

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**PERU**

**SANITATION SECTOR REFORM PROGRAM III**

**(PE-L1057)**

**LOAN PROPOSAL**

This document was prepared by the project team consisting of: Carmiña Moreno (INE/WSA), Project Team Leader; Henry A. Moreno (INE/WSA), Alternate Project Team Leader; Efraín Rueda (INE/WSA); Diego Buchara (LEG/SGO); and Cynthia Nuques (INE/WSA).

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Electronic Links	
<b>REQUIRED</b>	
1.	Link A – Policy Letter <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2211123">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2211123</a>
2.	Link B – Means of Verification Matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2151083">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2151083</a>
3.	Link C – Results Matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2152246">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2152246</a>
4.	Link D – Independent Macroeconomic Assessment <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2152250">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=2152250</a>

## ABBREVIATIONS

DNEP	Dirección Nacional del Endeudamiento Público [National Public Debt Department]
DNS	Dirección Nacional de Saneamiento [National Sanitation Department]
EPS	Empresas prestadoras de servicios municipales de agua y saneamiento [municipal water and sanitation service provider(s)]
FONAVI	Fondo Nacional de Vivienda [National Housing Fund]
INVERSAN	Fondo de Inversión en Saneamiento [Sanitation Investment Fund]
Kfw/GTZ	Kreditanstalt für Wiederaufbau / German Agency for Technical Cooperation
MEF	Ministerio de Economía y Finanzas [Ministry of Economy and Finance]
MINAM	Ministerio del Ambiente [Ministry of Environmental Affairs]
MAV	Maximum admissible value
MVCS	Ministerio de Vivienda, Construcción y Saneamiento [Ministry of Housing, Construction, and Sanitation]
OMP	Optimized Master Plan
PAPT	Programa Agua Para Todos [Water for All Program]
PEE	Plan de Estímulo Económico [Economic Stimulus Plan]
PNS	Plan Nacional de Saneamiento [National Sanitation Plan]
PPP	Public-private partnership
ProInversión	Agencia de Promoción de la Inversión Privada [Private Investment Promotion Agency]
RSP	Planes regionales de saneamiento [regional sanitation plans]
PRSS	Programa de Reformas del Sector Saneamiento [Sanitation Sector Reform Program]
PSP	Participación del sector privado [private sector participation]
SEDAPAL	Servicio de Agua Potable y Alcantarillado de Lima [Lima Water and Sewer Utility Company]
SFC	Sistema Nacional de Fortalecimiento de Capacidades en Agua y Saneamiento [National Water and Sanitation Capacity-building System]
SIAS	Sistema de Información de Agua y Saneamiento [Water and Sanitation Information System]
SISFOH	Sistema de Focalización de Hogares [Household Targeting System]
SUNASS	Superintendencia Nacional de Servicios de Saneamiento [National Superintendency of Sanitation Services]
UCPS	Unidad de Coordinación de Préstamos Sectoriales [Sector Loan Coordination Unit]
VMCS	Viceministerio de Construcción y Saneamiento [Office of the Deputy Minister for Construction and Sanitation]

## PROJECT SUMMARY

### PERU SANITATION SECTOR REFORM PROGRAM III (PE-L1057)

Financial Terms and Conditions				
<b>Borrower:</b> Republic of Peru			<b>Amortization period:</b> 20 years	
<b>Executing agency:</b> Ministry of Economy and Finance (MEF)			<b>Grace period:</b> 5 years	
			<b>Disbursement period:</b> 12 months	
<b>Source</b>	<b>Amount</b>	<b>%</b>	<b>Interest rate:</b> LIBOR	
IDB (Ordinary Capital):	US\$20 million	100%	<b>Inspection and supervision fee:</b> *	
			<b>Credit fee:</b> *	
Total:	US\$20 million	100%	<b>Currency:</b> Single Currency Facility <b>Option for conversion into Peruvian new soles:</b> Local Currency Facility (LCF)	
Program at a Glance				
<p><b>Program objective:</b></p> <p>The program's objective is to contribute to improve the efficiency, equity, and sustainability of water and sanitation services in Peru. The objective of this third and final operation in the programmatic policy-based series is to implement the structural, institutional, legal, and regulatory reforms in the following areas: (i) <i>sector institutional framework</i>, which requires the setting of investment targets and priorities at the regional level and at the level of the regional and municipal water and sanitation service providers (EPS), technical and management capacity-building for the Dirección Nacional de Saneamiento [National Sanitation Department] (DNS) and the Superintendencia Nacional de Servicios de Saneamiento [National Superintendency of Sanitation Services] (SUNASS), and the development of a regulatory framework for services in small communities; (ii) <i>financial policy</i>, which should establish objective criteria for allocation of public resources and effectively restructure EPS financial liabilities; (iii) <i>rate policy</i>, which should simplify rate structures, target subsidies, adjust rates to inflation, and incorporate the concept of environmental costs; (iv) <i>EPS management</i>, which requires good corporate governance practices and reporting by operators, as well as strengthening the training system for operations and management; and (v) <i>private sector participation</i>, which requires the development of a single promotion strategy, a methodology for raising awareness and communications in each process, and optimization of the process for structuring public-private partnerships (PPPs).</p> <p>This program is consistent with the sector challenges described in the Bank's Water and Sanitation Initiative (document GN-2446-3), particularly the Efficient and Transparent Utilities component, given its support for the consolidation of a policy, institutional, and regulatory environment that promotes efficiency and equity (see paragraph 2.2).</p> <p><b>Special contractual conditions:</b> See Policy, Results, and Means of Verification Matrixes, as well as the Policy Letter, Chapter V (see paragraph 5.1).</p>				
<p><b>Project consistent with country strategy:</b>    Yes [ <input checked="" type="checkbox"/> ]        No [ <input type="checkbox"/> ]</p>				
<p><b>Project qualifies as:</b>                                    SEQ [ <input checked="" type="checkbox"/> ]        PTI [ <input type="checkbox"/> ]    Sector [ <input type="checkbox"/> ]        Geographic [ <input type="checkbox"/> ]        Headcount [ <input type="checkbox"/> ]</p>				
<p><b>Procurement:</b> Not applicable because this is a policy-based loan program.</p>				

\* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

## I. CONTEXT AND PROGRESS

### A. Program context

- 1.1 This document presents the third and final loan operation in a programmatic series of three consecutive, independently-financed but technical interrelated one-tranche programmatic policy-based loans pursuant to document CS-3633. The Bank approved the first operation in this series (loan 1920/OC-PE) in November 2007, and the second (loan 2049/OC-PE) in November 2008. The proposal for the first operation is the framework document for the programmatic series (document PR-3202) and this document updates, supplements, and follows on that proposal, in accordance with memorandum EVP/1/2006 (PO-LO-2006).
- 1.2 **The Sanitation Sector Reform Program (PRSS)** is intended to improve the efficiency, equity, and sustainability of water and sanitation service delivery. The PRSS was based on a structured process of sector analysis, dialogue, consultation, and consensus on the diagnostic assessment, and actions with civil society, service providers, the donor community, and the other stakeholders involved, led by the Dirección Nacional de Saneamiento [National Sanitation Department] (DNS) with support from one of Peru's most prestigious universities, in a process that included a series of workshops with the parties involved, interviews with a large number of operators, and surveys, during the whole of the programmatic operation. After the sector diagnostic assessment identified the sector's main challenges, the problems and their causes were analyzed, reforms prioritized, and the overarching reform concept was designed.
- 1.3 **Prioritization of reforms.** As a result of this process, the Peruvian government prioritized a series of reforms in five areas: (i) the *sector's institutional framework*, which seeks to build the capacity of sector institutions and improve regional planning capacity; (ii) *financial policy*, which seeks to establish objective criteria for allocation of public resources and improve the financial condition of municipal water and sanitation service providers (EPS); (iii) *rate policy*, intended to simplify rate structures, target subsidies, and incorporate the concept of environmental costs; (iv) *EPS management*, which seeks to institute good corporate governance practices and reporting by operators; and (v) *private sector participation*, which seeks to optimize the process for structuring public-private partnerships (PPPs).
- 1.4 With the policy measures adopted in the first programmatic operation (loan 1920/OC-PE) mechanisms were established to enable optimum, equitable use of investment resources, and maximize return on the investment. Policy instruments were also designed that contributed to improvements in governance, transparency, and accountability of service providers, and strengthened corporate decision-making to ensure the long-term sustainability of service delivery. The operational capacities of the apex agency and regulatory authority were also strengthened in order to support effective execution of government programs, a regulatory framework was established for small cities and rural areas, and the rate system was adjusted to make service delivery more efficient and sustainable, through the approval of over six optimized master plans (OMPs) and rate formulas. Lastly,

policy guidelines have been established for linking specialized operators in order to improve service provider management.

- 1.5 With the second programmatic operation (loan 2049/OC-PE), the process of reforming the regulatory framework continued, and the reforms designed in the first operation were implemented. Specifically, the framework for sector organization in small- and medium-sized communities was developed, the rate and subsidy framework was improved to promote cost recovery, efficiency and equity, and streamlined procedures, five regional sanitation plans were begun, and eligibility criteria were set for the allocation of resources. The transparency and institutional sustainability of operators was enhanced through the signing of 15 operation contracts, and a national strategy for private sector participation (PSP) and a process methodology was identified to optimize the use of preinvestment resources, processing time, and compliance with legal requirements.
- 1.6 As a result of progress in the reforms, coordination among the different sector entities, the priority of the sector for the present government, and the need to intensify work on certain aspects and to include others not covered by the PRSS, the government has asked the Bank to support the structuring and financing of a possible second generation of reforms for the sanitation sector, which would also be a programmatic operation, preparation of which will begin during the last quarter of this year.

## **B. Macroeconomic framework**

- 1.7 Responsible macroeconomic management over a number of years has made it possible to implement countercyclical policies to address the current international economic conditions. GDP grew on average by 6.2% during the period 2002-2007, accelerating to 9.8% in 2008, its highest level since 1994. In recent years, the economic expansion was driven by domestic demand, although that has weakened in the last few months. Urban employment in companies with 10 or more employees tended to grow, reaching 8.3% in 2008. Total poverty declined from 48.7% in 2005 to 36.2% in 2008 although inequality grew in the country's interior.
- 1.8 When the economy was expanding, the government consolidated public finances and saved resources, which enabled it to implement an Economic Stimulus Plan (PEE) to cushion the impact of the crisis (some 3% of GDP).<sup>1</sup> The fiscal position improved from a deficit to 2.3% of GDP in 2002 to a surplus of 3.1% in 2007. The fiscal balance stayed in surplus during 2008 at 2.1% of GDP. The external public debt fell from 36.5% to 15.1% of GDP between 2002 and 2008, down to sustainable levels. The risk rating agencies DBRS, Fitch, and Standard & Poor's have upheld Peru's investment grade in 2009. The country risk is among the lowest

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<sup>1</sup> The PEE seeks to build infrastructure, support the private sector, and protect the vulnerable population. The execution period covers 2009 and 2010. However, the pace of execution so far has been slow.

