I. Introduction and Context

   A. Country Context

   Mexico is experiencing a solid economic growth but sharing prosperity remains a challenge. The Mexican economy has rapidly recovered from the deep contraction in 2009, supported by both external and domestic demand. Mexico’s current economic performance is solid, achieving a 3.9% growth in 2012. Although it has made steady progress in poverty reduction, almost 52 million Mexicans are still living under the national poverty line, with persistent and substantial differences across regions and ethnic groups.

   Oaxaca ranks among the poorest States of Mexico and faces a complex social environment. The State of Oaxaca, located in the southeast region of Mexico, is the third most economically marginalized State in Mexico, just above Chiapas and Guerrero. The development gap with the most advanced States has been constantly increasing for the last 15 years as reflected by the Shared Prosperity Convergence Index. In 2010, the State's GDP per capita was close to US$4,300, representing only 45% of the national average. 67% of its 3.8 million inhabitants live under the national poverty line and 30% of its population lives in extreme poverty. Over 16% of the population is illiterate, well above the national average of 7%. Oaxaca is also known for its tense social situation and recurrent protests including from indigenous groups pitting at times against pro-government forces and powerful local political elites.

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1 CONEVAL, 2010
2 In current US$
The Bank has been supporting the reform agenda for inclusive growth of Oaxaca through a strategic programmatic partnership since 2011. The Bank and the Government of Oaxaca (GoO) signed in June 2011 a Memorandum of Understanding (MoU) including a multi-year, multi-sectoral support to the State, combining a package of knowledge, convening and financial services, structured around four areas: (i) public sector modernization, (ii) human development, (iii) finance and private sector, and (iv) sustainable development.

Modernizing the Water and Sanitation sector is a priority of the Government of Oaxaca. The current GoO, which started its 6-year term in January 2011, has made institutional strengthening and public management modernization a priority of its administration, as embodied in the State Development Plan (2011-2016). In 2012 the GoO prepared with the support of the Bank a Strategic Plan for the Water Supply and Sanitation (WSS) sector that sets the objectives and the strategy for the development of the sector. The preparation of the Strategic Plan has been closely coordinated with the State finance ministry (SEFIN) that has played a leading role to initiate the modernization of the WSS sector.

B. Sectoral and Institutional Context of the Program

The institutional framework of the WSS sector of Oaxaca is characterized by an incomplete separation of the sector functions and by a lack of autonomy of the service providers. The State Water Commission (CEA), the State leading policy institution, is also operating WSS systems in 15 provincial cities, contracting around 85% of the investments made in the sector and providing operational assistance to some service providers mostly in urban areas. Other urban service providers include a State water department serving 300,000 people in the Metropolitan Area of Oaxaca city (ADOSAPACO), municipal departments and 30 municipal utilities with a separate board chaired by the mayor. In rural areas, service provision is highly scattered in about 10,000 communities, where municipal agencies or user committees operate the rural systems. The current legal status and governance of the service providers generate a high politicization of the tariff, service payment and staff appointment. Besides, only the municipal utilities benefit from a legal status allowing a direct access to federal programs. Other service providers need to rely on the Municipalities where they operate or on the CEA to seek federal financial resources.

Access to WSS services is among the lowest of Mexico. The State of Oaxaca has the second lowest drinking water coverage (77%) and the lowest sanitation coverage (70%) in the country. In rural areas, coverage rates are even lower (60% for water and 53% for sanitation). Treatment of collected wastewater is another serious issue, as only 6 of the 126 treatment plants in the State are considered as fully operational. Low coverage rate contrasts with the relative high availability of water resources as Oaxaca is the State with the fifth largest underground water reserves of the country.

Quality of the WSS services is generally poor. Intermittent water supply is widespread. For example, out of the 15 systems operated by the CEA, only one offers continuous supply.

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3 Defined as communities of less of 2,500 people.
4 CONAGUA, 2011.
Generally, service in piped distribution system varies from a few hours of supply a day to once every couple of weeks. The lack of systematic disinfection and intermittent supply prevent to distribute drinking water. Only a few more performing utilities have a culture of commercial services. Besides, rural service providers do not benefit from any structured scheme of technical assistance.

