DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

MULTIPHASE PROGRAM FOR INVESTMENT AND FINANCIAL AND INSTITUTIONAL STRENGTHENING OF STATES AND MUNICIPIOS PHASE II

(ME-0256)

LOAN PROPOSAL

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ABBREVIATIONS

BANOBRAS	Banco Nacional de Obras y Servicios Públicos, S.N.C.
CAP	Core action plan
DGPM	Diagnostic and Good Practices Manual
FORTEM	Program to Strengthen States and Municipios
POM	Program Operations Manual
SDP	Service delivery project
SEDESOL	Ministry of Social Development
SHCP	Ministry of Finance and Public Credit
SNG	Subnational government
WAL	Weighted average life

PROJECT SUMMARY

MEXICO
MULTIPHASE PROGRAM FOR INVESTMENT AND FINANCIAL AND INSTITUTIONAL STRENGTHENING OF STATES AND MUNICIPIOS
PHASE II
(ME-0256)

Financial Terms and Conditions[1]				
Borrower: Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS) Guarantor: United Mexican States Executing agency: Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS)			Amortization period: Grace period: Disbursement period:	Up to 25 years 4 years 4 years
Source	**Amount**	**%**	Interest rate:	Variable
IDB (Ordinary Capital)	US$200 million	100%	Inspection and supervision fee:	0%
Total	US$200 million	100%	Credit fee:	0.25%
			Currency:	U.S. dollars from the Single Currency Facility

Project at a Glance

Project objective:

To continue supporting Mexico's decentralization process by introducing improvements in the administration capacity of subnational governments (SNGs). To that end, support will be continued for: (i) the introduction of best practices intended to strengthen the management of public funds by SNGs; (ii) strengthening the financial and institutional standing of SNGs; and (iii) financing investment projects with high social returns and providing technical assistance to expand the capacity of SNGs to deliver public services.

Special contractual conditions:

Conditions precedent to the first disbursement: (i) evidence that the Program Operations Manual (POM) has been updated (see paragraph 3.4).

Exceptions to Bank policies:

None.

Project consistent with country strategy:	Yes [X]	No [ ]			
Project qualifies as:	SEQ [X]	PTI [ ]	Sector [ ]	Geographic [ ]	Headcount [ ]

Verified by CESI on: 5 May 2006

[1] The interest rate, credit fee, and inspection and supervision fee mentioned in this document are established pursuant to document FN-568-3 Rev. and may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendations. In no case will the credit fee exceed 0.75%, or the inspection and supervision fee exceed 1% ,of the loan amount.*

* With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. PROGRAM TO STRENGTHEN STATES AND MUNICIPIOS (FORTEM)

A. Background

1.1 The purpose of this report is to request approval for Phase II of the Program to Strengthen States and Municipios (FORTEM), approved in December 2001 (loan 1383/OC-ME). That program, executed by Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), was designed as a three-phase operation, each phase to be implemented over three years, with an estimated total cost of US$2 billion. The Bank would finance US$1 billion of that total: US$300 million each in Phases I and II, and US$400 million in Phase III.

B. FORTEM Phase I

1.2 The objective of FORTEM Phase I was to support the decentralization process in Mexico[1] by enhancing the management capacity and financial situation of states and municipios (subnational governments, or SNGs). The specific objective was for SNGs to introduce best practices aimed at strengthening the management of public resources; strengthen their financial situation; gain access to financing for investment projects with high social return; and to provide technical assistance to build capacity among SNGs to provide public services.

1.3 For execution of Phase I, a Diagnostic and Good Practices Manual (DGPM) was prepared for state and municipal governments in collaboration with an international rating agency. That manual is a collection of international best practices and specific methodologies for evaluating an SNG's progress with respect to them. This tool is used to perform financial and institutional diagnostic assessments of SNGs that wish to participate in the program. On the basis of the diagnostic assessment, a core action plan (CAP) is prepared that contains specific strengthening targets and means of verification. An obligatory component of the action plan is establishment of an investment planning system.

1.4 BANOBRAS sets the debt ceiling and the amount available to an SNG under the credit line. The SNG prepares an investment plan under the guidelines of the Program Operations Manual (POM). After the investment plan is approved by BANOBRAS and the Bank, credit line funds are available in three tranches: 50% upon signature of the contract, 30% once certain conditions set out in the CAP are fulfilled, and 20% once the remaining conditions have been met.

1.5 To date, a total of US$134 million (or 45% of the loan) has been disbursed in four onlending operations (two in the state of Jalisco, one in the state of Guanajuato, and one to the municipio of Uruapan). Eighty percent of funds are committed, and an

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[1] The program approval document (PR-2643) includes a thorough review of Mexico's decentralization process.

investment plan is being prepared in the state of Sinaloa to commit the remaining resources.

1.6 A key factor in the execution of Phase I was the ability to make disbursements in local currency. Under Mexico's Constitution, states and municipios can only borrow in the local currency and from local intermediaries. International financing, including IDB financing, has traditionally been channeled through BANOBRAS. In the first few years of Phase I, a mechanism was used that had been specially created by the federal government to hedge currency risk (the FOAEM state and municipal support fund). Through this compensation fund the government absorbed the foreign currency risk, passing the financing expenses on to the end borrowers. In pursuit of its policy of strengthening market mechanisms for financial operations, the government decided to terminate the FOAEM fund in May 2005. Thereafter, the Bank and other multilateral organizations had to rely on other alternatives to provide local currency to subnational borrowers. In light of these circumstances, the Ministry of Finance and Public Credit (SHCP) and BANOBRAS asked the Bank to consider providing local currency financing within the context of the FORTEM loan in execution. In response, in April 2005 the Bank's Board of Executive Directors approved the option of making FORTEM disbursements in local currency as a pilot initiative.