- in the region (243 basis points as of 24 August). On two occasions so far this year, the Peruvian government held successful international bond issues for US\$1 billion.
- 1.9 Inflation was 6.7% in 2008, which is higher than the target range owing to the rise in international food and fuel prices, and growth in domestic demand. The Central Reserve Bank cut the benchmark interest rate in 2009 by 525 basis points. In 2008 the current account recorded a deficit of 3.3% of GDP, owing to worsening terms of trade and a significant rise in imports. The source of financing for the external deficit was mainly long-term foreign capital flows. In 2008, the new sol depreciated against the U.S. dollar by 4.5%, and in 2009 the trend has shifted from appreciation at the start of the year to slight depreciation. Net international reserves were US\$32 billion at 18 August 2009.
- 1.10 Projections are for GDP growth in 2009 of between 2% (consensus forecast) and 2.5% (official figures). A sustainable fiscal deficit of 2% of GDP is anticipated for the year. Public sector external financing requirements for 2009 and 2010 will be US\$2.620 billion and US\$2.055 billion, respectively. More than half will be fast disbursing. Last, the macroeconomic conditions and policy actions to address the international financial crisis are consistent with a stable macroeconomic framework. However, certain sociopolitical vulnerabilities exist that might worsen in the medium term, in a context of frequent social conflicts and scant public support for political institutions. Also, the subnational elections in 2010 and the national elections in 2011 could contribute to economic uncertainty.

### **C. The water and sanitation sector**

- 1.11 **Conditions in the sector.** According to the 2006-2015 National Sanitation Plan (PNS), water (76%) and sanitation (57%) service coverage in Peru are below the regional average (91% and 77%, respectively), according to WHO-UNICEF. The diagnostic assessment of the PNS shows that water service continuity is on average 17 hours/day, while 37% of service providers report continuity below 12 hours/day. EPS report a high level of unmetered water (46%), inactive connections of approximately 23%, average payment arrears of five months, and rates not high enough to cover the actual costs of service (17% operating margin, not including SEDAPAL). In rural areas, of a sample of 1,630 systems studied, 59% do not disinfect water because they lack the necessary system or inputs. In this context, service is unreliable and unsustainable, and the likelihood of failing to meet the Millennium Development Goals is high. This situation is caused mainly by problems relating to the sector's institutional framework, financial policy, rate policy, EPS performance, and the PSP strategy.
- 1.12 **The main challenges of the sanitation sector** The sector diagnostic assessment identifies the following main challenges: (i) strengthen systems for investment planning and quantification of regional needs; (ii) institute a regulatory system for small cities and rural areas; (iii) strengthen the operating and management capacities of the DNS and SUNASS; (iv) devise government financing and intervention arrangements through transparent and uniform rules that promote



efficient management; (v) strengthen the financial capacity of service providers; (vi) promote a rate policy that enables service providers to cover their operating costs and finance long-term capital investments, (vii) target subsidies to poor users; (viii) educate and train service providers in how to formulate OMPs; (ix) strengthen the technical and administrative capabilities of service providers to deliver services efficiently; (x) formalize contractual obligations (rights and obligations) between service providers and the municipios for service delivery; (xi) strengthen the operational autonomy of service providers that may be vulnerable to political interference, and (xii) promote the development of public-private coparticipation arrangements so that specialized operators can provide efficient services.

**D. The Bank's strategy and coordination with other financing agencies**

- 1.13 **The Bank's country strategy with Peru.** This program is consistent with the new country strategy (document GN-2472-2) and its areas of major focus: (i) raising the economy's productivity and competitiveness; (ii) improving the efficiency of social policy; and (iii) creating a modern, decentralized, and efficient State. The PRSS supports the main elements of this strategy given that the proposed reforms will optimize investments in a social sector such as water and sanitation, promote joint participation by the public and private sectors at the national and subnational levels, and support the municipalities in the context of the decentralization process.
- 1.14 **Coordination with other financing and cooperation agencies.** This operation is the result of joint work between the Peruvian government, Kreditanstalt für Wiederaufbau (KfW), the German Agency for Technical Cooperation (GTZ), and the Bank within the sector policy framework. During program preparation, both KfW and the Bank financed consulting projects for the government to conduct the studies required to meet the commitments of this third programmatic operation. KfW will also support the reforms planned under this program with a parallel loan to the Peruvian government. The results of the PRSS were shared with the community of agencies, such as the World Bank, the Japanese Bank for International Cooperation, and the Andean Development Corporation (CAF).

## **II. THE PROGRAM**

**A. Objectives**

- 2.1 The objective of the program is to contribute to improve the efficiency, equity, and sustainability of water and sanitation services in Peru through support for a series of actions. These actions are calculated to achieve resource allocation based on efficiency criteria that maximize the benefits to the country while observing equity criteria, to achieve greater efficiency in service management by service providers, to bring about self-sufficiency for these entities, and to lay the foundations of equitable, universal coverage. The objective of this third and final operation in the programmatic series is to implement the reforms of the earlier operations, in order to achieve better resource allocation based on efficiency criteria that maximize the benefits to the country while observing equity criteria, as described above.

- 2.2 **The program and the Bank's Water and Sanitation Initiative.** This program is consistent with the sector challenges described in the Bank's Water and Sanitation Initiative, particularly the Efficient and Transparent Utilities component, given its support for the consolidation of a policy, institutional, and regulatory environment that promotes efficiency and equity.
- 2.3 With regard to the policy applicable to policy-based loan operations, the program satisfies the following conditions: (i) the reforms stem from an analysis of sector issues, supported in part by the Bank, which included an evaluation of alternative solutions; (ii) it promotes better linkage between programs and policies implemented as government policies in recent years; (iii) it addresses the country's institutional capacity and ability to implement reforms and includes instruments to strengthen that capacity and achieve results; and (iv) it focuses on areas of strategic importance in terms of impact on social development. The programmatic structure is warranted by: (i) the complex nature of the reforms; (ii) the timeframe to implement them; (iii) the need to explain and publicize the reforms; (iv) the need to ensure continuity; (v) the complexity of the institutional setting; and (vi) the flexibility required to adjust the policy reforms and commitments of subsequent programmatic operations in response to progress achieved.

## **B. Components**

- 2.4 The objective of each component, the policy conditions for disbursement of the resources for this third operation, and the adjustments made to the reform program established under the first programmatic operation, are described below. The fulfillment status of the policy commitments for this programmatic loan are presented in the Means of Verification Matrix (see electronic link B).
- 2.5 **Component I – Macroeconomic stability.** The objective of this component is to continue ensuring a macroeconomic environment in keeping with program objectives and with the main points of the sector policy letter.
- 2.6 **Component II – Institutional framework of the sector.** The objective of this component is to improve sector planning and organizational instruments, and to create incentives for the efficient management, operation, and administration of service providers in small- and medium-sized communities. This component includes the following activities:
- (i) *Investment planning.* The objective of this activity is to provide the government with a region-based sector planning instrument, based on a needs analysis of each service, and a tool for prioritizing interventions efficiently and equitably, so that the country can move forward in meeting the Millennium Development Goals. To meet the objectives of this third programmatic operation, the following policy conditions have been met: (a) updating of the PNS has begun, (b) a ministerial decision has been issued, approving the RSP [regional sanitation plan] methodology, and plan for its implementation has been adopted; and (c) the Water and Sanitation Information System (SIAS) is up and

running. To update the PNS, a sector diagnostic assessment was done of investments and service coverage, progress in sector policy considering reforms to the legal, regulatory, and public policy framework, including progress in the PRSS, and guidelines were presented for the new PNS along with an action plan for updating it in 2010. Nonetheless, the approved PNS will not be obtained as an outcome of the present programmatic operation, given that, during the process of preparing the PNS, Legislative Decree 1088 was issued (“Act Establishing the National Strategic Planning System and National Strategic Planning Center”), which meant that work had to be done on coordination, consensus-building, and public education. With regard to the RSPs, following the methodology that had been developed earlier, the Ministry of Housing, Construction, and Sanitation (MVCS) prepared five regional pilot plans, thereby meeting the commitment for the programmatic series. Based on that experience and documentation of the outcomes, the methodology has been established for implementing the RSPs. Lastly, to support sector planning using the SIAS designed under the two earlier programmatic operations, the SIAS was implemented for this operation, with security protocols for the handling of confidential information on service providers and a reporting system in operation, subject to verification by SUNASS and signature of a technical-cooperation agreement for the exchange and documentation of information between SUNASS and the MVCS.

- (ii) *Legislative framework for operators in small communities.* The objective of this activity is to improve conditions for efficient, sustainable sanitation services in small communities and rural areas through the establishment of a system for regulation, supervision and rates, and minimum criteria for the contracting of small- and medium-sized enterprises. As policy measures for this third operation, the regulatory arrangement for small sanitation companies and the regulatory arrangement for small communities are being instituted, and the new contracting system is being introduced for specialized operators for small cities, with a plan to implement the new regulatory model. Although the first programmatic operation called for these regulatory arrangements to be applied to 50 new small sanitation utilities, and the system for contracting of specialized operators for small- and medium-sized communities was expected be applied to 15 new operators, these targets were reset in the second programmatic operation because the analyses gave rise to a subdivision within the regulatory arrangements applicable to the utilities<sup>2</sup> and an agreement on

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<sup>2</sup> At companies serving more than 40,000 inhabitants, from 15,000 to 40,000 inhabitants, and from 2,000 to 15,000 inhabitants

the definition of provider regulatory and supervisory functions within a group of companies that previously had not been performed by any institution. These new tasks<sup>3</sup> delayed implementation of this model at the utilities in each range. Nevertheless, the measures under this third operation bridge the regulatory gap for this range of service providers, who serve more than one third of the country's population, and will provide a framework of conditions for service efficiency and operation that allows performance and the quality of services delivered to users to be evaluated without jeopardizing fulfillment of the objective set in the operation for this measure.

- (iii) *Institution-strengthening.* The objective of this activity is to improve the management capacity of the apex agency (DNS), the Water for All Program (PAPT), and the Sanitation Investment Fund (INVERSAN), as well as the operational capacity of the regulatory authority (SUNASS). To attain these objectives, it was agreed that this third programmatic operation would implement the new organizational structures of the DNS and the PAPT, approve the PAPT operations manual, and implement the institutional strengthening plan for SUNASS. The PAPT has been consolidated as an investment project execution unit with its own administrative management office, enabling it to focus on and streamline the development of investment projects and the transfer of investment resources. The DNS, in turn, has been restructured to efficiently conduct sector planning, policy development, investment program design, and monitoring and supervision. SUNASS has strengthened its institutional capabilities in the areas of supervision, enforcement and sanctions, rate-setting, consolidation of its institutional image, and administrative and human resources management. For INVERSAN, the terms of reference are ready for contracting the core team to commence operation, including the members of the board of directors, budget allocations have been approved for 2010, and the instruments have been issued to make it fully operational.

**2.7 Component III – Financial policy.** The objective of this component is to establish objective criteria for allocation of public resources, and to restructure EPS financial liabilities. The component includes the following activities:

- (i) *Investment financing.* The objective of this activity is to improve the public resource allocation and incentive system for operators, contributing to service efficiency and sustainability. As policy measures for this third operation, the resource allocation systems and

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<sup>3</sup> The tasks included several studies to develop the new arrangement, approval of a supreme decree, and the allocation of resources to perform the new functions.

the incentive policy to access investment financing are in the implementation process. Based on progress in the second operation, during which Ministerial Resolution 693-2008-VIVIENDA was issued, adopting criteria for the allocation of resources, a competition was announced in 2009, and in this third operation the MVCS is expected to report on the results of applications for the 2010 PAPT resource allocation. INVERSAN was created to supplement the system. On the basis of consultant studies commissioned under this operation, a ministerial resolution will be issued approving INVERSAN's general manual of operations, and its board of directors is expected to approve the fund's operating regulations and functions (ROF and CAP), whereupon it will be able to commence operations with the principal responsibility of channeling funds into the sector in 2010. The expected development outcome is a transparent, efficient, and equitable public resource allocation system that maximizes the economic return on government investments and helps operators to become efficient and provide sustainable services.

- (ii) *EPS debt profile.* The objective of this activity is to make the EPSs creditworthy. As a policy measure for this third operation, it was agreed that the process of restructuring the liabilities of the EPSs, specifically the debt with FONAVI, would be under way. The means of verification was to be the preliminary draft of a bill prepared by the Council of Ministers. The MVCS is in the process delivering this, and the measure is expected to be completed before the loan proposal is considered by the Board of Executive Directors. Regarding the target set in the first programmatic operation for debt restructuring to have been implemented at two EPSs for the second programmatic operation, and at two more for the third, the complexity of the reform identified in preparation of the second programmatic operation led to an adjustment of the measures for the second and third operations to reflect the agreements necessary between the MEF and the MVCS and the political process of debating the reform in Congress. Considering the implications and the expected development outcome of improving the debt profiles of the EPSs to make them creditworthy, work on this policy measure will continue in the next phase of the sanitation sector reform program that the Peruvian government has requested from the Bank, beginning in 2010.

2.8 **Component IV – Rate policy.** The objective of this component is to contribute to the rate and subsidy framework promoting cost recovery, efficiency, and equity, and streamlined procedures for responding to rate applications by the EPSs. This component includes the following activities:

- (i) *Rate structure and level.* This activity would enable companies to become financially self-sustaining in the long term with rates based on

real costs that include environmental costs, and universal service delivery. The following measures were agreed upon for this third operation: (a) the rate adjustment regulations for EPSs without an approved optimized master plan (OMP) will be modified, and an incentive proposal prepared to promote compliance with this regulation, since by law the EPSs cannot be required to comply retroactively; (b) the EPS rate structure will be reorganized into residential, low-income, commercial, industrial, and government categories; (c) SUNASS will approve the proposed subsidy system, including adjustments in the regulatory framework and the implementation plan; (d) SUNASS will approve the design of a regulatory accounting system for segregating charges for different services; (e) the regulations on maximum admissible values (MAVs) for discharges of industrial waste into the sewer system will be approved; (f) SUNASS will approve the methodology for charging for industrial discharges into the sewer system based on pollution factors; and (g) SUNASS will approve the rate regulations, incorporating the cost of using water sources and residential waste discharges into the structure of the OMPs. All planned measures have been completed as of the negotiation date for the operation, with the exception of submission of the MAV regulations to the Council of Ministers. These are expected to be sent prior to approval of the loan proposal by the Board of Executive Directors. Regarding the measures included in the first programmatic operation, although the system of subsidies could not be implemented in this third operation, given the complexity and impact of this measure, the subsidy system approved by SUNASS<sup>4</sup> and the work plan for its adoption and implementation during 2010 include a plan to explain and discuss it extensively with the EPSs and user representatives throughout the country. The objective of this component is not compromised, since this component will be part of the second generation of the reform program.

- (ii) *Rate approval process.* The purpose of this activity is to streamline the processing of the EPS optimized master plans (OMPs). The expected development outcome is to have service providers that are financially self-sustaining in the long term since rates will be based on actual costs, including environmental costs. For this third operation, it was agreed

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<sup>4</sup> The proposed system utilizes the Sistema de Focalización de Hogares [Household Targeting System] (SISFOH) to update the database of users entitled to a subsidy every five years. The EPSs submit a proposal to SUNASS indicating the users to receive subsidies, with verification of the SISFOH system, the amount of the subsidized rate, and who will pay a contribution to cover the subsidies. In the event that the contributions are insufficient for the financial close, the EPSs will ask the municipal and national governments to transfer the necessary resources to make up the difference. The subsidy will be granted solely for subsistence consumption (varying from place to place), not to exceed 15 cubic meters per family.

that SUNASS's board of directors approved the 20 OMPs for EPSs, and rate regulations were approved to include projects with private-sector participation to streamline the rate-setting process and for self-sustaining investments (Rate Regulations for the Inclusion of Projects with Private-Sector Participation). Although there is a difference in the number of companies with OMPs with respect to the number planned in the first programmatic operation, which called for the approval of 30 OMPs, this does not compromise fulfillment of the objective of this component because there are now six additional OMPs, and another 10 are in process, and since this component will be part of the second generation of the reform program.

2.9 **Component V – EPS management.** The objective of this component is to improve the institutional transparency and sustainability of water and sanitation operators. This component includes the following activities:

- (i) *Institution-strengthening.* The objective of this subcomponent is to improve the management, operational, and administrative capacity of water and sanitation services through a National Water and Sanitation Capacity-building System (SFC). The actions identified for this third programmatic operation were that the SFC would begin operating. Evidence of this is provided in sector reports on the inclusion of a “capacity building” line item in the 2010 budget; in the minutes of the National SFC Committee approving the plan of operations for 2009-2010; and in the DNS report presenting the training, technical assistance, and technological innovation programs being conducted under the framework of the SFC. The expected development outcome is for the SFC to offer training to sector agents (DNS, EPS, and operators and service providers).
- (ii) *Management tools.* The objective of this activity is to improve governance, accountability, and institutional sustainability in water and sanitation service management and operation, in order to ensure efficient service delivery based on the transparent allocation of responsibility and accountability, thus reducing EPS vulnerability to adverse political influence. To fulfill the agreed policy conditions for this component, the DNS prepared and approved a plan to implement the manual on accountability and performance by the local governments, when they provide the services directly, and signed 10 additional operating contracts, which include goals, incentives, and penalties, accountability mechanisms, and a code of good corporate governance. Progress was made in developing and approving a monitoring and supervision mechanism on governance at the EPSs. The expected development outcome is for service providers to be less vulnerable to political change, and EPS management and performance to become more transparent.

2.10 **Component VI – Private sector participation (PSP).** The objective of this component is to map out a national strategy for private sector participation and a process methodology that optimizes the use of preinvestment resources, processing time, and compliance with legal requirements by participating entities. This component includes the following activities:

- (i) *PSP promotion criteria and methodology.* The objective of this activity is to promote the sanitation sector's national PSP strategy and to develop a methodology for promoting PSP processes that defines the roles and responsibilities of participating entities. For this third programmatic operation, it was agreed at the time of the second operation that execution of the PSP program would be under way. This measure was fulfilled with the launch of four PSP processes for the provision of water and sanitation services, for which the DNS has contracted consultants to raise awareness for two projects, signature of a contract with a business agent has been proposed to contract an operator to manage water and sanitation services for the EPS Grau in Piura and the consultants have been prequalified to contract a business agent for Pucallpa. Although the first programmatic operation's target of having four PSP processes implemented for this third operation was not met, the activities conducted will make it possible for the PSP processes to follow a methodology that optimizes achievement of its objectives. The objective of this component is not compromised, since this component will be part of the second generation of the reform program.
- (ii) *PSP processes.* The objective of this activity is to optimize PSP processing (streamline and expedite), i.e. the processes for compliance with all legal requirements for the processing and approval of PSP arrangements. PSP has been an important issue for the government, and significant progress has been made in modernizing and adjusting the operating and functional procedures and processes necessary to optimize the PSP processes in the promotion stage. Experiences in the water and sanitation sector and in the promotion of PSP in other sectors have produced results, for example approval of the "Framework Law on Public-Private Partnerships for the Creation of Productive Employment and Rules to Streamline Private Production Processes" and its enabling regulations, supplemented by legislative decrees 1012 of 13 May 2008 and 146-2008 of 9 December 2008. The expected development outcome is for PSP processes to employ a methodology that optimizes compliance with requirements. In addition to these laws and regulations, the Office of the Deputy Minister for Construction and Sanitation (VMCS) has received the consultants' reports and approved the procedure for including specialized operators to provide services in small communities. With this package of laws and regulations, the sector can continue to make progress in promoting PSP in the sector.



### **III. FINANCING STRUCTURE AND RISKS**

#### **A. Costs and financing**

- 3.1 The present operation, which has been designed as a programmatic policy-based loan, will be disbursed in a single tranche of up to US\$20 million, which is expected to be disbursed in November 2009 under the Operational Framework for Lending in Local Currency (documents GN-2365-12 and GN-2365-6). As a programmatic policy-based loan, the proceeds will be disbursed in a single tranche once the loan agreement has been signed and the special and general conditions precedent have been met, according to the means of verification presented in the Verification Matrix (see electronic link B). The amount proposed for the program is justified given the actions and reforms that have been developed and implemented by the government, the continuity of the efforts of government agencies to modernize the sector's legal and institutional framework, the results obtained, and the benefits expected.

#### **B. Borrower and executing agency**

- 3.2 The borrower is the Republic of Peru, and the executing agency is the Ministry of Economy and Finance (MEF), acting through the National Public Debt Department (DNEP), which is responsible for negotiating the operation, and the Sector Loan Coordination Unit (UCPS), which is responsible for technical coordination in connection with program preparation and supervision. The MEF is the executive branch agency that regulates and coordinates all activities concerned with economic and financial matters. Its mission is to formulate, supervise, and evaluate sector policies and plans in line with overall government policy. The present program supports structural policy reforms to enhance the technical capacity of the MVCS, SUNASS, and the Private Investment Promotion Agency (ProInversión).

#### **C. Environmental and social impact**

- 3.3 The evaluation of the potential environmental impact of the operation was performed in keeping with Directive B13 of the Bank's Environmental and Safeguards Compliance Policy. Because this is a programmatic policy-based loan, it is not expected to have any direct adverse impact on the environment or natural resources, since no physical investments will be financed, and the measures established as conditionalities are designed to promote more rational management of water and sanitation services, seeking to avoid the adverse impact generated in the past due to the absence of a comprehensive vision. Also, given the nature of the actions supported, the program will have no direct or indirect adverse impact on indigenous populations. Because of the positive effects of improvements in the allocation of subsidies for water and sanitation services and the creation of more transparent and equitable rules for the allocation of public resources, this operation qualifies as social equity enhancing program.

**D. Key issues and risks**

- 3.4 Proper implementation of the proposed structural changes takes time and demands close coordination between entities. Several of the areas being developed will be revisited in the second generation of the PRSS, which is currently being prepared. The commitments made in the third programmatic operation were reviewed extensively with the entities involved, which have reconfirmed their commitments. The means of verification were prepared with support of consultants financed by the Bank and KfW.
- 3.5 Restructuring the financial liabilities of the EPS related to FONAVI is crucial for promoting the long-term sustainability of the EPS, particularly in the financial area. Accordingly, simultaneously with the restructuring of FONAVI's liabilities, the MVCS plans to promote a series of comprehensive reforms in its dialogue with the municipios and the EPS.
- 3.6 To achieve implementation of the SFC, consolidate the pilot SIAS projects in the regions, and begin to implement the new regulatory system for small sanitation companies in small communities established in Supreme Decree 031-2008-VIVIENDA of 30 November 2008, the government has asked the Bank to finance PE-L1077 under a Sector Facility, whose approval process is being carried out in parallel with this third programmatic operation.

**IV. IMPLEMENTATION AND MANAGEMENT PLAN**

**A. Monitoring and evaluation**

- 4.1 No changes have been made in the monitoring and evaluation mechanisms approved in the programmatic series document in 2007 and, as established in Memorandum EVP/I/2006 (PO-LO-2006), sent to the Loan Committee on 6 March 2006. The project completion report (PCR) will be prepared at the end of the third operation, within six months after the reforms for the third operation are concluded, to evaluate the impact of the program and the extent to which the objectives envisaged for the three operations making up the program as a whole have been met.
- 4.2 The MEF has coordinated timely compliance with the corresponding commitments and has been responsible for providing information on progress related to the Policy Matrix and the Results Matrix, as well as for providing the means of verification to the Bank. This is the third and final operation in the programmatic series begun in 2007 and the work plan has been complied with to date.

**V. POLICY MATRIX**

- 5.1 The Bank has reached agreement with the Peruvian government on the Policy Letter outlining the government's commitment to the objectives and actions of the entire series of programmatic loans, and reaffirming its commitment to the reforms and activities agreed upon with the Bank, which are attached as electronic link A.

The Bank agreed on the Policy Matrix in Annex II, which describes the policy commitments for this program (programmatic operation III). The Results Matrix and Verification Matrix for the third programmatic operation are attached as electronic links B and C, respectively.

### SANITATION SECTOR REFORM PROGRAM III POLICY MATRIX

Objectives	Responsible institution	Commitments Programmatic I (2007)	Commitments Programmatic II (2008)	Commitments Programmatic III (2009)
<b>I. GENERAL MACROECONOMIC POLICY FRAMEWORK</b>				
<b>GENERAL MACROECONOMIC POLICY FRAMEWORK</b>		Macroeconomic framework consistent with program objectives and with the guidelines established in the sector policy letter.	Macroeconomic framework consistent with program objectives and with the guidelines established in the sector policy letter.	Macroeconomic framework consistent with program objectives and with the guidelines established in the sector policy letter.
<b>II. INSTITUTIONAL FRAMEWORK OF THE SANITATION SECTOR</b>				
<b>INVESTMENT PLANNING:</b> To adopt a regional and local investment planning system based on coverage, efficiency, social, and environmental criteria.	Ministry of Housing, Construction, and Sanitation (National Sanitation Department)	<ul style="list-style-type: none"> <li>b. The National Sanitation Plan's areas of service and guidelines for prioritizing investments for the overall quantification of viable regional targets and investment amounts are defined.</li> <li>c. The Water and Sanitation Information System has been created for sector planning.</li> </ul>	<ul style="list-style-type: none"> <li>b. A methodology for formulating Regional Sanitation Plans is developed.</li> <li>c. The Water and Sanitation Information System is being implemented.</li> </ul>	<ul style="list-style-type: none"> <li>a. National Sanitation Plan has begun.</li> <li>b. Regional Sanitation Plans are being implemented.</li> <li>c. The Water and Sanitation Information System is operating.</li> </ul>
<b>REGULATORY FRAMEWORK FOR SMALL COMMUNITIES:</b> To introduce a regulatory framework for small communities and rural areas, and to improve the transparency of management models for small and medium-sized enterprises.	Ministry of Housing, Construction, and Sanitation (National Sanitation Department) and National Superintendency of Sanitation Services	<ul style="list-style-type: none"> <li>a. A regulatory system for small cities and rural areas and a system for contracting specialized operators for small and medium-sized communities are defined and designed.</li> </ul>	<ul style="list-style-type: none"> <li>a. A regulatory system for service providers in small communities and rural areas is approved.</li> </ul>	<ul style="list-style-type: none"> <li>a. A regulatory system for service providers in small communities and rural areas is being implemented.</li> </ul>

Objectives	Responsible institution	Commitments Programmatic I (2007)	Commitments Programmatic II (2008)	Commitments Programmatic III (2009)
<b>INSTITUTION-STRENGTHENING:</b>  To improve the management capacity of the apex agency and the operational capacity of the regulatory authority.	Ministry of Housing, Construction, and Sanitation (Office of the Deputy Minister for Construction and Sanitation)	a. The reorganization plan for the DNS and the “Water for All” program are defined and created, respectively, in accordance with the new sector policies.	a. The reorganization plan for the DNS and the “Water for All” program is being implemented.	a. The organizational structure for the DNS and the “Water for All” program is implemented.
	National Superintendency of Sanitation Services	b. The institutional strengthening plan for SUNASS is approved.	b. The institutional strengthening plan for SUNASS is being implemented.	b. The institutional strengthening plan for SUNASS is implemented.
<b>III. SECTOR FINANCIAL POLICY</b>				
<b>INVESTMENT FINANCING:</b>  To improve the public investment resource allocation system to generate efficient investments and sustainable services.	Ministry of Housing, Construction, and Sanitation (Office of the Deputy Minister for Construction and Sanitation)	a. Regulations are approved for the allocation of investment resources in sanitation projects.	a. The public investment resource allocation system for financing investments is being implemented.	a. The public investment resource allocation system for financing investments is implemented.
			b. The policy of incentives for access to investment finance is being implemented.	b. The policy of incentives for access to investment finance is in operation.
<b>EPS DEBT PROFILE:</b>  To improve the EPS debt profile.	Ministry of Housing, Construction, and Sanitation and Ministry of Economy and Finance	a. The legal framework for restructuring the debts of EPS with FONAVI and with SUNASS is approved.	a. The supplemental legal framework for restructuring EPS debt is prepared.	a. The process of restructuring EPS debt has begun.
<b>IV. SECTOR RATE POLICY</b>				
<b>RATE STRUCTURE AND LEVEL:</b>  To allow enterprises to become financially self-sustaining in the long term, by having a rate based on actual costs, including environmental costs.	National Superintendency of Sanitation Services	a. Regulations are approved for inflation rate adjustments for service providers without rate formulas.  b. Reorganization of the rate structure for EPSs into the following categories: residential, social, commercial, industrial, and government, is approved.	a. Regulations are introduced for inflation rate adjustments for service providers without rate formulas.  b. Reorganization of the rate structure for EPSs into the following categories: residential, social, commercial, industrial, and government, is being applied.	a. Updated regulations are being applied for inflation rate adjustments for service providers without rate formulas.  b. Reorganization of the rate structure for EPSs into the following categories: residential, social, commercial, industrial, and government, is being applied.

