

**SANITATION REGULATORY FRAMEWORK AND CONCESSION DEVELOPMENT FOR GOIAS,
BRAZIL**

(TC-96-07-295)

EXECUTIVE SUMMARY

EXECUTING AGENCY: Empresa de Saneamento do Estado de Goiás (SANEAGO)
Secretaria de Recursos Hídricos (SRH)

BENEFICIARIES: Service Users, SANEAGO and SRH

FINANCING: Modality: Grant from Facility I, TC
Beneficiary: US\$ 700,000
MIF: US\$ 700,000
Total: US\$1,400,000

OBJECTIVES: The project's objective is to create favorable conditions for private sector participation in the sanitation sector in Goiás. The project will develop: (i) an independent self-financing regulatory state agency; (ii) a plan which proposes alternative structures for service provision which would increase private sector participation in the management and provision of sanitary services in Goiás; and (iii) a model B.O.T. agreement using new Brazilian concession legislation.

SCHEDULE OF EXECUTION: Execution 24 months
Disbursement 30 months

SPECIAL CONTRACTUAL CONDITIONS: In addition to the general contractual conditions applicable to this operation, the following special conditions will be included in the agreement.

a. As conditions precedent to the first disbursement of MIF resources, the executing agency must furnish the Bank evidence of the following: (i) that it has hired or appointed the project coordinator; and (ii) the submission of an action plan for program execution.

b. A clause will also be included requiring that the contractor winning the B.O.T. reimburse the MIF for the costs of its development estimated at US\$300.000.

EXCEPTIONS TO BANK POLICY:

None.

I. COUNTRY ELIGIBILITY

- 1.1 On February 9, 1996 the Donors Committee of the Multilateral Investment Fund (MIF) declared the Federal Republic of Brazil eligible for MIF financing.

II. BACKGROUND

A. General framework

- 2.1 By the year 2000 Latin American countries will need US\$115 billion in investment to meet water supply and wastewater treatment goals. In sewage collection and treatment alone Brazil's requirements exceed US\$25 billion, or more than 20% of the continent's needs. Departing from traditional state-run monopolistic models for providing water and sewerage systems, Governments throughout the region are changing policy and regulation in the sector to allow for greater private sector participation.
- 2.2 Brazil's State of Goiás is located in Brazil's Central-Western region. Its 340,000 square kilometers cover 25% of the region and 4% of Brazil's land area. With a population of over 4 million, Goiás is the most populated State in the Western region. Its capital, Goiania, with a metropolitan area of six major municipalities and over 1.2 million inhabitants is the region's largest and fastest growing city.

B. Problems in the sanitation system

- 2.3 Goiás' rapid population growth and the lack of financial resources to keep pace with growth have contributed to continued significant and persistent coverage deficits in water and sanitary services. The Empresa de Saneamento do Estado de Goiás (SANEAGO), the state owned and operated water company, serves more than 90% of the state's population. Service levels are below national averages with 79% of households in the area having potable water (national service levels are 85%) and 35% of households have sewerage connections (as compared to 42% nationally).
- 2.4 Like many of Brazil's state and municipal water companies, resources generated by SANEAGO are not sufficient to keep pace with population growth. Further, with the deteriorating financial condition of many of Brazil's states governments (including Goiás), state resources to finance critical investments in sanitation infrastructure are very limited. A desire for improved efficiency and the recent scarcity of funds for expansion have increased interest in commercial methods and in attracting private capital for sector development. Increased private sector participation is critical to SANEAGO to improve its performance and efficiency as well as to help finance future expansion needs.

- 2.5 SANEAGO's expansion needs include a sewage treatment plant in Goiania. At present only 7% of Goiania's sewage is treated and untreated domestic sewage is dumped directly into one of the State's principal water courses, the Rio Meia Ponte. A preliminary assessment of water quality downstream from the sewage discharge point indicates that the river has a 60 km. stretch with extremely low dissolved oxygen levels and hence very limited ability to sustain aerobic aquatic life.
- 2.6 Taking advantage of Brazil's new concession legislation (see below), SANEAGO has decided to finance the sewage treatment plant through a build-operate-transfer (B.O.T.) concession agreement. Using this agreement as a model for future concessions, SANEAGO would use this mechanism to finance other high priority projects. The company has requested the Bank's financial assistance in developing this first B.O.T. as a prototype.
- C. Private sector participation in the water supply and sanitation sector
- 2.7 In February and March of 1995 Federal legislation (Lei No.8.987/95) was passed which allows municipalities to enter into concession agreements with private companies for the provision of public utility services. To date only two such arrangements have been concluded in the sanitation sector. However, a large number of municipalities in Sao Paulo and Rio de Janeiro are initiating the process of privatizing sanitary services independent of large state water agencies. Several of these efforts are being supported by the BNDES (Banco Nacional de Desenvolvimento) which has a program to lend resources to private investors in the sector.
- 2.8 Problems with the new legislation persist. These problems include the lack of state regulatory frameworks and agencies, and the lack of established norms for concession agreements. The World Bank Water Sector Modernization Project II, scheduled for approval late this year, will develop regulatory frameworks in selected states in Brazil's north and west.
- 2.9 At present SANEAGO is self-regulating, setting its own tariff levels, coverage targets, and efficiency indicators. The only regulatory oversight it receives is effluent standards which are set by the state's environmental agency, the Fundação do Meio Ambiente de Goiás (FEMAGO). Legislation, developed as part of the proposed project, will establish a regulatory agency in the state.

III. PROJECT OBJECTIVES AND BASIC COMPONENTS

- 3.1 The project's objective is to create favorable conditions for private sector participation in the sanitation sector in Goiás, Brazil. This project is intended to complement a future US\$130 million Bank loan for sanitation (BR-0169). The project

will develop: (i) an independent self-financing regulatory state agency; (ii) a study which proposes alternative structures for service provision which would increase private sector participation in the management and provision of sanitary services in Goiás; and (iii) a model B.O.T. agreement using new Brazilian concession legislation as a basis. It is anticipated that the development of a sound regulatory framework, a plan for enhancing private sector participation, and a "bankable" concession agreement will greatly facilitate participation by the private sector in the financing of sanitation infrastructure in Goiás.

A. Independent state regulatory agency (US\$250,000)

- 3.2 For the development of an independent self regulating agency, the proposed project will finance technical assistance from a consulting firm to: (i) prepare the regulatory framework; (ii) develop quality standards for service; and (iii) start-up and strengthening of the regulatory agency.

1. Preparing the regulatory framework (US\$100,000)

- 3.3 Sector regulations essential for setting up the regulatory agency will be defined. This task will include: defining roles for entities operating in the sector; developing regulations for concessions including principles and procedures for granting concessions; establishing criteria and procedures for tariffs; defining rights and obligations of service providers; and creating regulations on violations and penalties. The framework will be prepared in the form of legislation.

2. Quality standards for service (US\$100,000)

- 3.4 Rate guidelines (tariff policy) and quality standards for service will be defined. This task will include gathering and organizing of existing regulations, recommendations of new standards as necessary, and definition of parameters, and criteria.

3. Regulatory agency start-up and strengthening (US\$50,000)

- 3.5 This task will define the administrative structure of the agency including its organization, functions, staff requirements and budget. It will also develop information systems including models for evaluating operation of service providers. It will also provide in-country training for regulatory agency staff.

B. A plan for increased private sector participation (US\$100,000)

- 3.6 To complement the creation of a regulatory agency, the project will finance the development of a plan for improving the efficiency of water and sanitation service provision in the state of Goiás. The plan, which will be developed by an international consulting firm, will evaluate the possibility of regionalizing and decentralizing service provision and suggest actions to be taken in order to

increase participation of the private sector in investment, management, stock acquisition, and through concessions. The plan will include specific measures to: (i) increase coverage levels; (ii) decrease costs of service; (iii) improve service quality; and (iv) improve compliance with environmental legislation.

C. Model B.O.T. agreement (US\$300,000)

- 3.7 For a B.O.T. concession the proposed project will finance technical assistance for studies and preparatory work to bid and award a B.O.T. concession for a wastewater treatment plant for Goiania including: (i) designs and standards to be reflected in bidding documents; (ii) preparation of bidding documents including draft contracts; (iii) support to SANEAGO in the evaluation and selection of private investors proposals; and (iv) support to SANEAGO in the contract negotiation process. The MIF agreement will be structured so that negotiation costs will be reimbursed to the MIF by the winner of the concession after the agreement is signed.
- 3.8 The proposed technical assistance for development of the B.O.T. will help ensure that: (i) high quality bidding documents and bidding selection criteria are developed; (ii) a well structured and transparent bidding process and selection process is undertaken; and (iii) investor confidence is increased thereby attracting participation of qualified investors and enhancing competition.

D. Project coordination

- 3.9 Financing is included for a consultant to assist SANEAGO and the Secretaria de Recursos Hidricos coordinate program activities. Specific tasks to be carried out will include: developing final terms of reference; preparing bidding documents; coordinating the selection of consultants; and overseeing implementation of consultants' recommendations.