1.7 The inability to make disbursements in local currency caused considerable delays in execution of Phase I and brought the project to the brink of cancellation. Ultimately, authorization to make disbursements in local currency enabled execution to be resumed and a new onlending operation (for sanitation works) to be executed with the state of Jalisco. To date, three disbursements have been made to Jalisco in local currency at highly competitive rates for the equivalent of approximately US$60 million.

1.8 Another important feature of the Phase I design was that it gave a large number of SNGs access to program resources. In fact, one of the program's key performance indicators is that by the end of Phase I, a total of 15 SNGs have participated in the program. Several factors have contributed to the inability to meet this target. Firstly, while in 1999 FORTEM was the only mechanism supporting decentralization, by 2001 commercial banks were offering products to SNGs that were attractive from a financial standpoint. Secondly, FORTEM funds must compete not only with alternative sources of financing available in the market, but also with other programs available to SNGs through BANOBRAS. Thirdly, when the execution period began, the Bank did not have the option of granting financing in local currency. The mechanism used to hedge currency risk added further costs to Bank financing, making it less competitive compared to other products offered by

commercial banks.[2] Lastly, many SNGs that had initially expressed interest decided not to participate because of the conditions imposed by the program. While aware of the importance of preparing a diagnostic assessment and core action plan to strengthen government management, preparation (generally three to six months) and implementation times conflicted with the administration's political timelines.

1. Investment plans

1.9 The state of Jalisco accessed two onlending operations as part of Phase I. The first intervention of US$44.5 million financed rehabilitation of the highway network in the Central and Ciénega regions, in addition to other urban infrastructure projects in the state's northern and central regions. The second intervention of US$165 million financed the "Agua Prieta" and "El Ahogado" wastewater treatment plants in the suburbs of Guadalajara, together with other works necessary to expand wastewater treatment coverage to 100% of the population.

1.10 The state of Guanajuato accessed one onlending operation for US$24.4 million, which was used to finance the construction and modernization of the Silao-San Felipe highway in the municipio of San Luis; the southern beltway of the city of Celaya; and the Aldama, San Antonio el Chico, Santa Ana del Conde, and La Ladrillera vehicle bridges.

1.11 The municipio of Uruapan accessed US$6.2 million under the program, which was used to finance street paving, sewers, road widening, and other urban infrastructure projects, such as construction of a handicrafts market, relocation of street vendors from the Historic City Center, and signage for city streets.

2. Institutional and financial strengthening

1.12 With the institutional strengthening actions in Phase I, Jalisco has strengthened its investment planning system as well as its budgeting system; has brought its accounting system into line with federal accounting practices; conducts independent audits; makes its debt information available to the public; has strengthened its revenue practices; and has improved the quality of its expenditures. It has also begun to implement these practices in its 124 constituent municipios. All of these actions have helped the state to improve its administration and achieve solid financial performance. Standard & Poor's (S&P) has raised Jalisco's credit rating three times since it began participating in FORTEM. Jalisco's current credit rating is MxA+.

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[2] The Bank worked with the state of Michoacán during Phase I, but no onlending operation materialized. Although external consultants were contracted to prepare the diagnostic and basic action plan, a commercial bank offered the state lower interest rates without imposing the conditions required under FORTEM.

1.13 Strengthening actions in the state of Guanajuato were focused on improving revenue collection and administration, trimming expenditures, strengthening the investment planning system, and promoting transparency and the dissemination of information. Guanajuato's current credit rating is MxAA.

1.14 Strengthening actions in the municipio of Uruapan were focused on supporting tax collection. To that end, the municipio acquired a computer system for collection of real estate taxes, carried out publicity campaigns, and implemented a system to allow the payment of taxes at banks. The water authority was also strengthened, and transparency and the dissemination of information were promoted.

C. Activation of Phase II triggers

1.15 The following table summarizes the extent to which indicator targets have been met to trigger Phase II.

Targets and indicators	Status
Resources 50% disbursed, and 75% committed.	Substantially fulfilled. To date, 45% has been disbursed and the remainder is in the process of formalization with the State of Jalisco.
For SNGs	
They have earned, from rating agencies, a credit rating higher than at the time they joined the program.	Fulfilled. Jalisco, Guanajuato, and Uruapan have improved their credit rating since they began participating in FORTEM.
They have basic investment planning guidelines that ensure investment projects are subject to a financial, economic, and environmental evaluation.	Fulfilled. The three entities have an investment planning system and use project evaluation methodologies with the support and guidance of BANOBRAS's Project Evaluation Division.
They have effected a significant improvement in local tax effort.	Fulfilled. From 200l to 2005, tax revenues increased in real terms by: (i) 143% for Guanajuato; (ii) 168.3% for Jalisco; and (iii) 174.8% for Uruapan (through 2003).
They have an integrated financial management system containing, as a minimum, modules for accounting, budgeting, and cash management.	Substantially fulfilled. Jalisco and Guanajuato have brought their accounting system into line with the federal system established by the government accounting and public administration reporting unit of the SHCP, and Uruapan has accounting, budgeting, and cash management modules.
They have adequately separated environmental regulatory and execution functions.	Fulfilled. Jalisco, Guanajuato, and Uruapan have established a clear separation of functions in the state legal framework and the planning process in compliance with the federal General Law on Ecological Balance and Environmental Protection.
They present financial statements audited each year by an independent external auditor, publish their financial statements, and have an action plan to address observations and recommendations made by the external auditors.	Fulfilled. Jalisco, Guanajuato, and Uruapan engage independent auditors, publish their financial statements in public government media, and have an action plan to respond to and address any observations and recommendations.

