INTRODUCTION

1. This memorandum seeks your approval for the amendment of the Development Credit Agreement and Project Agreement for the Dar es Salaam Water and Sanitation Project. This Project has as its objective the provision of reliable, affordable, and sustainable water supply and sanitation services in Dar es Salaam and parts of the Coastal Region of the United Republic of Tanzania through: (a) rehabilitation of facilities for production, transmission, storage and distribution of drinking water, and waste water collection and treatment; (b) extension of piped water supplies and sewerage services; and (c) reorganization of the United Republic of Tanzania’s water utility company, the Dar es Salaam Water and Sewerage Authority’s (DAWASA) operations to achieve effective service delivery and financial sustainability. As part of the reorganization efforts anticipated in (c) of the Project objective, it was proposed to turn DAWASA into an asset holding company, transferring the actual operation of water and sewerage services to a private operator. To this end, after a competitive procurement process, City Water Services, Ltd. (a Tanzanian-registered private water operator with UK, German and Tanzania Shareholders) was appointed as operator, and DAWASA entered into a ten-year Lease Contract with City Water Services Ltd. on February 19, 2003. The proposed amendments are made to the Project as requested by the Government of the United Republic of Tanzania to this effect following the termination of the Lease Contract with City Water Services by the Government.

BACKGROUND

2. The above project was approved by the Executive Directors on May 27, 2003 (Report No. 25249-TA) and became effective on July 31, 2003. As currently designed, the Dar es Salaam Water Supply and Sanitation Project is a five year project which comprises a $164.6 million investment and operational support program co-financed by the International Development Agency (IDA - $61.5 million); African Development Bank (AfDB - $48.0 million); European Investment Bank (EIB - $34.0 million); Private Operator ($8.5 million in the form of equity in the operating company) and DAWASA/Government of Tanzania ($12.6 million).

3. The Project has five components namely, (i) water supply rehabilitation and extension, (ii) wastewater system rehabilitation and extension, (iii) community water and sanitation, (iv) institutional strengthening, and (v) medium-term development. All components, except for parts of the institutional strengthening, were placed directly under the control of DAWASA. Under the Project arrangements, DAWASA, as the asset holding company, retained the responsibility for procuring, supervising and, in part, financing the major rehabilitation contracts and retained the financial responsibility for replacing systems, except for small equipment and
small pipe segments. DAWASA was also responsible for Community Water Supply and Sanitation projects in areas not then covered by City Water Services and for undertaking studies to identify and design future water sources and sanitation improvements. The Project was designed to provide City Water Services with substantial control over the operations of the water supply and sewerage systems in the DAWASA designated service area. Four contracts were signed by DAWASA and City Water Services on February 19, 2003: a Lease Contract, a Supply and Installation of Plant and Equipment (SIPE) contract, a Purchase of Goods (POG) contract and a Government Subloan Agreement. A Development Contract was also signed between the United Republic of Tanzania and DAWASA setting out the framework for the development of capital investments.

4. In exchange for a monthly rental fee, the Lease Contract transferred DAWASA's rights and responsibilities for providing water supply and sewerage services, including billing and collection, to City Water Services; covering substantially all of the DAWASA service area. The Lease Contract also engaged City Water Services to design, procure, and supervise construction contracts to rehabilitate and to extend the secondary and tertiary water mains in the DAWASA designated service area (the "Delegated Works"). The SIPE contract engaged City Water Services to undertake priority works to strengthen water treatment, transmission and distribution assets, pending the procurement of major rehabilitation contracts funded by the EIB and AfDB. The SIPE contract included the procurement of bulk meters, which are needed to set up pressure zones for better control of the water distribution system. The POG contract engaged City Water Services to procure 173,000 customer meters needed to improve water management and customer billing and collections. Under the Lease Contract, City Water Services was to meter all government and large commercial customers within the first year. Under the Subloan Agreement, DAWASA agreed to on-lend $5.5 million to City Water Services to finance the initial procurement of consumables and operating equipment, such as vehicles and computers, etc., and to help offset operating cash deficits in early years until billing and collection improvements made operations financially sustainable. This is financed from the Operating Costs expenditure category.

5. Both City Water Services and DAWASA were separately licensed to provide water and sewerage services under the Electricity and Water Utilities Regulatory Authorities Act of 2001 by the responsible Minister of Water acting as the Interim Regulator. As provided under the Lease Contract, separate water supply and sewerage Operator and Lessor tariffs were approved by the regulator for City Water Services and DAWASA. A special First New Domestic Water Supply Connection fee was to be charged on water consumption, collected by City Water Services, held in trust, and used to finance new connections for the poor. The combined customer water supply tariff included a life-line provision in that domestic water customers only paid the Operator tariff for the first 5 cubic meters of water consumed.

