1. Key development issues and rationale for Bank involvement

The República Bolivariana de Venezuela has recently initiated a comprehensive reform program in the water and sanitation sector. The program aims to decentralize service provision to municipalities from regional and provincial utilities, target investments to poor and under-serviced consumers, facilitate community participation in the sector and create incentives for the improved operational and commercial efficiency of operators. Despite recent improvements in the sector, Venezuela faces considerable challenges in achieving sector performance objectives.

Key sector challenges and the priorities of the Government program are to:

- Improve service coverage and quality, targeting poor consumers. Service levels remain low by regional standards, as 87% of citizens have access to potable water and 71% have access to sanitation. Significant pockets within the country are without access or receive poor quality water or sanitation services. The Government estimates that over 4.4 million people have no access to piped water and 8.4 million residents are not connected to a sanitation network. Rural consumers are particularly under-serviced – only 66% receive potable water and 40% have access adequate sanitation. Significant variation in service levels also exists between regional utilities. Access to potable water, for example, ranges between 90% for HIDROCAPITAL and 67% for HIDROLLANOS. For those with access to water and sanitation, the quality of service is often sub-optimal. Water supply, for example, is not uniformly continuous and often fails to meet basic quality standards. It is estimated that the poor living in urban ‘barrios’ and rural areas receive the poorest quality of water and sanitation services. As a result many of these consumers are forced to use alternative and more expensive water sources. For example, it is common in the urban ‘barrios’ in central Venezuela for poor consumers to pay approximately US$ 1.90 m³ – more than 4.4 times the average national tariff – for water purchased from a tanker.

The Government’s sector reform and investment program aims to address access and poor service levels in the sector and has established ambitious targets. By 2015 the Government aims to increase access to potable water and sanitation to 99%. In the same period the Government aims to increase, from 18% at present to 60%, the volume of wastewater that is treated.
Consolidate the institutional reform and decentralization program. The Government has outlined a comprehensive sector reform program in the Water and Sanitation Law\(^1\) (LOPSAPS), passed in December 2001. This Law takes advantage of reform experiences in many countries in the Latin American region and provides an excellent opportunity to reform sector institutions under sound principles of efficiency, equity and social participation in decision-making. At the institutional level the reform main objectives of the reform are:

(i) the transfer the responsibility for service provision to the municipalities through the development of decentralized service providers - *Unidades de Gestión* (UGs) – based on criteria of technical and economic efficiency;

(ii) the creation of a regulatory agency (*Superintendencia Nacional de los Servicios de Agua Potable y de Saneamiento* (SUNSAPS), to oversee the implementation of the Law, regulate tariffs and subsidies, and develop a monitoring system for the sector;

(iii) the establishment of a policy making and financing body for the sector (*Oficina Nacional para el Desarrollo de los Servicios de Agua Potable y Saneamiento* (ONDESAPS), whose primary responsibilities will be the management of a funding mechanism for targeted sector investments, policy formulation and facilitation of the provision of technical assistance to decentralized service providers including guidance on the establishment of the UGs;

(iv) the creation of a national bulk water company to operate and expand regional water infrastructure; and

(v) the establishment of a sector financing fund to channel public resources to the sector under a consistent policy framework.

The Government has made progress towards the creation of these institutions. However, regulations for the Law remain only partially developed and the Ministry of Environment and HIDROVEN\(^2\) currently share the responsibilities designated for these institutions. Further consolidation in the sector and institutional framework is required.

Successful implementation of decentralization strategy. Service provision in the country’s 23 provinces is currently managed by a network of ten regional utilities affiliated with HIDROVEN and a series of decentralized providers including individual municipalities and the *Corporación Venezolana de Guyana* (CVG). The Government program envisions the phased and well thought-through transfer of services from the regional utilities to municipalities that will most often voluntarily affiliate into *Unidades de Gestión* (UGs). The UGs will be designed following the analysis of different options, using technical and economic efficiency criteria and based on a sound planning exercise and intensive participatory process involving the state governments, municipalities and community associations. The Government reform program envisions the complete transfer of services to decentralized operators by December 2006. The transfer process is currently underway in the State of Guárico where the regional utility HIDROPAEZ will be replaced by five UGs by early 2006. The Government has completed studies on the formation of UGs in the states of Cojedes, Carabobo and Aragua and has initiated others. It remains critical to disseminate the experiences of HIDROPAEZ to other regional utilities that will soon initiate the process of transferring service responsibilities to UGs. The Government will need to ramp up the transfer process in other states in order to meet the target of December 2006.

Create incentives for the operational and commercial efficiency of decentralized operators. A critical priority for the Government will be to ensure that decentralized operators are able to achieve standards for operational and commercial efficiency. This is particularly critical given that the current network of regional utilities have been unable to significantly improve on key operational and commercial objectives. Non-revenue water is currently 62% and has grown steadily since it was measured at 57% in 1997. These

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\(^{1}\) Ley Orgánica para la Prestación de los Servicios de Agua Potable y Saneamiento (LOPSAS) 2001.

\(^{2}\) La Compañía Hidrológica Venezolana (HIDROVEN).
levels of financial and operational water losses far exceed standards for other developing countries where 40% losses are considered average. HIDROVEN suggests illegal connections are a major contributor to poor non-revenue water performance in the country. An inadequate record maintenance and rehabilitation likely also contributes to high losses.

The Government has prioritized the rehabilitation of dilapidated water supply networks together with updating cadastres and consumer databases in its medium-term investment program as means to reduce non-revenue water losses. The Government has also prioritized deepening and expanding the participation of community associations in the sector to improve, in part, operational performance. Effective cooperativas – community associations that manage small-scale rural water systems – and Mesas Técnicas de Agua – associations involved in monitoring neighborhood-level segments of urban rural water supply and sanitation networks – have had an impact on identifying and reducing both leakages and illegal connections.

Numerous challenges persist in enhancing the commercial performance of regional utilities and decentralized providers. The sector has not yet incorporated modern administrative practices, including – but not limited to – human resources management policies. Metering coverage was estimated at 14% in 2001. Revenues usually are not sufficient to meet operating costs - the ratio of revenue to operating costs was estimated at 86% in 2002. Billing and collection performance is also inadequate as total sector collection in 2003 amounted for merely 73% of the total billing and it is reported that the percentage of consumers being billed is particularly low. A critical challenge in the Government sector reform program obviously will be to create incentives for decentralized service providers to improve operational and commercial management and performance.

Ensure a sustainable investment program. The poor fiscal health of the sector translates directly into the lack of adequate and predictable investment. Government investment in the water and sanitation sector has been volatile in recent years – decreasing by 23.5% between 1998-99 and increasing subsequently by 62.3% between 2000-2001. The recent volatility in sector financing has made it difficult to initiate a sustainable medium-term investment program needed to rehabilitate infrastructure and extend services to consumers without access.

The Government reform program envisions the creation of a transparent Fondo de Asistencia Financiera to be administered by ONDESAPS to coordinate and strategically target government and multilateral investments in the sector. Additionally, the Government has outlined an ambitious investment program for the sector that will enable it to meet the 2015 sector performance targets. The investment program estimates that a total of US$ 4.77 billion will be required between 2003-2015 for the rehabilitation and development of water supply, sanitation and wastewater treatment infrastructure, which implies an average annual investment of approximately US$ 500 million for the sector. In comparison, Venezuela invested US$ 637 million in the five-year period between 1997-2001. The challenge for the Government will be to generate and effectively absorb investment resources of this magnitude. In any case, it will be necessary for the Government to develop criteria for high impact, poverty reducing priority investment program.

Rationale for Bank Involvement

The Bank is uniquely positioned to support the Government’s Program in the water and sanitation sector. First, the Government has demonstrated a strong commitment to improving water and sanitation services for the poor and under-serviced through comprehensive reforms and targeted investments. The Bank has the opportunity to support a robust poverty-focused Government program with the potential to have a major impact on access to basic services in the medium-term. The proposed loan would be structured under an Adaptable Program Loan (APL). This instrument will provide a framework for implementing the comprehensive medium-term investment Program designed by the Government to achieve the provision of efficient and sustainable service providers throughout the country. The APL would enable the Government to take a phased approach to planning and establishing the UGs while building the
necessary institutional, monitoring, and oversight capacity envisioned in the Law. Second, the Government has requested Bank support with the investment program and associated transfer of water and sanitation services to decentralized operators in eight states. Under the proposed operation the Bank has an opportunity to support sustainable reform in the sector. Third, the Bank is currently preparing a CAS update for Venezuela due in March 2005 that will have a strong focus on poverty reduction and basic service delivery. The proposed operation is scheduled for inclusion of the CAS and reinforces the core pillars of the Bank’s country strategy. Fourth, the proposed Bank engagement complements ongoing and planned Bank operations in the country. In particular, the project would complement the ongoing Caracas Slum Upgrading Project (CAMEBA) and a proposed follow-on upgrading investment requested by the Government for additional municipalities. Fifth, the Government has secured investment assistance from the CAF and the IADB to support reform and investment in the sector. However, the Government has indicated that Bank involvement may contribute to furthering the reform process. Parallel multilateral investments in the sector reinforce the likelihood that sector institutional reforms will be supported and implemented and that the Government’s projected investment program will receive assistance.

2. Proposed objective(s)
The overall objective of the proposed program is to support the Government to implement a medium-term reform and investment program in the water and sanitation sector in eight of the 23 states as means to achieving the target of universal water and sanitation coverage by 2015. Specifically, the project aims to support: (i) the transfer of service provision from national regional water and sanitation utilities to decentralized operators – Unidades de Gestión (UGs); (ii) investments in urban and rural water and sanitation infrastructure targeted to poor consumers; (iii) strengthening of community participation activities in the sector through cooperatives, Mesas Técnicas de Agua and other community associations; (iv) improvement of the operational and commercial efficiency of decentralized operators through the provision of technical assistance and financing specific activities.

3. Preliminary description
Instrument. The team proposes the use of an Adaptable Program Loan (APL) to enable continuous Bank engagement in the water and sanitation sector and provide a framework for Bank support for the Government’s medium-term program. The APL will enable the Government to develop a phased approach to planning and investment in the sector in parallel to strengthening policy-making, regulatory and decentralized service provision institutions. It is envisioned that Phase I will support priority investments and institutional strengthening activities in eight states while subsequent phases may potentially add other states.

Implementation. The project will be implemented by HIDROVEN under the supervision of the Ministry of Environment. HIDROVEN has demonstrated strong commitment in implementing the Water and Sanitation Law despite challenging sector and political conditions. HIDROVEN has also developed experience in project implementation through existing and previous operations with CAF and IADB. The implementation of the project will require close collaboration of HIDROVEN with regional utilities. The proposed project will be implemented in eight states currently receiving services primarily through HIDROCENTRO, HIDROANDES, HIDROCARIBE and the corporation CVG. Under the coordination of HIDROVEN, each regional utility will be responsible for developing a priority investment program and leading the process of analysis, consultation and technical assistance associated with the transfer of the services to Unidades de Gestión (UGs). Under the project – Phase I of the proposed APL – the regional utilities will also be responsible for supervising urban and rural water supply and sanitation infrastructure investments in their respective jurisdictions.

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3 According to preliminary discussions on the CAS between the Government and the Bank.
4 Compañía Venezolana de Guayana
Selection of participant states and prioritization of projects. The Government has outlined a US$ 4.77 billion investment program for the sector between 2003 and 2015. The investment program for the eight participating states will be prioritized based on criteria for poverty, service deprivation and sustainability. The Government has developed useful indices that disaggregate the quality of services by municipalities. In 2001, the Instituto Nacional de Estadísticas (INE) conducted a study of the quality of water and sanitation services in the country’s 335 municipalities and determined that 231 municipalities, approximately 70%, received insufficient water and sanitation services. It is likely that this measure – along with those for poverty and project impact – will be used for sub-project selection. During project preparation the Bank will work with the client to develop a transparent and poverty driven criteria for sub-project selection.

The proposed project will be implemented in eight states – Amazonas, Anzoategui, Aragua, Bolivar, Cojedes, Delta Amacuro, Sucre and Trujillo. The selected states are disproportionately poor, with seven of the states at or above the national poverty incidence of 48.6 percent. Service levels in the selected states vary yet remain considerably below Government medium-term targets for the sector.

Project Components. The Project will finance the following five components:

(i) Institutional development component (US$ 3 million) – to support the design and set up of UGs and the transfer of services to the municipalities, capacity building and other technical assistance to facilitate the reform and decentralization process;
(ii) Urban water supply and sanitation component (US$ 40 million) – to finance the extension of water supply and sewerage systems, rehabilitation of existing infrastructure, and improvement of commercial and technical efficiency of service providers;
(iii) Rural water and sanitation supply (US$ 20 million) – to finance integrated investments in water supply and sanitation systems;
(iv) Community infrastructure management (US$ 4 million) – the Project envisages the creation of a sub-project fund to directly finance community managed investments in capacity development and small works - supply systems, equipment, rehabilitation and extension of services; and
(v) Project management (US$ 4 million) – to support Project execution, supervision and monitoring.

4. Safeguard policies that might apply
The project will trigger Bank safeguard policies for Environmental Assessment and Involuntary Resettlement. The Project’s safeguard-related procedures will ensure that subprojects comply with national environmental laws and regulations as well as Bank environmental and social safeguard policies and that any impacts are addressed and managed through the application of appropriate guidelines. The preliminary approach includes the following points: (i) the Ministry of Environment will be responsible for the planning and implementation of the environmental aspects of the Project; (ii) during Project preparation, Environmental Assessments (EAs) for priority first year projects will be prepared as well as the Environmental Action for their implementation; (iii) the results and experiences derived from the first year subprojects EAs will be used to prepare Guidelines for the environmental and social handling of projects at a general level as manual of environmental and social best practices for the implementation of projects in the water and sanitation sector; (iv) the implementation of projects and compliance with the Environmental Action Plans will be supervised during the first year to identify any necessary adjustments to be made to the Guidelines; and (vi) The Guidelines will be applied to all subprojects subsequently financed under the APL.
5. Tentative financing

Source: ($m.)
BORROWER 21.0
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT 50.0

Total 71.0

6. Contact point

Gustavo Saltiel
Task Team Leader
Senior Water Engineer
1818 H St., NW
Washington, DC 20433