They show, in a sample of *randomly* selected projects, that the projects comply with sector criteria for economic, financial, and environmental viability, criteria of long-term financial sustainability, and procurement and contracting procedures.	Fulfilled. All projects executed were evaluated and determined to comply with procurement regulations, as well as economic, financial, and environmental feasibility requirements. With respect to sector criteria, actions adhered to POM.
They comply with the Bank's public utilities policy, for which purpose a review will be undertaken of the existing regulatory framework and of the rates to be charged for the delivery of these services.	Fulfilled. BANOBRAS verified that economic and environmental standards were in compliance with the FORTEM provisions set out in the POM.
For BANOBRAS	
It has moved forward in its process of financial and institutional strengthening, particularly with regard to the functional separation and strengthening of the regulatory and operations areas.	Fulfilled. In compliance with the contract terms of loan 1214/OC-ME, an organization was consolidated with mechanisms to effectively separate, monitor, and supervise the lending process, and to permit instruments for identifying, managing, and controlling risks. An adequate separation of processes is being maintained and regulations have been established to enforce compliance with the various lending requirements. See organization chart at Banobras.
It has pared back its operating costs to levels that are sustainable over the long run.	Fulfilled. In the last 6 years, operating expenses have been reduced, including administration and promotion expenses (by 41% between 2000 and 2005). The decrease in operating costs is an institutional priority, and its future sustainability is in line with the institutional strategy reflected in the institutional annual work plans.
It has made significant headway in implementing its information technology plan and has implemented a management information system that is consistent with that plan.	Fulfilled. The most important systems have already been automated, namely: (i) comprehensive portfolio system, at 100%; (ii) management information system to support high-level decision-making; (iii) lending process management tracking system that generates lending process indicators; and (iv) automated calculation system for determining total debt ceilings for borrowers.
At least 15% of its processes have become ISO 9000 certified.	Fulfilled. Except for the Internal Oversight Division, which will be certified in June 2006, all offices have a valid certificate of compliance with quality standard NMX-CC-9001-IMNC-2000, ISO 9001:2000. Consequently, most processes (promotion, lending, finance, and risk management) are certified, consolidating a comprehensive quality management and improvement process. This objective is in line with the quality model in the policy established by the federal government.
It has launched a pilot credit project for municipios classified in the category of medium to high marginality, according to the criteria of the Ministry of Social Development (SEDESOL). Participation by relatively less developed subnational governments will also be verified in order to continue promoting social equity.	Fulfilled. Diversification and expansion of the portfolio has been promoted to include municipios classified as having medium to high levels of impoverishment. Of the 513 municipios served in 2005, 18.8% have a very low level of impoverishment, 24.3% have a low level of impoverishment, 25% have a medium level of impoverishment, 26% have a high level of impoverishment, and 5.8% have a very high level of impoverishment, in accordance with the impoverishment criteria defined by the National Population Council and SEDESOL.

1.16 Pursuant to clause 4.05 (i) of loan contract 1383/OC-ME for Phase I and the Program Operations Manual, all projects included in the SNG investment plans that have been financed with FORTEM resources comply with the environmental conditions required by the Bank and the provisions of the federal General Law on Ecological Balance and Environmental Protection of the Government of Mexico. Compliance was verified in the corresponding documentation and through physical inspections of works by the environmental specialist at the Bank's Country Office in Mexico.

D. Changes in context since Phase I approval

1.17 The process of institutional and financial strengthening supported by FORTEM is more advanced now than when Phase I of the program was approved. All states now have a credit rating from at least 2 rating agencies, and 82 municipios have at least 1 rating. This process has been driven by the bank regulation by SHCP. Current regulations stipulate that if an SNG does not have two ratings, it will be penalized with additional capital requirements for its operations. For ranked entities, those requirements vary depending on the credit quality determined by the ratings.

1.18 In addition to capital requirements, rating agencies demand high quality information and have become key players in the analysis and dissemination of that information. As a result, SNGs have been forced to improve the quality and quantity of information they disclose to the markets and the public, allowing more effective control over government management. For example, S&P, which assigned its first national rating to a Mexican state in 2000, now rates 28 states, the Federal District, and 49 municipios. Of those, 6 states and 13 municipios have a rating of at least MxAA-.

1.19 Sources of financing for SNGs have also changed considerably since Phase I was approved. Since the mid-1990s the federal government has been introducing changes in the legal framework that governs SNG financing. The changes have expanded available financing alternatives and reduced the federal government's role in these operations. Such measures have resulted in the development of SNG financing arrangements based on market vehicles that emphasize prudent behavior by both financial institutions and borrowers. These institutional changes in legislation governing Mexico's financial sector have encouraged commercial banks to participate in financing SNG programs and public works. This process has benefited from macroeconomic stabilization in recent years in Mexico, which brought with it a considerable decline in the real interest rate.

1.20 Some recent examples of financing from commercial banks for local governments illustrate this change. Currently, BBVA and Bancomer offer a credit line for long-term productive investment that is targeted at state and municipal governments and their public agencies. In July 2005, the Banorte financial group granted a qualified

structured bank loan to the municipio of Navojoa, Sonora, which was used to restructure its public debt. In February 2006, the state of Guerrero restructured its debt (which had risen to a total of 1,843,600,000), obtaining more favorable terms and conditions; ScotiaBank and Dexia were the main financial backers. In February 2006, the Banorte financial institution began to finance schemes for the delivery of services that would permit the direct participation of private investment in public works construction in Oaxaca.[3] Although information is limited, these cases demonstrate a trend that will no doubt gain momentum over the coming years, introducing significant changes in the market of available financing for SNGs.

1.21 In recent years, the Mexican securities market has offered a new financing alternative for SNGs. In 2001, the Government of the State of Morelos issued its first securities offering in an operation for 216 million pesos with a seven-year term, while the municipio of Aguascalientes issued a placement for 90 million pesos with a five-year term. The greatest growth in securities issues occurred from 2002-2003, by seven states and six municipal governments. Until 2005, the cumulative amount of issues was nearly 25 billion pesos (at 2005 prices), or approximately US$2.3 billion. That figure is equivalent to nearly 4% of the total debt of the states, municipios, and the Federal District during the 2000-2005 period. In all cases, the interest rate paid on most of the stock certificates was higher than the 28-day TIEE rate [Mexican interbank lending rate]. Because of this and the costs of placement, other SNGs still do not use this type of financing.

1.22 At present, there is no solid trend indicating the direction and pace of development of the securities financing market for local governments. The group of issues between 2001 and 2005 is characterized by a mix of maturity terms, a limited number of participating governments, and significant differences in the interest rates of the securities placements. However, in the medium and long term, the securities market can become a competitive source of financing for local governments.

1.23 Moreover, federal transfers that have supplemented resources derived from decentralized federal spending (under Ramo 33 and other agreements), as well as the SNGs' own resources, have expanded the maneuvering room of local governments, although this does not necessarily imply stronger or more stable finances.

[3] The first public-private co-investment is for construction of the judicial center in Reyes Mantecón, and the government office center in Tlalixtac de Cabrera.

E. Phase I evaluation[4]

1.24 As part of the process of preparing for Phase II, an external evaluation was performed of Phase I. Following are the most significant results of that evaluation.

1. Competitiveness compared to other sources of financing

1.25 The original FORTEM was designed for the existing conditions in the Mexican financial market, in which SNGs had difficulties servicing their debt and limited access to financing. In this context, FORTEM was an innovative vehicle for fulfilling the decentralization objectives. However, the financial markets gradually became more solid, deep, and liquid, offering alternative sources of financing, while at the same time the finances of the SNGs were strengthened. As a result, the competitiveness of FORTEM's resources has been diluted and there is a need to strengthen the program's design and to supplement its resources with other IDB and BANOBRAS products, in order to maintain the SNGs' interest. The table below summarizes the advantages, disadvantages, and recommendations identified in the evaluation.

Advantages	Disadvantages	Recommendations
• Term and grace period • Lower real cost than bond issues • Global financing • Technical assistance • Support in project evaluations • Multi-year programming • Local currency	• Commitment fees • Procurement standards • No tax financing • Overregulated execution processes • Conditionality of disbursements based on CAPs	• Simplify procedures in the different phases • Minimize and streamline the CAP development process • Help develop projects as part of institutional strengthening • Facilitate access to nonreimbursable funds for technical assistance • Support public-private partnership programs • Supplement with other IDB and BANOBRAS products • Raise the awareness of governments and local legislatures of FORTEM's advantages

2. Program effectiveness

1.26 Although difficulties are encountered with the methodology used to measure the program's effectiveness, evidence suggests that factors other than the design elements themselves have a greater impact on effectiveness. The level of

4 "Multiphase Investment Program and Institutional Strengthening of States and Municipios" (FORTEM). Phase I Evaluation. Decide Soluciones Estratégicas, S.C. (April 2006).

empowerment and commitment of the authorities that manage the programs, as well as continuity and their capacity to institutionalize the activities recommended in the CAPs, are key to the program's effectiveness.

1.27 In this regard, Guanajuato and Uruapan had less positive experiences than Jalisco. Uruapan already had a development strategy and used FORTEM as a vehicle to implement it. Jalisco was able to leverage the credibility of the IDB to promote the institutional strengthening of the Finance Ministry, among the government's other operational areas. The continuity of the process was also critical to its success. Likewise, BANOBRAS' delegation in the state actively participated in monitoring, using various vehicles from that institution to complement and strengthen the FORTEM program. Based on this experience, the evaluation recommends that activities be deepened that promote and disseminate the main characteristics of the program in order to foster stakeholder commitment, and that mechanisms be sought that encourage the continuity of institutional strengthening actions developed as part of the CAP.

3. Compliance with core action plans (CAPs)

1.28 In general, the analysis of documentation on progress towards targets established in the CAPs shows that those targets were met as designed. The fact that one of the requirements of the disbursement framework is compliance with the CAP is positive, as it promotes improvements in areas that are responsible for preparing the documents, negotiating actions and targets that can be committed to in the CAPs, as well as in the integration of required monitoring systems. However, it is clear that the actions contained in the CAPs will be developed in the long term, as changes are often required that could lie beyond the scope of action of government authorities. Accordingly, the intervention of legislative bodies is necessary to give depth to institutional innovations.

4. Use of resources

1.29 The evaluation verified consistency between the projects contained in the authorized SNG investment plans and areas eligible for program financing. No projects were identified in the investment programs that were inconsistent with the uses of resources authorized in the POM.

5. Effectiveness of manuals

1.30 Preparation of the DGPM has contributed to the development of instruments for measuring the quality of the fiscal statistics of the SNGs. This is an instrument with uniform criteria for evaluating the institutional and financial performance of SNGs, by establishing standards and tracking systems to confirm progress in implementing strengthening measures. The evaluation recommends that the various modules of

the DGPM be updated, based on progress with respect to transfers and additional resources channeled to the SNGs.

6. Negotiation, procurement, and supervision processes

1.31 Activities to prepare the documentation required to be eligible for program resources imply a substantial cost for the potential users of the credit that in many cases is not easily quantifiable, particularly for municipios with limited financial capacity. Preparation of the financial and institutional diagnostic, the CAP, and the investment plan (with a socioeconomic evaluation of the projects) increases the final cost of the loan, which is a disadvantage compared to the strategy being promoted by commercial banks (simple credit line with full disbursement).

7. General recommendations

1.32 FORTEM should be a catalyst for major projects, by supplementing credit resources and, more importantly, providing adequate resources and the technical assistance necessary for the SNGs to achieve institutional strengthening and undertake more significant projects.

1.33 A strategy should be defined to promote FORTEM based on the market and the needs of the SNGs, and on the objectives of the policy for decentralizing and financing those governments.

1.34 FORTEM should target two SNG groups, namely those that: (i) because of the lag in their institutional development and weak public finances, lack real access to commercial financing; and (ii) individually or regionally can benefit from productive and/or social investment projects that are sizable enough to require the support of a development institution like the Bank.

F. Lessons learned from Phase I execution

1.35 Following is a discussion of a number of lessons learned during execution of Phase I that complement the observations from the evaluation and serve as the basis for the modifications recommended for Phase II (see paragraph 2.4).

1.36 *Institutional and financial capacity of SNGs*. While strengthening of institutional and financial management through FORTEM continues to be important for many SNGs (typically those that are not ranked or that have a low credit rating), there is one group of SNGs that requires other more specialized assistance, e.g. assistance related to developing the capacity to prepare complex investment projects or innovative financing mechanisms, like public-private partnership programs for the delivery of public services.

1.37 *Sources of financing for SNGs*. The financial conditions for the Bank's resources do not compare all that favorably with market conditions, as was the case in the past.

This clearly evidences the need to reduce the transaction costs of working with FORTEM and of increasing the value-added that can be offered to the SNGs.

1.38 *Diagnostic assessments and core action plans*. The processes of preparing financial and institutional diagnostic assessments for SNGs that would like to participate in the program, as well as the design and negotiation of the CAPs, are slow processes and discourage some potential beneficiaries from participating.

1.39 *Investment plans*. The program (BANOBRAS-IDB) should have the technical capacity to provide support in the design of SNG investment plans and to ensure a rigorous analysis of complex projects.

1.40 *Financing limits for SNGs*. The financing limits set for SNGs were impractical and artificial (and, therefore, had to be eliminated). In some cases, the characteristics of the investment plans to be financed and the costs incurred to implement the program recommendations made it inefficient to respect the anticipated limits.

1.41 *FORTEM dissemination strategy*. Promotion efforts included in Phase I were inadequate. The program's resources must compete with funds from other sources. Additionally, the effectiveness of the proposed measures to a large extent depends on the ability to ensure continuity and the commitment of the authorities involved. This requires an ongoing and systematic dissemination effort, by BANOBRAS as well as the Bank.

1.42 *Lending spread*. The variability of the lending spread that the Bank charges its borrowers pursuant to the Bank's capital adequacy policy (document FN-568-3) causes operational and financial problems for BANOBRAS. Due to legal difficulties, BANOBRAS may not adjust rates agreed with the SNGs to reflect changes in the Bank's lending spread. This means that once the rate is agreed with the borrower, any changes must be absorbed by BANOBRAS.

1.43 *Credit fee*. Payment of a credit fee for the entire amount of the credit line adds operating costs for BANOBRAS that cannot be passed on until there is a signed agreement with an SNG.

1.44 *Audits*. The program requires various review mechanisms that in some cases are redundant and add considerable costs for the end borrowers. This is true in the case of the operations and financial audits required as part of the program. Those audits overlap with internal audits performed by BANOBRAS (audits by the Internal Oversight Division and the Auditor's Office of the Treasury). BANOBRAS borrowers are also required to perform a number of audits of compliance with their own fund accountability and transparency regulations, such as audits conducted and/or required by the state and/or municipal controller offices and those required by the local legislatures.

G. The Bank's strategy

1.45 The Bank's sector strategy is in line with the Bank's Country Strategy with Mexico for the 2002-2006 period. This strategy, approved by the Bank's Board of Executive Directors on 27 March 2002, proposes focusing the Bank's operations on four priority vectors: (i) modernization of the social sector and poverty reduction; (ii) integration; (iii) modernization of the State and subnational decentralization and development; and (iv) improvement of private sector productivity. Strengthening of the capacity of subnational governments is a basic requirement within the strategic vector of modernization of the State, not just for purposes of preserving the macroeconomic and political stability of its spheres of influence and of the country, but also to make significant progress on other important development challenges, such as improvements in the delivery of basic social services. In this context, characterized by a growing SNG role in budget administration and the delivery of basic public services, it is foreseeable that the Bank's actions at the SNG level will also take on growing importance in the future.

1.46 Phase II will continue meeting SNG demands, using BANOBRAS as its main partner and building on the lessons learned in Phase I. The Bank will play a more active role in disseminating the benefits and advantages of the program, and it will support BANOBRAS and the SNGs in the institutional and financial diagnostic process, and in preparation of the investment plans. Given the competition that the program's resources face, special emphasis will be placed on reducing transaction costs and coordinating FORTEM interventions with other Bank and BANOBRAS instruments to increase the value-added of our intervention.

1.47 For less developed SNGs, which consequently have more to gain from institutional and financial strengthening such as the strengthening supported in Phase I, the same methodology will be applied that links access to investment resources to adoption of good practices for financial and institutional management. However, those requirements will be eliminated for SNGs that have already made progress in these areas. In such cases, Phase II will place emphasis on providing technical assistance and financing for the development of economically profitable investment projects that expand the capacity for delivering public services. In this way, FORTEM's new phase will seek to increase the value-added by channeling resources towards areas where our intervention can have a greater potential impact.

1.48 It is hoped that the impact of Phase II activities will be boosted in the area of public-private partnerships. The federal government has been promoting different public-private partnership formulas called "service delivery projects" (SDPs), which permit the leveraging of resources earmarked for investment in public services. This is an attempt to help accelerate economic growth and better utilize public funds. These schemes permit a reduction in the public infrastructure deficit, the building of relationships with the private sector based on transparency and

adequate management of project-related risks, more efficient delivery of higher quality public services, and better stewardship of public funds.

1.49 The first projects were awarded toward the end of 2005. The federal government is now considering more than 20 possible SDPs for approximately 24 billion new pesos. To the extent that experience with this type of project has grown, there is beginning to be significant interest in implementing them at the state and municipal levels. However, the requirements from an institutional, legal, and financial standpoint to execute this type of projects successfully are important. A successful scheme requires an appropriate legal and institutional framework that provides transparency and confidence for private investors; capacity for identifying projects that can be successfully carried out under this type of scheme; capacity for designing the project such that the risks are properly assigned; and the capacity for managing and administering service agreements with the private sector.

1.50 As part of actions that complement FORTEM, work is being done with the MIF to define a technical assistance program within the cluster "Supporting Competitiveness through Public-Private Partnerships". Activities to be supported as part of this program include development of a framework for service delivery through public-private partnerships at the subnational level that is consistent with the framework being implemented at the federal level and can be used as a model for SNGs; dissemination of the framework among SNGs; design and establishment of the regulatory framework in the SNGs participating in the program; technical assistance and training for the SNG units in charge of the framework; and preparation of specific service delivery agreements.

1.51 Eventually, SNGs that benefit from this program and implement a public-private participation framework for service delivery could apply for FORTEM funding to finance commitments they assume. At the same time, the possibility is being considered of creating a conditional credit line so that BANOBRAS and the Bank, through its Private Sector Department, can co-finance private companies that are the beneficiaries of these public-private partnership programs.

H. Coordination with other entities

1.52 Given that the World Bank is also executing programs to support Mexico's decentralization process, frequent meetings are held with that entity to prevent redundancy and to collaborate and organize complementary activities, particularly in the case of activities carried out in the same states. Progress has also been made in coordination with USAID and the U.S. Trade Development Association (TDA). This latter entity has financed the preparation of some diagnostic assessments and CAPs.

1.53 The Japan Special Fund (JSF) has contributed funds to implement a program of new and innovative financing vehicles for small- and medium-sized municipios

(ATN/JF-9548-ME). This financing is expected to support eight municipios in the state of Quintana Roo in designing, implementing, and issuing a bond to raise funds to finance infrastructure projects. Depending on the outcome, this pilot experience could be expanded to other interested SNGs in Mexico.

1.54 The Spanish General Cooperation Fund (FGCE) has also provided resources (ATN/FG-9064-ME) in support of actions that improve intergovernmental cooperation between the state of Jalisco and its municipios, promoting better institutional and financial performance by the municipal governments.

II. THE PROGRAM

A. Objectives

2.1 The general objective of the program is to continue supporting the decentralization process in Mexico by enhancing the management capacity of subnational governments (SNGs). Specifically, support will be continued to: (i) introduce best practices aimed at strengthening the management of public resources by SNGs; (ii) strengthen their financial and institutional situation; and (iii) finance investment projects with high social return and technical assistance to build capacity among SNGs to provide public services.

B. Description

2.2 Like Phase I, the program has been structured as a credit line that will be administered by BANOBRAS and will seek to encourage SNGs to adopt a number of good practices for institutional and financial management. Insofar as the agreed targets are met, the SNGs will have access to Phase II resources to finance technical assistance for their strengthening and investment plans. Resources will be available to the SNGs in three tranches, contingent upon progress in complying with their core action plans (CAPs). The Diagnostic and Good Practices Manual (DGPM) and Program Operations Manual (POM) will continue to be used as the basic documents, and sector criteria for economic, financial, and environmental viability and the sustainability of the investments, as well as the Bank's public utilities policy, will continue to be observed.

2.3 Expressions of interest to participate in Phase II of the program have been received so far from the states of Jalisco (approximately US$60 million for in institution-strengthening and investments in safe drinking water), Sinaloa (approximately US$115 million for institution-strengthening and sustainable coastal management), and Hidalgo (approximately US$8 million for an institutional and financial strengthening program that will culminate in preparation an investment plan for its financing in 2007).

C. Phase II changes

2.4 The changes proposed for Phase II derive from lessons learned in the execution and evaluation of Phase I (see paragraph 1.35) and are intended to tailor the program to the actual conditions currently experienced by SNGs, and to make our activities more flexible and relevant.

2.5 *Execution arrangement within the Bank*. Given the importance of the FORTEM program as one of the Bank's primary instruments for working with SNGs in Mexico, as well as the need for: (i) ongoing and systematic dissemination efforts;

(ii) technical capacity to support the design of the SNG investment plans; (iii) capacity to ensure a rigorous analysis of complex projects; and (iv) capacity to propose timely adjustments to the design of the operation as execution progresses, the Bank's Country Office in Mexico will be supported by a multidisciplinary project team responsible for liaising with BANOBRAS for all aspects of the program: promotion, dissemination, project creation, support for preparation of diagnostic assessments, preparation and negotiation of CAPs, development of investment plans, technical review of investment plans prior to approval, and disbursements. The project team's responsibilities will include ensuring that investment projects with significant risks, such as involuntary resettlement or impacts on critical natural areas, comply with the Bank's rules and are properly supervised. This team will have specific, quantifiable targets for onlending operation approvals, disbursements, incorporation of new clients, and portfolio quality.

2.6 *Core action plans*. The responsibilities of the project team will include ensuring that the financial and institutional diagnostic assessments, as well as the CAP, are completed by no later than one month after the formal request is made by the SNG.

2.7 *Local currency financing*. Highly relevant experience was gained in Phase I on the mechanisms available to the Bank to access these resources, as well as the dynamics of disbursement authorization and processing. For Phase II, there is an expectation that disbursements will continue to be made in local currency under the new "Operational framework for lending in local currency" (document GN-2365-2). In such case, the Bank will seek to provide the requested financing through the end of the original loan term. However, it may not be feasible to do so. Therefore, in order to provide BANOBRAS with a greater range of local currency financing options, conversions of local currency disbursements will be subject to two additional financial terms:

- *Repayment schedule*. Conversions will have the flexibility to set the terms and repayment schedule in relation to the respective final maturity and weighted average life (WAL). In such regard:
  - It will be possible to make such changes at each disbursement, so each disbursement could have a repayment schedule different from the final maturity and WAL of the original contract;
  - Such flexibility will be subject to the restriction that the WAL and final term of the modified repayment periods of the disbursements, taken together, not exceed those of the corresponding original contract. With such restrictions, the repayment structures may be bullet amortizations with shorter maturities and/or extended grace periods;
  - The modified repayment structures will be designed by mutual agreement between the borrower and the Bank.

2.8 *Price based on actual financing costs*. When the repayment schedule is such that all amortizations can be fully funded: (i) the Bank's cost of funds may be passed through to the borrower; (ii) the lending rate on such conversions will reflect the Bank's cost of funds plus the lending spread applicable to Ordinary Capital loans; and (iii) the refinancing fees specified in the Local Currency Facility will not apply.

2.9 *Amount of financing for each SNG*. The amount of financing for each SNG will take into consideration the debt ceilings for each SNG set by BANOBRAS, the features of the investment plan to be financed, the type of recommendations that need to be implemented as part of the CAP, and expected demand for financing from other SNGs.

2.10 *Work with more developed SNGs*. For more developed SNGs, Phase II will emphasize providing technical assistance and financing to develop economically profitable investment projects that help build capacity to provide public services, rather than on general actions aimed at strengthening the management of public funds and improving the SNG's financial condition. FORTEM resources are therefore expected to be supplemented to the extent necessary with resources from the Infrastructure Fund recently approved by the Bank's Board of Executive Directors.

2.11 *Lower transaction costs*. The requirement to prepare an institutional and financial diagnostic assessment and a CAP will be eliminated for SNGs with a credit rating of at least MxAA- from two internationally recognized rating agencies.[5] The establishment of an investment planning system ensuring that projects are subject to a technical, financial, environmental, and socioeconomic evaluation, if none exists, will continue to be a mandatory prerequisite to access program funds. As in other cases, BANOBRAS will set the debt ceiling and the amount available to the SNG under the credit line. The SNG will prepare the investment plan in accordance with POM guidelines, including projects that must comply with the Bank's policies.

2.12 *Financing matrix*.[6] At an SNG's request, the Bank may finance up to 100% of the costs of eligible investment plans.

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[5] AA is the second category in the ranking system used by rating agencies. S&P ratings range from MxAAA down to MxD. S&P rates regional and local governments in more than 34 countries. The same analytical method is applied across the board, focusing on several economic factors (including demographic data, economic structure, and growth prospects); administrative systems and institutional legitimacy (including intergovernmental structure, political stability, and administration and public policy systems); fiscal flexibility and financial performance (which includes sources of revenue and flexibility in expense trends, budget performance, and financial requirements); and financial position (including liquidity, debt levels, and off-balance-sheet or contingent liabilities).

[6] In accordance with the Bank's new expense eligibility policy (document GN-2331-1) and the financial parameters for expense eligibility adopted by Mexico. Also applicable to paragraphs 2.13 and 2.14.

2.13 *Financing of recurring expenses*. The Bank may finance recurring expenses on a project-by-project basis, at the borrower's request.

2.14 *Financing of taxes and fees*. At the borrower's request, Bank financing may cover taxes and associated fees that represent a significant cost in the procurement of goods and services, provided that the Bank considers the amount of such taxes and fees to be reasonable.

D. Cost and financing

2.15 Table II-1 presents the estimated total project costs and financing proposed for Phase II over four years.

Table II-1
Cost and financing (in US$ millions)

Categories	Phase II
	IDB
1. Credit line	200
2. Finance charges	0
Total	**200**

2.16 The loan terms and conditions are summarized in the table below.

Table II-2
Loan terms and conditions

Source of financing:	Ordinary Capital
Currency:	Single Currency Facility
Amortization period:	Up to 25 years
Grace period:	4 years
Disbursement period:	4 years
Interest rate:	Variable
Credit fee:	0.25%

III. PROGRAM EXECUTION

A. Borrower, guarantor, and executing agency

3.1 The borrower and executing agency will be Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), who will act as fiscal agent of the Government of the United Mexican States. The guarantor will be the United Mexican States.

B. Program guidelines and instruments for Phase II

3.2 Based on experience with execution of Phase I, an agreement was reached to continue using a set of program guidelines and instruments, as described below.

1. Diagnostic and Good Practices Manual (DGPM)

3.3 The DGPM will continue to be used in Phase II execution for financial and institutional diagnostic assessments. It is being updated to reflect recommendations from the Phase I evaluation.

2. Program Operations Manual (POM)

3.4 The POM used in Phase I will continue to be the most important tool for verifying compliance with the Bank's requirements. It will be amended to reflect the changes described in section II.C of this document, "Phase II changes." Evidence that the POM has been updated will be a condition precedent to the first disbursement of Phase II.

3. Core action plan (CAP)

3.5 As in Phase I, a proposed CAP will be prepared based on the diagnostic assessment and DGPM and is to include: (i) specific objectives for strengthening in the financial, institutional, and service management areas; (ii) recommended activities to meet those objectives; (iii) dates by which the SNG commits to meet the agreed targets; (iv) indicators and targets for each disbursement; and (v) the means of verification of outcomes. The financial and institutional strengthening areas included in the CAPs will be determined case by case basis in accordance with the SNG's needs and execution capacity, using the findings of the diagnostic assessment for each of the DGPM submodule and the expected degree of progress towards the benchmark for each submodule. The only mandatory area of application for all SNGs will be the establishment of an investment planning system.

3.6 In parallel with preparation of the CAP, BANOBRAS will set: (i) the ceiling for borrowing by the respective SNG; (ii) the amount it may access under the credit line; and (iii) the lending terms and conditions.

3.7 On the basis of the proposed CAP, BANOBRAS will negotiate with the corresponding SNG to determine: (i) the modules representing the most important institutional and financial reforms for the SNG; (ii) performance benchmarks and expected targets; (iii) means of verification; (iv) amount and terms of the loan; (v) performance benchmarks to be used in determining access to the credit line; and (vi) monitoring and control instruments. Once negotiations are finalized, BANOBRAS will prepare a final report on the CAP and send it to the Bank for its no objection.