**Financing of the WSS service operations is largely subsidized leading to increased political interferences and affecting the performance of the service providers.** The combination of low tariff, lack of efficiency and low collection rate leads to highly subsidized service providers. Tariffs cover only 45% of the operating costs and 19% of the total service costs. The general reliance on subsidies increases the political dependence of the service providers as well as affects the performance of the service providers as sufficient subsidies are not always available when needed. There is no economic regulation of the providers and no subsidy scheme targeted to the poorest.

**Financing of the WSS sector investments highly depends on yearly unpredictable federal transfers.** Over the period 2007-2011 it is estimated the sector benefited from around $40 million of annual investments, but investments actually fluctuate a lot over the years (it varied erratically between $20 million and $90 million over the analyzed period). The unpredictability of the resources available is preventing medium-term investment planning both at State and service provider level. Besides 98% of the investments are financed by the federal government (respectively 62% from the federal water commission CONAGUA and 36% from the federal finance ministry) and 2% from the GoO’s budget, illustrating the fiscal centralization and dependency from the federal institutions. Nearly all the resources for investments in the sector received from the federal government are channeled through SEFIN. The investments are split equally between sanitation and water supply.

**There is a general lack of data on service level and provider performance.** In urban areas only a few utilities have the tools and systems to measure key performance indicators, while in rural areas there is no mechanism to monitor service access and sustainability.

### C. Relationship to CPS

**Alignment of the Program with the CPS for Mexico.** The proposed Program is aligned with the objectives of the “*Mexico Prospero*” working line of the National Development Plan (2013-2018), and with the Bank’s Country Partnership Strategy (CPS) for Mexico (2014-2019) under preparation that features water and the subnational engagement prominently. It would support three of the four proposed themes in the CPS for eradicating poverty and promoting shared prosperity: (i) *Increasing Social Prosperity*, by improving water management and promoting the sustainable access to clean and safe drinking water; (ii) *Promoting Green Growth*, by enabling an environment that supports and strengthens service providers, thus improving effectiveness in water provision and social and environmental sustainability of the sector; (iii) *Strengthening Public Finances and Government Efficiency*, by encouraging a results-based approach in public budgeting and management and by reinforcing government’s own systems for delivery of water supply and sanitation services, building on sound fiduciary, environmental and social practices.

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5 Team analysis of the sector financing
II. Program Development Objective(s)

The Program Development Objective is to improve the quality and sustainability of WSS services and WSS sector information in the State of Oaxaca. To achieve this Objective, the Program will provide a multi-year steady financing framework to increase the legal and financial autonomy of service providers in priority areas, strengthen their operational performance and establish the tools to collect key sector data.

III. Program Description

The proposed operation will support the implementation of a new WSS sector Modernization Program of the GoO to increase the legal and financial autonomy of service providers in priority areas, strengthen their operational performance and improve sector information, through the following activities:

- **Institutional framework modernization** – Preparation of a new WSS sector law, by-law and organization manual of the CEA, preparation of a standard by-law for autonomous municipal or inter-municipal WSS service providers.

- **WSS service improvement in the Oaxaca city Metropolitan Area** – Rehabilitation and extension of production or storage capacity, rehabilitation, hydraulic optimization and sectorization of water / sewerage networks, macro- and micro-metering, update of the network mapping and commercial system in a priority service area of ADOSAPACO (hydraulic sector “S2”).

- **WSS service improvement in provincial cities** - Same activities as just above, as well as the creation or improvement of the accounting system of the service providers in 18 priority provincial cities.

- **WSS service sustainability strengthening in rural areas** - Provision of equipment and tools to CEA to perform its new role of TA delivery to rural service providers; training, provision of tools and systems, development and dissemination of communication materials to strengthen rural WSS service providers supplying a population between 500 and 2,500 inhabitants; IT infrastructure and equipment to implement an information system for the rural water sector.

