

PERU
NATIONAL RURAL WATER SUPPLY AND SANITATION PROJECT
(Loan No. 7142-PE)

PROPOSED AMENDMENT AND RESTATEMENT OF THE LOAN AGREEMENT

PART I – BACKGROUND

1. PRONASAR is a US\$80 million project supported by an IBRD loan (7142-PE) of US\$50 million, which was approved on August 29, 2002 and became effective on March 12, 2003. The Project is designed to increase the sustainable use of water supply and sanitation facilities in rural areas and small towns while emphasizing improvements in hygiene practices and training in operation and maintenance. To achieve this objective, the loan includes the financing of the following four components: (i) US\$40.9 million for the rehabilitation and expansion of existing water and sanitation systems (80% of the component) and the construction of new systems (20% of the component) in rural areas; (ii) US\$2.6 million for the improvement of service quality, rehabilitation and expansion of water supply and sanitation systems in small towns; (iii) US\$1.6 million for consultant services to enhance public sector capacity in the rural water and sanitation sector; and (iv) US\$2 million for project management, supervision, monitoring, evaluation and audits for MVCS. The project's closing date is December 31, 2008.

2. To date, approximately US\$6 million (12%) of the loan has been disbursed (the original disbursement estimate through January 2006 was 65% of the loan amount), with total commitments of US\$9.1 million (19%). The key constraints in project implementation include:

- *Institutional changes in Peru:* FONCODES was established in 1991 as an autonomous public entity, with independent governance and administrative systems. In June 2003, after loan effectiveness, FONCODES was transferred to MIMDES which required that the social fund assume the Ministry's complex and highly centralized administrative and fiduciary procedures thereby constraining the agency's ability to effectively implement the project. Under new budgetary processes, yearly Execution Agreements between FONCODES and MVCS were required to authorize disbursements under component 1 of the project. Signing annual Execution Agreements, however, delayed implementation between 4 to 8 months in each of the first 3 years of project's execution, severely limiting the implementation progress of the component. Also in 2003, in the context of the Government of Peru's decentralization agenda, central government transfers to FONCODES were reduced while transfers to sub-national governments were increased.
- *Lack of adequate resources and capacity for the implementation of Component 1 by FONCODES:* Under the original project design, FONCODES would use own resources for the management and supervision of Component 1. However, due to changes in the intergovernmental transfer system, the social fund was unable to assign adequate budget to project management activities. Additionally, FONCODES staff assigned to the project implementation did not have adequate capacity and experience.
- *Resistance to change in FONCODES:* PRONASAR's innovative project cycle was designed to address issues of sustainability and rehabilitation of deteriorated systems built by FONCODES under previous administrations through enhanced community participation and improved project preparation. However, the focus of FONCODES staff during implementation has remained on the execution of works with minimal consideration for community capacity building and participation. FONCODES staff continues to view the

project's emphasis on social activities, a longer pre-investment period and community and district municipality co-financing as unnecessary.

- *Diffusion of responsibilities:* Implementation of Component 1 by two agencies, under two different Ministries, has resulted in unduly cumbersome implementation procedures and slowed project execution. The presence of multiple executing agencies has also generated an atmosphere of rivalry and lack of accountability making it difficult to identify and correct problems.
- *Atomized procurement arrangements:* The initial tendering process was designed in small lots that were ultimately unattractive to local private firms. Many lots failed to attract any bids at all. The initial tendering process was also delayed due to the lack of counterpart familiarity with Bank norms and procedures. This situation was partially corrected for the second tendering process, where new contracts were designed with a larger scope.
- *Lack of financial resources for training at all levels, including district municipalities, consultants, and central government officials:* The capacity of water user associations, district municipalities and of the regional officials of FONCODES was significantly overestimated during project preparation and hence the need for intensive training and capacity enhancement was not incorporated into the original project design. It was only during implementation that the scope of the capacity gaps became apparent. Additionally, the Government did not consider it appropriate to use loan proceeds to finance training activities, concentrating instead on physical works. The lack of adequate training resources hampered the ability of both FONCODES and MVCS to invest in improved staff capacity to take on the challenges implied under the new project cycle.

Implementation status was downgraded in October 2004 due to these factors. The Bank team has subsequently been working with the authorities to develop different approaches to improve project implementation including an independent institutional assessment which made recommendations on alternative approaches for improved implementation. During the Mid-Term Review (September 2005) the Bank team reached an agreement with the Government on the need to find an alternative to FONCODES for the implementation of Component 1. The team and the Government subsequently engaged in detailed discussions on alternative implementation arrangements and the drafting and negotiation of the attached revised loan agreement.

3. Implementation progress has been satisfactory for component 2, which is executed directly by the MVCS. This component aims to delegate the provision of water and sanitation services to specialized operators in 12 small towns (district municipalities) in Peru. The decentralization process has generated an increased demand for technical and investment support from district municipalities to further improve basic services. During appraisal it was expected that services in district municipalities needed only marginal investments, thus the component represented only 5% of the total project amount. However, a detailed assessment of municipal water and sanitation services in a sample of municipalities carried out by MVCS has found that the water and sanitation situation in most towns is far worse than expected.

PART II – PROPOSED AMENDMENT

4. After the proposed amendment, the project will continue to support two of the pillars in the CAS: Equity and social justice, including access to basic services, and the support of a more decentralized state. Increased and sustainable access to water and sanitation services in rural and small towns where poverty is heavily concentrated is in line with the strategic objectives of the

CAS related to having a direct impact on the lives of the poor. The proposed implementation arrangements will enhance the role of district municipalities in project planning, financing and implementation, thus supporting ongoing decentralization efforts by the Government.

5. The changes needed to improve project implementation involve a major amendment and restatement of the Loan Agreement including:

- **Implementation Arrangements.** The proposed amendment will concentrate full implementation responsibility for project execution within the MVCS, the Ministry in charge of the water and sanitation sector in Peru. The MVCS will be responsible for all procurement and fiduciary processes related to the project including payments, financial transfers, contracting and no objection requests. The Ministry's procurement and financial management capacity has been assessed by the Bank, as it currently executes other components. Improvements to streamline its processes will be introduced as part of the Revised Operational Manual.
- **Reallocation of loan proceeds among components.** This amendment includes the reallocation of loan proceeds among components in the following way: (i) increasing financing under Component 2, Water supply and Sanitation in Small Towns, by US\$3.7 million, with the objective of meeting the demand from 15 additional small towns willing to delegate the provision of water and sanitation services to autonomous, specialized operators; (ii) increasing financing by US\$1.1 million for Component 4, Project management, monitoring, evaluation, audits and supervision to enable MVCS to effectively implement Component 1; and (iii) using US\$2.4 million from the unallocated category and a reduction of US\$2.4 million from Component 1 to pay for the increased expenditures under Components 2 and 4. The Government's decision to reduce the scope of the rural component is also informed by availability of donor resources for water and sanitation in rural areas. However, PRONOSAR is the only current source of finance in the sector for small towns.
- **Modify procurement arrangements.** The amendment will provide an opportunity to use the updated Bank Procurement Guidelines (May 2004) which allow for increased flexibility and faster implementation. Additionally, the ceiling for goods and services, other than consultant service contracts using national competitive bidding, has been increased to US\$ 350,000 based on current cost estimates and MVCS' enhanced experience in procurement management.
- **Introduce training as a disbursement category.** The introduction of a training category will help improve quality of project implementation. The proposed amendment would allow the use of loan proceeds for the training of community beneficiaries, water boards, municipalities, sector professionals and government officials to enhance the skills and knowledge necessary to implement projects based on community participation methodologies and the use of appropriate engineering designs to achieve sustainability of the interventions.
- **Update performance indicators to reflect major changes to the loan agreement.** The restructuring of the Loan has required a reassessment of project scope and targets based on current costs and demands from district municipalities. Based on this reassessment, the expected number of project beneficiaries has been revised modestly from 875,000 to 811,000, of which 686,000 will benefit from the rehabilitation and construction of rural water and sanitation systems under component 1 and 125,000 will benefit from improved services under the small towns component.

6. **Update economic analysis and loan closing date.** The revised economic feasibility of the project was based on an analysis of a sample of subprojects and presents a positive net present

value of US\$22 million and an internal rate of return of 22%. The original closing date of December 31, 2008 will remain the same; with project implementation expected to catch up, due to parallel implementation in different provinces and improved procurement arrangements that will allow for accelerated and more effective implementation.

7. ***Conditions of Amendment Effectiveness.*** The following conditions were identified by the project team and approved by the Government during technical discussions, as necessary for the Amendment to become effective. They have been included in the attached Amendment:

- *The Revised Operational Manual is satisfactory to the Bank.* MVCS has already submitted a draft operations manual, and it is anticipated that a Manual acceptable to the Bank will be finalized prior to effectiveness.
- *All existing contracts with specialized consultant firms are amended by FONCODES and by the MVCS.* The Ministry has initiated negotiations with the firms to transfer contracts from FONCODES to MVCS.
- *An Execution Agreement between FONCODES and MVCS for 2006 is signed.* The Agreement has been prepared, signed by MVCS and is pending the signature of MIMDES.
- *The Annual Implementation Program for 2006 (including the Annual Procurement Plan) is prepared and satisfactory to the Bank.* This condition has been met.
- A legal opinion is produced that is satisfactory to the Bank, showing that the proposed Amendment has been duly authorized and delivered on behalf of the Borrower and is legally binding upon the Borrower in accordance with its terms; and all the existing contracts mentioned above have been duly amended and executed, and are legally binding upon FONCODES, PIU and contractors in accordance with their terms.