

**PRIVATE SECTOR INVOLVEMENT IN POTABLE WATER AND SEWERAGE IN
SAN PEDRO SULA
(TC9810070)**

EXECUTIVE SUMMARY

**Beneficiary and
implementation agency:**

Municipality of San Pedro Sula.

Project Specific Objectives:

The objective of the operation is to ensure that the process of transition from potable water and sewerage services provided by the Municipality, to services provided by the private sector, is as smooth and trouble-free as possible.

The activities to be financed by the operation can be split into two broad categories: a) project planning and control, as well as coordination of the different actors, to assist the Municipality of San Pedro Sula with the Project management of the entire operation, b) drafting of all legal and contractual documents required during and after the transition process, and c) the preparation of information.

Project cost and financing:

MIF (Window I):	US\$ 500,000
MIF (Contingent Recovery):	US\$ 250,000
Municipality of San Pedro Sula:	US\$ 325,000
Total:	<u>US\$ 1,075,000</u>

The MIF funds will be offered as a grant for the activities relating to planning and coordinating the conversion of DIMA into a private company. MIF funds related to the preparation of the concession document and the tendering process will be offered on a contingent basis and will be recovered from the private company formed from the municipal water division, *División Municipal de Agua*, DIMA, and a private operator. This company will have a concession from the Municipality to provide the potable water and sewerage services.

The term for implementation of the operation will be approximately 12 months, commencing in June, 1999.

Disbursement of the funds will be over a period of approximately 18 months.

**Special Contractual
Conditions:**

Conditions prior to the first disbursement of the TC resources will be to the IDB's standard conditions.

Exceptions to IDB Policy:

None.

I. Country and Project Eligibility

- 1.1 Honduras was declared eligible for all forms of MIF financing by the Donors Committee on December 14, 1993. The proposed project is considered eligible for financing under the Technical Cooperation Facility. The project supports the legal and regulatory reforms necessary to permit greater private sector involvement in the water sector and is expected to have an impact on investment flows, as required under Article III, Section 5 (a) of the Agreement Establishing the MIF. A Memorandum of Eligibility for the proposed project was forwarded to Region 2 by the MIF on 9th October 1998.

II. Background

- 2.1 Potable water and sewerage services in San Pedro Sula are provided by DIMA, a municipal division, with nominal autonomy and its own board of directors headed by the mayor. The services are good compared with many authorities in Honduras. However, DIMA has lost its good reputation in recent years, due to interference by the municipal government in management decisions, a refusal to maintain tariffs at a level needed to sustain the services, increased debt service commitments and deteriorating commercial performance.
- 2.2 The new municipal government stated its intention of rectifying the situation and changing the institutional arrangements to ensure real autonomy for DIMA and greater involvement for the private sector. As part of the preparation of a Municipal Development loan for San Pedro Sula, 1024/SF-HO, the IDB arranged a consultant to work with DIMA and the Municipality to study the strategic alternatives open to the organization. The final proposal is for DIMA to be converted into a private company, for 49% of the company to be sold to an international operator and for the company to enter into a concession arrangement with the Municipality for the provision of potable water and sewerage services. The remaining shares may be transferred from the Municipality to the private operator at a later date.
- 2.3 The loan, 1024/SF-HO, will provide funds to ensure the DIMA, and the private company when it is first formed, strengthen their operations and continue to expand coverage in accordance with a previous investment plan during the process of divestment. Once this process is complete, all investment and working capital will be raised or provided by the company itself.
- 2.4 The IDB has supported the municipalities in assuming responsibility for the way water and sanitation services are provided with an active loan for Puerto Cortés as well as one in preparation for other medium size cities. The IDB has also encouraged the involvement of the private sector, and although the above loans move the sector closer to private provision, neither of them explicitly requires private investment. The loan to San Pedro Sula does require that there be a private investor.

- 2.5 A new law has been prepared, with support from the IDB, which governs the way potable water and sanitation services are provided in Honduras. Specifically the law defines a new regulatory framework for the sector. The Administration has not marshaled the political forces necessary and the law has not yet been presented to the National Congress. Both Congress and the Administration are showing interest, and it seems there will be an effort to pass the law in the near future.