The IPF component will finance strategic TA activities to support the achievement of the targets of the Program that are not normally funded by the federal programs and for which the GoO seeks a specific oversight of the Bank, namely: (i) Performance-based TA contract(s) with a professional operator / consultancy firm to assist on investment planning, train providers on leaks detection / repair, reduction of commercial losses, collection increase, customers service, design of communication campaigns. Performance indicators of the TA contract could be aligned with the Disbursement Indicators of the Program, (ii) one training contract to build the capacity of the central and regional offices of the State Water Commission to perform their new role of TA to rural service providers, and (iii) TA to design and implement the rural information system.

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6 The GoO has indicated so far its interest to give priority to investments of the Program in water supply. Inclusion of investments in sanitation systems will be further discussed during the preparation process. PDO and Program amount may be adjusted accordingly.

7 TA would cover operational, financial, social and legal assistance.
IPF component might also finance a few activities related to the implementation of the PforR’s Program Action Plan.

IV. Initial Environmental and Social Screening

Environmental aspects of the Program. An initial screening of the Program shows that it should not include activities that pose a risk of potential significant and irreversible adverse impacts on the environment (e.g., Category A type projects). The potential negative environmental effects related to the Program are likely relatively minor to possibly moderate, such as erosion or sedimentation due to earth works, well drilling, construction works, operation of campsites, noise and dust from equipment and earthworks, spills of petroleum based products, worker health and safety, storm water runoff into water courses, and contractor’s presences in urban areas. The environmental context is variable as the Program is statewide with cities varying considerably in population. The leading technical agencies (ADOSAPACO and CEA) and the environmental permitting and enforcement agencies at federal level (SEMARNAT/CONAGUA/PROFEPA), state level (IEEDS), or municipal level have varying capacity related to environmental management. Potential risks include works in sensitive environmental areas, insufficient environmental management plans, inadequate implementation by construction contractors, or the unplanned release of contaminants in receiving waters due to spills or severe storm events. Based upon the present information, there is no anticipated significant reputational risk due to environment.

Social aspects of the Program. In terms of land acquisition and resettlement the impact of the investments to be supported under the Program are likely to be negligible. Civil works anticipated, will have a small physical footprint and will involve the rehabilitation of water and possibly sewage networks using the existing right of way in urban areas. Indigenous communities in Oaxaca represent important potential beneficiaries of activities planned for rural areas, and are likely to support institutional strengthening to improved service sustainability. Overall, the major challenge facing the modernization of the water sector in Oaxaca is that of social sustainability, due to the widespread resistance to paying for services and the prevalence of illegal connections in urban areas, and the limited organization and financial capacity of rural schemes to sustain the systems they build. Mexico and the State of Oaxaca has a strong access to information law implemented by the Instituto Federal de Acceso a la Información y Protección de Datos (IAFI). Although the activities proposed will have little or no resettlement impact, and will strengthen the institutional capacity of water providers serving rural indigenous communities, there are however significant challenges related to resistance to paying for services that would need to be addressed through comprehensive social management and communication efforts.

Environmental and social assessment. The Bank will prepare an Environmental and Social Assessment (ESSA) of the proposed Program, including review of existing regulations and policies, their legal and practical applicability at the Program level, institutional capacity, the effectiveness of implementation in practice. The ESSA, like the other assessments, will include an analysis of the governance aspects relevant in the sector in the State and specific to the Program to be financed. These challenges may affect achieving the particular PDO and will also include reviewing the use of transparency and grievance mechanisms at the community or
municipal level. If needed, measures incorporated in the PAP will be developed with the borrower to enhance environmental and social management capacity and performance.

**Environmental and social aspects of the IPF component.** The IPF component of the operation is classified as environmental category C, as the component only deals with technical assistance that do not involve potential significant environmental or social negative impacts.

V. **Tentative financing**

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VI. **Contact point**

**World Bank**
Contact: Charles Delfieux
Title: Water and Sanitation Specialist
Tel: (202) 473-5210
Email: cdelfieux@worldbank.org

**Borrower/Client/Recipient**
Contact: Iliana Sotomayor
Title: Advisor of the State Minister of Finance
Tel: (+52) 951 515 9657
Email: ilianasotomayor@gmail.com

VII. **For more information contact:**
The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop