

SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM (HO-0115)
TEGUCIGALPA MUNICIPAL DEVELOPMENT PROGRAM (HO-0135)

EXECUTIVE SUMMARY

Borrower	Republic of Honduras		
Executing Agency	Ministry of Finance through Private Trust		
Amount and Source		First Phase <i>(covered by the attached resolution)</i>	Second Phases <i>(to be presented to the Board at a later stage)</i>
San Pedro Sula Account	IDB Financing (FSO)	US\$27 million	US\$09 million
	<u>Local Counterpart</u>	<u>US\$03 million</u>	<u>US\$01 million</u>
	Total	US\$30 million	US\$10 million
Tegucigalpa Account	IDB Financing (FSO)	US\$36 million	US\$15 million
	<u>Local Counterpart</u>	<u>US\$04 million</u>	<u>US\$10 million</u>
	Total	US\$40 million	US\$25 million
Total	IDB Financing (FSO)	US\$63 million	
	<u>Local Counterpart</u>	<u>US\$07 million</u>	
	Total	US\$70 million	
Terms and conditions	Amortization period	40 years with 10 year	
	Disbursement period	grace	
	Interest rate	5 years	
		1% for the first ten years	
		2% thereafter	
	Inspection and supervision	1.0%	
	Credit fee	0.5%	
Objectives	The proposed Program aims at a sustainable improvement in urban services in Tegucigalpa and San Pedro Sula. The strategy for achieving this improvement has two principal elements: an overhaul of the municipalities' financial management, and the modernization of the arrangements for service provision. The <u>financial overhaul</u> will rely on instituting greater transparency (better information made widely available in formats consistent with accepted standards), greater efficiency (in the management of both expenditure control and revenue collection), and more rigorous discipline (access to credit will be automatically controlled through the independent and timely monitoring of financial benchmarks). Alongside this financial reform, the municipalities will implement a strategy for improving the arrangements for <u>delivering urban services</u> , most notably potable water and sewage, roads and public transport, solid waste management, and		

management of marginal neighborhoods. This will involve wider use of private sector firms in actual service delivery, together with a radical reorganization and strengthening of the municipalities' capacity to supervise the performance of private providers.

Description

The Program will support these objectives by financing: (1) technical assistance to improve the municipalities' financial management and service supervisory capacity; (2) the implementation of action plans for restructuring the above services, using service, leasing or concession contracts to transfer operational and, where possible, investment responsibilities to private firms; and (3) eligible municipal investments for responsibilities not transferred to private parties under the restructuring plans. Access to investment funding will be linked to compliance with performance benchmarks and transaction-oriented conditionalities, as spelled out in the eligibility matrices presented in Annex III-1.

Under the San Pedro Sula component, the Program will: (1) foster an overall reorganization of the Municipality; (2) help modernize municipal finance by developing an income enhancement strategy, establishing reliable financial information systems, and fostering transparent management practices (US\$1 million); (3) transform the Municipality's environmental management unit into a regulatory unit (US\$250,000); (4) help corporatize the municipal water agency and finance short-term investments in support of the privatization (US\$9 million); (5) support the decentralization of public transport to the municipal level, help establish a semi-autonomous urban transport agency with dedicated sources of funding, and finance key public transport and road investments (US\$7 million); (6) help contract out solid waste management services and finance the rehabilitation and expansion of the existing landfill (US\$2 million); and (7) help the Municipality implement a comprehensive strategy to up-grade existing marginal neighborhoods and rationalize future urban growth (US\$9.5 million).

Under the Tegucigalpa component, the Program will: (1) help modernize municipal finance by developing an income enhancement strategy, establishing reliable financial information systems, and fostering transparent management practices (US\$1 million); (2) transform the Municipality's environmental management unit into a regulatory unit (US\$250,000); (3) support the decentralization of public transport to the municipal level, help strengthen the key functions of the urban transport sector (planning, programming and contracting), establish a financing mechanism to ensure road maintenance, and finance key public transport and road investments (US\$17 million); (4) help contract out solid waste management services, help create micro-

enterprises for service provision in marginal neighborhoods, and finance the rehabilitation of the existing landfill and development of a new landfill site (US\$1 million); and (5) help the Municipality implement a comprehensive strategy to legalize land ownership, upgrade existing marginal neighborhoods, and rationalize future urban growth (US\$18 million).

Program Phasing. Bank support to each of the two cities will be divided into two phases in order to account for a series of limitations that the municipalities presently have in their capacity to implement the proposed Program. The first phases will be financed through the loan outlined in the attached resolution. Each of the second phases would be financed through separate loans (one for each city), to be presented to the Board through a memorandum referencing the present document and presenting evidence that pre-agreed trigger conditions have been met.

The presentation of the San Pedro Sula Second Phase (US\$9 million) to the Board would be triggered by the Municipality's implementation of a Bank-approved plan to restructure the outstanding debt on a municipal bond issued two years ago to finance a sports stadium. This is expected to happen within the next eighteen months. (See paragraph 1.23).

The presentation of the Tegucigalpa Second Phase (US\$15 million) to the Board would be triggered by the signature of a Bank-approved agreement (between by the Municipality and the Central Government) to transfer the responsibility for potable water and sewage services from the Central Government to the Municipality. This is expected to happen within the next twelve months. (See paragraph 2.25).

Execution arrangements. Resources will be passed on to the two municipalities through a trust fund (hereafter referred to as the Municipal Development Trust Fund, MDTF), which will have two distinct accounts, one for each city. The MDTF will be managed by a private, competitively selected local commercial bank.

The MDTF will grant subloans based on the eligibility matrix agreed upon for each city. Subloans will carry a variable rate (eighty-five percent of the average passive rate in the local banking system) and a maturity reflecting the economic life of project asset (with a one-year grace). Each subloan will come with a cascade of guarantees aimed at ensuring that the sovereign guarantee does not need to be called. Re flows from subloans will be used by the Government to repay the IDB debt. Any excess would be used to finance municipal projects under conditions similar to that of the Program.

Relationship of Project in Bank's country and sector strategy	The proposed Program is part of a new generation of Bank operations aimed at wholesaling Bank resources to municipalities. It should be seen as a first step which beneficiary municipalities are taking on the way to strengthening their financial management in order to access financial markets. This step is consistent with the strong decentralization movement that has been taking place in Honduras since the beginning of the decade.
Environmental and Social Review	Due to the nature of the Program, no project-specific Environmental Impact Assessment (EIA) was carried out ex-ante. However, institutional mechanisms will be established as part of the Program to ensure streamlined but effective review of environmental and social impacts (see paragraphs 2.29 and 2.59).
Benefits	The reforms sponsored by the Program will yield two major benefits. <u>First</u> , they will bring about discipline and transparency in the financial management of the municipalities, which should result in enhanced resource allocation. <u>Second</u> , they will improve the efficiency and equity of service delivery, through increased pricing and management efficiencies. This will enable expanded service coverage for the poor.
Risks	<p><u>Implementation capacity.</u> Both operations are complex: they entail full-fledged reforms of most service sectors under municipal responsibility. In this respect, they are the municipal equivalent of a structural adjustment operation. The capacity of the municipal administrations to implement the proposed reforms will be key in ensuring the sustainability of the proposed Program. In both municipalities, there are encouraging signs: a clear political will on the part of the municipal executive, a high level of technical competence on the part of higher management, and a strong consensus that reforms are necessary. It is the Project Team's opinion that both municipalities are well prepared to initiate the reform process.</p> <p><u>Political risks.</u> Working with municipalities entails a different set of risks involving intergovernmental relations. <u>Short-term risks</u> are present mainly in Tegucigalpa, where the municipal and central governments are from different parties. The proposed financing mechanism has been designed to shield the Program from short-term political risks: appraisal of specific projects will be delegated to a technically competent, politically neutral third party (the Trustee), while the Bank's Country Office in Honduras will make final project approval decisions, initially at least. <u>Long-term risks</u> are inherent to long-term sub-sovereign lending, especially where the municipal finance market is too incipient to impose discipline. For the next fifteen years, the way the municipalities are managed will be one of the most important factors influencing their capacity to repay the</p>

various loans they will secure from the MDTF. While the Bank is ultimately covered by the Sovereign's guarantee, a series of features have been included in the proposed Program to reduce the uncertainty of future municipal management. First, whenever possible, the proposed service reforms will be institutionalized through long-term contractual arrangements (service contracts, concessions), making reforms more irreversible. Second, for each specific subloan granted by the MDTF, a series of self-standing guarantees will be established to mitigate risks of municipal default.

**Special
contractual
conditions**

As a condition prior to first disbursement, the Borrower will submit evidence to the Bank that:

- (1) The MDTF has been legally established and the Credit Guidelines governing its operations have entered into effect in a form substantially equal to that of the draft guidelines agreed with the Bank; in particular, the Credit Guidelines will incorporate the eligibility matrices presented in Annex III-1 (see paragraph 3.1);
- (2) An agreement between the Central Bank and the Ministry of Finance has entered into effect specifying the procedures which the Central Bank will follow to debit and credit the MDTF accounts (see paragraph 3.1); and
- (3) The MDTF Trustee has been recruited according to the terms of reference agreed upon with the Bank (see paragraph 3.1).

Other contractual conditions. The loan contract will provide for the reimbursement of expenditures incurred by the municipalities to finance activities eligible under the Program in accordance with Bank procedures, for an amount up to US\$500,000 per municipality (see paragraph 3.19).

Emergency measures. The loan contract will also allow the following temporary exceptions to the Program's execution arrangements in order to address the emergency conditions recently brought on by the Tropical Storm Mitch (see paragraphs 3.21 and 3.22).

- (1) Until the end of the sixth month after the loan contract has entered into effect or until the MDTF becomes operational, whichever comes first, the two municipalities will be authorized to commit and spend Program resources up to an amount of US\$12 million for Tegucigalpa and US\$9 million for San Pedro Sula without meeting the special contractual conditions (1) to (3) above. Instead, the following conditions will apply:

- Resources may only be used to finance studies and works for elements of infrastructure (a) in sectors covered by the Program and (b) which have been destroyed or damaged by the storm.
- Specific activities must be authorized ex-ante by the Bank's Country Office in Honduras.
- The municipality must commit to repay the activity to be financed under the terms outlined in paragraph 3.12.

(2) During the first six months the loan contract is in effect, streamlined procurement procedures will apply (see below).

**Poverty
Targeting and
Social Sector
Classification**

The economic evaluation carried out suggests that the proposed Program is a Poverty Targeted Investment (PTI) since about 55% of the Tegucigalpa and 45% of the San Pedro Sula beneficiaries are below the Bank's poverty threshold. In absolute value, Program benefits are likely to accrue in vast majority to the poor. In Tegucigalpa, the water component and the marginal neighborhood component are the two most poverty-targeted components. They will mobilize 66% of Tegucigalpa resources and 80% of their benefits will accrue to households under the poverty threshold. In San Pedro Sula, the marginal neighborhood component is the most poverty-targeted component. Its amount represents 50% of San Pedro Sula resources and its benefits will accrue almost entirely to the poor. The water component (30% of San Pedro Sula resources) will also benefit the poor in a significant fashion: it will result in a strong redistribution of welfare from richer neighborhoods presently consuming too much under-priced water to marginal areas currently not receiving service. (See paragraphs 4.9 to 4.11.)

Consequently, it is proposed to apply paragraph 2.93 of the FSO Eighth Replenishment document (AB-1704) and have IDB financing account for up to 90% of total Program amount.

**Exception to
Bank policies**

None

Procurement

All contracting will follow the Bank's policies. International public bidding will be used for procurement of works in excess of US\$1,000,000 and for acquisition of goods and services in excess of US\$350,000. National procurement regulations will apply under these thresholds (see paragraph 3.14).

However, during the first six months the loan contract is in effect, streamlined procurement procedures will apply, as per the Bank's draft policy on procurement procedures for emergency projects recently submitted to the Board (see paragraph 3.21).

I. Context

- 1.1 This loan proposal presents two city-specific municipal development operations, for the cities of Tegucigalpa and San Pedro Sula, respectively. Chapter I looks at the operations' environment, focussing on those factors likely to impact the performance or creditworthiness of the municipalities. The national context is summarized in Section A, while Sections B and C analyze the current financial status and future outlook of the two cities. The Bank's experience with municipal development operations is presented in Section D.

A. The national context

- 1.2 The national economy: encouraging signs but overall volatility. The national economy grew by 4.5% in 1997 and is expected to continue to grow at about the same rate in the medium term. However, due to a high population growth rate, GDP per capita grew at an average of only 1.5% in the 90s and returned to its 1980 level. Inflation decreased drastically over the last eighteen months (from 27.3% in January 97 to 14.2% in June 1998), but the sustainability of this trend is uncertain. The exchange rate has been gradually depreciating but did not match inflation. A one-off devaluation may therefore soon be necessary. The country's external debt is over 115% of GDP and debt service absorbs 31% of export revenues.
- 1.3 The new Government has adopted a series of measures to boost economic growth, most notably an IMF-endorsed monetary program and the *Ley de Incentivos a la Producción, la Competitividad y Apoyo al Desarrollo Humano (Decreto 131-98)*. The Law, which alleviates taxation on personal and business income and reinforces taxation on the sales of non-basic goods, is expected to help reduce the public deficit. It will also boost exports by extending the tax-free status of special export zones to the entire country. While these measures should help stabilize the macro-economic environment in the short-term, it is not clear what their long-term effect will be in the absence of more structural reforms.
- 1.4 The macro-economic environment will have three impacts on the proposed Program. (1) The level of income of the general population and the basic goods price index will determine the solvency of households and affect their demand for the urban services packages sponsored by the Program. (2) The high inflation rate will erode the municipality's current savings, since only a fraction of municipal current income is inflation-buoyant. (3) Currency devaluation will make loan repayment more difficult, since the Bank lends in dollars but the projects to be financed will generate income in local currency. Measures to mitigate the impact of these factors are included in the present loan proposal (see Chapter III), nevertheless the promotion of a national policy framework conducive to a more stable macro-economic environment is expected to be a key element in determining the success of the program.

- 1.5 The municipal sector framework: strengths, weaknesses and consolidation. The second set of national-level factors likely to affect Program performance involves the municipal legal and fiscal framework. From a legal standpoint, the Municipal Law (*Decreto Legislativo 134-90* of October 29, 1990) sets a solid base for municipal decentralization. The delineation of responsibilities between the Central Government and local governments is clear: municipalities are in charge of all local infrastructure services¹, with the notable exception of urban transport and traffic control enforcement which remain the responsibility of the Central Government (Article 13). The Law enables municipalities to contract out service provision under a variety of arrangements, including service contracts and concessions. The assignment of financial resources to municipalities is just as clear. According to the Law (Articles 73 to 91), municipalities have access to four sources of revenues. (1) They may charge service fees, which must be set to reflect real costs of municipal service provision. (2) They collect six local taxes², whose rates they can set according to the Law's strict guidelines. (3) They receive Central Government transfers, representing 5% of the National Tax Revenues. 20% of such transfers are shared equally between the country's 289 municipalities. The remainder is shared on a per capita basis. (4) Finally, municipalities can issue debt. Bond issues must be duly authorized by the Central Bank and the Ministry of Finance. Foreign debt must also be authorized by Congress. In terms of governance, the decision-making body is the *Corporación Municipal*, whose members are elected on a proportional basis from party lists, and the executive branch is headed by the *Alcalde Municipal*, who is at the top of the winning list. The fact that the *Alcalde's* list systematically has a majority at the *Corporación* facilitates decision-making, but may also give the governing party unchecked power.
- 1.6 Two major discrepancies appear when comparing the legal framework described above with the country's reality. First, transfer payments from the Central Government have been extremely unsteady: they come late and are often partial. This creates uncertainty as to the amount of resources available and, consequently, prevents the possibility of using transfers as a source of collateral for municipal debt. Second, in Tegucigalpa and other, smaller cities – but not in San Pedro Sula – the responsibility for the provision of water services lies with a national public entity, known as SANAA, not the municipality. This has created tension as to what the role of the Municipality of Tegucigalpa should be in this sector. This issue is elaborated further in paragraph 2.22 below. In general, there is agreement regarding the fact that the country's decentralization framework – one of the Region's most advanced – is still in a process of evolution and consolidation. This clearly introduces a certain amount of volatility in the proposed operations.
- 1.7 The municipal finance system. The third set of national-level factors comes from the country's municipal finance system. Municipalities have access to two major sources of capital financing: concessionary funding from multi-lateral, bilateral and central government agencies; and the local financial markets.

¹ Urban development planning and regulation, solid waste management, potable water and sewage, drainage, urban roads.

² Three of them account for over 40% of average current revenues: the property tax, a personal income tax, and a business tax assessed on sales.

- 1.8 **Concessionary funds.** Over the past ten years, there has been an increase in the amount of soft money going to municipalities, in response to the increasing decentralization of basic services, through three main windows. (1) The *Fondo Hondureño de Inversión Social* (FHIS), which enjoys a well-deserved reputation of integrity and efficiency, co-finances small-scale, mostly social municipal infrastructure projects such as schools, markets or community water systems in marginal neighborhoods. (2) The now-defunct *Banco Autónomo de Municipalidades* (BANMA), a first-tier public bank established in 1965 to lend to local governments, was used to channel development resources including IDB's (see paragraph 1.34) to medium to large municipalities. This mechanism became politically manipulated and financially inefficient and was discontinued in 1994. BANMA's outstanding loan portfolio was transferred to the State. (3) The biggest/strongest cities in the country have access to bilateral and multilateral funding in an ad-hoc fashion. In particular, the Bank has financed a US\$50 million urban development program for the city of San Pedro Sula (loan 849/SF-HO approved in 1990) and recently approved a US\$13.8 million waste water project for the city of Puerto Cortés (loan 997/SF-HO, 1997). Similarly, the US International Agency for Development (USAID) has financed a municipal development program involving the country's 32 biggest municipalities. This experience is reviewed in section D below.
- 1.9 **Market funds.** Honduras' financial markets are at an early stage of development as reflected by the low level of *bancarización* of the economy, the lack of debt instruments with maturity over one year, and the inefficiency of financial groups. This is the combined result of macroeconomic volatility and an incomplete legal framework³. The banking sector is considered small with respect to the size of the country. At the same time, it is too fragmented (with over 20 banks and many more financial institutions) and therefore quite inefficient, resulting in a passive to active yearly rate spread of as much as 15%. Consequently, the municipal loan market is limited to short-term loans (usually under two years), carries expensive market rates⁴, and is accessible to the country's strongest municipalities only, mostly to finance cash needs. Capital markets are small but growing. There are two privately operated stock/bond markets in the country. They suffer from the same shortcomings as the banking sector with regard to lack of regulation and the short-term nature of the funds supplied.
- 1.10 In general, it is acknowledged that the major obstacle to the development of a steady municipal finance system in Honduras is the present state of development of local financial markets (supply side) rather than the state of development of the municipal sector (demand side). While the development of the local markets is an endeavor that lies beyond the scope of the proposed Program, the proposed Program will have to be careful to promote rather than discourage it.

³ The incompleteness of the legal framework refers to: (1) inadequate banking regulations and ineffective enforcement; (2) insufficient information disclosure requirements; (3) incomplete contract law and securities law; and (4) ineffective judicial system.

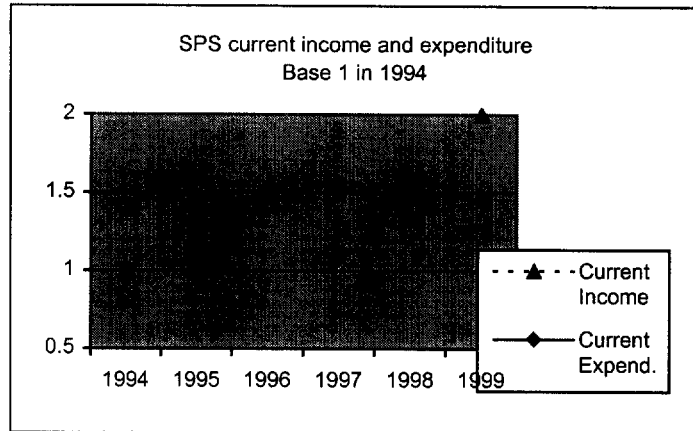
⁴ In the last 12 months, active rates went down from up to 40% a year to about 26/28% a year as a result of increased liquidity in the system and improved macroeconomic outlook.

B. The municipal context: San Pedro Sula

- 1.11 The creditworthiness of the two municipalities has been appraised on three accounts: (1) the structure of the local economy and its influence on the municipality's finance; (2) the municipality's institutional and management capacity; and (3) the structure, history and outlook of municipal finance.
- 1.12 Population and Economy. Located in the northwest part of the country, San Pedro Sula is the second largest city in Honduras, with 525,000 inhabitants and a 6% annual growth rate. The city is the core of a growing metropolitan area which is home to about 900,000 inhabitants and is the fastest growing economic region in Honduras. The area contributes an estimated 30% of the country's GDP and an estimated 40% of the country's exports. Agriculture is steadily declining as a source of employment (from 23% of all regional jobs in 1988 to 10% in 2010) but is expected to remain strong in terms of output, most notably thanks to the role of coffee and banana exports. At the same time, industrial activity is developing very rapidly (from 29% of all regional jobs in 1988 to 40% in 2010), with the garment industry, base metals and chemicals, and in-bond assembly, making major contribution to the employment level. Overall, the regional economy is a strong asset for the Municipality of San Pedro Sula⁵ and provides a relatively buoyant tax base to finance the expenditure needed to sustain growth.
- 1.13 Management history and situation. San Pedro Sula has long had a strong civic tradition reflected in a municipal government that took pride in maintaining some distance from national political parties, and in a reputation for financial prudence and effective service delivery. A weak administration with close ties to the national government took over in 1994 and a series of misguided decisions undermined the Municipality's financial standing and the quality of its service delivery, compromising years of leadership that had made San Pedro Sula a model in Central America.
- 1.14 A new administration took office in 1998 with a commitment to reverse the crisis in the Municipality's finances and performance. High-level, politically independent experts were contracted either as civil servants or as consultants to head the administration's main directorates (finance, water, roads and environmental services). The policy of financing an operating deficit with short-term borrowing from commercial banks was halted. Expenditures have been controlled with a 25% reduction in payroll. The expensive short-term debt was renegotiated at lower interest rates and a longer term. The new mayor's team is taking advantage of the technical expertise still in place in the municipality and is actively pursuing reforms in areas such as water, garbage, road, land use and financial management.
- 1.15 Financial situation and outlook. Detailed financial information is available in the Program's technical file (document PRE/1). In general, it is difficult to compare present with past performance, because historical data is not reliable.

⁵ This is reflected in the fact that proceeds from the business tax represent about 30% of total municipal current incomes and have been keeping up with inflation.

- 1.16 Revenue side. The 1997 municipal tax effort was US\$20/capita, about 2% of gross regional product. The Municipality relies heavily on two taxes, the business tax and the property tax, which together provide 40% of total revenues. Service provision is an important but still under-exploited revenue source (17%). Non-current sources of income represent around 15% of total, with Central Government transfers accounting for nearly 5%.



- 1.17 The new administration has initiated intense efforts to increase tax receipts, but the majority of revenue growth observed in the past six months has been due to improved effectiveness in collecting arrears and tax income has grown only enough to match inflation. A major effort is needed to increase the efficiency in collection of principal taxes, especially the betterment charges, where collection rates are very low (32%) and decreasing, and the service fees and real estate tax (collection rate: 62%), where higher collection rates are believed to be within reach.
- 1.18 On the expenditure side, the new administration has shown a remarkable commitment to good practices. First, it reduced personnel costs by cutting staff from 2,000 to 1,500⁶ and by negotiating a long-term salary arrangement with existing staff. Second, effective expenditure control procedures have been put in place. These combined measures will enable the Municipality to close FY1998 with current expenditure of US\$10.8 million, down 17.5% from 1997, and with total current savings of US\$2.4 million, to be compared with a 1997 current deficit of US\$0.4 million. Third, the new administration reduced capital expenditure to a historical minimum of US\$2.2 million in 1998, waiting for more favorable long-term financing to be available to carry out its investment program.
- 1.19 In this context, the Municipality's debt situation is the major source of concern. The previous administration financed recurrent cash deficits with very expensive short-term loans, would delay payments to providers and contractors, and embarked in the financing of a series of over-ambitious, risky projects. As a consequence, the overall municipal debt is now standing at US\$52.5 million, more than three times the Municipality's current revenues.
- 1.20 However, not all this debt carries the same weight. Lps. 267 Ml, equivalent to today's US\$20.5 million corresponds to Bank loan 849/SF-HO, contracted in 1990. Given the soft FSO terms it carries and the very favorable exchange rate at which the Central Government has agreed to be repaid by the Municipality, this portion should be repaid easily through betterment charges.

⁶ This was made all the more difficult by the fact that the new administration belongs to the same party as the old one, which means that political compromises acquired by the previous administration are harder to repeal.

- 1.21 Much more intractable is the Municipality's involvement in the financing and construction of a multi-sport facility for the Sixth Central American Games in 1997. The construction of the stadium and the organization of the games were managed by the Committee for the Organization of the Sixth Games (COSG), a not-for-profit organization established by Presidential Decree and chaired by the President of the Republic. The COSG was supposed to use two sources of financing to get the stadium built: (1) a US\$15 million, six-year bond issued by the Municipality and authorized by the Central Bank, to be repaid through the sale of VIP seats for a 30 year term; and (2) a US\$3.5 million subsidy by the Central Government. However, due to poor overall management and generalized cost overruns, the project required US\$8 million of additional government subsidy and the COSG ended its operations with another US\$8 million outstanding debt with the construction companies that built the stadium. Additionally, only 23% of the 4000 VIP seats have been sold to date, which threatens the Municipality's capacity to service the bond.
- 1.22 The current municipal administration is in the process of implementing a series of measures to alleviate the burden that this situation imposes on the Municipality's finances. Such measures include: (1) establishing a debt service fund to restore the bondholders' confidence; (2) reaching an agreement with the Central Government as to how the other outstanding obligations will be shared; and (3) pursuing a proactive administration of the Complex while preparing for its eventual divestiture through long-term concession or outright sale.
- 1.23 The San Pedro Sula component of the proposed Program has been dimensioned to take into account the uncertainties created by the stadium situation. The Municipality's debt-carrying capacity has been appraised under three scenarios corresponding to possible outcomes for the Sextos Juegos debt problem. In the worst case scenario, the Municipality is left to assume the US\$8 million outstanding debt to suppliers and must repay the US\$15 million municipal bond plus US\$6 million of interest. Its additional debt-carrying capacity is close to zero. In the base scenario, the Central Government takes over the debt to suppliers but the Municipality keeps the bond on its book. Its additional debt-carrying capacity is US\$27 million. In the best case scenario, the Government takes over the debt to suppliers and the Municipality manages to transfer the complex and the obligation to repay the bond to a third party. Its debt-carrying capacity is US\$36 million. To take the three scenarios into account, it is proposed that the Bank's support to San Pedro Sula be divided into two phases. Under the first phase, the Bank would make US\$27 million available to the city, through the loan covered by the attached resolution. Under the second phase, the Bank would, through a separate loan, increase by US\$9 million the amount of resources available under the Program to finance additional works and technical assistance in the same sectors. The San Pedro Sula second phase loan would be presented for consideration by the Board when the Municipality has designed and implemented a viable plan to restructure the debt of the municipal bond. This is expected to happen within the next eighteen months.
- 1.24 A second source of concern is the financial status of the local provider of water and sewage, DIMA. DIMA's obligations carry an implicit full-faith and credit guarantee from the Municipality. DIMA's total outstanding debt exceeds US\$46 million, roughly the size of the Municipality's own debt. Of this, about US\$30 million are due to international organizations.

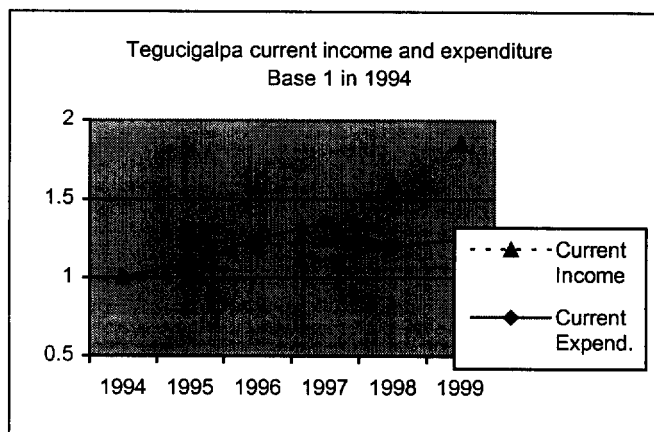
DIMA can not presently rely on operating surplus to cover these obligations, which dictates that reserves must be built by the Municipality in case of default. Plans to restructure DIMA and privatize water services have been formulated and may be financed by the Bank under the present Program.

C. The municipal context: Tegucigalpa

- 1.25 Population and economy. The city of Tegucigalpa is Honduras' capital. It is home to an estimated one million people who are spread with relatively low density across very uneven topography, with nearly 60% of the population living in so-called marginal barrios. Population growth has been estimated at nearly 5% over the last ten years, with about 2.5% driven by internal growth and 2.5% generated by rural migration.
- 1.26 Overall, Tegucigalpa's economy is much less dynamic than that of San Pedro Sula. The service sector plays an important role, with the presence of the Central Government accounting for an significant part of the gross regional product. In-bond assembly activities, which began a few years ago, should be boosted by the recently approved *Ley de Incentivos a la Producción, la Competitividad y Apoyo al Desarrollo Humano (Decreto 131-98)* which makes the entire country a free-trade zone for exports. Agriculture and related activities also play a significant part in Tegucigalpa's economy (about a fourth of gross regional product), although little exportable goods are produced. As a consequence of the relatively weak structure of the regional economy, proceeds from the business tax only account for 25% of municipal current income.
- 1.27 Management. The municipal government of Tegucigalpa has had a long tradition of inefficient and non-transparent management, as evidenced by a 1997 operating deficit of about US\$2 million (representing 15% of current income), frequent delays in debt service payment, and low capital investment relative to current expenditure (10% in 1997). Proximity to the Central Government has greatly factored in the high observed level of political interference with municipal management, most notably with respect to the setting the price of local public services.
- 1.28 The new municipal administration, which took office at the end of January 1998, has initiated a major reform plan aimed at radically improving public service provision. This plan includes the following initiatives: (i) reorganization of municipal functions into three departments (Infrastructure, Social Programs and Municipal finances) each headed by a Director and coordinated by a General Manager directly accountable to the Mayor; and streamlining the municipal administration (in three months, staff size was cut from 4,500 to 1,500); (ii) improvement of current revenues with an innovative "autocertification" program to curb previously widespread tax evasion; (iii) improvement of the Municipality's cash flow via the renegotiation of US\$4.7 million of short term debt with the local banking sector; (iv) increase in the role of the private sector in service provision; and (v) integration of community participation in project selection and financing.

1.29 Financial situation and outlook. Detailed financial information is available in the Program's technical file (document PRE/2). The note of caution made for San Pedro Sula as to the reliability of historical data also applies to Tegucigalpa.

1.30 On the income side, the new administration has achieved a 35% increase in projected current income (total: US\$15.6 million for 1998), mostly because the confidence inspired by the new administration has led many people to resume paying their taxes. However, tax effort remains low (US\$13/capita/year) and overall tax efficiency remains very low because: (1) registries of contributors are out of date, especially for the property tax and the business tax; (2) procedures governing the revenue generating process are unclear; and (3) the municipal tax ordinance has not been updated for 10 years.



1.31 On the expenditure side, the current administration has initiated a drastic effort to reduce personnel costs, notably by cutting staff from 4,500 to 1,500. This required payment of US\$3.8 million in severance packages during the current year but should yield the Municipality about US\$5.25 million per year in current savings. Overall, the Municipality went from a 1997 current deficit of US\$2.8 million to a 1998 current surplus of US\$3.4 million.

1.32 On the other hand, the new administration had committed itself to a series of ambitious projects, mainly in the area of road infrastructure, for a total amount of US\$15 million. This would have boosted total spending to US\$31 million for 1998. In the perspective of an IDB loan and following discussion with the Project Team, this investment plan was frozen to a more reasonable level (under US\$7 million), which will allow the Municipality to close FY1998 with a US\$4.5 million borrowing requirement. The tendency of the current administration to engage in ambitious projects is a risk for the viability of the program and will have to be closely monitored.

1.33 The size of the debt (US\$20.4 million) does not represent a major threat for the Municipality's financial stability. However, most of this debt is expensive, short-term, commercial debt. A few weeks after taking office, the new administration successfully negotiated a rescheduling of all its commercial debt, achieving a 12% average reduction in interest rates. Another refinancing plan is underway, to convert a portion of the existing 28% three-year debt into 22% ten-year debt, an option made possible by the existing excess of liquidity in Honduras' financial markets. If this endeavor is successful, the debt situation of the Municipality will become quite favorable.

A comparative summary of the two municipalities' creditworthiness

		San Pedro Sula		Tegucigalpa	
	Criterion	Situation	Outlook	Situation	Outlook
Economic	Economic base	Strong	Sensitive to economic cycle	Weak	Not sensitive to economic cycle
	Population's economic wealth	Above national average		Above national average	
	GRP/capita	US\$900		US\$700	
Management	Independence from political interference	Medium to Strong	Uncertain past 2001	Low to Medium	Uncertain past 2001
	Technical skills of administration	High for management, medium to low for intermediate technical staff	= / +	Medium to high for management, low for intermediate technical staff	= / +
Finance	Annual local tax income/cap.	US\$20	+ until 2001	US\$13	+ until 2001
	Tax income as % of GRP	2.2%		1.9%	
	Flexibility of expenditure liabilities	Medium	+ until 2001	Medium	+ until 2001
	Debt situation	Weak to very weak	Very uncertain in the short term (Sextos Juegos issue)	Medium to strong	+ until 2001
	Outstanding debt/capita	US\$180		US\$25	
	Overall	Medium	+ until 2001	Medium	Uncertain

GRP: Gross Regional Product

Source of Data: IDB, Municipalities and Project Team Estimates

D. IDB and Municipal Lending: Lessons Learned

1.34 The IDB has had a large portfolio of loans to support the development of municipal governments. Two lessons learned from this experience, in Latin America generally, and particularly in Honduras, are most appropriate for the proposed operation.

- (a) Using publicly owned development banks as intermediaries gave rise to acute moral hazard problems. These banks provided municipalities with soft repayment obligations while the nature of the loan guarantees weakened the banks' incentives to ensure project financial viability. The proposed program will impose hard budget constraints on the municipality through a system of cascading repayment guarantees, while expectation of the

In the last ten years, the Bank financed two municipal development operations in Honduras. A full account of their performance is available in the Program's technical files (document PRE/3). The main lessons, consistent with those listed above, are summarized below.

(1) The Honduras Municipal Development Program (Loan 820/SF-HO), approved in 1988, was a US\$15 million multiple works operation, designed to provide financing to the Government-owned *Banco Autónomo de Municipios* (BANMA). The operation suffered the deficiencies listed in paragraph 1.35 and failed to provide a sustainable solution to the lack of financing experienced by Honduran municipalities. US\$8 million of the initial US\$15 were canceled and BANMA was eventually dissolved in 1994.

(2) In 1990, the IDB approved a US\$49.5 million urban infrastructure project for San Pedro Sula (849/SF-HO). This project is now fully disbursed. While the physical components of the operation were implemented with no delays and below projected costs, the institutional strengthening objectives were only partially met. In particular, the operation failed to strengthen the fiscal capacity of the Municipality and did not lead to increased expenditure efficiency. A number of factors lead to these shortcomings. First, project design was centered around the construction of physical infrastructure and envisaged fiscal strengthening as a marginal aspect. The fact that the actual borrower was the Central Government made this oversight easier. Second, the Municipal Government in power during the last three years of program execution (1994 to 1997) proved to be extremely weak.

possibility of future borrowing (from the local private sector, PRI or other market sources) will provide incentives to meet agreed upon indicators of financial prudence.

- (b) Municipally managed utilities were not in a position to impose user charges needed to ensure loan repayments. The proposed program will help set up the autonomous service providers and private sector participation necessary to ensure that user charges are maintained at levels that cover debt service and operating costs. One of the sources of resistance to financially viable utility tariffs was the desire to keep basic services accessible to low income populations. In practice, however, low charges led to under-investment and poor service coverage of marginal neighborhoods. The proposed program will seek to put in place explicit targeted subsidies to extend services to the low-income population.
- 1.35 Region II's recently defined municipal and urban development strategy seeks to help Central American cities become better places to live and more efficient places to work. To face this challenge, municipalities will have to learn to become effective service providers -- most often by delegating actual service provision to the private sector -- and reliable credit clients. The proposed Program will take Tegucigalpa and San Pedro Sula one step in this direction. The next step for these two municipalities should be to issue medium to long term debt in the local/regional markets.

II. Program Objectives and Description

A. Program objectives and strategy

- 2.1 The proposed Program aims at a sustainable improvement in urban services in Tegucigalpa and San Pedro Sula. The strategy for achieving this improvement has two principal elements: an overhaul of the municipalities' financial management, and the modernization of the arrangements for service provision. The financial overhaul will rely on instituting greater transparency (better information made widely available in formats consistent with accepted standards), greater efficiency (in the management of both expenditure control and revenue collection), and more rigorous discipline (access to credit will be automatically controlled through the independent and timely monitoring of financial benchmarks). Alongside this financial reform, the municipalities will implement a strategy for improving the arrangements for delivering urban services, most notably potable water and sanitation, roads and public transport, solid waste management, and marginal neighborhood management. This will combine wider use of private sector firms in actual service delivery, with a radical reorganization and strengthening of the municipalities' capacity to manage and supervise the performance of these private providers. An Urban Services Supervisory Office will be established and trained to spearhead the later of these efforts.
- 2.2 The Program will support these objectives by financing: (1) technical assistance to improve the municipalities' financial management and service supervisory capacity; (2) the implementation of action plans for restructuring the above services, using service, leasing or concession contracts to transfer operational and, where possible, investment responsibilities to private firms; and (3) eligible municipal investments for responsibilities not transferred to private parties under the restructuring plans. Access to investment funding will be linked to compliance with performance benchmarks and transaction-oriented conditionalities, as spelled out in the eligibility matrices presented in Annex III 1.

B. Tegucigalpa

1. Urban transport (US\$17 million)

- 2.3 Main problems. A total of over 1.8 million person trips are taken within the urban area on a daily basis, 30% of which are taken on foot, and 43% on bus public transport. Traffic congestion is significant in several key areas and worsening due to the following technical problems: (1) The public transport system is not effectively regulated nor efficiently run. Private operators, who are heavily subsidized by the government, are given little incentive to tailor service to user needs or operate efficiently. (2) The capacity of the primary network is limited by the lack of continuity of and connectivity between major urban road segments, and by ineffective separation between conflicting trips (local vs. through traffic, private vehicles vs. pedestrians vs. public transport vehicles). (3) Roadway infrastructure suffers from chronic under-investment in construction and especially maintenance. As a

result, nearly 50% of the primary road network and 85% of the secondary and tertiary road networks are in poor condition.

- 2.4 Existing institutional and financial realities impede solution of these technical deficiencies. There is a lack of administrative coherency and continuity, no organized funding mechanisms, and little planning and programming capacity, which severely constrains the performance of any kind of infrastructure work.
- 2.5 Modernization strategy. Financial sustainability will be promoted by the creation of an independent fund (Central District Transport Fund, or CDTF), which will have sole access to all existing and new sector related incomes (local registration fee, parking fees, cargo facilities usage fees, and possibly a local overcharge on gas). This fund will permit municipal use of sector revenues according to strict priorities: (1) sector administrative costs, (2) baseline network maintenance requirements⁷, (3) debt service for that part of the loan dedicated to rehabilitation activities, and (4) financing of investment⁸. Institutional consistency is to be assured by the timely formation of fundamental functions within the existing Urban Development Directorate, including (1) establishment of a road inventory system, (2) development of a coherent procedure for contracting⁹, and (3) initiation of a rational project programming process.
- 2.6 What the Program will finance. While improvement of public transport should be the first priority within the transport sector, there is little the Municipality can do directly in this effort. A series of studies is presently being conducted to explore the feasibility of transferring control from central to municipal hands and, if deemed advantageous, propose a strategy with regard to this transition process.¹⁰ Upon agreement with the central government with regard to this proposal, loan funds will be available to finance technical assistance in support of the transfer process, the re-structuring of tariff and contract regulations, and the establishment of a public transport regulatory function within the Urban Development Directorate. In addition, it will be possible for loan funds to be used to finance investment projects deemed necessary to support the municipalization process.
- 2.7 Program technical cooperation (US\$500,000) focuses on: (1) aiding the formation of fundamental functions within the Urban Development Directorate—roadway inventory, contracting procedures/policies, project programming process; (2) development of priority works—efficiency projects, connectivity/continuity projects; and (3) creation and establishment of the CDTF—legal and procedural design, revenue enhancement.

⁷ Defined as proper maintenance of that portion of the paved roadway network in good condition.

⁸ The Bank Program will enable the municipality to complete an initial package of works. These works will gain public acceptance for increases in sector charges to levels that will assure reliable coverage of, at minimum, the core responsibilities (1-3 above). Additional drawdowns will be contingent on the proven financial sustainability of the Fund, as determined through yearly audit.

⁹ All road infrastructure related services (maintenance, construction, supervision) will be contracted out by the Municipality.

¹⁰ Among the initiatives being conducted is a US\$150,000 study (financed by the French Fund for Technical Cooperation) aimed at investigating the feasibility of a privately run mass transit system using electric buses/trolley-buses.

- 2.8 The execution of the investment plan will be conditional upon the successful implementation of the technical assistance plan (see Annex III-1). The investment plan has three components: (1) rehabilitation works (US\$8 million), which aim to upgrade those portions of the paved road network in poor condition (est. 167km), according to a nine-year improvement plan; (2) investments of high economic priority (at minimum US\$3.3 million), which could include: indirect promotion of public transport (dedicated bus lanes, bus priority measures in major radial corridors), and efficiency works (integrated traffic control system for Central Business District; other works aimed at improving the access to and within the city center); and (3) connectivity/continuity projects consistent with the municipality's investment plan (at maximum US\$7.9 million).

2. Marginal neighborhoods (US\$18 million)

- 2.9 Main issues. More than half the population of Tegucigalpa (some 75,000 households) lives in informal neighborhoods, in some degree of illegality. Where title is actually disputed, as in more than 80 of the city's 175 informal neighborhoods, illegality imposes substantial costs. Uncertainty about title means that makeshift construction can persist for years and utility companies as well as the Municipality are reluctant to invest in infrastructure. This informality has two fundamental sources: the administrative process of authorizing formal subdivisions and the question of actual ownership. The political payoff from resolving these problems has encouraged the municipal administration to set up procedures for regularizing some informal neighborhoods. However, for a number of reasons, results have so far been limited.
- 2.10 Modernization strategy. The strategy for dealing with the informal neighborhoods will have two fundamental objectives: (1) improving conditions in existing neighborhoods through land regularization and infrastructure upgrading; and (2) improving the land market performance to ensure that future urban growth is more orderly. The Program will contribute to this second objective by funding the design and implementation of new regulations for the promotion of low-cost subdivisions and of a land use policy.
- 2.11 **Regularization.** The process for issuing individual title will be developed in parallel with the design of arrangements for purchase from the current owner. To expand the Municipality's ability to provide legalization services, a standard "package" of tasks and specifications, which could be contracted out to different agencies, will be developed to cover the entire process. To provide interim security where there is no dispute about rights to the individual plots, the Municipality will explore the options for issuing documents that recognize the standing of the occupants ("imperfect title"). The design of suitable arrangements for the purchase of individualized titles will give priority to neighborhoods where land is owned by the Municipality and where title could be issued once purchase arrangements are completed. After the regularization and purchase "packages" have been developed, they will be tested on three pilot neighborhoods. The title registry system to be designed will need to pay special attention to the legal arrangements necessary to protect the rights of women in common-law households.

- 2.12 **Upgrading.** The Municipality's capacity for neighborhood upgrading with water projects, sewage, drainage, and road paving, will be enhanced by enlisting the help of neighborhood organizations, *patronatos*, and NGOs for development and implementation. A condition prior to the execution of the components will be the presentation of the detailed implementation arrangements (for project selection, preparation, financing, contracting and repayment) for the no-objection of the Bank and Facility Manager. The project selection mechanism will have to reconcile equity objectives (assigning more to poorer neighborhood) with efficiency objectives (letting local communities decide the works that they deem most needed). As part of the design of the financing and repayment package, the municipality will enter into discussion with the FHIS and the newly formed Housing Fund (FOSUVI) to establish if some general agreement can be reached regarding subsidies for joint financing of upgrading projects in the marginal neighborhoods. These arrangements will be refined in a pilot exercise during the first year of execution. A variant of the program will be designed for the paving of bus routes, a high priority for the neighborhoods' occupants. In this case, the individual works will be more costly and the repayment scheme will be different as it will target commercial rather than residential properties.
- 2.13 **Low-cost subdivisions.** A detailed survey of existing regulations for authorizing subdivisions and an analysis of their impact on land costs will be the first step towards making a supply of affordable sub-divisions. The outcome will be a proposal for a lower minimum standard for subdivision covering lot size, minimum pedestrian walkways, and minimum standards for the provision of water. The new standards will be backed up by the design of deliberately simplified procedures that will encourage private landlords to put this kind of product onto the legal market. A training component will be critical for ensuring that municipal staff understands the empirical basis, social objectives and proposed procedures for applying the new standards.
- 2.14 **Land use policy.** The development of a land use policy will be designed to support the implementation of the other components. Technical assistance will help develop data to quantify the demand for different kinds of subdivisions and to identify the sectors of the city where this demand is located. This information will be the basis of a campaign to promote the development of a suitable number of low-cost sub-divisions to accommodate future urban growth.
- 2.15 What the Program will finance. The variable costs of legalization, estimated at not more than \$100 per lot, will be shared by the beneficiaries and the Municipality, each paying 50%. The Program will finance the legalization of 20,000 households over a three-year period, requiring US\$2.5 million including fixed costs. The arrangements for purchasing land should generate net income for the Municipality, and the proceeds will be earmarked to increase the size of the upgrading component.
- 2.16 The precise dimensioning of the neighborhood upgrading component in terms of the number of households to be served will not be determined until pilot projects confirm estimates of the willingness of households to pay for improvements. The financial dimensioning of the Municipality's investment in this component was carried out as

follows. Municipal authorities determined that, of the estimated \$27 million debt that could be carried on the *Caja Unica*'s free cash flow, some \$17 million would be targeted to this component. Of these, the municipality proposes to devote about US\$10 million to the road paving projects. Effective cost recovery arrangements will be developed and the municipality estimates that the adjacent properties could be assessed for 40% of the total costs. The remainder (US\$7 million) would go to local upgrading projects. A preliminary decision that the municipality would be prepared to assume 60% of the costs, with beneficiaries assuming the remainder, suggests that some 6,000 households could be benefited under this component.

- 2.17 The technical assistance necessary for the promotion of affordable subdivisions including the training for the Municipal staff is estimated at US\$150,000. The technical assistance necessary for the development of the land-use policy is estimated to be US\$350,000.

3. Solid waste management services (US\$1 million)

- 2.18 Main issues. The Tegucigalpa metropolitan area generates 420 tons of domestic and 60 tons of industrial waste every day. Uncollected waste, which amounts to nearly 100 tons/day, comes principally from the marginal areas and is dumped illegally creating serious health problems. The only legal dumping site is an open landfill, 7 km from the city center where there is no sanitary control, nor is there control of access. The landfill is nearing its full capacity and, without rehabilitation, must be replaced within two years.
- 2.19 The solid waste collection and disposal services, as well as street cleaning are provided by a department within the Urban Services Directorate. Management is poor and the services are (and are perceived as) deficient, leading to environmental, aesthetic and sanitary deterioration, which, in turn, leads to a low willingness to pay and low tariff collection rates. The income from the services goes to the general municipal account and costs are met from the general municipal budget, so there is no link between cost and income from the services. The Municipality has already made two of the first steps towards reform of the services. A private firm has been contracted to collect the refuse from about 20% of the city center. Small, private companies have been contracted to supply labor for street cleaning. There are also tentative steps towards using community-based micro-enterprises for the collection of refuse in the marginal settlements, where access is difficult.
- 2.20 Modernization strategy. A general strategy of modernization has been developed to further involve the private sector in the service provision and as a source of investment, in both equipment and a new sanitary landfill. The Municipality will be left with the role of supervisor and environmental regulator. (1) Two contracts will be granted for the collection of household and industrial waste in the city center and the formal neighborhoods. The arrangement with the private contractor already in place will be expanded, as one of these contracts, to cover approximately 50% of the area. (2) Local micro-enterprises will be given service contracts (as opposed to labor contracts) for street cleaning in the city center and formal neighborhoods. (3) Nine micro-enterprises, based on community participation, will be established for the collection of refuse in the marginal settlements. These enterprises, duly incorporated, will be contracted by the Municipality

and will be responsible for depositing the refuse in local containers and, when the containers are full, transporting them to the official landfill site. (4) A concession will be granted to a private company for the management, cleaning, upgrading and expansion of the existing landfill. The upgrading and expansion will extend the useful life of the landfill to six years. (5) A BOT concession will be granted to a private company for the construction, management and operation of a new landfill site before the existing landfill reaches capacity. (6) The tariff regime will be restructured to reflect true costs and an agreement will be negotiated with ENEE for adding the fee for refuse collection to the electricity bill. The income from the services will be isolated from income from other municipal services. (7) The Urban Services Supervisory Office will supervise the contracts with the various private sector organizations.

- 2.21 What the Program will finance. Most of the investment in equipment and infrastructure will be left with the private sector and the Program will finance mainly technical assistance. (1) A specialist consultant will be contracted to manage the incorporation of the private sector in waste collection and disposal services¹¹. (2) A pilot project will be undertaken to determine the optimum means of involving the micro-enterprises in the marginal settlements. (3) A public education program will focus on pre-collection, waste separation, household waste reduction and recycling. (4) Studies to identify a suitable site, feasibility studies, preliminary designs and environmental evaluation for the new landfill will be undertaken. Loan funds may also be applied towards investment in the rehabilitation of the existing landfill, to make the site more secure, protect the environment and expand the site's capacity. The eligibility matrix links actual progress achieved in this sector's modernization strategy with disbursement of funds in other sectors (see Annex III-1).

4. Potable water and sewerage (Second Phase: US\$25 million¹²)

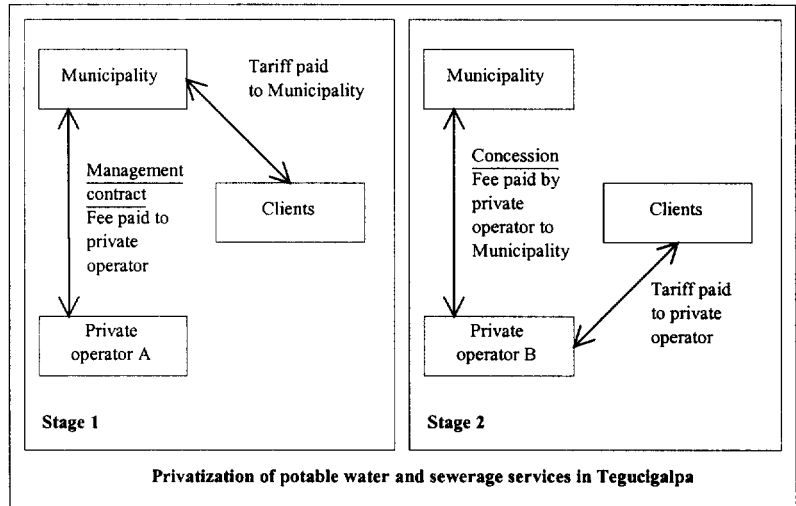
- 2.22 Main issues. Potable water and sewerage services are provided not by the municipality, but by SANAA, the *Servicio Autónomo Nacional de Agua y Alcantarillado*. The services are poor and suffer from serious management and financial problems. Tariffs are inadequate, even if commercial performance is improved, and the services depend entirely on subsidies from the Central Government. There is serious overstaffing and other inefficient work practices. The institutional problems must be solved before any further investment is made to improve services and expand coverage. The Municipality has expressed its wish to take over responsibility for the potable water and sewerage services and to undertake the institutional reorganization necessary, a move consistent with the national sector reform which has been supported by the Bank over a number of years.

¹¹ Definition of the contractual framework; definition of service benchmarks; preparation of tender and contract documents; restructuring of the tariff regime and design of the municipal supervisory office.

¹² The total amount of this component will be US\$ 15 million of IDB resources plus US\$10 million of system's operating surplus to be re-invested in the system.

2.23 Modernization strategy. Only with the commercial discipline of the private sector will the services be managed with the independence, efficiency and sustainability required to attract finance for service to meet the city's needs. The proposal is to utilize the private sector in two phases; firstly, to manage the system while it is being put into a state where the risks can be properly assessed and, secondly, to operate the system under a concession.

2.24 The first stage will coincide with the hand-over of responsibility for the services from SANAA to the municipality. It will comprise a contract, for three years, with a private company for the management of the system for a fee. The operator will have, as a parallel activity, responsibility for developing the



information that will allow the risks related to the provision of the services to be more precisely assessed. This will include drawing up an accurate asset register and updating the client database. The second stage will grant to a concessionaire the use of the infrastructure and the obligation to take full operating and commercial responsibility for the services. The concessionaire will also be responsible for investment in new infrastructure and goals for service coverage will be established in the concession. The term of the concession will be long enough for the concessionaire to recover investment made and will be at least fifteen years. The Urban Services Supervisory Office will be responsible for the supervision of the contracts. Until a national regulatory entity is established, regulation will be by contract.

2.25 Phasing. Given the uncertainty surrounding the decentralization process for the potable water and sanitation services, it is proposed that Bank support for this sector be made available under a second phase, to be financed through a separate loan of US\$15 million. The Tegucigalpa second phase loan would be presented for consideration by the Board when the service decentralization agreement mentioned in Annex III-1 has been signed by the Municipality and the Central Government. This is expected to happen within the next twelve months.

2.26 What the second phase would finance. The potable water and sewerage services would be supported with an amount of US\$15 million: the estimated deficit for the period of the management contract. Financing would cover technical assistance and investment in works. The technical assistance would be used to (1) strengthen the operations and develop the information necessary prior to letting the concession; and (2) finance public relations and publicity campaigns required for preparing the public for the involvement of the

private sector and the inevitable increase in tariffs. In particular, funds would be made available to finance a referendum to consult with the population of Tegucigalpa on the overall modernization strategy. Investment would be principally for rehabilitation, extension and strengthening of the existing infrastructure where this would have a large effect on tariff income.

5. Environmental management (US\$250,000)

- 2.27 Main issues. The city of Tegucigalpa suffers acute environmental problems, most of them related to the provision of public services: (1) 100,000 m³/day of sewage contaminates the Río Choluteca. (2) Nearly 100 tons of solid waste go uncollected daily, while another 300 tons are disposed of in a landfill in poor sanitary condition. (3) There is serious air contamination due to traffic congestion. (4) Unregulated urban growth is responsible for the development of high-risk areas on the city's hillsides.
- 2.28 There is insufficient capacity to manage the environment and the Environmental Management Unit (EMU), which lacks political support within the Municipality, has conflicting responsibilities, providing some environmental services while regulating others. The EMU lacks the people, resources and technical expertise to carry out its legal mandate to assist the Ministry of Environment's Directorate for Environmental Control and Evaluation (DECA) with local planning and regulation of the environment.
- 2.29 Modernization strategy. The strategy is designed to serve two complementary objectives: (1) correct the institutional weakness with regard to environmental management; and (2) design and implement a mechanism to identify and mitigate this Program's environmental and social impacts. A large part of the Municipality's investment and service improvement will revolve around the Program, and the second objective will be a stepping stone towards the first.
- 2.30 From an institutional standpoint, the EMU will assume a planning and regulatory role. The EMU will receive training for these new responsibilities. Responsibility for services that are presently carried out by the EMU, such as maintenance of cemeteries and management of parks, will be transferred to the Urban Services Directorate of the Municipality, which will contract the services out to private companies. A Municipal Environmental Management mechanism, comprising Project Review and Environmental Planning¹³, will be implemented. Project Review is a process by which the EMU will review specific projects for environmental impacts. This process, which will be formalized by a written agreement between the Ministry of Environment and the Municipality, will involve: (1) analysis of a project brief; (2) contracting a qualified firm to undertake the EIA; (3) analysis of the EIA, and agreement on a mitigation plan, in accordance with the environmental license issued by DECA; and (4) monitoring of the implementation of the mitigation plan. Environmental Planning is a process by which the EMU will acquire environmental data, and organize them to aid decision-making within the Municipality. This will involve the establishment and maintenance of an Environmental Information

¹³ Both processes are presented in the Program's ESIR, available in the Program's technical files (PRE/4).

System (EIS) accessible to the general public, as well as the management of an Environmental Risk Mapping System (ERMS).

- 2.31 What the Program will finance. Loan funds may be used to contract technical assistance to: (1) reorganize and train the EMU; (2) design, and collect baseline data for, the EIS; and (3) refine the ERMS by collecting primary information on three environmentally sensitive zones. Loan funds may also be used to purchase office equipment, software and analysis equipment. The EMU's current expenditure, estimated at US\$110,000 per year, including a biannual data collection exercise for the EIS, will be financed from the Municipality's general budget.

6. Municipal organization and finance (US\$1 million)

- 2.32 Issues. The Municipality's financial management has been improving in the last six months, mostly because the new Mayor brought in a few very experienced financial officers. However, there remains a series of serious problems. (1) There is no clear definition of functions, responsibilities and procedures within the Finance Department. (2) Management information systems are non-existent. (3) Expenditure authorization and payment procedures are unclear. (4) Revenue generation functions are not integrated, disorganized and supported by very weak systems. (5) Budgeting, financial planning and cash management have only recently been linked and their integration needs to be refined and monitored. (6) Cost accounting and capital budgeting functions are non-existent.
- 2.33 Modernization strategy. The proposed modernization strategy aims at consolidating the Municipality's reorganization; strengthening tax administration; establishing financial management and information management systems; and providing systematic support to the private participation components of the various sector reforms.
- 2.34 What the Program will finance. Loan funds will be applied to contract technical assistance (US\$150,000) to complement the reorganization of the Municipality, which will include: (1) the design of functions, responsibilities, and qualifications; (2) the formulation of a comprehensive human resources management plan; (3) the definition of the system requirements that best suit the proposed organization; and (4) the implementation of the proposed changes. Investments in computers, local network and training will amount to an estimated US\$300,000.
- 2.35 In the area of tax administration, an estimated US\$200,000 of technical assistance will be contracted to: (1) design an efficient tax collection cycle; (2) design the operational model for each of the major taxes; (3) involve, when possible, local financial intermediaries in tax administration; (4) establish operational units for tax administration, audit and control; and (5) generate a reliable data base for each tax.
- 2.36 With respect to financial administration and transparency, an estimated US\$50,000 of technical assistance will be contracted to: (1) design information generation and quality control procedures; (2) design a methodology to evaluate the overall financial performance of the municipality including a set of simple but relevant indicators; (3) establish feedback

mechanisms from the Chief Financial Officer to the areas of budget, planning, cash management, and treasury; (4) define and implement clear reporting requirements, including public disclosure requirements; and (5) develop and implement a training program.

- 2.37 Finally, a central service privatization unit will be established within the Directorate for Urban Services to manage the various privatization processes involved in the sector strategies. This will include the water & sanitation service contract and concession, the solid waste service contracts, the road concessions and all other service outsourcing. The unit will be responsible to: (1) assess the legal, regulatory and institutional environment; (2) define the best option for private sector involvement; (3) contract and supervise specialized services to carry out the feasibility studies and prepare bidding documents; (4) select and contract private operators; and (5) monitor the implementation phase. An estimated US\$300,000 of technical assistance will be needed to support the privatization unit.

C. San Pedro Sula

1. Urban transport (US\$7 million)

- 2.38 Main issues. Approximately 500,000 daily trips are taken on motorized transport within the urban area, 69% using public transport and 31% private vehicles. Because of the level terrain and low auto ownership, there are also a significant number of trips taken by non-motorized modes (walking, bicycle). Traffic congestion occurs sporadically, but frequently, at several intersections of components of the primary road network, a phenomenon symptomatic of a pre-congested traffic system.¹⁴ Worsening travel conditions have been a result, not of inadequate highway infrastructure, but of (1) increasing usage of private vehicles, spurred by declining quality of public transport service and marginalization of non-motorized transport users, and (2) inefficient usage of existing highway capacity. Another key technical problem has been the lack of adequate maintenance of the existing road network.
- 2.39 Existing institutional and financial realities impede solution of these technical deficiencies. (1) There is a lack of administrative continuity. Each political change results in radical shifts in programs, administrative structures, and human resources. (2) There is also a lack of an effective programming process. The absence of objective criteria for determining funding priorities has lead to inadequate dedication of funds for road maintenance and inconsistent capital investment.
- 2.40 Modernization strategy. A Municipal Transport Agency (to be known as *Autoridad Municipal de Transporte*, or AMTRA) will be created as an autonomous municipal entity. Institutionally, AMTRA will be headed by a board, which will appoint and remove the general manager, who will be responsible for the overall administration of the agency, including all recruitment decisions. Technically, AMTRA will have three main

¹⁴ Slight increases in volumes relative to supply capacity will lead to significant, chronic travel delays.

responsibilities: (1) road infrastructure maintenance and development;¹⁵ (2) traffic circulation and parking management; and (3) public and non-motorized transport planning and regulation. Financially, AMTRA will have sole access to the to-be-established Municipal Urban Transport Fund, which will tap all existing and new sector-related incomes (local registration fee, tolls levied at city's radial access points, and possibly a local overcharge on gas). Payment of AMTRA administrative costs and network maintenance requirements will receive priority over new investment. Financing for infrastructure development will come from two sources: (1) loans using the Fund as the primary source of repayment and bearing the Municipality's full faith and credit guarantee; and (2) concession agreements using dedicated sources within the Fund (a to-be-defined portion of tolls) as the only source of repayment, i.e. without municipal guarantee.

- 2.41 What the Program will finance. While improvement of public transport should be the first priority within the transport sector, there is little the Municipality can do directly in this effort. Should the municipal decentralization under study become a reality, loan resources will be made available to support it, as explained for Tegucigalpa in paragraph 2.6.
- 2.42 The Program will finance technical cooperation (US\$1.3 million) to: (1) finalize the design and support the establishment of AMTRA; (2) form AMTRA's non-motorized transport department/identify, develop and implement its first group of projects; (3) form AMTRA's maintenance, rehabilitation, and investment department/identify, develop and implement their first groups of projects; (4) form AMTRA's traffic management department/develop and implement an integrated traffic control & circulation plan for the Central Business District (CBD); (5) design and implement a strategy to enhance sector revenues; and (6) improve engineering capacity. Once AMTRA and the Municipal Urban Transport Fund have been properly established, loan funds will be made available to finance investment projects under the following conditions: (1) AMTRA administrative and maintenance operations are covered by the Fund revenues¹⁶; (2) the Fund's debt-service coverage ratio exceeds 1.4; and (3) the project to be financed is part of the road infrastructure investment plan.
- 2.43 The investment plan contemplates five categories of investments, respectively aimed at: (1) indirectly promoting public transport (US\$4.0 million) and improving non-motorized transport facilities (US\$500,000); (2) improving the efficiency of existing capacity (US\$5.0 million); (3) improving inter-regional traffic facilities, specifically by-pass roadway corridor (US\$10 million); (4) rehabilitating deteriorated roadway segments, with priority given to CBD facilities (US\$5.0 million); and (5) improving the connectivity of the existing roadway network by building missing links (up to US\$28 million). For each of the first four categories, thresholds have been established which will have to be exceeded before loan funds can be applied to the next category.

¹⁵ All road infrastructure related services (maintenance, construction, supervision) will be contracted out by AMTRA.

¹⁶ The following recurrent costs will have priority for the Fund: (1) AMTRA's operating budget, as voted by its board, but not to exceed 10% of the Fund's total revenues; and (2) routine and periodic maintenance of primary road network (est. 127km).

- 2.44 Another source of financing for the investment plan will be a concession-type structure currently being designed through a MIF-funded technical cooperation. Under the proposed arrangement, a private company would perform a package of strategic road construction and maintenance works within municipal boundaries (up to US\$10 million) in exchange for periodic payments of a set value secured from existing toll revenues.¹⁷

2. Marginal neighborhoods (US\$9.5 million)

- 2.45 Background and problem definition. Some 40,000 households, affecting about 35% of the housing stock, live in a significant degree of illegality. Most of these neighborhoods are on private land where the absence of legal title is due to failure to comply with certain municipal codes and, for the most part, there is no uncertainty regarding ownership of the lots. 8,000 households, are located on public land that is unsuitable for occupation: rights of way, flood basins and under high-tension pylons. Relocating such households on municipal land encourages others to fill the vacated space. Each year the city must accommodate 3,500 to 4,000 additional households that cannot afford housing in the formal market.
- 2.46 Modernization strategy. The strategy will use the same instruments (land regularization, infrastructure upgrading, sub-division promotion, and land use policy) as for Tegucigalpa, but the priorities differ significantly. In San Pedro Sula, the problem of regularizing land title in the existing informal neighborhoods is much less acute and a greater commitment can be made to the neighborhood up-grading. The promotion of legal, low-cost subdivisions will be carried out in conjunction with a program to inform the occupants of the unsuitable land sites of new opportunities provided.
- 2.47 What the Program will finance. The target for regularization has been set to 10,000 households over the Program's life, requiring about US\$1.5 million of loan resources under the conditions spelled out for Tegucigalpa in paragraph 2.15. Unit costs for upgrading infrastructure services in informal neighborhoods have been estimated in the \$1000 to \$2000 range. The precise dimensioning of this sub-component in terms of the number of households to be served will not be determined until the first year of execution. However, the initial estimation is based on the assumption that some 40% of project costs can be recovered from the beneficiaries. The Municipality has chosen to devote some \$10 million to this sub-component implying that some 11,000 households could benefit. The technical cooperation required for subdivision promotion and land use policy is estimated at US\$250,000.

¹⁷ PRI has been involved in project design and may be interested in spite of the small amount of the deal.

3. Solid waste management services (US\$2 million)

- 2.48 Main issues. San Pedro Sula produces about 275 tons/day of domestic waste of high organic content and an additional 70 tons/day of commercial waste. There is no reliable information on hazardous wastes. Coverage as well as service quality is poor, collections only taking place every one to two weeks in many neighborhoods. Total collection capacity, using rented trucks, is under 50% of waste production. The waste is taken to the municipal landfill, which covers over 35 hectares, about 17 km from the city center, where it is deposited on open ground, creating an environmental hazard.
- 2.49 Inadequate financial and institutional arrangements explain this poor state of affairs. The Municipal Waste Division (*División Municipal de Limpieza*, DIMUL) lacks managerial and financial autonomy. Fees are set by the Municipality and revenues go directly to the municipal treasury. Operating funds, which are allocated from the municipal budget, bear no relationship to income, and there is no incentive to lower costs. Spending efficiency is low (total cost per ton is US\$30) and so is user willingness-to-pay for poor services (collection rate is below 65%).
- 2.50 Modernization strategy. The MSPS has decided to privatize solid waste services by transferring responsibility for their provision to private companies, the new contractors or concessionaires being responsible for operation and maintenance as well as financing new works. The Urban Services Supervisory Office will supervise the contracts. The process for involving the private sector is being developed through a JSF-funded technical cooperation and will consider three key points: (1) whether or not the commercial risk¹⁸ can be transferred to the private sector; (2) whether the collection concessions or contracts should be limited to San Pedro Sula or whether they should include neighboring cities; and (3) how many area-based collection concessions or contracts should be let to induce competition between different providers. Calls for bids are expected for February 1999, and concession contracts could enter into effect by July 1999.
- 2.51 What the Program will finance. The Program will finance investments not transferred to the private sector under the concessions. Vehicles and other operator's equipment, such as weigh-scales, with a useful life of less than the term of the financing, will be excluded. Landfill rehabilitation and expansion may be included (estimated cost of US\$2.3 million). For the existing site, this would consist of the establishment of leachate and gas collection systems, the compacting and closing off of the top layer, and the fencing off of the entire area. For the expansion site, the project would also include the delineation of the new fill and buffer areas, the sealing of the base, and the development of a filling plan. The rehabilitation of the landfill access road will also be part of the project.

¹⁸ Under a normal concession, the private company would have the right to provide the services for the population of San Pedro Sula who would be considered to be the company's clients. The company would accept the commercial risk. Under a service contract, the company's client would be the Municipality, who would pay a fee for defined services. These services may include fee collection, but the risk related to the amount collected would normally reside with the Municipality.

- 2.52 Loan funds will also be used to finance technical assistance to strengthen the new Urban Services Supervisory Office, and community-education campaigns aimed at increasing the efficiency of pre-collection and at developing a pilot screening and recycling program.

4. Potable water and sanitation (US\$9 million)

- 2.53 Main issues. DIMA, the *División Municipal de Agua*, provides good potable water and sewerage services when compared with others in Honduras. However, DIMA has a corporate structure that permits the local political authorities to interfere in management. This has resulted in tariffs that are too low and staffing levels that are too high; a combination of low revenues and high costs that is proving unsustainable. Although there is considerable requirement for investment just to keep pace with population expansion, not to mention the need for sewerage disposal infrastructure, the priority must be for a new corporate framework that ensures management and financial autonomy by involving the private sector.
- 2.54 Modernization strategy. Meaningful private sector participation can be initiated in the short term. DIMA is well managed, and will be transferred to the private sector while changing as little as possible. DIMA will be converted into a private company, (referred to as *Servicios de Agua Potable y Alcantarillado S.A.*, SAPASA). The Municipality will initially hold 100% of SAPASA's shares but, immediately after its legal incorporation, SAPASA will be capitalized through public bidding to attract an operator with international experience to take a 49% equity share and full control over the firm's management. The contractual vehicle for the provision of the services will be a concession contract between the Municipality and SAPASA. Existing infrastructure would remain the property of the Municipality. SAPASA would have the obligation of investing in new infrastructure, and an investment plan, defined either as works to be constructed, expected level of coverage or in terms of other indicators, would be part of the concession agreement.
- 2.55 DIMA at present has responsibilities other than the provision of services. It is responsible for the protection of watersheds within the Municipality. This responsibility will be transferred to the Urban Services Directorate and a private firm will be contracted to carry it out. Suitable personnel will be transferred from DIMA to the Urban Services Supervisory Office for the supervision of this contract, as well as for the supervision of the concession with SAPASA.
- 2.56 What the Program will finance. Loan funds will be used to finance technical assistance and physical works. Technical assistance (US\$2 million) will include the strengthening of commercial and operating practices to reduce costs and improve revenue collection. It will also include a component for public relations, education and publicity. Investment will be concentrated on activities that will lead to a short-term increase in revenue, including the routine expansion of the networks to cover new areas and complementary works to complete the last masterplan. These investments are required before the concession takes effect. Their estimated value is US\$7 million. Much more investment is required in San Pedro Sula, not least for sewerage, the lack of which is leading to serious pollution not only of San Pedro Sula itself, but also of several communities between the city and the sea.

These, and other important works, will be included in the investment plan for the concession.

5. Environmental management (US\$250,000)

- 2.57 Main issues. The main environmental problems are related to water. San Pedro Sula is dependent on its abundant sources of water, but their management leaves something to be desired. Both the city's groundwater aquifer and the surface water sources are exploited without adequate control and are seriously polluted due to poor disposal of the city's wastewater. There is also serious pollution due to poor collection and disposal of solid waste, more than 200 tons being disposed of inadequately each day, either illegally or at the official landfill which has no provision for sanitary disposal. Other environmental risks relate to (1) the city's location in a seismically unstable area, and (2) air and other pollution caused by traffic congestion in the city center.
- 2.58 The Municipal Law of 1991 charges the Municipality with the conservation of the environment. It has a formal mandate to support the Environmental Evaluation and Control Directorate (DECA, *Dirección de Evaluación y Control Ambiental*) in regulation, supervision, monitoring and granting licenses associated with the environment. San Pedro Sula's environmental division is concerned primarily with the provision of services, such as the administration of parks, at the expense of regulation of the environment. The management of watersheds, a municipal responsibility, is undertaken by DIMA, but is compromised by a shortage of human and financial resources.
- 2.59 Modernization strategy. The strategy to modernize environmental services in San Pedro Sula focuses on separation of service provision from environmental regulation. The responsibility for the supervision of contracts for the provision of services will be transferred to the Urban Services Supervisory Office. The Municipal Environmental Unit (*Unidad Ambiental de San Pedro Sula, UNASP*) will be responsible solely for the regulation of the environment, in support of DECA and as set out in the relevant laws and regulations. These responsibilities will include: 1) analyze all projects to determine the legal requirements for the evaluation of environmental impact, 2) write Terms of Reference for the relevant Environmental Impact Assessment, 3) ensure that mitigation actions defined in the Environmental Impact Assessment are included in construction, operating and concession contracts, 4) supervise all construction, operating and concession contracts to ensure compliance with the requirements of the Environmental Impact Assessment, 5) ensure that all concession contracts for the provision of public services have a component for public education, 6) ensure community participation as part of the Environmental Impact Assessment, and 7) build a database of environmental information, contract environmental audits and maintain a map of environmental risks up-to-date. The UNASP will be financed in part by levies on user charges when they exist, as for example in the case of potable water and sewerage. The balance will come from the Municipality's general budget.
- 2.60 What the Program will finance. Loan funds will be used for the transformation of the UNASP to undertake its new mandate as a regulator. The funds will cover: (1) the

equipment required by the unit for undertaking its works including computers and basic laboratory equipment¹⁹; (2) the software necessary for the establishment of the necessary environmental databases and mapping; (3) a consultancy to write operating procedures for the unit; and (4) training for the unit's staff.

- 2.61 The loan will also finance a study of particular environmental problems related to the management of the city's water resources, both surface and groundwater. The study will define the problems and make recommendations for resource management. The study will also determine the economic value that should be placed on the raw water for its use.

6. Municipal organization and finance (US\$1 million)

- 2.62 Main problems. In spite of the substantial improvement achieved in the last six months, financial management still suffers from a series of structural deficiencies. (1) The overall municipal organization is inefficient, especially in the area of income generation. (2) There are no financial planning/forecasting models and no cash management procedures. (3) Financial and non-financial information systems are weak and run on two distinct, non compatible platforms. (4) There is only sporadic control over decentralized municipal entities such as DIMA.
- 2.63 Modernization strategy. The proposed strategy aims to: (1) implement an overall reorganization of the municipality; (2) improve its financial situation; (3) increase the effectiveness of financial management; and (4) enhance the transparency of the municipal administration. With regards to this fourth objective, the goal is to keep the local community informed on (1) resource utilization, (2) long term commitments which the Municipality enters into, and (3) the degree of accomplishment of the objectives which the new administration announced when taking office.
- 2.64 What the Program will finance. Loan resources will be applied to finance technical assistance and computer systems. On the revenue side, an estimated US\$65,000 of technical assistance will be contracted to: (1) consolidate the responsibility for administering taxes and fees under the *Dirección Municipal de Impuestos*; (2) create a taxpayer registry with a unique identification key; (3) coordinate procedures in the areas of billing, invoicing, collection, payment schemes and facilities; (4) initiate judicial steps needed to obtain payment of past dues, most notably from large tax payers; (5) strengthen the management of the betterment tax and link it to the real estate tax; and (6) establish a tax policy unit to prepare and update the revenue strategy of the municipality.
- 2.65 On the expenditure size, an estimated US\$65,000 of technical assistance will be contracted to: (1) decentralize the execution of municipal budget and set fund utilization rules and reporting requirements; and (2) establish and monitor a set of simple indicators regarding the size and the composition of expenditure in order to ensure that the current prudent track is not abandoned, and that positive cash flows are generated to face existing obligations.

¹⁹ Only simple routine analysis will be carried out by the UNASP; any comprehensive analyses or studies will be let to private laboratories.

- 2.66 In the area of financial management, the main focus is to create a level of middle management, which the municipality currently lacks, and to strengthen the technical skills of front line personnel. To this end, an estimated US\$100,000 of technical assistance will be invested to sponsor the full-scale implementation of the planning methods and models that are currently being developed. This component will also require investment and training in information systems (overall estimate: US\$50,000 for system design and US\$400,000 for equipment including service plan), to establish an effective Management Information System in support of decision-making.
- 2.67 As to the transparency package, an estimated US\$110,000 of technical assistance will be contracted to sponsor: (1) the adoption by the municipality of a unique set of accounting principles, pursuant to Honduran law and practice; (2) the reclassification and consolidation of debt and debt service obligations, and the monitoring of a set of indicators encompassing debt of all municipal agencies like DIMA; and (3) the monthly publication of the municipality's key financial indicators and list of contracts procured.
- 2.68 Finally, an estimated US\$200,000 of technical assistance will be contracted to design and implement the reorganization of the municipality, based on a strong simplification of the present structure. This will include the definition of functions and responsibilities, the formulation of a comprehensive human resources management plan, and the actual implementation of the changes.

D. Dimensioning, cost and financing

1. Cross-sectoral integration and capital budgeting session

- 2.69 The sector-specific approaches described above have been consolidated from a financial, socioeconomic and environmental point of view. This involved the following steps. (1) Sector-specific investment needs were assessed and ranked by decreasing order of economic return.²⁰ (2) The sector-specific and overall debt-carrying capacities of the municipality were appraised based on conservative projections of current income and expenditure.²¹ (3) Three distinct investment scenarios were then crafted to reflect three contrasting political strategies, all of them within the realm of the "financially viable". The first scenario was heavily biased towards road infrastructure; the second one towards environmental projects (solid wastes, potable water and sanitation); and the third had a strong social focus, with improvement of marginal neighborhoods as its main component. (4) A conceptual analysis of the costs and benefits of investment in each sector was carried out and then aggregated across sectors for each scenario. This enabled a comparison of the relative cost/benefit efficiency of each scenario and the manner benefits would accrue to various groups of inhabitants. (5) Similarly, the environmental impacts of the three scenarios were appraised based on streamlined environmental criteria. (6) Finally, the results of these technical analyses were discussed with the *Alcaldía* during an extensive capital budgeting session. A decision as to the "optimal scenario" was arrived at, mixing

²⁰ See paragraph 4.8.

²¹ See paragraph 4.1.

elements of the three proposed scenarios to reconcile the political agenda of the municipal government with the results of the technical analysis.

- 2.70 The assignment of resources within eligible sectors will be left flexible, allowing transfers from one component to the next. However, safeguards have been established to ensure that: (1) a minimum program is carried out in social and environmental sectors; and (2) not more than a maximum amount is spent on roads. Beyond the establishment of these safeguards, the capital budgeting session proved a useful tool to help the municipal executive rationalize investment decisions.

2. Structure, cost and financing

- 2.71 Bank support to San Pedro Sula will be divided into two phases to accommodate the uncertainty on the Municipality's debt-carrying capacity created by the Sixth Games debt situation (see paragraph 1.23). Bank support to Tegucigalpa will also be divided into two phases; the first multi-sectoral; the second dedicated solely to the potable water and sanitation sector (see paragraph 2.25).

- 2.72 The resolution presented for approval to the Board with the present document corresponds to the first phases for each city only. Bank financing for the first phase of the Program will amount to US\$63 million and will come from the Fund for Special Operations (FSO). Of this, Bank financing will amount to US\$27 million for the San Pedro Sula component, and to US\$36 million for the Tegucigalpa component. The Municipalities have committed to bring 10% of local counterpart funds on each specific project to be financed.

<i>FSO conditions</i>	
Term	40 years
Rate	1% first 10 years
	2% thereafter
Grace period	10 years
Inspection fee	1%
Credit fee	0.5% of undisbursed balance

- 2.73 Each of the second phases would be financed through separate loans (one for each city), to be presented to the Board through a memorandum referencing the present document and presenting justifications that pre-agreed trigger conditions have been met. The presentation of the San Pedro Sula Second Phase (US\$9 million) to the Board would be triggered by the Municipality's implementation of a Bank-approved plan to restructure the outstanding debt on a municipal bond issued two years ago to finance a sport stadium. The presentation of the Tegucigalpa Second Phase (US\$15 million) to the Board would be triggered by the signature of a Bank-approved agreement (between by the Municipality and the Central Government) to transfer the responsibility for potable water and sewage services from the Central Government to the Municipality.

2.74 The following cost allocation table reflects the “optimal scenario” arrived at during the capital budgeting session and highlights the sector-specific spending safeguards agreed upon (in *italic* in the table, with the character of the safeguard: amount not to exceed the value indicated [<] or amount not to be under the value indicated [>]). The cost table also presents the cost allocation proposed for the second phases.

All data in in US\$1,000	Tegucigalpa						San Pedro Sula					
	1 st phase			2 nd phase			1 st phase			2 nd phase		
	IDB	Local	Total	IDB	Local	Total	IDB	Local	Total	IDB	Local	Total
Admin. Costs	680	-	680	275	-	275	520	-	520	165	-	165
Subloans	34,080	3,710	37,790	14,250	9,830	24,180	25,550	2,785	28,335	8,000	850	8,850
Water & Sew.	-	-	-	14,250	9,830	24,180	8,000	1,000	9,000	3,000	400	3,400
Urban Transport	15,500	1,710	17,210	-	-	-	6,000	800	6,800	3,000	400	3,400
<i>Safeguard</i>			< 18,000						< 8,000			
Marginal Neigh.	16,430	1,900	18,330	-	-	-	8,500	850	9,350	5,000	800	5,800
<i>Safeguard</i>			> 16,000						> 8,000			
Solid Waste	900	100	1,000	-	-	-	1,800	135	1,935	-	-	-
Finance TA	1,000	-	1,000	-	-	-	1,000	-	1,000	-	-	-
Environment TA	250	-	250	-	-	-	250	-	250	-	-	-
<i>Safeguard</i>			> 250						> 250			
Financial costs	1,240	290	1,530	475	70	545	930	215	1,145	245	55	300
Interests	880	0	880	325	0	325	660	0	660	245	55	300
Credit comm.	0	290	290	0	70	70	0	215	215	100	90	190
Inspection fee	360	0	360	150	0	150	270	0	270	100	0	100
Total	36,000	4,000	40,000	15,000	10,000	25,000	27,000	3,000	30,000	8,000	1,000	9,000
%	90%	10%	100%	60%	40%	100%	90%	10%	100%	80%	10%	90%

III. Financing Mechanism and Program Execution

A. Borrower

- 3.1 The borrower for the proposed Program will be the Republic of Honduras. Resources will be passed on to the two municipalities through a trust fund (hereafter referred to as the Municipal Development Trust Fund, MDTF), held and operated by a private commercial bank recruited through public bidding by the Ministry of Finance. The MDTF will have two distinct and separate accounts, one for each city. As a condition prior to first disbursement, the Borrower will submit evidence to the Bank that: (1) the MDTF has been legally established; (2) the Credit Guidelines governing its operations have entered into effect in a form substantially equal to that of the draft guidelines approved by the Bank; (3) the Trustee has been recruited according to the terms of reference agreed upon with the Bank; and (4) an agreement between the Central Bank and the Ministry of Finance has entered into effect specifying the procedures which the Central Bank will follow in managing disbursements to the MDTF.
- 3.2 As sovereign borrower, the Republic of Honduras will be ultimately responsible for the repayment of the Bank's loan in the event of municipal default. However, to minimize the probability that the Government of Honduras would need to use its own resources to repay the IDB loan, a series of credit enhancement mechanisms and guarantees will be put in place on each subloan.

B. The Municipal Development Trust Fund

- 3.3 This section summarizes the MDTF Credit Guidelines, a draft of which is available in the Program's technical files (document EXE/1). The Credit Guidelines will apply in the same fashion to the two cities, with two exceptions. (1) The total financing available has been set to reflect each city's debt-carrying capacity. (2) Some of the sector eligibility conditions differ from one city to the other because the sector reforms pursued incorporate different elements.

1. MDTF location, structure and management

- 3.4 The MDTF will work as a line of credit granting loans to the Municipality according to the Credit Guidelines. The following table summarizes the different functions involved in any MDTF transaction.
- 3.5 Responsibilities. The Trustee will be responsible for: (1) appraising specific projects by enforcing pre-agreed technical criteria (see subsection 3 below) and making a recommendation as to project approval to the IDB Country Office in Honduras (COF/CHO); (2) authorizing disbursements on approved projects; (3) performing proactive portfolio surveillance and distressed-debt workouts, and assessing performance against a set of relevant benchmarks; and (4) keeping the Program's books and producing financial statements, and providing progress reports to both the IDB and the GOH every six months.

Function	Responsible party	Observations
Project preparation and submission to MDTF	Municipality	Activities financed with own funds or Program-sponsored technical assistance
Project appraisal and recommendation	Technical Unit within the Trustee	Based on the eligibility matrix of the Credit Guidelines (see Annex III-1)
Project approval decision	IDB Country Office in Honduras	Decision is final
Signature of loan contract	Municipality and Trustee	
Disbursements	Trustee	Disbursements to the MDTF will be authorized by IDB and effected through the Central Bank
Loan collection	Trustee until year 5, via local commercial banks.	See paragraph 3.18 for long-term portfolio management
Portfolio Monitoring	Trustee until year 5	
Trustee supervision	IDB Country Office in Honduras	Appropriate handling of funds and reflows. External auditors perform in depth review twice a year.

- 3.6 The Trustee will be required to establish a Technical Unit which will be responsible for the evaluation of projects. To this end, the Trustee will contract a private firm with significant experience in municipal and infrastructure lending.²² The firm will be recruited by international public bidding, on the basis of terms of reference and a shortlist to be approved by the IDB.
- 3.7 Compensation. The Trustee will be contracted by the Ministry of Finance for an initial period of five years, after which a to-be-defined portfolio management strategy will be implemented. (See paragraph 3.18). Compensation will be in the form of an annual fixed fee made of two components: (1) underwriting and disbursement (for the first three years); and (2) portfolio monitoring, workouts and loan collection (from the second year on).²³
- 3.8 COF/CHO will be responsible for: (1) the overall monitoring of Program execution, most notably with respect to the performance of the financing mechanism²⁴; (2) the authorization of IDB disbursements to the Central Bank; and (3) the approval of specific projects upon recommendation by the Trustee.

2. Eligibility of funds

- 3.9 Once conditions prior to first disbursement have been met, the Municipality will submit to the Trustee requests for funding for specific projects (technical assistance or investment). The Trustee will check three levels of compliance to recommend project approval/rejection to COF/CHO. These conditions are laid out in the eligibility matrices presented in Annex III-1 and summarized below.
- (a) Performance Compliance. The Municipality's performance will be assessed against financial, management and transparency benchmarks. If, at any time during the last six months, one or more of these performance benchmarks has not been respected, no request

²² Since such experience is absent from the Honduran banking sector, it is likely that the Trustee will need to rely on an foreign firm.

²³ Annual operating costs are estimated to be in the range of US\$300,000 during Program execution and US\$200,000 thereafter.

²⁴ This includes the continuing supervision of the appropriate handling of funds by the Trustee. A biannual external audit will be carried out to this end.

for funding will be considered other than for TA projects aiming specifically at helping the Municipality reach the performance benchmarks.

- (b) Sector Compliance. When the Municipality is in “performance compliance”, the sector of the project under study will be checked. These sector-specific conditions aim at ensuring the swift implementation of the modernization strategies agreed upon. Some conditions concern access to TA activities, while others will cover investment activities.
 - (c) Project Compliance. When the Municipality is in both “performance” and “sector compliance”, the specific project will be reviewed. TA projects will be financed as long as they form part of the agreed sector modernization strategies. Investment projects will be checked for technical, financial, environmental and socioeconomic performance according to reasonable standards.
- 3.10 The Trustee will recommend project approval/rejection to COF/CHO which will make the final decision. COF/CHO involvement is meant to mitigate the risk of Trustee’s capture. When the project is approved, a subloan contract will be signed by the Mayor, duly authorized by the *Corporación Municipal*, and the Trustee. The agreement will be a simple document, with a detailed budget, a disbursement schedule, a monitoring protocol and the detailed description of the loan repayment scheme and guarantee package.

3. On-lending conditions

- 3.11 Criteria. On-lending conditions have been determined taking into account the following four considerations. (1) The MDTF, as a temporary instrument to channel IDB financing to municipalities, must be financially viable -- i.e. cover all Program costs, including cost of IDB funds and operating costs -- and mitigate the risk of municipal default borne by the Central Government. (2) The MDTF should lend in local currency so as not to overburden the municipalities with the exchange risk, a risk they are particularly ill equipped to deal with. (3) The on-lending conditions should adjust to the movement of local interest rates to help establish a hard-credit culture. (4) The on-lending rate should adjust automatically (as opposed to being administered) and in an agile and transparent fashion (i.e. according to an easy-to-compute, public index). (5) The on-lending conditions should be below market rates to transfer some of the FSO benefits to municipal projects pursuing developmental objectives.
- 3.12 These considerations were applied to set the on-lending conditions. The following conditions are proposed. (a) Rates will be variable rates in lempiras and will be adjusted every six months to eighty-five percent of the weighted average of deposit rates in the local banking system.²⁵ (b) Maturities will be set to reflect the economic life of project assets (25 years for technical assistance). In particular, subloan maturity must never exceed the term of the IDB loan so as not to create a negative mismatch between subloan repayment and IDB debt service. (c) Grace periods will be set at disbursement plus one year.

²⁵ An index registered by the Central Bank, currently at 18%.

4. Handling of funds: disbursements, contracting, monitoring and reporting

- 3.13 Disbursements. Program execution and disbursement are expected to last four and five years respectively. Disbursement of Bank funds will follow a two-level process. The replenishment of the Ministry of Finance's account in the Central Bank will follow the IDB procedures for advancing funds to borrowers (document CC-5411). Transfers from this account to the MDTF will be automatic.²⁶ Disbursements from the MDTF to municipalities will follow the procedures laid out in the Credit Guidelines, involving the following steps: (1) approval of the specific project and signature of the subloan agreement as per paragraph 3.9 above; (2) opening of a project account by the Municipality with a commercial bank; (3) authorization of disbursement and transfer of funds by the Trustee to the Municipality's project account. The expected schedule of disbursement of the IDB loan is as follows (in US\$ million).

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
San Pedro Sula	3.00	6.75	6.75	6.75	3.75	27.00
Tegucigalpa	4.00	9.00	9.00	9.00	5.00	36.00
Total	7.00	15.75	15.75	15.75	8.75	63.00

- 3.14 Contracting. All contracting will follow the Bank's policies. International public bidding will be used for procurement of works in excess of US\$1,000,000 and for acquisition of goods and services in excess of US\$350,000. National procurement regulations will apply under these thresholds.
- 3.15 Monitoring and reporting . For activities exceeding US\$1 million, the Trustee will carry out on-site inspections every three months during construction to ensure that the disbursement and the construction schedules are in phase. The Municipality will present to the Trustee (1) a pre-inspection report before each inspection and (2) a project completion report within two months of last disbursement for an activity.

5. Repayment of subloans and guarantee structures

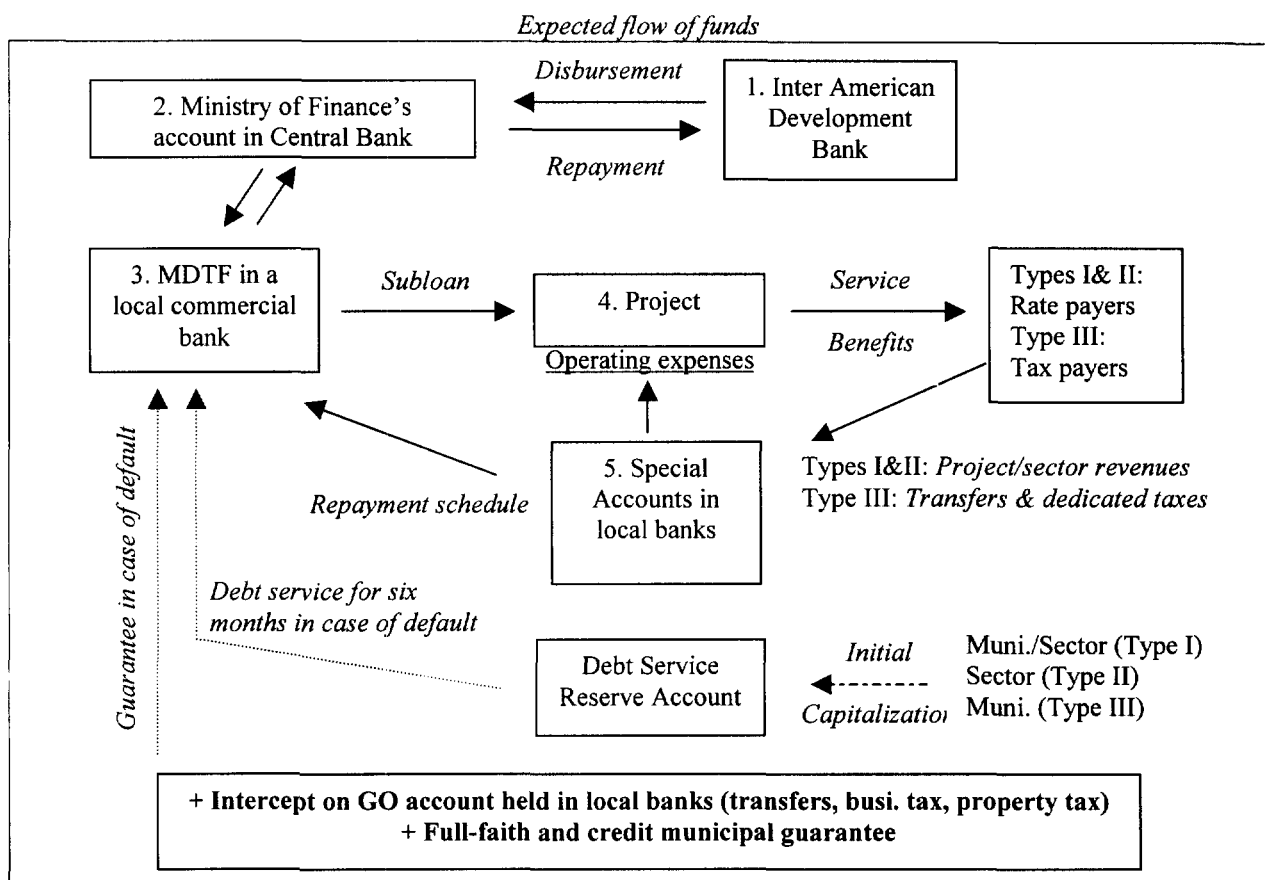
- 3.16 The MDTF will offer three basic products, to finance: (I) revenue-generating projects; (II) projects from revenue-generating sectors; and (III) other projects. Subloan agreements will make provision for the following arrangements.
- (a) Source of repayment. The municipality will establish special accounts with local commercial banks to isolate the primary source of subloan repayment and make it available to repay the MDTF. For Type I loans (project finance type), the special account will be established at project level (one account for each project) and the primary source of repayment will be project revenues; for Type II loans (sector loans), the special account will be established at sector level and the primary source of repayment will be dedicated sector revenues; the primary sources of repayment for type III loans (General Obligations, GO) will be, in this order, (1) intergovernmental transfers; (2) the business tax²⁷; and (3)

²⁶ The Trustee will be required to pay interests on any funds in its possession either before they are disbursed to the municipalities.

²⁷ The municipal tax most buoyant with inflation.

the property tax. For every project, the special account guidelines (*reglamento*) will be part of the subloan agreement. In order to be eligible to collect municipal revenues and manage one or more special accounts, commercial banks must sign a contract with the MDTF, which binds them to comply with a pre-agreed schedule of automatic transfers from the special accounts to the MDTF.

- (b) Debt Service Reserve Account (DSRA). Additionally, the Municipality will establish a DSRA with the Trustee to temporarily cover any shortfall between the special accounts' aggregate balance and aggregate debt service requirements. At any time, the DSRA will need to maintain a level of funding equal to six months of 20% of the aggregate debt service. The capitalization of the DSRA will be financed with counterpart (i.e. municipal) funds for the subloans for which the DSRA is created/augmented²⁸. The DSRA balance will be invested in low-risk, highly liquid market instruments so as to maintain its value over time. When the end of a loan's repayment period nears, corresponding DSRA funds will be applied to cancel the last six months of debt service.



²⁸ Counterpart funds other than those needed to capitalize the DSRA will not be channeled through the MDTF but will be spent directly by the municipality to cofinance the projects. Such funds will be recognized by the Trustee upon presentation of the appropriate documentation.

- (c) Guarantees. The risk of default will be further reduced by a guarantee structured in two tiers. (1) The MDTF will have a senior right of intercept on the GO special account held in commercial banks. (2) Additionally, the Municipality will provide a full-faith and credit guarantee whereby any municipal income must be applied to cover outstanding MDTF obligations.

- 3.17 As an exception to the described arrangement, it is proposed that the general municipal guarantee does not apply to projects undertaken in the water sector for the Tegucigalpa component of the Program. The Tegucigalpa water sector is a highly risky sector and the risk will be shared between the Municipal Government, who is willing to face the daunting task of revitalizing services in the Capital, and the Central Government, who is partly responsible for the poor present condition of the services. Water projects in Tegucigalpa would therefore only be secured by tariff revenues and the Sovereign guarantee.

6. Collection of subloans

- 3.18 The collection of subloans will be ensured by the Trustee for at least five years from Program start, via the special account mechanism described in paragraph 3.16 above. On the third year of Program execution, a consultancy will be contracted by the Ministry of Finance to design a strategy for the management of the MDTF portfolio after the fifth year. This strategy will look into several options including: (1) securitization or sale of part or all of the MDTF portfolio on the secondary market; (2) transfer of the portfolio management responsibility from the Trustee to a commercial bank, recruited by public bidding; (3) take over by the Ministry of Finance. Factors such as the level of macro-economic stability and the state of development of local financial markets are expected to play an important part in working out the best option.

7. Utilization of reflows

- 3.19 As an on-lending facility, the MDTF has been designed to break even, not to generate profit above the IDB conditions. The repayments of subloans will be channeled automatically from the MDTF to the Ministry of Finance's account at the Central Bank. Reflows will go primarily to repay the IDB loan. Any re-flow in excess of IDB debt repayment will accrue to the Central Government. The only proposed restriction is that reflows be used to finance projects with objectives similar to that of the proposed Program. After a period of five years, the Bank and the Government may decide to re-assess the utilization of reflows.

C. Retroactive financing

- 3.20 The municipalities have incurred expenditures to contract technical assistance and purchase equipment aimed at the preparation and implementation of the reforms contemplated by the proposed Bank Program. It is proposed that up to US\$500,000 of such expenditures be eligible for retroactive Bank financing for each municipality when these expenditures have been pre-approved by the Project team and made in accordance with Bank procedures. Reimbursement will be made through one "retroactive financing

subloan”, guaranteed with a GO pledge, to be granted automatically by the Municipal Development Trust Fund once: (1) the conditions prior to first disbursement have been met; and (2) the municipality is in performance and sector compliance. Similarly, up to US\$500,000 per municipality of such expenditures will be recognized as counterpart funds for future MDTF sub-loans.

D. Emergency measures

3.21 The following measures are proposed as temporary exceptions to the Program’s execution arrangements in order to address the emergency conditions recently brought on by the Tropical Storm Mitch.

- (1) Until the end of the sixth month after the loan contract has entered into effect or until the MDTF becomes operational, whichever comes first, the two municipalities will be authorized to commit and spend Program resources up to an amount of US\$12 million for Tegucigalpa and US\$9 million for San Pedro Sula without meeting the special contractual conditions mentioned in paragraph 3.1. Instead, the following conditions will apply:
 - Resources may only be used to finance studies and works for elements of infrastructure (a) of the sectors covered by the Program and (b) which have been destroyed or damaged by the storm.
 - Specific activities must be authorized ex-ante by the Bank’s Country Office in Honduras.
 - The municipality must commit to repay the activity to be financed to the Ministry of Finance under the terms outlined in paragraph 3.12.
- (2) During the first six months the loan contract is in effect, streamlined procurement procedures will apply, as per the Bank’s draft policy on procurement procedures for emergency projects recently submitted to the Board.
 - One general information notice will be published in the United Nations “Development Business” Journal within one month of loan contract effectiveness.
 - The following procurement procedures will be used for individual projects:

Procurement rules (All amounts in US\$)	Thresholds for works	Thresholds for goods	Thresholds for consultants
Direct contracting	< 100,000	< 50,000	< 50,000
Private bidding with at least three qualified firms	< 500,000	< 200,000	< 200,000
National Public Bidding	< 3,000,000	< 350,000	< 350,000
International Public Bidding	> 3,000,000	> 350,000	> 350,000

3.22 Once the Municipal Development Trust Fund is operational, all debt owed by the municipalities to the Ministry of Finance will be reassigned to the MDTF (i.e. will become owed by the municipalities to the MDTF), following arrangements similar to those to be used for retroactive financing.

E. Bank supervision

- 3.23 At the outset of Program execution, a joint FI2/CHO mission will organize a start-up workshop with all local actors. Every six months thereafter during execution, the Bank will carry out a monitoring mission to review the external financial audit of the MDTF and assess Program performance. The Trustee will be responsible for providing pertinent financial and progress reports.
- 3.24 Program performance will be reviewed on the basis of the benchmarks presented in Annex III-2. A key benchmark with regard to the financial strengthening of the Program will be the rating to be obtained by each municipality from an international rating agency before the end of the second year of Program execution. Another, more concrete benchmark will be the time and conditions at which the municipalities achieve access to the local/regional financial markets. Central benchmarks related to service quality and coverage will be written into the private provision contracts. They shall be monitored closely by each municipality's Urban Services Supervisory Office.
- 3.25 Needs for specific modifications to the Credit Guidelines will be discussed with the GOH, the Trustee and the two municipalities, and approved by the Bank during the biannual monitoring meetings. In particular, the need for ex-ante approval of projects by COF/CHO will be re-assessed after 18 months of Program execution in light of the MDTF's performance.
- 3.26 Given the complexity of the proposed operations and the level of involvement of COF/CHO, it is planned that COF/CHO and FI2 dedicate 40 and 5 staff weeks a year respectively to Program supervision. Additionally, COF/CHO will use about US\$50,000 a year of its administrative budget to recruit specialized consultants as needs arise.

IV. Financial, Socioeconomic and Environmental Impacts of the Program

A. Financial impacts

- 4.1 **Methodology.** From a financial standpoint, each operation has been dimensioned according to the Municipality's overall debt-carrying capacity, a notion that aggregates two variables: the debt-carrying capacity of the Municipality's *Caja Unica* and that of the sectors to be reformed under the current program.
- 4.2 The first variable was determined by employing the following methodology. (1) Starting from the analysis of the present financial situation of the Municipality, projections were made for revenues and expenditures over the next 15 years.²⁹ (2) The Free Cash Flow was estimated taking into account existing commitments, notably outstanding debt repayment. It was used as the key variable to determine the amount of debt that the Municipality will be able to service, at the conditions granted by the MDTF.³⁰
- 4.3 The second variable was assessed on a sector by sector basis. The institutional reforms to be carried out under the proposed Program should lead the urban transport sector, the solid waste sector and the water sector to become financially autonomous. All sectors to be reformed were separated financially from the rest of municipal operations by identifying the projected costs and revenues that proposed sector investments would generate. Sector-specific cash flow streams were then estimated taking into account very conservative income estimates, most notably when the proposed income sources have yet to be established.
- 4.4 The two variables were finally aggregated and the overall size of the debt was determined by imposing two prudential limits to debt service throughout the amortization period: (a) debt service should not exceed 35% of consolidated current income; and (b) debt service should not exceed 75% of consolidated cash flows.
- 4.5 **Results.** The debt-carrying capacity of San Pedro Sula was appraised under the three Sextos Juegos scenarios described in paragraph 1.23. It amounts to US\$0 (worst case), US\$27 (base) or US\$36 million (best case) depending on the scenario, hence the proposed conditional second phase to be presented to the Board at a later date. The debt-carrying capacity of Tegucigalpa without the water sector is US\$36 million. The dimensioning of the potable water component (to be financed under the second phase) does not come from debt-carrying capacity calculations but from an analysis of the investment requirements for

²⁹ The following hypotheses were made. (1) Income generation has been estimated by modeling dynamically the projected behavior of each source of revenue according to tax base, tax coefficients and collection rates. The overall average growth rate of current revenues is a conservative 11% per year in Lempiras. (2) Similarly, current expenditure has been estimated to grow at an average of 7% a year.

³⁰ Based on historic data series for Honduras (1990-98), the following parameters were used to determine the on-lending rate (85% of the average passive rate): (1) Inflation stabilizes at 10%. (2) Active rate in banking system maintains a fixed spread of 11% over inflation. (3) Average passive rate is 70% of active rate.

the first three years. It will be viable with an 80% long-term increase in tariff, which is deemed politically acceptable.

- 4.6 The main features of the financial outlook are similar for the two municipalities. In the short term, current income will grow and current expenditure diminish, but the service of existing short term debt will seriously limit the current surplus generated. In the longer term, debt obligation will stabilize (short of future debt) and the current surplus will keep increasing, generating additional debt-carrying capacity to be utilized by future administrations.
- 4.7 Consequently, the behavior of the two main financial indicators is similar for the two cities. (1) The debt service to current saving ratio increases rapidly in the first two years to reach the 75% cap on year 2 in Tegucigalpa and 3 in San Pedro Sula. Thereafter, debt obligations remain constant but the current surplus keeps increasing, resulting in a decrease in the ratio, down to a very comfortable 50% on year 8. (2) The debt service to current income ratio increases more slowly and reaches the 35% cap on year 6 in both cities, at the end of the grace period of the last projects financed with IDB debt. It goes down to 20% on year 10. Exhaustive financial analyses are available in the Program's technical file (document PRE/5).

B. Socioeconomic impact

- 4.8 The reforms sponsored by the Program will yield two major benefits. First, they will bring about discipline and transparency in the financial management of the municipalities, most notably thanks to the link the financing mechanism will promote between measured performance and access to loan resources. Enhanced resource allocation is to result. Second, reforms will improve efficiency and equity in service delivery. Through increased pricing and management efficiencies, they will reduce physical and commercial losses, as well as wasteful consumption. In the water sector for instance, this will generate the necessary revenue stream to finance maintenance; cause present water losses to be converted into surplus water for new consumers; defer investments for rehabilitation and expansion due to premature deterioration and excess demand; and release funds to expand coverage to new consumers – benefiting those most often left out of public service coverage: the poor. By the same token, loan repayments by users will allow public funds absorbed by (often ill-targeted) sector subsidies to be released to meet other needs.
- 4.9 The investments considered under the Program will leverage reform efforts to achieve improvements in service quality and coverage. An economic evaluation was conducted for the four main proposed investment components of the Program. For each type of investment, the main quantifiable costs and benefits were defined and analyzed, using mostly secondary sources of information. In each case, the analysis commented on the reasonableness of the proposed cost levels and the distribution of costs and benefits by income group, using the Bank's poverty definition as the point of reference³¹. Where

³¹ According to the Bank's benchmark definition of poverty, the poor in Honduras are those households with a monthly per capita income under 715 Lempiras (Lps). On this definition, 55% of all Tegucigalpa and 45% of all San Pedro Sula households are poor, according to the September 1997 household survey data. However, the 715 Lps

possible, the economic rate of return of the investment was calculated, using the appropriate conversion factors to establish social opportunity cost.³² Where this was not possible, due to the lack of precise data either for the quantification of costs or of benefits, recommendations were made for an economic evaluation method, to be implemented on a project-by-project basis in the course of Program execution. In several of the sectors, recommendations were also made for the adoption of project selection procedures likely to result in acceptable economic rates of return.

- 4.10 The results of the economic analysis are available in the Program's technical files (document PRE/6). The table next page summarizes the various benefits taken into account and looks at the distribution of benefits amongst the different groups of beneficiaries. The data presented correspond to Tegucigalpa. Similar data is available for San Pedro Sula.
- 4.11 The economic evaluation carried out suggests that the proposed Program is a Poverty Targeted Investment (PTI) since about 55% of the Tegucigalpa and 45% of the San Pedro Sula beneficiaries are below the Bank's poverty threshold. In absolute value, Program benefits are likely to accrue in vast majority to the poor. In Tegucigalpa, the water component and the marginal neighborhood component are the two most poverty-targeted components. They will mobilize 66% of Tegucigalpa resources and 80% of their benefits will accrue to households under the poverty threshold. In San Pedro Sula, the marginal neighborhood component is the most poverty-targeted component. Its amount represents 50% of San Pedro Sula resources and its benefits will accrue almost entirely to the poor. The water component (30% of San Pedro Sula resources) will also benefit the poor in a significant fashion: it will result in a strong redistribution of welfare from richer neighborhoods presently consuming too much under-priced water to marginal areas currently not receiving service.
- 4.12 Explicit subsidy programs have been agreed upon to make the operation affordable to the poor. They include: (1) subsidized sale of municipal land (which entails no cash outlay for the municipality); (2) marginal neighborhood upgrading programs whereby paving and other community works will be subsidized in those communities that accept to bring a fraction of the financing; and (3) a water connection program whereby local water systems will be installed at a fraction of cost in those neighborhoods that express willingness to pay for recurrent expenses.³³ The decentralization and restructuring of public transport in Tegucigalpa may have a strong impact on the poor. The current subsidy scheme is particularly inefficient. Should decentralization take place, it will be a challenge for the

level is a country-wide benchmark, applying to rural and urban areas alike. In still very rural Honduras, a 715 Lps monthly per capita revenue would be considered extremely low for an urban dweller.

³² Technically, the evaluations were conducted in constant 1998 Lempiras at border prices. The main adjustments made to financial costs were the following. (1) Identifiable taxes and subsidies were removed. (2) Unskilled construction labor was assigned a conversion factor of 0.75, reflecting the differential of 25% between unskilled wage rates in construction compared with other sectors and also reflecting the overall unemployment rate of 6.3%. (3) A general adjustment factor of 1.05 was assigned to imported inputs to reflect the estimated impact of the trade tax regime on the equilibrium exchange rate.

³³ The water tariff structures proposed (to be finalized in the case of Tegucigalpa) include a baseline rate plus incremental blocks, to take account of the higher share of marginal investments made necessary by high-consumption clients. This will help make low-income bills affordable.

Municipality to design and establish a well-targeted, efficient and affordable subsidy system.

	Water and Sanitation Services	Solid Wastes Services	Urban Transport	Marginal Neighborhood Improvement
Nature of benefits	Enhanced quality/reliability, expanded coverage (measured by willingness-to-pay).	<ul style="list-style-type: none"> - Collection services: enhanced quality/reliability, expanded coverage (measured through tariff incomes). - Environmental benefits of landfill were not taken into account. 	<ul style="list-style-type: none"> - Road maintenance: savings in Vehicle operating Costs. - Efficiency road improvements: time savings for users. 	<ul style="list-style-type: none"> - Land legalization: increased security of tenure (measured through increased value of land). - Paving of bus routes: time and money saved by local residents. - Improvement of barrios: increased access to public services (measured through increased value of land).
Quantified benefits/rate of return when available (Tegucigalpa)	<ul style="list-style-type: none"> - Service coverage to go from 85% to 95% (potable water) and 66% to 80% in 10 years. - Net welfare for each household given a connection: US\$15.3 to US\$42.7/month. - Net welfare for each household with existing connection: US\$1.55 to US\$3.56/month. - Total net welfare: US\$10.8 to 14 million/year. 	<ul style="list-style-type: none"> - Willingness to pay: about US\$35/ton of waste collected, about 40% above efficiency costs. - Coverage to increase from 25% of city area to about 90%, with bulk of new coverage for marginal areas. 	<ul style="list-style-type: none"> - Road maintenance: average 20-year IRR of 18.5% with 5% estimated traffic growth. - IRR of efficiency projects between 13.5% and 50% for those with data available. 	<ul style="list-style-type: none"> - Land titling: Expected increase in land value between 11 and 58% of present land value. - Bus route paving: 18 projects were analyzed, with return of -1% to 98%, the majority above 30%. - Improvement of barrios: prioritization mechanism will need to be established to reflect willingness-to-pay.
Indicative distribution of sector benefits by groups	Very strong distributive impact: <ul style="list-style-type: none"> - All new connections are in marginal neighborhoods. - Marginal neighborhood dwellers now pay US\$4.5/household a month for about 3.5 m³. With the project, they would pay about 0.25\$/ m³. 	Strong distributive impact: <ul style="list-style-type: none"> - Coverage in marginal neighborhoods will increase from less than 20% to more than 80%. - Will represent a net additional expenditure for slum residents, but supposedly out-weighted by perceived marginal benefits. 	Uncertain distributive impact: part of the impact will depend on the way the Government responds to the Program in the negotiation of subsidies for public transport. <ul style="list-style-type: none"> - If all the benefits of reduced operating costs are passed on in lowered fares to bus users, a significant proportion of the benefit will accrue to the poor. - If the Government takes the opportunity to lower the public transport subsidy, the main beneficiaries will be private vehicle owners (of whom 70% are non-poor) and the State. 	Very strong distributive impact: <ul style="list-style-type: none"> - Component targeted toward low-income neighborhoods using the 1988 census data and the Ministry of Health Inventory of Barrios. - 100% of benefits will accrue to the Poor. - Costs will be recovered partially only, and in a progressive fashion.

Source: Ian Walker et al., ESA, September 1998

C. Environmental impact

4.13 The Program is expected to have mostly environmental benefits. First, it will contribute significantly to the improvement of the two cities' public service infrastructure, the poor present condition of which has been the cause of serious environmental problems. Second, it will be a stepping stone in the establishment of an environmental management capacity at municipal level. (See paragraphs 2.29 and 2.59).

4.14 Consequently, the Program's main environmental risk is politico-institutional: if the Environmental Management Unit does not receive political support from the Municipality's highest level, the Program may lead to an increase in the number of infrastructure projects implemented without consideration for environmental aspects. To

mitigate this risk, the disbursement of any investment funds will be conditioned to the proper establishment of the EMU and approval of specific projects will require that the Project Review Process designed during Program preparation be abided by.

- 4.15 Another risk is related to the privatization processes which the Program will support. The sharing of existing environmental liabilities between the municipality and future (private) operators will have to be carefully looked into, especially in sectors such as landfill management and waste water services. The proposed Program will require that the municipality contract the necessary expertise to carry out a complete environmental diagnostic of all facilities to be privatized as an input to the structuring of the deal and the eventual drafting of the concession contract.

D. Risks

- 4.16 The proposed Program entails two fundamental risks: implementation risks and political risks.

- 4.17 Implementation capacity. Both operations are complex: they entail full-fledged reforms of most service sectors under municipal responsibility. In this sense, they are the municipal equivalent of a structural adjustment operation. The capacity of the municipal administrations to implement the proposed reforms will be key in ensuring the sustainability of the proposed Program. In both municipalities, there are encouraging signs – yet with different styles: a strong political will on the part of the municipal executive and a high level of technical competence on the part of higher management; and a strong consensus that reforms are necessary. Past experience of structural reforms show that external technical assistance is of limited help in the absence of internal political consensus for reforms in which idiosyncrasy plays a predominant role. The reform process must belong to the municipalities. It is the Project Team's opinion that both municipalities are well prepared to enter this process.

- 4.18 Political risks. Working with municipalities entails a different set of risks involving intergovernmental relations. Short-term risks are present mainly in Tegucigalpa, where the municipal and central governments are from different parties. The consideration of this risk was instrumental in the design of the financing mechanism: project evaluation will be delegated to a technically competent, politically neutral third party, while final project approval/rejection decisions will, at least initially, be made by the Bank's Country Office in Honduras. Long-term risks are inherent to long-term sub-sovereign lending, especially where the municipal finance market is too incipient to impose discipline. For the next fifteen years, the way the municipalities are managed will be one of the most important factors influencing their capacity to repay loans they will secure from the Trust Fund. While the Bank is ultimately covered by the Sovereign's guarantee, a series of features have been included in the proposed Program to reduce the uncertainty of future municipal management. First, whenever possible, the proposed service reforms will be institutionalized through long-term contractual arrangements (service contracts, concessions), making reforms more irreversible. Second, for each specific subloan granted by the MDTF, a series of self-standing guarantees will be established to impel the

Municipality into repayment. The proposed Program will provide both municipalities a unique opportunity to build a solid credit history, and, in case of subloan default, will put the country's judicial system at test – two stepping stones for the development of a real municipal finance market.

Annex III-1 (1)
Eligibility Matrix for Tegucigalpa

This matrix outlines the conditions that need to be fulfilled for the disbursement of funds to be authorized. Four main types of conditions exist: conditions prior to first disbursement, general performance conditions, sector eligibility conditions, and project eligibility conditions.

A. Conditions prior to first disbursement

1. Agreement between Ministry of Finance (MFIN) and Municipality on Municipal Development Trust Fund (MDTF) and its regulations.
2. Agreement between MFIN and Central Bank on role of the Central Bank in managing MDTF accounts.
3. Recruitment of Trustee in accordance with the terms of reference agreed on with the Bank.
4. Conditions established in IDB general norms.

B. General performance conditions

1. Fulfillment of financial indicators

- debt service/current income ratio less than 35%, with exception for 1999: up to 50%.
- debt service/cash flow ratio less than 75%.

2. Fulfillment of transparency requirements

- Publication in three national newspapers of the financial statements audited by certified external auditors, commencing with year-end 1999 and every six months thereafter. The statements should be published by the end of the month following the close of each six-month period (end of July for the first half and end of January of the follow year for the second half).
- Publication in three national newspapers of the list of contracts awarded every three months.
- Creation of a Web site providing the information mentioned in the two previous points.
- Monthly publication of the relevant financial indicators (providing at least the two ratios mentioned in point 1) on the municipality's Web site.
- Publication of environmental data every six months on the Web page commencing in the year 2000.
- Publication of performance indicators [to be established in each sector] for each service provided by the Municipality, every six months on the Web page.

3. Fulfillment of the cost control targets

- The percentage increase in total human resources spending from one year to the next (taking the last two years for which the accounts have been closed and audited) must not exceed the average annual inflation rate during the aforesaid two years as computed by the Central Bank.
- If external resources are used to fund spending on infrastructure, only long-term financing may be used.
-

4. Implementation of technical assistance for financial strengthening

- The timetable considered for technical assistance (to be attached to the Credit Regulations) may not be more than two months late.

5. Fulfillment of environmental requirements

- (a) These conditions will apply commencing six months after the effective date of the IDB loan contract:
 - Approval by the Municipality of an agreement to strengthen the Environmental Unit in order to grant it greater powers in issuing and enforcing standards and regulations.
 - Strengthening of the Environmental Management Unit in accordance with the profile agreed on.
 - Establishment of a system to review the environmental impact of municipal projects and particularly requests for financing from the Municipality to the MDTF.
- (b) Commencing one year after the effective date of the IDB loan contract, the following will apply:
 - Environmental base line data established.
 - Measures and publication (on the Web page) of environmental data every six months.
 - Updating of Environmental Risk Maps.

C. Sector eligibility conditions

Urban transport sector

The projects are classified into:

Group A: efficiency works (traffic/parking control strategies, integrated traffic light system in Central Business District), indirect support for public transport (bus priority measures, dedicated lanes).

Group B: connectivity and continuity projects

Group C: rehabilitation works

1. Commitments will be limited to a maximum of: (1) US\$2 million for Group C projects, or (2) US\$3 million for Group A+B projects before the municipality has completed the

following actions:

(a) Strengthen the Urban Development Directorate to ensure that the following actions have been fulfilled:

- Development of a sustainable road inventory system that includes monitoring.
- Start up of "basic functions" that include contracting and programming.

(b) Establish the Central District Transport Fund. Determination of the Fund's legal and financial status is subject to an expert opinion on whether it is feasible and advisable, based on technical, economic, and financial considerations. This opinion will need to be given within six months. The AMDC will make a proposal to the IDB in this regard.

2. The Transport Fund's current income will be used to cover, in this order: (1) administrative expenses incurred for "basic functions" of the road sector; (2) the cost of maintaining the network in good condition; and (3) debt service on loans for Group C projects. This condition will not apply before the Fund is set up. During the Fund's first fiscal year, its current income may be used to cover only one half of the aforesaid expenses, with the remaining 50% being covered with other municipal resources.

Monitoring: At the end of each fiscal year, the municipality will present the Fund's audited financial statements for the year just ended as well as the budget for the next year. If the criteria mentioned above are not met, the following steps will be taken: (1) the budget for the following year will need to include sufficient resources to fulfill the commitments pending; and (2) approvals of road projects will be suspended until such commitments have been fulfilled.

Potable water and sewerage sector

General sector conditions

1. An interagency commission, to be set up, will determine, at least three months prior to the actual transfer of service responsibility to the municipality, that the goods, equipment, services, and financial condition of the present operator are not impaired or weakened in such a way as to adversely affect the smooth functioning in the future of the service to be transferred to the AMDC. In addition, it will guarantee the continuity of the service in suitable conditions for the user, during the transition period.
2. A decentralization agreement will be signed between the Government of Honduras and the Municipality. The agreement will take effect by June 30, 1999, at the latest.
3. The agreement will need to include the following points:
 - Preparation of an updated inventory of all of the assets, property, credits, and other rights connected with the service.
 - Transfer of responsibility for potable water and sewerage service to the Municipality.

- Transfer of productive assets and the records, plans, studies, data bases, and other assets related to the delivery of service but not the liabilities (debts, employee liabilities, other liabilities).
- Commitment by the Municipality to award a management contract to an experienced operator through international competitive bidding.

Eligibility condition for technical assistance for advertising and education campaigns, and the referendum

4. That the pre-qualification notice for the management contract has been published.

Eligibility conditions for other technical assistance

5. That responsibility for providing SANAA services has been transferred to the Municipality.
6. That a management contract is in force and the Bank's approval of the contract has been obtained.
7. That a new rate structure sufficient to cover the operating and maintenance expenses and service on the debt is in place.
8. That the operator has a business plan that includes an investment plan for the duration of the management contract.

Solid waste sector

Conditions for the program. Approval will not be granted for any project (in any sector) except for technical assistance for solid waste projects, unless the Municipality has:

(a) By the end of the second year (after the effective date of the IDB loan contract):

- granted the private sector a concession for collection services by means of a transparent process;
- hired microenterprise cleaning companies to collect and transport solid waste in marginal neighborhoods, thus providing coverage for 40% of the population;

(b) By the end of the third year (after the effective date of the IDB loan contract):

- rehabilitated the dump for operation as a sanitary landfill in accordance with reasonable technical standards;
- granted a concession to the private sector for management of the rehabilitated sanitary landfill;
- attained a bill collection rate of 90%.

Sector eligibility conditions. For the Municipality to have access to IDB resources for the solid waste sector, it must demonstrate that it has:

- introduced a system of monitoring and follow up of the contracts signed in the Municipal Cleaning and Sanitation Department;
- set up a special account for the services (revenue and expenses).

Marginal neighborhood sector

	Group	Estimated cost	Observations
A	Paving of bus routes	US\$10,000,000	
B	Community works	US\$6,500,000	
C	Legalization	US\$2,000,000	Minimum: US\$2,000,000
D	Technical assistance		

Sector eligibility conditions

Groups A and B (Conditions of sector eligibility for investment resources are applied independently to each of the two groups)

1. The Municipality will need to obtain the Bank's nonobjection to the proposed plan for subcomponent execution. This mechanism will need to include the subcomponent management and execution arrangements.
2. The Municipality will need to obtain the Bank's nonobjection to the project identification/selection system. This mechanism will need:
 - to involve the beneficiaries,
 - to take into consideration the beneficiaries' willingness to pay as a measure of the project's economic benefit,
 - to encourage resources to be raised from the beneficiary community itself, and
 - to take into account the poverty levels for purposes of equity.
3. The Municipality will need to obtain the Bank's nonobjection to the project financing and repayment mechanism. This mechanism shall:
 - take into consideration questions of equity, and
 - be easy to administer.
4. The Municipality will need to obtain the Bank's nonobjection to the subcomponent contracting plan. This mechanism must conform to the general contracting requirements of the program.

Group C

Legalization	Conditions
<p>1. Design processes whereby the municipality, the inhabitants, and NGOs can <u>contract external services for a complete package</u> of regularization tasks.</p> <p>(a) Legal analysis (b) Topographical survey (c) Socio/economic study: study of the willingness/ability to pay. (d) preparation of title.</p> <p>2. Develop a property registration program in order to register titles in the neighborhood itself. In issuing and registering titles, special attention will need to be paid to protecting the rights of women, notably those living in common-law households.</p> <p>3. Select three neighborhoods for a "pilot" program to test the process and demonstrate that the objectives of times/costs can be attained; verify register program.</p> <p>4. Prepare a timetable for contracting whereby (a) the municipality contracts directly for land legalization; (b) NGOs, as executing agency, contract externally for process of land legalization.</p> <p>5. Provide training to topographers, companies, NGOs, officials in execution of procedures.</p>	<p>1. Proposed process is reviewed and approved by IDB</p> <p>2. Proposed process is formally authorized by municipal council</p> <p>3. Report to the IDB on the results of pilot program</p> <p>4. Contracting plan for the approval of the Trustee</p>
Purchase/sale of land	Conditions
<p>1. Develop a viable procedure for determining the market value of legalized properties.</p> <p>2. Propose financially viable arrangements for the purchase of municipal lands by households in the existing marginal neighborhoods.</p> <p>a. Immediate payment by the beneficiary b. Credit facilities: - clarify the procedure in case of arrears/default on payments - take into consideration the municipal subsidy explicitly and transparently.</p> <p>3. Develop proposals for channeling proceeds from sale to the Neighborhood Improvement Fund.</p>	<p>1. Proposed procedure reviewed and approved by the IDB.</p> <p>2. 80% of residents agree to pay estimated cost per unit.</p>

D. Summary of project eligibility conditions

General project criteria

1. Technical criteria: Each request for financing will need to include a technical study and a study of costs based on acceptable standards. Rights of way and land titles for project construction must be secured by the Municipality.
2. Financial criteria: Each request for financing will need to include a detailed financial study. When applicable, tariffs will need to be set so as to cover long-run marginal costs.
3. Environmental criteria: Conditions set forth in the Environmental Law with regard to Environmental Impact Assessment will need to be abided by. In particular, each request will need to include an environmental study based on acceptable standards. Each privatization project will need to include a diagnostic assessment of the environmental liability and a study of how the liability will be shared between the municipality and the private operator. Financing will not be provided for projects in risk zone IV.
4. Economic criteria: The criteria to be applied vary from sector to sector. In most cases, a preliminary list of potential investments has been drawn by the Municipality and reviewed for economic feasibility with the Bank. Projects have been classified according to their economic return and spending requirements have been established for each category.
5. Social criteria: When applicable, the acceptability of the project will need to be determined by means of a survey.

Sector specific project criteria

1. Solid waste sector

- No financing will be provided for goods and equipment related to waste collection and transport.
- A study of alternatives will need to be preformed to identify the most technically appropriate solution overall for the rehabilitation of the sanitary landfill.
- A detailed environmental impact assessment must be performed for the landfill rehabilitation.
- Debt-service-coverage ratio (after investment but based on historic tariffs) > 1.0

2. Marginal neighborhoods

- The economic study will be based on the assessment of the project benefits expected to

- accrue to the poor, using the poverty map being developed.
- A maximum cost will be set per household or beneficiary, to be agreed between the Municipality and the Bank before Program start.
 - 60% of the beneficiaries must indicate their agreement prior to commencement of the project.
 - Except in the case of municipal lands or public areas, the approval or nonobjection of the formal owners of the land will be required before improvement works start.
 - 20% of the project costs must be paid by the beneficiaries before the construction works begin
 - The beneficiaries of this program may not sell or assign the housing constructed or improved for a period of at least ten (10) years, unless the transfer is made on account of the death of his legal heirs.

3. Transport sector

- Debt-service-coverage ratio for Urban Transport Fund (UTF), after investment but based on historic income of, must be greater than 1.0 the first two years, 1.4 thereafter

4. Water sector

- Debt-service-coverage ratio for potable water and sewerage services (after investment but based on historic tariffs) > 1.0

Annex III-1 (2)
Eligibility Matrix for San Pedro Sula

This matrix outlines the conditions that need to be fulfilled for the disbursement of funds to be authorized. Four main types of conditions exist: conditions prior to first disbursement, general performance conditions, sector eligibility conditions, and project eligibility conditions.

A. Conditions prior to first disbursement

1. Agreement between Ministry of Finance (MFIN) and Municipality on Municipal Development Trust Fund (MDTF) and its regulations.
2. Agreement between MFIN and Central Bank on role of the Central Bank in managing MDTF accounts.
3. Recruitment of Trustee in accordance with the terms of reference agreed on with the Bank.
4. Conditions established in IDB general norms.

B. General performance conditions

1. Fulfillment of financial indicators

- debt service/current income ratio less than 35%, with exception for 1999: up to 50%.
- debt service/cash flow ratio less than 75%.

2. Fulfillment of transparency requirements

- Publication in three national newspapers of the financial statements audited by certified external auditors, commencing with year-end 1999 and every six months thereafter. The statements should be published by the end of the month following the close of each six-month period (end of July for the first half and end of January of the follow year for the second half).
- Publication in three national newspapers of the list of contracts awarded every three months.
- Creation of a Web site providing the information mentioned in the two previous points.
- Monthly publication of the relevant financial indicators (providing at least the two ratios mentioned in point 1) on the municipality's Web site.
- Publication of environmental data every six months on the Web page commencing in the year 2000.
- Publication of performance indicators [to be established in each sector] for each service provided by the Municipality, every six months on the Web page.

3. Fulfillment of the cost control targets

- The percentage increase in total human resources spending from one year to the next (taking the last two years for which the accounts have been closed and audited) must not

exceed the average annual inflation rate during the aforesaid two years as computed by the Central Bank.

- If external resources are used to fund spending on infrastructure, only long-term financing may be used.

4. Implementation of technical assistance for financial strengthening

- The timetable considered for technical assistance (to be attached to the Credit Regulations) may not be more than two months late.

5. Fulfillment of environmental requirements

1. Within six months after the effective date of the IDB loan contract, the Municipality shall have provided for the establishment of the Environmental Unit as an Office reporting to the Mayor and an organization satisfying the requirements and characteristics described in the annex to the Social Impact and Environment Report.
2. Within six months after the effective date of the IDB loan contract, the Municipality shall have entered into an agreement with the Natural Resources and Environment Secretariat for the decentralization of the environmental processes established in the Environmental Law. This agreement shall set out the responsibilities at each level of authority and the environmental procedures including the receipt, analysis, approval, and licensing of projects with potentially adverse environmental and social effects and environmental audits.
3. Within twelve months after the effective date of the IDB loan contract, the Municipality shall have set up the Environmental Management System in accordance with the criteria established in ISO14001. By that same date, the Municipality shall have determined the base line for the environmental management system and started publishing (on the Web page) the results thereof. Also, it shall have updated the Environmental Risk Maps.

C. Sector eligibility conditions

Urban transport sector

1. Signature of contract for operation of the toll booths. Will permit disbursements for projects (modernization and expansion of the toll booth infrastructure) and technical assistance (design of the Municipal Transport Authority AMTRA).
2. AMTRA legally established with an organizational structure (approval of the statutes and charter of AMTRA, appointment of the Board of Directors and the Manager).
3. Establishment of the Urban Transport Fund (FTU). Determination of the legal status and financing of the Fund and allocation of its resources.

Will permit disbursements for technical assistance for the establishment of AMTRA offices and basic functions - non-motorized transport, dedicated corridors, maintenance, road engineering, increased sector revenues, decentralization of public transport ¹.

4. Compliance with the following "basic functions" of AMTRA:
 - Road maintenance administration system
 - Contract administration
 - Investment programming
5. The current income of the FTU will be used to cover, in this order: (1) AMTRA administration expenses (not less than US\$1 million); (2) routine and periodic maintenance expenses for priority network (not less than US\$2 million); and (3) the debt service on loans for rehabilitation projects.

Monitoring: at the end of each fiscal year, AMTRA will present the Fund's audited financial statements for the year just ended as well as the budget for the next year. If the criteria mentioned above are not met, the following steps will be taken: (1) the budget for the following year will need to include sufficient resources to fulfill the commitments pending; and (2) approvals of projects in the road sector will be suspended until such commitments have been fulfilled.

Potable water and sewerage sector

General sector conditions

1. A letter of commitment from the Municipality to the IDB will be drafted, stipulating that DIMA will be converted to a corporation by the name of *Servicios de Agua Potable y Alcantarillado S.A.* (SAPASA), and that a concession will be entered into with SAPASA.
2. The process of seeking bids from an international operator as a partner in SAPASA must be initiated, i.e. the terms of reference for hiring the consultant to assist with the creation of SAPASA must be ready and the notice for the recruitment of this consultant must have been published.

Eligibility conditions for technical assistance (except advertising and education campaigns, which are not linked to conditionalities)

3. A consultant will be hired to set up SAPASA (for which the use of MIF funds is envisaged under a parallel operation).
4. The necessary study for the transfer to the Municipality of responsibility for

^{1/} Decentralization will be subject to approval by the central government of the plan being designed.

management of the catchment basin will commence.

Condition of general eligibility for investment in physical works

5. A new financially sustainable inflation-adjusted tariff structure will be in place.

Solid waste sector

Sector Conditions

1. Final report of the Technical Cooperation financed by the Japan Special Fund will be ready and a strategy will be chosen for granting concessions for the services, depending on the results. A letter of commitment from the Municipality to the IDB outlining the strategy that it is committed to follow will be drafted.

Eligibility conditions for technical assistance (except advertising and education campaigns, which are not linked to conditionalities)

2. The process of bidding on the concession will commence, i.e. meaning the terms of reference are ready and the notice of the bidding has been published.

General eligibility condition for investment in physical works

3. A new financially sustainable inflation-adjusted tariff structure will be in place.
4. At least the first contract (either a concession or other contractual instrument) will be entered into with the private sector.

Marginal neighborhood sector

	Group	Estimated cost	Observations
A	Improvement of housing and minimum basic services	US\$7,500,000	
B	Legalization	US\$1,500,000	Minimum: US\$1,500,000
C	Technical assistance	US\$500,000	

Group A

1. The Municipality will need to obtain the Bank's nonobjection to the proposed plan for subcomponent execution. This mechanism will need to include the subcomponent management and execution arrangements.
2. The Municipality will need to obtain the Bank's nonobjection to the project identification/selection system. This mechanism will need:
 - to involve the beneficiaries,
 - to take into consideration the beneficiaries' willingness to pay as a measure of the project's economic benefit,
 - to encourage resources to be raised from the beneficiary community itself, and
 - to take into account the poverty levels for purposes of equity.
3. The Municipality will need to obtain the Bank's nonobjection to the project financing and repayment mechanism. This mechanism shall:
 - take into consideration questions of equity, and
 - be easy to administer.
4. The Municipality will need to obtain the Bank's nonobjection to the subcomponent contracting plan. This mechanism must conform to the general contracting requirements of the program.

Group B

Legalization	Conditions
<p>1. Design processes whereby the municipality, the inhabitants, and NGOs can <u>contract external services for a complete package</u> of regularization tasks.</p> <p>(a) Legal analysis (b) Topographical survey (c) Socio/economic study: study of the willingness/ability to pay. (d) preparation of title.</p> <p>2. Develop a property registration program in order to register titles in the neighborhood itself. In issuing and registering titles, special attention will need to be paid to protecting the rights of women, notably those living in common-law households.</p> <p>3. Select three neighborhoods for a "pilot" program to test the process and demonstrate that the objectives of times/costs can be attained; verify register program.</p> <p>4. Prepare a timetable for contracting whereby (a) the municipality contracts directly for land legalization; (b) NGOs, as executing agency, contract externally for process of land legalization.</p> <p>5. Provide training to topographers, companies, NGOs, officials in execution of procedures.</p>	<p>1. Proposed process is reviewed and approved by IDB</p> <p>2. Proposed process is formally authorized by municipal council</p> <p>3. Report to the IDB on the results of pilot program</p> <p>4. Contracting plan for the approval of the Trustee</p>
Purchase/sale of land	Conditions
<p>1. Develop a viable procedure for determining the market value of legalized properties.</p> <p>2. Propose financially viable arrangements for the purchase of municipal lands by households in the existing marginal neighborhoods.</p> <p>a. Immediate payment by the beneficiary b. Credit facilities:</p> <ul style="list-style-type: none"> - clarify the procedure in case of arrears/default on payments - take into consideration the municipal subsidy explicitly and transparently. <p>3. Develop proposals for channeling proceeds from sale to the Neighborhood Improvement Fund.</p>	<p>1. Proposed procedure reviewed and approved by the IDB.</p> <p>2. 80% of residents agree to pay estimated cost per unit.</p>

D. Summary of project eligibility conditions

Same as in Tegucigalpa

Annex III-2

Table of benchmarks for monitoring Program performance

A. Performance of proposed financing mechanism

Note: T_0 is the date at which the IDB loan contract will enter into effect (date of ratification by Parliament).

Features to be evaluated	Benchmark	Target	Source of information
Overall efficiency of financing mechanism	Formal establishment of MDTF	$T_0 + 1$ month	COF/CHO
	Date of signature of first sub-loan contract	$T_0 + 2$ months	
	Average duration between submission of request for funding by municipality and signature of subloan agreement (project appraisal/approval)	4 weeks for normal projects; 4 to 12 weeks for complex projects (e.g. water sector)	
	Number of projects approved	Average 10 per year	Progress report by Trustee to IDB and GOH
	Respect of expected IDB loan disbursement schedule	Tentative disbursement schedule	
	Level of satisfaction of municipalities in their dealing with Trustee	[Qualitative]	Biannual monitoring meetings
	Transparency of fund management by Trustee	As determined by yearly independent audits	
Role of COF/CHO	Average number of days COF/CHO's involvement adds to the project approval cycle	7 days (tentative: target to be confirmed after first few transactions)	COF/CHO
	% of Trustee's recommendations overruled by COF/CHO	[no target]	
Financial viability of projects selected	Average debt service coverage ratio of revenue-generating projects	1.4	Progress report by Trustee to IDB and GOH
	Average debt service coverage ratio of revenue-generating sectors in which projects are financed	1.4	
	Average debt service coverage ratio of Municipality	1.33 (=1/0.75)	
	Number of subloans defaulting ¹ in the first three years	0	
	Number of subloans for which the municipality's GO guarantee must be called	0	

¹ i.e. subloans for which debt service payments are late and the debt service reserve account has to be tapped.

Technical quality of projects selected for financing	[To be assessed through independent evaluation of a sample of 10 projects two years after their completion].		
Long-term development of municipal credit market	% of MDTF portfolio resold on secondary market five years after Program completion	50%	Ministry of Finance
	Financial conditions at which loans resell on secondary market	[Will depend on market conditions at time of sale]	Ministry of Finance

B. Financial strengthening of the Municipality

Aspect to be evaluated	Benchmark	Target	Source of information
Quality and timeliness of financial information	Opinion of independent auditors	Unqualified opinion by year 1999	Progress report by Trustee to IDB and GOH
Compliance with transparency package defined in Eligibility Matrix	Yes/No	Yes	
Financial situation of Municipality	(1) Debt service to free cash flow ratio (2) Debt service to current income ratio	(1) < 75% (2) < 30%	
Overall municipality's creditworthiness	Shadow rating granted by international rating agency in 2000	Country ceiling	
Access of municipality to financial markets	Successful issuance of paper in the Central American market	By end of 2001	Ministry of Finance

C. Modernization of services

Sector	Benchmark	Target	Source of information
Water and sanitation sector	Date of transaction	Tegu: Service contract signed by $T_0 + 6$ months SPS: Concession agreement signed by $T_0 + 18$ months	Progress report by Trustee to IDB and GOH
	Increase in coverage and quality of service	As specified in contracts with private providers	Monitoring by Urban Services Supervisory Office
Solid waste sector	Date of privatization of collection services	Tegu: Main contracts for formal areas signed by $T_0 + 6$ months; for informal areas, 9 contracts signed before $T_0 + 12$ months. SPS: Main contract(s) signed by $T_0 + 6$ months.	Progress report by Trustee to IDB and GOH
	Increase in coverage and quality of collection services	As specified in contracts with private providers	Monitoring by Urban Services Supervisory Office
	Rehabilitation of landfill	Rehabilitation project completed before $T_0 + 24$ months	Progress report by Trustee to IDB and GOH
	Date of privatization of landfill management	Contracts signed before $T_0 + 30$ months	
	Increase in quality of waste disposal	As specified in contract with landfill manager	Monitoring by Urban Services Supervisory Office
Urban transport	Decentralization of public transport regulation and planning has entered into effect	Before $T_0 + 12$ months	COF/CHO
	Restructuring of industry successfully completed	[Measure of success will depend on exact reform structure]	
Marginal Neighbor.	Land regularization component: number of lots regularized per Program year	Tegu: 5,000 San Pedro Sula: 2,500	Progress report by Trustee to IDB and GOH
	Neighborhood Upgrading: distributive impact of projects as measured by the % of total project benefits accruing to households under the Bank poverty threshold	80%	Special consultancy to review targeting of project benefits
Environ. Management	Establishment of Environmental Regulation Unit	By $T_0 + 6$ months	Progress report by Trustee to IDB and GOH
	Establishment of environmental management instruments (risk mapping system, environmental information system, project review process, and environmental licenses database)	By $T_0 + 12$ months	
	Publication of basic environmental data	From $T_0 + 12$ months on	

PROPOSED RESOLUTION

**HONDURAS. LOAN ____/SF-HO TO THE REPUBLICA DE HONDURAS
(San Pedro Sula and Tegucigalpa Municipal Development Program)**

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the República de Honduras, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the San Pedro Sula and Tegucigalpa Municipal Development Program. Such financing will be for the amount of up to US\$63,000,000, or its equivalent in other currencies, except that of Honduras, which are part of the resources of the Fund for Special Operations, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.