Objectives	Responsible institution	Commitments Programmatic I (2007)	Commitments Programmatic II (2008)	Commitments Programmatic III (2009)
	Ministry of Housing, Construction, and Sanitation (National Sanitation Department) and National Superintendency of Sanitation Services	<ul style="list-style-type: none"> <li>c. Guidelines for the subsidy system are approved.</li> <li>d. Regulatory accounting guidelines to segregate charges for water, sewer, and wastewater treatment services are approved.</li> <li>e. Regulations on the quality and quantity of industrial waste discharges are developed.</li> </ul>	<ul style="list-style-type: none"> <li>c. The methodological framework is approved for implementing the subsidy system for the water and sanitation sector.</li> <li>d. Regulatory accounting system to segregate charges for water, sewer, and wastewater treatment services is designed.</li> <li>e. Maximum admissible values for wastewater discharge into the sanitary sewer system are proposed.</li> <li>f. Guidelines on charging for discharges into the sewer system based on organic loading are approved.</li> </ul>	<ul style="list-style-type: none"> <li>c. The subsidy system is being implemented.</li> <li>d. Regulatory accounting system to segregate charges for water and sanitation services is designed.</li> <li>e. Maximum admissible values for wastewater discharge into the sanitary sewer system are approved.</li> <li>f. Rate methodology on charging for discharges into the sewer system is approved.</li> <li>g. Optimized master plan (OMP) for calculation of water and sewer rates explicitly incorporates the concept of cost for use of water sources and wastewater discharges.</li> </ul>
<b>RATE APPROVAL PROCESS:</b>  To improve the rate approval process by adapting the optimized master plan (OMP) to the type of EPS and increased EPS capacity.	National Superintendency of Sanitation Services  National Superintendency of Sanitation Services  Ministry of Housing, Construction, and Sanitation (National Sanitation Department) and National Superintendency of Sanitation Services.	<ul style="list-style-type: none"> <li>a. 6 EPSs with approved OMPs.</li> </ul>	<ul style="list-style-type: none"> <li>a. 15 EPSs with approved OMPs.</li> <li>b. Simplified rate procedure for self-sustaining investments is approved.</li> </ul>	<ul style="list-style-type: none"> <li>a. OMP for calculation of water and sewer rates explicitly incorporates the concept of cost for use of water sources and wastewater discharges.</li> <li>b. 20 EPSs with approved OMPs.</li> <li>c. Simplified rate procedure for self-sustaining investments is being implemented</li> </ul>

Objectives	Responsible institution	Commitments Programmatic I (2007)	Commitments Programmatic II (2008)	Commitments Programmatic III (2009)
<b>V. MANAGEMENT OF SERVICE PROVIDERS</b>				
<b>INSTITUTION-STRENGTHENING:</b>  To improve the management, operational, and administrative capacity of water and sanitation services.	Ministry of Housing, Construction, and Sanitation (National Sanitation Department)	a. Capacity-building system is being implemented.	a. Capacity-building system is being implemented.	a. Capacity-building system is in operation.
<b>MANAGEMENT TOOLS:</b>  To improve governance, reporting, and institutional sustainability in water and sanitation service management and operation.	Ministry of Housing, Construction, and Sanitation (National Sanitation Department) and National Superintendency of Sanitation Services	b. Model operating contract, including targets, incentives and penalties, reporting mechanisms, and a corporate governance code is approved.	b. Guidelines are approved on the dissemination of information on local government accountability and performance related to direct service delivery.  c. 10 operating contracts are signed, including targets, incentives and penalties, reporting mechanisms, and a corporate governance code.	b. The implementation plan is approved for the guidelines on the dissemination of information on local government accountability and performance related to direct service delivery.  c. New operating contracts are signed, including targets, incentives and penalties, reporting mechanisms, and a corporate governance code.
<b>VI. PRIVATE SECTOR PARTICIPATION</b>				
<b>PSP PROMOTION CRITERIA AND METHODOLOGY:</b>  To promote the sanitation sector's PSP strategy nationally.	Ministry of Housing, Construction, and Sanitation (Office of the Deputy Minister for Construction and Sanitation)	a. National PSP strategy in the sanitation sector, including financing policies for government investments, is being implemented.	a. Implementation of the PSP program for water and sanitation service delivery at EPSs has begun.	a. PSP program for water and sanitation service delivery at EPSs is in execution.
<b>PSP PROCESSES:</b>  To optimize PSP processing.	Private Investment Promotion Agency	b. The operational and functional processes and procedures necessary to optimize PSP processes in the promotional stage are defined.	b. The operational and functional processes and procedures necessary to optimize PSP processes in the promotional stage are approved.	b. The operational and functional processes and procedures necessary to optimize PSP processes in the promotional stage are regulated and in effect

Objectives	Responsible institution	Commitments Programmatic I (2007)	Commitments Programmatic II (2008)	Commitments Programmatic III (2009)
	<p>Ministry of Housing, Construction, and Sanitation (Office of the Deputy Minister for Construction and Sanitation)</p> <p>Private Investment Promotion Agency</p>	<p>d. Regulations establishing adjustment criteria for processing private initiatives are being implemented.</p>	<p>c. Design of the procedure for incorporating specialized operators to provide services in small communities has begun.</p> <p>d. Processing of PSP through private initiatives is being implemented.</p>	<p>c. The procedure for incorporating specialized operators to provide services in small communities is approved.</p>