PROJECT IMPLEMENTATION EXPERIENCE

6. As mentioned above, the Project became effective on July 31, 2003. The Operator mobilized in August 2003 and began the take over of operating staff and assets in the DAWASA designated service area. Within the first 12 months City Water Services was in breach of many key provisions of the Lease Contract. In particular, CWS had begun to consistently fail to remit
the Lessor tariff to DAWASA and to deposit the First Time New Domestic Water Supply Connection Fee into the First Time New Domestic Water Supply Connection Fund on a timely basis. Beginning in July 2004, City Water Services ceased payment of the monthly rental fee to DAWASA. Initially, City Water Services sought a substantial Operator tariff increase to alleviate its cash flow difficulties, under the “material change” provisions of the Lease Contract. In August 2004, an audit ordered by the Interim Regulator and conducted by PriceWaterhouseCoopers (PWC) to determine whether changes in key assumptions, such as water available for sale or costs of production, warranted a tariff increase under the Lease Contract. When PWC found that no “material changes” had occurred, City Water Services sought to renegotiate the Lease Contract.

7. IDA assisted with the formal renegotiation attempt during April and May 2005 by funding a regulatory specialist to facilitate the discussions between the parties. The renegotiation was not successful, however, and DAWASA terminated the Lease on June 1, 2005. Following the termination of the City Water Services Lease Contract, IDA engaged the Government to ensure continuity in the delivery of water supply and sewerage services and to maintain the policy framework for the Project. The Government agreed to an interim arrangement that retained the separation of the responsibilities between the Operator and DAWASA, as the asset holder, to facilitate the future transition to private sector participation. A new entity, the Dar es Salaam Water and Sewerage Corporation (DAWASCO) was formed under the Public Corporations Act, with capital of TZS 2 billion to be provided by the Government. DAWASCO took over City Water Services’ responsibilities on June 1, 2005, and began implementing a 100 Day Rescue Plan in July 1, 2005. A new Lease Contract and Subloan Agreement for $6 million were signed between DAWASA and DAWASCO in September 2005 both taking effect retroactively as of July 1, 2005. A new Development Contract was also entered into between the Government and DAWASA.

8. The Project continues to record steady progress in spite of the drawn out and failed renegotiation process with City Water Services surrounding the Lease contract as well as delays encountered on some components of the rehabilitation program. Most of the contracts (rehabilitation of water treatment plant-CP1, rehabilitation of transmission mains-CP2, rehabilitation of sewerage network-CP5) are under execution; rehabilitation of sewage treatment ponds-CP4 and rehabilitation of sewage pumping stations-CP6 are at advanced stages of procurement processing. Progress on Part 1 of the rehabilitation of the distribution network under the delegated works contract is encouraging. Disbursements are on track (a little over 30% of IDA financing after about 24 months of implementation). After falling behind for a number of months, DAWASA is currently in compliance with maintenance of minimum balance in the operating account.

9. While the termination of the Lease (after 22 months of implementation) has not had a significant impact, it has been agreed to move the mid-term review by six months (December 2006) to allow time for the new implementation arrangements to set in. However, given the uncertainty surrounding the capacity of the new operator (DAWASCO), the supervision team has recommended the downgrading of the Project Development Objective rating to Moderately Satisfactory (MS) and the Implementation Progress rating (IP) to Moderately Unsatisfactory.
These ratings will be reviewed during the enhanced monitoring period of one year (up to June 30, 2006).

PROPOSED AMENDMENTS AND IMPLICATIONS ON PROCUREMENT, SAFEGUARDS AND THE MONITORING AND EVALUATION FRAMEWORK

10. The proposed amendments will (i) reflect the change in implementation arrangements resulting from the change of Operator from City Water Services to DAWASCO; (ii) reflect changes to the Project description stemming from the change in the status of works mapped for supervision by the Operator under the original lease from delegated to non-delegated in the new lease with DAWASCO and the introduction of new activities under the non-delegated works; (iii) make the necessary reallocation of credit proceeds to reflect the changed situation including allowance for a new subloan to DAWASCO and additional resources for Training/Capacity Building and new emergency items identified during execution of the Project; and (iv) extend the Project closing date by 12 months on account of the loss of execution momentum arising from the protracted failed Lease contract re-negotiation process and delays encountered in procurement processing and mobilization of contractors on key contract packages and the completion dates of certain activities such as the development of the strategic sanitation plan on waste water management and drainage and the feasibility study and design work for waste water management facilities by six months from December 31, 2006 and December 31, 2007, respectively; and (v) reflect any necessary changes to the Project’s performance monitoring indicators.