III. Project Objectives and Basic Components

- 3.1 The purpose of the operation is to ensure that the process of transition from potable water and sewerage services provided by the Municipality, to services provided by the private sector, is as smooth and trouble-free as possible.
- 3.2 The activities to be financed by the operation can be split into three broad categories: a) project planning and control, as well as coordination of the different actors, to assist the Municipality of San Pedro Sula with the project management of the entire operation, b) drafting of all legal and contractual documents required during and after the transition process, and c) the preparation of information.
- 3.3 Under the first set of activities the consultant that is hired will assist the Municipality by undertaking the following:
- a. Identify all of the activities necessary and plan in detail the entire transition process. The Consultant will also identify the activities necessary to incorporate the water and sanitation operators in all, or some, of the other cities in the Sula Valley.
 - b. Design a mechanism and procedures for the transfer of personnel from DIMA to the new company. The procedures will include those for redundancies or for the transfer of personnel to other municipal departments as necessary.
 - c. Coordinate the process of transition from the present situation until the privatization process is complete, including; i) the incorporation of DIMA as a new operating company, and ii) the transfer and retrenchment of personnel.
 - d. Coordinate activities complementary to the transition such as the implementation of public-awareness and education campaigns, the institution of the new tariff regime¹, the passing of responsibility for watershed management to the municipal environmental department and the creation of the Urban Services Supervisory Office which will, among other things, supervise the concession contract.
 - e. Design and implement the process of tendering for the private operator to become a shareholder and produce all of the pre-qualification and tendering documents necessary. This must include; i) putting into effect the campaign that will be necessary to publicize the process and to attract the interest of appropriate companies, ii) soliciting offers from private operators to participate as shareholders in the new operating company, iii) selecting the private operator, and iv) negotiating and putting into operation the concession.

¹ A tariff study has already been commissioned by DIMA.

- 3.4 Under the second set of activities the consultant that is hired will be required to undertake the following:
- a. Undertake detailed design of the corporate structure of the new water and sewerage operating company and produce the Articles and Memorandum of Association and any other documents necessary for the legal incorporation of the company.
 - b. Design the concession contract and produce all of the contractual documents necessary.
 - c. Produce all of the tender documentation necessary for the selection of the firm to participate in the new arrangements, including: advertising for expressions of interest, producing a short-list of firms, calling for formal bids, assessing and selecting the successful firm. This will include a Prospectus, and other information necessary to publicize the call for offers.
- 3.5 Under the third set of activities the consultant will be required to make available all relevant information to the participants on the tender for the private operator. These will include gathering the information, cataloguing it in a Memorandum of Information and making it available in a room set aside for the purpose in San Pedro Sula.
- 3.6 The operation will cover other, short-term, consultancies that may be required to undertake specific tasks, especially those related to the gathering of additional information.
- 3.7 The operation will include the activities of the Municipal implementing agency, which will be financed with counterpart funds.

IV. Implementation

- 4.1 The beneficiary of the Project will be the Municipality of San Pedro Sula, who will be responsible for its implementation. The Municipality will utilize the implementation agency already established for the management of the Municipal Development Project subject to IDB Loan No. 1024/SF-HO. The unit is a municipal department and it will be strengthened as necessary.
- 4.2 It is anticipated that a single consulting firm will be contracted to undertake the technical assistance provided by the Project. This will ensure undivided responsibility for planning the process and carrying it out. As requested by the Municipality, the selection and hiring of the consulting firm will be undertaken by the IDB in accordance with standard IDB procedures.
- 4.3 Terms of Reference for the technical assistance related to the Project have been drafted and are appended to this Memorandum. Advertisements will be placed in the publication: "UN Development Business" asking for consulting firms to express their interest in the

Project. A short list will be drawn up, and firms on the short list asked to prepare and submit their proposals.

- 4.4 The final timetable will be agreed with the consulting firm that undertakes the technical assistance as part of the relevant contract. It is envisaged as given below:

Tentative Timetable	
Advertisement placed in "UN Development Business".	15 th April 1999
Short list of consulting firms established and final proposals requested.	7 th May 1999
The Consultant selected.	15 th June 1999
The Consultant mobilized.	30 th June 1999
Prospectus available and campaign for international operator launched.	15 th Aug. 1999
Draft statutes available for the new <i>Sociedad Anónima</i> .	15 th Sept. 1999
Draft concession documents available.	15 th Sept. 1999
Documents available for tendering of private sector participation in the new <i>Sociedad Anónima</i> .	30 th Sept. 1999
New <i>Sociedad Anónima</i> legally constituted.	31 st Dec. 1999
Offers received for private sector participation.	30 th Jan. 2000
a) Private sector participation formalized, b) shares in the new <i>Sociedad Anónima</i> transferred, and c) the concession contract legalized.	31 st May 2000

V. Cost and Financing During Implementation

- 5.1 The MIF funds will be offered as a grant for the activities relating to planning and coordinating the conversion of DIMA into a private company. MIF funds will be offered on a contingent recovery basis for expenses related to the preparation of the concession document and the tendering process. The MIF funds will finance 90% of the main consultancy and approximately 60% of any additional short-term consultancies required.
- 5.2 Counterpart funds will be required to cover 10% of the costs of the main consultancy work and approximately 40% of additional short-term consultants. The Municipality, using counterpart funds will also be required to provide adequate working arrangements for the main consultants. The arrangements will include the provision of office space, equipment, computers, printers, secretarial services and transport (this contribution may be "in-kind"). Finally, the Municipality must budget for, and cover, with counterpart funds the work of the implementation agency related to the operation.