E. Cost and financing

- 3.10 Total program costs are US\$1,400,000 of which the MIF is being asked to finance US\$700,000. SANEAGO and the State will contribute the equivalent of US\$700,000 or 50% of project costs. The State's contribution will be used to hire local personnel, office space, and for direct financing of some of the activities. A summary of costs by subprogram is furnished in the following table.

	In US\$ 000		
	MIF	LOCAL SUPPORT	TOTAL
<u>REGULATORY FRAMEWORK</u>			
Diagnosis	50	--	50
Development of Legislation	50	50	100
Proposal Development	50	50	100
Establishment of Agency	50	180	230
Training and Technical Assistance in Execution	<u>50</u>	<u>85</u>	<u>135</u>
Subtotal	250	365	615
<u>PRIVATE SECTOR PARTICIPATION PLAN</u>			
Diagnoses	75	25	100
Plan	<u>25</u>	<u>10</u>	<u>35</u>
Subtotal	100	35	135
<u>B.O.T DEVELOPMENT</u>			
Diagnoses/Bid documents	200	250	450
Evaluating Proposals	50	25	75
Contract Negotiation	<u>50</u>	<u>25</u>	<u>75</u>
Subtotal	300	300	600
Contingencies	<u>50</u>	<u>0</u>	<u>50</u>
Subtotal	50	0	50
GRAND TOTAL	700	700	1400

F. Execution

- 3.11 The project will be executed jointly by the Secretaría de Recursos Hídricos and SANEAGO. A working group to oversee development of the program has been established in SANEAGO composed of staff from the Secretaría, FEMAGO, and SANEAGO. It is anticipated that this technical cooperation will require 18 months for execution. The project will be considered complete when the new regulatory mechanism is in place, a plan for broader private sector participation in the sector is complete, and financial closing of the project is achieved. It is anticipated that this project will be approved in advance of the proposed loan so that bidding the B.O.T. and development of the regulatory framework are well underway when the loan is approved.
- 3.12 The hiring of consultants will be conducted in accordance with Bank and MIF procedures. The coordinator will be contracted individually. Two specialized consulting firms will be used to perform other program tasks. One firm will develop the regulatory framework and develop the plan for increased private sector participation. A second firm will be contracted to develop the bidding documents for the B.O.T. and assist in the negotiations.

G. Disbursements

- 3.13 Grant funds will be disbursed in accordance with Bank procedures, and the procurement of goods and services will be limited to MIF-eligible countries. A revolving fund of 10% will be provided.

H. Supervision

- 3.14 The operation will be supervised by the Bank's Country Office in Brazil. The executing agency will submit quarterly progress reports which contain the following information: (i) progress in drafting and processing local legislation for the regulatory framework; (ii) progress in the implementation of each proposed activity; and (iii) recommendations for reallocating resources among cost items without altering the financial conditions or increasing the amount of financing. The executing agency will submit its final report within three months of project completion. The report will summarize all activities conducted and achievements.

I. Environmental considerations

- 3.15 Within the water sewerage masterplan, finalized in December 1997, a model has been developed to determine the carrying capacity of the Rio Meio Ponte. This model will be calibrated to determine appropriate standards/treatment levels for the plant. The contractor will follow Brazil's rigorous environmental licensing legislation in development of the design and construction of the plant.
- 3.16 The Profile was reviewed by the CESI on March 30, 1998. The CESI requested that the terms of reference for developing the regulatory framework incorporate environmental aspects.

J. Special contractual conditions

- 3.17 As a condition precedent to the first disbursement, the executing agency will present to the Bank: (i) evidence that it has hired or appointed the coordinator; and (ii) a detailed plan of activities for carrying out the program. A clause will also be included requiring that the contractor winning the B.O.T. reimburse the MIF for the costs of its development estimated at US\$300,000.

IV. BENEFITS AND RISKS

- 4.1 Implementation of this program will establish the legal, institutional and technical framework for increasing private sector participation in the water and sanitation sector in Goiás. Additionally, it will improve the efficiency and quality of service delivery through modifying the existing structure to facilitate increased private sector participation. Finally, by financing B.O.T. preparation, it will facilitate construction of the Goiânia sewage treatment plant while at the same time develop a model B.O.T. agreement future use in the state.
- 4.2 In Brazil's sanitation sector, the process of establishing regulatory frameworks and increasing private sector participation

in service delivery have been hindered by a series of bureaucratic, legal, and labor related obstacles. Although the state of Goiás has indicated a strong interest in moving forward with this activity, there is the possibility that its execution could suffer unforeseen delays.

V. FULFILLMENT OF ELIGIBILITY CRITERIA

- 5.1 This operation is consistent with the MIF's objectives to expand the private sector's role with priority given to projects which support the expansion of private sector investment in infrastructure.
- 5.2 The proposed project is also consistent with specific criteria for eligibility of projects, specifically Article II, Section 2 (d) of the MIF agreement which specifies the financing of technical assistance for privatization.
- 5.3 The line of activity for concessions has not been used to finance the B.O.T. as a separate activity because of the need to integrate development of the regulatory framework financed by the program with development of the B.O.T.

VI. CONSISTENCY WITH THE BANK'S STRATEGY FOR THE COUNTRY

- 6.1 The Bank's country strategy is focussed on: (i) promoting the reform and modernization of the public sector both at the Federal and state levels; (ii) supporting the process of modernization of the productive sectors; and (iii) addressing the socio-economic inequities and poverty alleviation by increasing the effectiveness of social spending, with priority given to programs designed to improve the quality as well as the coverage of services in education, health and nutrition, and potable water supply and basic sanitation.
- 6.2 The strategy for the sector emphasizes modernization of the legal institutional framework to improve service delivery, expand coverage, and foster private sector participation. The creation and strengthening of independent regulatory agencies and the administrative and financial improvement of local utilities delivering service are key elements of this strategy.

EXPECTED RESULTS

General objective of the program: create favorable conditions for private sector participation in the sanitation sector in Goiás.

COMPONENTS	ACTIVITIES	EXPECTED RESULTS
I. <u>Independent regulating agency</u>	<p><u>Preparing the regulating framework</u></p> <ul style="list-style-type: none"> - Specialized consulting firm to prepare the regulatory framework including: defining roles for entities operating in the sector; developing regulations for concessions including principles and procedures for granting concessions; establishing criteria and procedures for tariffs; defining rights and obligation of service providers; and creating regulations on violations and penalties. <p><u>Defining rate structure and quality of standards for service</u></p> <ul style="list-style-type: none"> - Consulting for the design of rate policies, economic costs and rate guidelines. - The same consulting firm will define quality standards for service. The task will include gathering and organizing of existing regulations, recommendations of new standards as necessary, and definition of standards, parameters, and criteria. <p><u>Regulatory agency start up</u></p> <ul style="list-style-type: none"> - This task will define the administrative structure of the agency including its organization, functions, staff requirements and budget. It will also develop information systems including models for evaluating operation of service providers. Finally, in-country training for regulatory staff will be provided. 	<ul style="list-style-type: none"> - Institutional framework developed 6 months from signature of the contract. New legislation presented in 7 months. - Rate policy and guidelines established in 6 months. - Internal manual and operational procedures. Length of consulting approximately 3 months. - Information systems developed and implemented in approximately 4 months. - Guidelines for organizations responsible for providing these services, specially in the areas of sanctions and other related regulations. Length: approximately 4 months. - Hardware and software acquired and installed during executing of subprogram III. Length 1 month. - Human resource training. 7 months.
II. <u>Plan for Increased Private Sector Participation</u>	<ul style="list-style-type: none"> - Plan for SANEAGO's restructuring to allow for more private sector participation 	<ul style="list-style-type: none"> - Plan with specific recommendations in four months.
III. <u>Development of a Model B.O.T. Agreement</u>	<ul style="list-style-type: none"> - Development of financial, regulatory, legal, technical, environmental diagnosis and designs (6 months). - Development of bidding documents and contracts (2 months). - Support in evaluation (2 months). - Support in negotiation (2 months). 	<ul style="list-style-type: none"> - Contractor for treatment plant selected. - Model B.O.T. agreement developed.

PROPOSED RESOLUTION

**BRAZIL. NON REIMBURSABLE TECHNICAL COOPERATION PROGRAM FOR
A SANITATION REGULATORY FRAMEWORK AND CONCESSION DEVELOPMENT
FOR THE STATE OF GOIAS**

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the State of Goias of the Federative Republic of Brazil and to adopt such other measures as may be pertinent for the execution of the plan of operations referred to in Document MIF/AT-_____ with respect to a technical cooperation, the purpose of which is to create a sanitation regulatory framework and concession development for the State of Goias.
2. That up to the amount of US\$700.000 is authorized for the purpose of this resolution, chargeable to the Technical Cooperation Facility of the Multilateral Investment Fund.
3. That the above mentioned sum is to be provided on a non-reimbursable basis.