(a) Changes in Implementation Arrangements: The termination of the Lease Contract ended City Water Services’ role as the Operator. This role has been assigned to DAWASCO since June 1, 2005. City Water Services’ role in the design and supervision of the secondary and tertiary water mains (i.e., the Delegated Works) also ceased on termination. The City Water Services’ SIPE and POG contracts were similarly suspended. To complete the works begun under the SIPE contract, DAWASA intends to engage the principal SIPE subcontractor(s) as the prime contractor(s). The POG contract will be terminated, as the 100,000 meters already purchased are judged to be adequate to cover requirements through the end of the Project. DAWASA expects to enter into a contract with the existing Non-Delegated Works Construction Supervision Consultant or a new engineering services firm to continue its supervision of Delegated Works contracts started before the termination of the Lease Contract as well as design and supervision of the remaining secondary and tertiary rehabilitation packages. DAWASCO will not be responsible for any new Delegated Works contracts, except for the installation of customer connections and water kiosks or elements of the delegated works that will be assigned from time to time.

(b) Project Description: The Project components remain substantially unchanged as per the existing Project description. One significant change is the reduced order of meters from 173,000 to the current stock of 100,000. Three new works components are being requested:

1) Groundwater development: This involves drilling three deep, large-capacity boreholes to test the water quality and capacity of the large, deep aquifer located under Dar es Salaam (identified by the Future Water Sources Study).
2) **Repair of a breach on Ruvu River at Kidogozero:** Unless corrected this will substantially lessen the water available to the DAWASA water supply system, especially during periods of drought.

3) **Construction of a waste management facility:** This would handle solid waste for the city of Dar es Salaam and allow for disposal of sludge from the wastewater ponds, which is currently being accumulated onsite.

(c) **Re-Allocation of Credit Proceeds:** IDA commitment to the Project will remain at the original SDR 45,000,000.00. Allocations to Categories 1, 4, and 5 will increase whereas Categories 2, 3, and 7 will decrease. The proposed changes to schedule 1 are as follows, and are reflected in the table below.

- Provide additional funds of SDR 2,450,000 for Category 1 (Works);
- Reduce by SDR 2,750,000 the amount for Category 2 (Goods);
- Reduce by SDR 1,300,000 the amount for Category 3 (Consulting Services);
- Provide additional funds of SDR 350,000 for Category 4 (Training);
- Provide additional funds of SDR 3,600,000 for Category 5 (Support to Operator); and
- Reduce by SDR 2,350,000 the amount for Category 7 (Unallocated).

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<tr>
<th>Category</th>
<th>Original</th>
<th>Change Amount</th>
<th>Revised</th>
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<tr>
<td>1. Works</td>
<td>14,250,000</td>
<td>2,450,000</td>
<td>16,700,000</td>
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<tr>
<td>2. Goods</td>
<td>6,300,000</td>
<td>-2,750,000</td>
<td>3,550,000</td>
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<tr>
<td>3. Consulting Services</td>
<td>16,900,000</td>
<td>-1,300,000</td>
<td>15,600,000</td>
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<tr>
<td>4. Training</td>
<td>350,000</td>
<td>0</td>
<td>700,000</td>
</tr>
<tr>
<td>5. Operating Costs of the Operator</td>
<td>4,000,000</td>
<td>3,600,000</td>
<td>7,600,000</td>
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<tr>
<td>6. Refunding of the Project Preparation Advance</td>
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<td>850,000</td>
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<td>7. Unallocated</td>
<td>2,350,000</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>45,000,000</strong></td>
<td>0</td>
<td><strong>45,000,000</strong></td>
</tr>
</tbody>
</table>

The increase in works is to accommodate scope and price changes on existing contracts and to include three new activities: (i) ground water development; (ii) Kidogozero breach repair; and (iii) waste management facility. The increase was partially offset by the shift of Delegated Works amounts to the AfDB. The decrease in goods reflects the reduction in the number of customer meters to be procured under the POG contact and the shift of pipe procurement into supply and installation contracts classified as works. The decrease in consulting services is due principally to the reallocation of the contingency to other categories. Training was increased by $500,000 to build capacity at DAWASA and the Ministry of Water and Livestock Development. The Operating Costs category was increased by $6 million to provide operational support to DAWASCO through the Subloan mechanism. City Water Services did not utilize the entire $5.5 million Subloan available to it.

(d) **Retroactive Financing:** Given the emergency circumstances surrounding the termination of the Lease, the IDA management team, in discussion with the Government proposed the advancing of resources by DAWASA to DAWASCO for the purchase of essential chemicals,
other consumables to ensure uninterrupted water supply and sewerage services. Additional resources for the hiring of short-term technical assistance and logistical support in the execution of the 100 days Rescue Plan were also recommended during the June 2005 joint supervision mission by all three co-financers of the Project. Consequently, retroactive financing of an estimated $3,157,000 (SDR 2,230,000) is hereby proposed to be financed out of the Operating Costs category for this purpose. This will cover eligible emergency expenditures incurred by DAWASCO since June 1, 2005.

(e) Procurement: The Project Implementation Plan has been updated. The termination of the Lease Contract has not had any material impact on the procurement plan since most of the activities are Non-Delegated and, of those which were Delegated, all contracts were signed with DAWASA. The Waste Management Facility will be procured under a Design, Build and Transfer arrangement.

(f) Safeguards: An Environment Management Plan and a Resettlement Policy Framework were prepared under the Project and new activities such as the construction of the waste management facility will be undertaken in accordance with the said documents. In addition, the construction of the Waste Management Facility will further enhance the mitigation measures for the management of sludge from both on-site facilities and waste stabilization ponds.

(g) Effect on Monitoring and Evaluation and Results Framework: The main departure from forecasted monitoring indicators (Schedule 5 of the Development Credit Agreement) is: (i) the reduction of customer meters from 173,000 to the current stock of 100,000 and (ii) the extension of the completion dates of the following studies by six months (a) development a strategic sanitation plan for waste management and storm water drainage and (b) carrying out feasibility studies for the construction of waste water management facilities and associated design work. All other performance targets are deemed to be feasible based on the adjustment made in revised Project Implementation Plan.

(h) Effect On Closing Date: Given the delays encountered during the first 24 months of execution of the Project, due in part to the protracted failed negotiation between the executing agency and the private operator as well as teething management and procurement problems, the government has propose an extension of the closing date of the Project by 12 months – i.e., from December 31, 2008 to December 31, 2009.

BENEFITS AND RISKS AFTER AMENDMENTS

11. Benefits – There are not anticipated changes in the benefits associated with the Project. Reliability, affordability, and sustainability of the services will improve for the approximately 3.0 million people in the DAWASA designated service area. With the proposed extension of 12 months and adjustment made in the implementation program, the Project outcome of ensuring 80% of the population with access to piped water supply and 70% with 24-hour supply will be attained. This will contribute to the attainment of the MDGs for water and sanitation services in DAWASA designated service area specifically and Tanzania in general.
12. **Risks** – The Project risk remains substantial as appraised. Most of anticipated risks associated with the operator (poor performance, inadequate equity injection, withdrawal of the international operator, focus on construction rather than services to customers, etc.) emerged during implementation. The updated Project Implementation Plan takes cognizance of the Government position that the termination of the Lease with City Water Services was one of contract failure, not policy failure, and therefore made the necessary adjustments to ensure that some of the underlying mitigation measures are addressed under the interim arrangements with DAWASCO. The mitigation measures include (i) the calibration of the network through the installation of bulk meters and (ii) the mobilization of the customer database through the introduction of a new billing system is being fast tracked. The two activities are aimed at ensuring a more credible database (technical, financial, and commercial) for maintaining current operations and providing better data for the medium term institutional correction plan which will include the option of exploring the introduction of a potential successor private operator. A new financial model (with a new working capital arrangements and tariff adjustments) aimed at tracking the sustainability of the operation has also been put in place and will be monitored under the enhanced supervision period of 12 months from June 1, 2005.

**RECOMMENDATION**

13. I am satisfied that the proposed modifications of Cr. 3771-TA comply with the Articles of Agreement of the Association, and recommend that the Executive Directors approve amending the legal agreements for the credit in accordance with the terms of this memorandum. The amendments to the Development Credit Agreement and the Project Agreement will then be forwarded to the Government of the United Republic of Tanzania for signing.

Paul Wolfowitz  
President