5.3 An estimate of costs is given below.

	MIF (grant) (US\$)	MIF (contingent) (US\$)	Counter- Part (US\$)	Total: (US\$)
Consultancy services described in this document:				
Design, plan and coordinate transition process.	300,000		30,000	330,000
Undertake tendering.		200,000	20,000	220,000
Produce legal documents for new operator.	50,000		5,000	55,000
Produce concession contract.		30,000	3,000	33,000
Produce tender documentation.		20,000	2,000	22,000
Prepare information.	100,000		10,000	110,000
Provision of office space, equipment, transport and secretarial services for consultants.			165,000	165,000
Implementation agency within the Municipality of San Pedro Sula.			60,000	60,000
Contingency (short-term consultancies).	50,000		30,000	80,000
Total:	500,000	250,000	325,000	1,075,000

VI. Project Justification and Risk

- 6.1 The project is justified on several counts. The project is an essential step in the modernization of the way water and sanitation services are provided in metropolitan areas of Honduras. If it is successful, it will provide a model by which efficient and sustainable potable water and sanitation services can be provided, not just to those presently served, but also to new customers.
- 6.2 The project is required, as there will be no medium and long-term investment in potable water and sanitation services in San Pedro Sula unless private capital is tapped. The potable water and sewerage component of the Municipal development loan for San Pedro Sula (1024/SF-HO), is conditional on the activities in the project, but only provides the investment needed to prevent a decline in the services while the transition process is completed.
- 6.3 There are certain risks associated with the project. The first of these risks is political: that there will be no political support for the project and opponents to the scheme will exploit the public's fear of privatization and increases in tariffs to stall or even scupper the project. There is considerable evidence that while the public are not prepared to pay for

poor services provided by the government (local or central), they are prepared to pay a reasonable tariff for services provided by an entity perceived as genuinely independent. There has been considerable success at using *Cabildos Abiertos* to foster wide support for modernizing water services, even when the public understands the implications in terms of tariff increases. The Municipal Development Project includes funds for publicity and education campaigns aimed at the population of San Pedro Sula to explain the importance of public health and the role of good water and sewerage services.

- 6.4 A second risk must be that no private sector company, that is prepared to participate as a shareholder in the new operating company, is able to guarantee the investment required. It will be important to gain the confidence of the public as soon as possible, improve the services and institute a viable tariff regime. A company, operating within a clear contractual framework that guarantees a reasonable return as long as certain levels of performance are maintained, is the best way to secure the type of corporate financing required.
- 6.5 There is at present an initiative by the mayors of the Sula Valley to join the process of modernization and to create a single operator for the whole area. A study will be undertaken, possibly with the support of the IDB, into viability of such a project. This is a worthy cause that the IDB has supported in the past. However, there are several political and practical issues that must be resolved. The present process will not be held up while the study is being made. The study will consider ways in which the other municipalities can join the process once it has commenced and the private operators that are interested will be made aware of the potential for the expansion in business.

VII. Project Performance Criteria and Benchmarks

- 7.1 The performance of the operator itself cannot be a specific requirement of the project, but performance criteria should be included in the concession contract. The criteria for performance must include those used for other projects in Honduras including:

Operators' Performance Indicators: Global Indicators			
Indicator	Unit	Initial Values	Ultimate aim
Max. water unaccounted for:	(% of production)	50	30
Min. collection performance:	(% of invoiced)	85	98
Connections metered:	(% of total)	50	80
Response to complaints:	(hours)	24	12

- 7.2 The success of the project must be measured against the success at attracting a good private operator to take a shareholding in the new operating company and to attract sufficient private capital to make the investment required in the medium and long-term. This can only be properly assessed after the operator has been in place for a number of

years. For the assessing the project in the short-term we must take as an indicator of success that the process of transformation has been completed, all of the legal precedents have been signed. The people of San Pedro Sula must be receiving water and sewerage services for a price that represents value-for-money for them and gives the new company a return that makes its investment worthwhile.

VIII. Exceptions to Policies and Procedures

- 8.1 There will be no exceptions to the IDB and MIF policies and procedures.

PROPOSED RESOLUTION

**HONDURAS. TECHNICAL COOPERATION FOR THE PROGRAM TO THE PRIVATE
SECTOR INVOLVEMENT IN POTABLE WATER AND SEWERAGE
IN SAN PEDRO SULA**

The Donors Committee of Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the Republic of Honduras, and to take such additional measures as may be pertinent for the execution of the project described in document MIF/AT- with respect to a technical cooperation to the private sector involvement in potable water and sewerage in San Pedro Sula.

2. That up to the amount of US\$750,000, or its equivalent in other convertible currencies, is authorized for the purpose of this resolution, chargeable to the resources of the Technical Cooperation Facility of the Multilateral Investment Fund, of which: (a) up to the sum of US\$500,000, or its equivalent, is to be provided on a non-reimbursable basis; and (b) up to the sum of US\$250,000, or its equivalent, is to be provided on a contingent recovery basis.