the staff of the Debt Policy, Strategy and Risk Management Department, whose responsibility is to analyze the concessionality of the loans revealed that the reasons for analyzing only one credit terms was due to receiving only one draft financing agreement for each project from the Resource Mobilization Department which is mandated to mobilize financial resources. Further, the interviews revealed that comparative analysis is limited as a creditor will have been identified by the time a project proposal is forwarded to the Department and in some cases, the creditor would have financed the feasibility study. Consequently, there are risks that loans contracted may not be the most cost effective in the market.

2. Inadequate Evaluation of Credit Terms

- 4.41. The Debt Management Performance Assessment, 2021, DPI 9.1 states that the terms and conditions of the loans need to be subject to financial analysis that goes beyond concessionality analysis. The aim is to obtain the lowest possible borrowing costs, including grants and technical assistance, within the guidelines of the annual borrowing plan and in line with the Medium-Term Debt Strategy (MTDS) in terms of currency, maturity and fixed or floating rate composition. The financial analysis should include assessment of interest rates (including fees); currency, and concessionality of the loans; penalty fees and other charges; the disbursement and maturity profiles; and impact on the existing debt service profiles.
- 4.42. Review of loan correspondence files for all the sampled projects revealed that only concessionality analysis were done, financial analysis such as currency, penalty fees and other charges, disbursement and maturity profiles and impact on existing debt service profiles were not performed in order to obtain the lowest possible borrowing cost.
- 4.43. Further, interviews with the staff of the Debt Policy, Strategy and Risk Management Department revealed that inadequate staff and skills in debt management attributed to this shortfall. Further, review of The National Treasury Strategic Plan 2018/19-2022/23 revealed the Debt Policy, Strategy and Risk Management Department is supposed to have 19 Officers under authorized establishment. However, only six (6) officers are in-post, with a varying shortfall of 13 officers.
- 4.44. In the absence of financial analysis, it is not possible to confirm that concessional loans are obtained at the lowest possible borrowing cost.

3. Inadequacies in Loan Negotiation

- 4.45. A review of Section 51 of The Public Debt and Borrowing Policy 2020 states that the Government will consider and negotiate terms and conditions offered by different potential lenders when contracting debt.
- 4.46. Section 5.2.2 of the MEFMI Manual recommends that for effective loan negotiation, the negotiating team should comprise of well-trained professionals who can meaningfully engage the experienced negotiating teams of creditor

institutions or countries. Further, the manual states that there must be representation from the sectors involved, the parent ministry, the Ministry of Finance, the debt office, and the government legal office (Attorney General).

4.47. A review of loan correspondence files and interviews with PDMO staff revealed the following weaknesses in loan negotiations:

a. Inadequate Negotiation on Co-Financing Clauses.

4.48. The goal of the negotiation process is to obtain reasonable terms of credit to minimize the risks of loan contracting. However, review of financing agreements for the sampled projects revealed that two (2) out of six (6) sampled projects have co-financing clauses which have negative impact on the contracted loans as shown below:

4.49. Mwache Dam Project is financed by International Development Association (IDA) and Agence Francaise De Development (AFD). Review of AFD financing agreement, revealed that one of the conditions precedent for the AFD agreement is that a drawdown request could not be submitted to the lender if a co-financier had suspended any payments on the project.

4.50. In the circumstance, there are risks of paying commitment fees and other related charges on loans where there is suspension on payments by co-financier on the project.

4.51. Further, review of financing agreement for Nairobi Water and Sanitation Project revealed that if the borrower prepays any amount due to a co-financier in full or in part before the technical completion date, they must prepay the entire or a portion of the facility within 30 calendar days. Therefore, in the event a new financier is introduced and prepayment occurs, this clause may have a negative impact on liquidity position of the government.

4.52. Therefore, The National Treasury should have negotiated for removal of this clauses from the financing agreements to avoid these risks.

b. Inadequate Negotiation and Non-Adherence to Legal Advice from The Attorney General's Office

4.53. Review of DeMPA, 2021, DPI 9.2 requires consultation of legal advisers from the first stage of the negotiating process to the conclusion of the legal

agreements related to the borrowing. In doing so, debt managers can help governments clarify their rights and obligations and protect their position to the greatest degree possible in the relevant jurisdictions.

- 4.54. Comparison of legal clearances and signed financing agreements revealed that legal advices to negotiate for amendment of some of the clauses and fulfilment of conditions precedent were not considered in four (4) out of six (6) sampled loans, as analyzed in the **Table 6** overleaf.

Table 6: Analysis of Attorney General's Legal Advises

Project	Date Legal Clearance Was Issued	AG's Advice To Negotiate Draft Financing Agreement	Comments On The Signed Financing Agreements/Status of the project	Reason For Non-Adherence
Nairobi Water And Sanitation Project	07 March 2019	For the seat of arbitration to be neutral, the AG advised to negotiate clause 17.2 to have London as the seat of arbitration and Nairobi as the venue of arbitration. Also, the clause on immunity be deleted and replaced by 'any waiver of immunity will be to the extent permitted by Kenyan law'.	No Changes made, Paris remained the seat of arbitration and the clause on immunity was not deleted.	AFD proposed the clauses to remain unchanged in compliance with governing law which is French.
Bus Rapid Transit Line 5 Project	25 March 2019	The AG advised to negotiate for the suppliers and consultants to include Kenyan nationals or juridical persons incorporated and registered in Kenya. The AG advised since the agreement a Buyer credit loan it does not qualify for tax exemption and recommended the paragraph to be deleted.	No changes made.	The desk officer of this loan gave the reason that the loan is government to government therefore, the terms are non-negotiable and the loan is concessional.
Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project	17 April 2020	AG advised TNT to confirm that the mandatory requirements for seeking external financing as contained in Treasury Circular 12/2018 dated 29 October 2018 has been complied with.	Mandatory requirements for seeking external financing were not adhered to.	TNT relied on commitment letter from the implementing agency to fulfill the mandatory requirements.
Kenol-Sagana-Marua Highway Improvement Project	23 December 2019	AG advised TNT to confirm availability of counterpart funding required for the project.	Commitment to provide GoK counterpart funds for the project were not made available as required.	TNT relied on commitment letter from the implementing agency to fulfill the mandatory requirements

Source: OAG Analysis of Loan Agreements and AG Legal Advises

- 4.55. Failure to negotiate as advised by AG before signing financing agreements may lead the GoK to contract loans on unfavorable terms which may not benefit the taxpayers.
- 4.56. Further, non-adherence on AG's advice to fulfil mandatory requirements before signing the loans had contributed to stalling of projects at implementation phase, and payments of commitment fees on Kenol-Sagana-Marua Highway Improvement Project and Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project.

c. Inadequate Negotiation on the Use of Creditor's Procurement Policies and Guidelines

- 4.57. According to the PFM Regulations of 2015 Regulation 194 (1) (r), in addition to the provisions of Section 63 of the Act, the functions of the PDMO established under Section 62 is to ensure adherence to the accepted guidelines and procedures for procurement involving funds provided under foreign aid.
- 4.58. Review of signed financing agreements revealed that the projects were to exclusively use creditors' procurement rules during procuring of consultants and contractors. According to interviews with the implementing agencies, the use of creditors' procurement policies, rules and guidelines have a requirement of prior review by creditor at every stage of the procurement process before issuance of a No-Objection letter allowing the implementing agency to proceed to the next stage of procurement.
- 4.59. In addition, interviews with implementing agencies of sampled loans revealed that these prior review processes take a long time leading to delays in procurement of consultants and civil works contractors. This delay can lead to deferral of the first drawdown of loan funds, necessitating payment of commitment fees on undisbursed loan amounts which could be avoided through adequate negotiations on favorable timeframes for prior review processes.

C. Delays in Fulfilment of Conditions Precedent

4.60. The following observations were made:

Non-disbursing Loans Due to Delayed Fulfilment of Conditions Precedent

4.61. Section 63 (d) of the Public Debt and Borrowing Policy 2020 states one of the functions of the Front Office is to seek legal opinions from the Attorney General on loan negotiations and liaise with implementation agencies to ensure that conditions precedents are fulfilled in time to save government from undue costs on commitment fees.

4.62. Review of Commonwealth Secretariat Debt Recording Management System (CSDRMS) printed excerpt provided by The National Treasury revealed that for the three financial years under review (2019/20 to 2021/22), a total of 70 loans had been contracted out of which 17 were non-disbursing. These non-disbursing loans had accumulated commitment fees of **KES 110,506,448.47** at the time of audit as summarized in **Appendix V**.

4.63. At the time of audit, three (3) of the six (6) sampled loans had accrued commitment fees of **KES 158,750,956.82** as shown in the **Table 7**.

Table 7: Accrued Commitment Fees for Sampled Loans

Project Name	Conditions Precedent	Commitment Fees Paid (KES)
Nairobi Water and Sanitation Project	1. Legal Opinion 2. Subsidiary Agreement	64,410,385.29
Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project	1. Legal Opinion 2. Submission of a works and Compensation Schedule 3. Satisfactory evidence that all PAPs have been compensate	72,931,541.69
Kenol-Sagana-Marua Highway Improvement Project, respectively.	1. Legal Opinion 2. Submission of a works and Compensation Schedule 3. Satisfactory evidence that all PAPs have been compensated	21,409,029.85

Source: OAG Analysis of Accrued Commitment Fees

- 4.64. The reasons for the payment of commitment fees at the time of audit are as follows: -

Nairobi Water and Sanitation Project:

- 4.65. The Nairobi Water and Sanitation Project had incurred commitment fees totaling KES.64,410,385.29 due to delay in commencement of the project. At the time of audit, the project was under design stage and beneficiaries had not been identified, land acquisition was pending and relocation of utilities had not commenced. Additionally, TNT had not released counterpart funding, a pointer to financial risk to taxpayers' money as this will further delay the project implementation.

Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project:

- 4.66. This project is currently being implemented in phases starting from Nyali Bridge to Mtwapa and Mtwapa to Kilifi Bridge. A site visit undertaken during the month of January 2023 revealed that parts of the project are due to stall because of land acquisition and resettlement of PAPs. In an effort to mitigate against further financial risks, the consultant and KeNHA have proposed a Resettlement Action Plan Implementation Plan (RAPIP) to guide in involuntary land acquisition and resettlement of PAPs along the project road.
- 4.67. The consultant has documented land acquisition areas which include built Mtwapa Town, Majengo Kanamai, Proposed Weighbridge Location and Mbogolo Bridge. As of January 2023, 12 months or 33% of contract period had elapsed, and no decision had been made on land acquisition and compensation; relocation of 52 power poles within the priority construction zone, and 50 power poles within the proposed Mtwapa Market Roundabout Bridge.

Kenol-Sagana-Marua Highway Improvement Project:

- 4.68. This project is progressing on site locations that the contractor has access to, however, out of 1544 cases submitted for compensation, only 113 cases have been compensated. It was explained that some claimants do not have complete ownership documents, while others await settlement in court due to disputes. Other properties like Frapa Hotel, Kangocho-Kerugoya Junction, Karatina Township and Marua Interchange were initially not part of the road corridor but

have been affected by re-alignment of the road. All these land disputes as well as unsettled compensations are affecting loans negatively in terms of implementation as these delays will further lead to payment of more commitment fees and other charges.

Establishment of Bus Rapid Transit Line 5 Project:

- 4.69. At the time of audit, this project was at the detailed design stage and an interview with the implementing agency, Kenya Urban Roads Authority revealed that the project is facing challenges such as accessing counterpart funding due to inadequate fiscal space by The National Treasury and long turnaround time to obtain no-objection letters from the development partner. Additionally, according to a progress report dated 09 February, 2023, the key challenge faced by the consultant is that the location of bus depot which is essential for the effective operation of Bus Rapid Transit (BRT) buses had not been determined. In order for the consultant to meet the desired timeline, this final depot location needs to be known, and delay of this decision will lead to delayed implementation resulting to payment of commitment fees.

Mwache Dam Project:

- 4.70. While the construction works on the dam had not started at the time of audit, there is a high chance of incurring commitment fees due to delays in land acquisition and compensation as acquisition has only been completed in phase one (1) out of the three (3) phases. No reasons have been given for delays in completing the other phases by National Lands Commission and TNT.

D. Inadequate Monitoring and Evaluation of Contracted Loans

1. Inadequate Coordination, Review and Monitoring of Utilization of External Resources by Public Debt Management Office

- 4.71. Regulation 194 (1) (s) of the Public Finance Management (PFM) Regulations, 2015 states that, in addition to the provisions of Section 63 of the Act, the functions of the Public Debt Management Office shall be to coordinate, review and monitor the utilization of external resources including joint programming,

joint work plans, joint visits, joint implementation, and monitoring and evaluation. However, the following inadequacies were observed: -

- 4.72. Interviews with staff from the Public Debt Management Office (PDMO) revealed that once a loan agreement is signed and disbursements progressively made to projects, the PDMO does not directly monitor and evaluate the utilization of the project funds as per project loan requirements. However, PDMO relies on project progress reports from the implementing agencies which may lack some material facts on the project's status, which may further expose government to financial risks. The interviews further revealed that inadequacy in monitoring and evaluation was due to inadequate staff number, knowledge and skills.
- 4.73. Joint visits, monitoring and evaluation aid in establishing the real challenges the projects are facing in order to make effective decisions on time to avoid payment of avoidable costs and other charges or cancellation of non-feasible projects in time.

2. Inadequate Collaboration between Stakeholders

- 4.74. Regulation 205 (i) of PFM Regulations, 2015 requires that for the purposes of debt management operations and loan administration, the accounting officers of a national government entity in close collaboration with the national government entity responsible for National Planning, shall be responsible for implementing, monitoring and evaluating, all projects and programmes within their jurisdiction.
- 4.75. Assessment of the six (6) sampled loans revealed that there is inadequate collaboration between different stakeholders whose inputs are required for efficient implementation of projects. The stakeholders include: National Lands Commission, National Environment Management Authority, County Governments and other authorities that issue approvals.
- 4.76. This inadequacy had contributed to delay in implementation of the projects which may further result to stalled projects and payment of commitment fees.

3. Inadequate Enforcement of The National Treasury Circulars and Guidelines.

- 4.77. Section 12 (2) (k) of PFM Act, 2012 states that National Treasury shall issue guidelines to national government entities with respect to financial matters and monitoring their implementation and compliance.
- 4.78. The PIM Guidelines issued through Circular No. 16/2019 of 24 January, 2020 provides a framework for efficient and effective management of public investments, that includes project identification and conceptual planning, pre-feasibility and feasibility studies, selection for budgeting, implementation, monitoring, evaluation and reporting, closure, sustainability and ex-post evaluations to ensure value-for-money and optimal use of public resources.
- 4.79. However, interviews with the PIM Unit revealed that, in May 2020 an Executive Order issued which, transferred the mandate of PIM Unit to the State Department of Planning which rendered the guidelines non-operational. The Executive Order No. 1 of 2022, reinstated the mandate of PIM Unit to The National Treasury. However, at the time of audit, the guidelines were not being adhered to. This was attributed to inadequate capacity in the PIM Unit and lack of awareness on the guidelines at the MDA levels.
- 4.80. Non-enforcement of these guidelines, value-for-money and optimal use of public resources may not be realized as loans may be contracted without adequate scrutiny and appraisal.

The National Treasury Responses to Audit Findings and Recommendations

- 4.81. At the conclusion of the audit, an exit meeting was conducted. Subsequently, the audit report was sent to The National Treasury, requesting for their comments on the audit findings and recommendations. The comments from The National Treasury are as shown in **Appendix VI**.

5.0 CONCLUSION

- 5.1 The National Treasury had made several efforts in guiding the processes of loan contracting such as preparation and approval of Public Debt and Borrowing Policy, 2020, PIM Guidelines, 2020 and Mandatory Checklist for Loan Requirements. However, the findings of the audit, indicate that The National Treasury has not carried out external loan contracting processes effectively, to minimize costs and risks of borrowing. This was evidenced by inadequate measures in:
 - 5.2 Guiding the identification, planning and approvals of projects before loan signing, resulting to delays in commencement of the projects and re-designing of feasibility studies.
 - 5.3 Ensuring assessment of credit terms and conditions adequately before signing of the loan agreements, which may result to contracting loans with unfavorable terms and conditions.
 - 5.4 Ensuring all conditions precedent are met on time and funds are disbursed as per agreed schedules, resulting to payments of commitment fees.
 - 5.5 Monitoring and evaluation mechanisms in ensuring project funds are utilized as per the project loan requirements, which may result to overlapping priorities and financing of non-feasible projects.

6.0 RECOMMENDATIONS

- 6.1 In view of the findings and conclusions of the audit, makes the following recommendations are made for implementation by The National Treasury.
- 6.2 To ensure that external loan contracting is done effectively to minimize cost and risk of borrowing, The National Treasury should ensure that:
- 6.3 Implementing agencies involve project beneficiaries during projects identification and designs through public participation in order to enhance ownership, social accountability and sustainability of the projects.
- 6.4 Land acquisition, compensation and relocation of utility lines are financed in-advance through GoK development counterpart funding before signing of financing agreements.
- 6.5 The time between feasibility studies and actual time for signing financing agreements is reduced to avoid costs of redoing feasibility studies and to hedge against foreign exchange fluctuations.
- 6.6 Additional loans are signed when the initial loan has been utilized and a detailed evaluation of remaining works have been done to establish the exact quantities of pending works.
- 6.7 The capacity and skills of DPDM are enhanced for adequate evaluation and negotiation of favorable credit terms and conditions and for adequate monitoring and evaluation of loan projects.
- 6.8 A framework for collaboration between all relevant stakeholders involved in debt-funded projects should be established for efficient coordination during project planning and approvals to avoid delays in implementation.
- 6.9 In collaboration with implementing agencies, have adequate measures to ensure all the conditions precedent are met within timeline to avoid non-disbursing of loans, which results to payment of commitment fees on undrawn amounts.

6.10 Enforce adherence to Circulars and PIM Guidelines by enhancing the capacity of PIM Unit and create awareness on the guidelines at the MDA levels for efficient and effective management of public investments, to ensure value-for-money and efficient use of public resources.

7.0 APPENDICES

Appendix I: The Six (6) Loans Sampled for Main-Study

No.	Loan Type	Creditor Name	Loan Description	Loan Amount	Currency	Agreement Date	Implementing Agencies
1	Commercial /Export credit	Export - Import Bank - Korea	Establishment of Bus Rapid Transit Line 5 Project	59,000,000	USD	29/01/2021	Kenya Urban Roads Authority
2	Bilateral	Agence Francaise De Development	Nairobi Water & Sanitation Project	100,000,000	EUR	02/03/2020	Athi Water Services Board
3	Multilateral	International Development Association	Second Informal Settlement Improvement Project	134,800,000	EUR	17/08/2020	Ministry Of Lands And Housing
4	Multilateral	International Development Association	Additional Financing for Coastal Region Water Security and Climate Resilience Project	128,800,000	EUR	03/03/2022	Ministry Of Water
5	Multilateral	African Development Bank	Kenol-Sagana-Marua Highway Improvement Project-AGTF	31,150,000	EUR	09/01/2020	Ministry of Roads and Public Works
6	Multilateral	African Development Bank	Bagamoyo-Horohoro-Lunga Lungu-Malindi Road Project - Phase1	108,000,000	EUR	10/06/2020	Ministry of Roads and Public Works

Appendix II: List of Documents Reviewed

No.	Document Reviewed	Information Obtained
1.	The Constitution of Kenya, 2010	Understanding the legal framework on public debt
2.	PFM Act, 2012	Understanding the legal framework governing external loan contracting operations
3.	PFM Regulations, 2015	
4.	Public Debt and Borrowing Policy, 2020	Understanding Public Debt Management Office roles and processes
5.	Budget Policy Statement	Obtaining information on fiscal framework, budget estimates, budget deficit, fiscal risks and national government priorities
6.	Medium Term Debt Management Strategy, 2022	Obtaining information on debt sustainability, optimal mix to be applied in external loan contracting
7.	National Treasury Strategic Plan	Understanding The National Treasury current establishment, objectives and strategies
8.	External Resource Handbook	To understand the policies and framework guiding external resource mobilization or external borrowing.
9.	Public Investment Management Guidelines (PIM Guidelines), 2020	To understand processes for project identification, approval for financing, selection for budgeting, implementation, sustainability and ex-post evaluation..
10.	MEFMI Public Debt and Procedures Manual	To understand the loan contracting process and roles of different stakeholders.
11.	IDI Public Debt Manual & GUID 5250	Understanding the public debt audit process of external loan contracting

No.	Document Reviewed	Information Obtained
12.	Debt Management Performance Assessment (DEMPA tool) 2021	Understand debt management assessment tools to analyze PDMO processes.
13.	Good Debt Management Practices - UNCTAD Principles	To benchmark internationally accepted practices in external loan contracting and compare with Kenyan processes.
14.	Loan Agreements	To understand the scope of the project, costs and undertakings by borrower
15.	Concept Note	Understand the need for the project
16.	Feasibility Studies and Proposals	Understand the viability of the project, detailed scoping
17.	Loan Negotiation Minutes	Understanding representation of the negotiation team, roles of each representative and their contribution
18.	Legal Clearance	Understanding the importance of legal clearance, the advices therein and incorporation into the final loan agreement.
19.	Legal Opinion	Understanding the importance of legal opinion, the amendment suggested and incorporation in the final loan agreement
20.	Aide Memoires	Understanding the project conceptualization and preparation phases
21.	Project reports	Understanding the progress of the project and the challenges experienced
22.	Commonwealth Secretariat Debt Recording Management System Data	Evaluate non-disbursing loans and associated costs

Appendix III: List of Persons Interviewed

No.	Position of the Interviewee	Department / Agency	Purpose of the Interview
1.	Principal Economist - Resource Mobilization Department		To understand the roles of the department, policies & guidelines used, external loan contracting processes and information on desk officers in charge of sampled loans.
2.	Director – Macro and Fiscal Department		To understand the roles of the department in external loan contracting, policies used and information on tax exemptions clauses on loan agreements.
3.	Director – Asia & Pacific Division, Resource Mobilization Department	The National Treasury	To get a general understanding of the of the loan contracting processes with regard to a sampled project funded by Korea Export Import Bank.
4.	Principal Economist – Africa Development Bank, Resource Mobilization Department		To get a general understanding of the loan contracting process with regard to two sampled projects funded by The African Development Bank.
5.	Director - Public Investment Management Unit (PIM)		Roles of the department, policies & guidelines used, challenges in discharging their duties and recommendations.
6.	Manager - Debt Policy, Strategy and Risk Management (Middle-Office)		Roles of the department, policies & guidelines used, information on loan concessionality calculations, financial analyses, challenges in discharging their duties and recommendations.

No.	Position of the Interviewee	Department / Agency	Purpose of the Interview
7.	Director - Development		To understand their involvement in External Loan Contracting process as an implementing agency and to get more information on two sampled loan-funded projects (Kenol-Sagana-Marua Highway Improvement Project and Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project)
8.	Project Engineer – Kenol-Sagana-Marua Highway Improvement Project and Bagamoyo-Horohoro-Lunga Lunga-Malindi Road Project)	Kenya National Highways Authority (KeNHA)	To establish whether beneficiaries were involved in project identification and preparations before projects are approved for financing and challenges they are facing in implementing projects. To conduct field verification.
9.	Assistant Director – Design and Research	Kenya Urban Roads Authority (KURA)	To understand their involvement in External Loan Contracting process as an implementing agency and to get more information on a sampled loan-funded project (Establishment of Bus Rapid Transit Line 5 Project)
10.	Assistant Director – State Department of Housing	Ministry of Lands, Housing and Urban Development	To understand their involvement in loan contracting process as a parent ministry / implementing agency and to get more information on a loan-funded project (Second Informal Settlement Improvement Project – KISIP 2)

No.	Position of the Interviewee	Department / Agency	Purpose of the Interview
11.	Deputy Director – Water and Sanitation Management	Ministry of Water and Sanitation	To understand their involvement in External Loan Contracting process as a parent ministry and to get more information on two sampled loan-funded projects (Nairobi Water & Sanitation Project and Additional Financing for Coastal Region Water Security and Climate Resilience Project – Mwache Dam)
12.	Project Coordinator – Kenya Water Security Climate Resilience Project	Ministry of Water and Sanitation	To establish whether beneficiaries were involved in project identification and preparations before projects are approved for financing and challenges they are facing in implementing projects. To conduct field verification.
13.	Project Engineer – Nairobi Water and Sanitation Project	Athi Water Works Development Agency (AWWDA)	To establish whether beneficiaries were involved in project identification and preparations before projects are approved for financing and challenges they are facing in implementing the project.
14.	Managing Director	Nairobi City Water and Sanitation Company	To understand their involvement in External Loan Contracting process as the end-user operator for the Nairobi Water & Sanitation Project.
15.	Chief Officer / Project Coordinator – Second Informal Settlement Improvement Project	Nakuru County - Lands and Physical Planning Office	To establish whether beneficiaries were involved in project identification and preparations before projects

No.	Position of the Interviewee	Department / Agency	Purpose of the Interview
16.	Project Coordinator - Second Informal Settlement Improvement Project	Kisumu County - Lands and Physical Planning Office	<p>are approved for financing and challenges they are facing in implementing the project.</p> <p>To establish whether beneficiaries were involved in project identification and preparations before projects are approved for financing and challenges they are facing in implementing the project.</p>

Appendix IV: List of Audit Criteria

No.	Criteria	Source
1.	Public money shall be used in a prudent and responsible way.	Constitution of Kenya, 2010
2.	PDMO is required to minimize the cost of public debt management and borrowing over long-term taking account of risk and ensure the sharing of the benefits and costs of public debt between the current and future generation.	PFM Act 2012, Section 62 (3)
3.	Establishment, objectives, mandate and functions of the Public Debt Management Office within The National Treasury	PFM Act, 2012, Section 62 – 63
4.	The accounting officers of a national government entity shall be responsible for ensuring that during the project identification and design, the intended beneficiaries are involved through the public participatory approach to planning through public forums to enhance leadership, ownership, social accountability and sustainability of the project	PFM Regulations, 2015, Regulation 205 (d)
5.	In order to mitigate the Government against any potential financial risks of paying commitment fees and other charges on loan amounts due to delays in commencement of project implementation, checklist of mandatory requirements must be provided to The National Treasury by Ministries, Departments and Agencies (MDAs), National Government entities and County Governments before contracting external financial support.	Public Debt and Borrowing Policy, 2020, Paragraph 43
6.	In guaranteeing and borrowing money, the national government shall ensure that its financing needs and payment obligations are met at the lowest possible cost in	PFM Act, 2012, Section 50 (1)

No.	Criteria	Source
	the market, which is consistent with a prudent degree of risk, while ensuring that the overall level of public debt is sustainable.	
7.	The terms and conditions of the loans need to be subject to financial analysis that goes beyond concessionality analysis.	DeMPA, 2021, DPI 9.1
8.	Upon project approval, the Cabinet Secretary will constitute in each case: a negotiation committee for each external loan and grant, a Government securities auction committee for issuance of domestic securities, and a committee for issuance of Government securities in the local or international bond market.	Public Debt and Borrowing Policy, 2020, Paragraph 105
9.	For effective loan negotiation, the negotiating team should comprise of well-trained professionals who can meaningfully engage the experienced negotiating teams of creditor institutions or countries	MEFMI Public Debt and Procedures Manual, Section 5.2.2
10.	Consultation of legal advisers is required from the first stage of the negotiating process to the conclusion of the legal agreements related to the borrowing.	DeMPA 2021, DPI 9.2
11.	The functions of the PDMO established under section 62 shall be to - ensure adherence to the accepted guidelines and procedures for procurement involving funds provided under foreign aid.	PFM Regulations, 2015, Regulation 194 (1) (r)
12.	A function of the Front Office is to seek legal opinions from the Attorney General on loan negotiations and liaise with implementation agencies to ensure that conditions precedents are fulfilled in time to save government from undue costs on commitment fees.	Public Debt and Borrowing Policy, 2020, Paragraph 63 (d)

No.	Criteria	Source
13.	A function of the Public Debt Management Office established under section 62 shall be to- coordinate, review and monitor the utilization of external resources including joint programming, joint work plans, joint visits, joint implementation, and monitoring and evaluation.	PFM Regulations, 2015, Regulation 194 (1)(s)
	The National Treasury shall issue guidelines to national government entities with respect to financial matters and monitoring their implementation and compliance.	PFM Act, 2012, Section 12 (2) (k)

Appendix V: Analysis of Non-Disbursing Loans (2019/2020 – 2021/2022)

No.	Creditor Category	Creditor Name	Description	Agreement Date	Instalment Amount	Currency	Commitment Fee (Fx)	Commitment Fee (Kes) (Exchange Rate: 29.03.2023)
1	Bilateral	Govt of Fed. Republic of Germany - GTZ	Promotion of Youth Employment and Vocational Training in Kenya, Phase II	30/12/2019	12,000,000	EUR	-	-
2	Bilateral	Govt of Fed. Republic of Germany - GTZ	Lake Nakuru Biodiversity Conservation Project	30/12/2019	29,000,000	EUR	-	-
3	Multilateral	European Investment Bank	Expansion of water supply and wastewater in Kisumu city	01/10/2020	35,000,000	EUR	131,736.11	18,838,263.73
4	Bilateral	Agence Francaise De Development	ASAL Rural Roads Project	02/10/2020	60,000,000	EUR	507,500.00	72,572,500.00
5	Export Credit	Export - Import Bank - Korea	Nairobi ITS Establishment and Junctions Improvement Project Phase II	29/01/2021	100,000,000	USD	-	-
6	Multilateral	Organisation of Petroleum Exp Countries	Samatar- Wajir Road Project	02/02/2021	20,000,000	USD	-	-
7	Bilateral	Saudi Development Fund	Samatar-Wajir Road Project	07/06/2021	75,000,000	SAR	-	-

8	Multilateral	Arab Bank For Econ.Dev.In Africa	Samatar-Wajir Road Project	07/06/2021	15,000,000	USD	-	-
9	Bilateral	Agence Francaise De Development	Engineering and Science Complex of The University of Nairobi	29/10/2021	30,000,000	EUR	78,333.34	11,201,667.62
10	Bilateral	Government of Italy	Malindi Integrated Health Development Program - MISHDP Phase II	26/01/2022	6,395,373	EUR	-	-
11	Bilateral	Govt of Fed. Republic of Germany - GTZ	Linking Farmers to Markets through Improvement of Rural Roads in Western Kenya	09/02/2022	17,000,000	EUR	-	-
12	Multilateral	African Development Fund	Program to Build Resilience for Food and Nutrition Security in The Horn of Africa(Djibouti, Kenya, Somali and South Sudan	23/02/2022	30,000,000	AUA	59,803.16	7,894,017.12
13	Multilateral	International Development Association	Additional Financing for Coastal Region Water Security and Climate Resilience Project	03/03/2022	128,800,000	EUR	-	-
14	Bilateral	Government of France	Supply of Forest Firefighting Equipment and Associated Services	17/03/2022	22,000,000	EUR	-	-

15	Multilateral	International Development Association	Additional Financing Emergency Locust Response Project	28/04/2022	31,400,000	EUR	-		
16	Multilateral	International Development Association	National Agricultural Value Chain Development Project	10/06/2022	223,300,000	EUR	-		
17	Multilateral	International Development Association	De-Risking, Inclusion and Value Enhancement of Pastoral Economies in the Horn of Africa Project	29/06/2022	132,600,000	EUR	-		
							TOTAL (KES)	110,506,448.47	

Appendix VI: The National Treasury Responses to Audit Findings

Audit finding	Response from The National Treasury	Auditors' Comments
<p>B. 1. INADEQUATE CREDITOR EVALUATION AND NEGOTIATION</p> <p>Review of loan correspondences for all the sampled projects revealed that in analyzing concessionality of the loans only one creditor is identified for each loan whose credit terms and conditions were evaluated without considering other potential creditors. (Para 4.39)</p>	<p>The parameter used is loan concessionality i.e percentage concessionality and not the number of creditor's /lenders evaluated forms the basis. Minimum concessionality threshold is 35% for GoK and 25% for OECD benefit including tax exemption for Officially Aid Funded Projects (OAFPs) in line with Income Tax Act.</p>	<p>The response does not adequately address the issue therefore, the finding remains as reported.</p>
<p>In this circumstance it is not possible to confirm that the value of loans disclosed in financial agreement are competitive. (Para 4.40)</p>	<p>Competitiveness of the value of loans is the function of the concessionality mutually negotiated between the lender and the borrower and <i>not the quantum of financing agreement analysed</i>. The value of the loans is a function of the Economic Rate of Returns, Net Present Value of the Loan and the Project, value for money among many other' variables. The finding is therefore misleading.</p>	<p>The response does not adequately address the issue therefore, the finding remains as reported.</p>
<p>B. 2. INADEQUATE EVALUATION OF CREDIT TERMS</p> <p>DeMPA (2021) DPI 9.1 states that the terms and conditions of loans need to be subject to financial analysis that goes beyond concessionality analysis. (Para 4.41)</p> <p>Review of loan correspondence files for all the sampled projects revealed that only concessionality analysis were done (Para 4.42.)</p>	<p>Please note that the finding is not the true picture of what is to be considered in arriving at concessionality of loan. Concessionality is a function of all the variables mentioned in paragraph 4.48 and 4.49 hence to suggest that these variables were not considered is inadequate to arrive at an extensive finding.</p>	<p>The finding remains as reported since this was the position as at the time of conclusion of the audit.</p>

Audit finding	Response from The National Treasury	Auditors' Comments
<p>An interview with the Debt Policy, Strategy and Risk Management Department (Middle Office) revealed that inadequate staff and skills in Debt Management attributed to this shortfall. (Para 4.43)</p>	<p>There is no relationship between the number of staff at the Debt, Policy, Strategy and Risk Management Department and the quality of work except for the time delays. A recommendation for staff enhancement is however welcome.</p>	<p>The finding remains as reported since this was the position as at the time of conclusion of the audit.</p>
<p>In absence of financial analysis, it is not possible to confirm that concessional loans are obtained at the lowest possible cost, therefore makes it impossible to confirm sustainability of public debt portfolio. (Para 4.44)</p>	<p>The comment is erroneous and onerous.</p>	<p>The finding remains as reported since this was the position as at the time of conclusion of the audit.</p>
<p>B. 3. a. INADEQUATE NEGOTIATION</p>		
<p>Review of AFD financial Agreement, revealed that a drawdown request could not be submitted to lenders if a co- financier had suspended any payment on the project. (Para 4.49)</p>	<p>Is in order and in the spirit of avoiding to pay for projects where one of the co-financiers had suspended any payments. Please note that payments can only be made by any financier, when all conditions are met — refer to definition on non- disbursing loan.</p>	<p>The finding remains as reported since this was the position as at the time of conclusion of the audit.</p>
<p>B. 3. b. INADEQUATE NEGOTIATION AND NON-ADHERENCE TO ATTORNEY GENERAL'S LEGAL ADVICE</p>		
<p>Comparison of legal clearance and signed financing agreements revealed that legal advices were not negotiated for as advised in four (4) out of six (6) sampled loans (Para 4.54)</p>	<p>The legal advice issued by the Office of Attorney General are usually adhered to and considered throughout the negotiation process. However, the negotiations aim is to arrive at a middle ground where all parties are satisfied and that the agreed text are not to be in any way in contradiction to the Constitution of Kenya 2010, and the requisite Kenyan Laws together with the Laws of the Development Partner in question. In this case, a mutual consent of both Parties is respected.</p>	<p>The finding remains as reported since this was the position as at the time of conclusion of the audit.</p>

Audit finding	Response from The National Treasury	Auditors' Comments
	<p>Please also note that IMF/World Bank funded projects, there are certain clauses that are standard and non-negotiable as these clauses are agreed upon at High Level meetings between the Governors of the World Bank of which Kenya is part of.</p>	
<p>B. 3. c. INADEQUATE NEGOTIATION ON USE OF CREDITOR'S PROCUREMENT POLICIES AND GUIDELINES</p> <p>Review of signed financing agreements revealed that loan proceeds will exclusively use creditors' procurement rules during procuring of consultants and contractors. (Para 4.58)</p>	<p>Different financing agreement for externally funded projects follow procurement methods as agreed by the contracting Parties and as provided by PPADA, 2015. Also note that certain mode of financing such as ECPF, ECA or rather the Turnkey model have different procurement methods as approved and provided by the lending countries and as agreed by OECD as most of these are Export Credits.</p>	<p>The finding remains as reported since this was the position as at the time of conclusion of the audit.</p>

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