3.8 The requirement to prepare an institutional and financial diagnostic assessment and CAP will be eliminated for SNGs with a credit rating of at least MxAA- or its equivalent from two international rating agencies recognized as such under applicable Mexican law. Disbursements will be made against requests submitted by BANOBRAS, together with the respective rating opinion. The establishment of an investment planning system that ensures projects are subject to technical, financial, environmental and socioeconomic evaluation, if no such system exists, will remain a mandatory prerequisite for access to all program resources. For disbursement of the last 10%, SNGs must present evidence satisfactory to BANOBRAS that they possess an investment planning system that ensures projects are subject to technical, financial, environmental and socioeconomic evaluation. As in other cases, BANOBRAS will determine the amounts and terms on which an SNG can access the credit line. The SNG will prepare the investment plan in accordance with the POM guidelines with projects that must comply with the Bank's policies.

4. Investment plan

3.9 As in Phase I, once a decision has been made on the amount to which an SNG may have access under the credit line, the SNG will submit an investment plan to BANOBRAS identifying the list of projects eligible for financing under the criteria and requirements of the POM. The investment plan must be substantiated by studies that support inclusion of the projects in it. Such studies will assess project technical, financial, environmental and socioeconomic feasibility in accordance with the POM. Once approved, BANOBRAS will send the investment plan to the Bank for its no objection.

5. Formalization and rules for credit line access

3.10 Agreements on the CAP and access to the credit line to finance the investment plan will be formalized through a loan agreement between BANOBRAS and the respective SNG, which will include the following documents: (i) the CAP; (ii) the approved investment plan; and (iii) a procurement plan. The credit line resources

will be available in three tranches, as follows: (i) upon signature of an agreement with BANOBRAS, the participating SNG will have access to 50% of the credit line, which may be used for technical assistance to carry out the CAP and/or to finance investments under the SNG's investment plan; (ii) once the initial conditions set forth in the CAP have been met, the SNG will access a second disbursement of 30% of the credit line to finance its investment plan or the unfinanced remainder of the strengthening plan; (iii) upon fulfillment of the remaining conditions under the CAP, the SNG will have access to the remainder of its resources. For SNGs that do not require a CAP, the credit line resources will be available upon signature of the contract.

3.11 The disbursement and expenditure verification arrangements used by BANOBRAS with each SNG are described in the POM and will be included in the respective onlending contract between BANOBRAS and the SNG.

6. Process review and evaluation

3.12 All of the matters mentioned above will be subject to joint periodic reviews by BANOBRAS and the Bank to verify their scope and that objectives have been met. This exercise will also serve to make any useful or necessary adjustments to the various mechanisms so as to efficiently meet the needs of SNGs. The logical framework designed for the program (document PR-2643) will be used to measure the impact of Phase II.

C. Disbursement procedures and revolving fund

3.13 As the executing agency for Phase II, BANOBRAS will submit disbursement requests to the Bank's Country Office in Mexico, accompanied by a breakdown of payments in accordance with the specifications agreed with the Bank, and the record of disbursements and local contributions. All original supporting documentation for disbursements will remain with the executing agency's state offices.

3.14 BANOBRAS is to ensure that the disbursement requests are duly supported by the evidence normally required and have been agreed upon with the Bank. BANOBRAS and the participating SNGs are to keep all the supporting documentation (e.g. contracts, orders, invoices, receipts, payment vouchers, supplier certificates, certificates of origin) duly filed and available for review by authorized officers of the Bank and external auditors.

3.15 During its inspection visits, the Bank's Country Office in Mexico will verify by sampling that the executing agency has the supporting documentation for disbursement requests in its files, and that the resources have been used as specified in the loan contract.

3.16 Disbursements to establish and replenish the revolving fund in the amount of up to 5% of the loan follow applicable Bank rules and regulations. The fund will be replenished as requested by BANOBRAS, based on data presented in the breakdown of payments.

3.17 The preliminary disbursement timetable for Phase II (Table III-I) is compatible with the execution capacity and availability of local counterpart resources.

Table III-1
Preliminary disbursement timetable
(in US$ millions)

Source	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Total**
IDB/OC	50	50	50	50	200
Total	50	50	50	50	200
%	25	25	25	25	100

D. Procurement

3.18 Bank policies and procedures will be followed for the procurement of all goods, services, and works, which will be subcontracted in their entirety. International competitive bidding will be used whenever the estimated value of the goods or related services being procured is US$500,000 or less, or the estimated value of works is US$10 million or more. Tenders for amounts below these thresholds will be conducted in accordance with local legislation, to the extent compatible with Bank procurement principles. International competitive bidding will be used to procure consulting services with an estimated value of US$200,000 or more. Mexico already has standard bidding documents approved by the Ministry of Public Administration and the World Bank, which will facilitate application of Bank procurement policies and procedures.

3.19 BANOBRAS will conduct a prior review of procurement processes for goods, works, and consulting services to be carried out by the SNGs. BANOBRAS has presented evidence to the Bank's satisfaction that it possesses a procurement system and the necessary staff to perform this task. Finally, It has been agreed with the Bank's Country Office in Mexico that all controls and verifications by the IDB will be done by sampling on an ex post basis when the amounts involved are below the thresholds for international competitive bidding.

E. Program monitoring

3.20 Inasmuch as this is a multiphase program, monitoring and evaluation will be ongoing so as to validate and verify the effectiveness of the mechanisms proposed to support the SNGs in their efforts to improve their financial and institutional situation.

3.21 The Bank will give its prior no objection to: (i) the institutional and financial diagnostic assessments; (ii) the CAPs for the SNGs; and (iii) the investment plans. The POM will indicate the percentages and amounts for investments in specific sectors. After the first few reviews, the Bank and BANOBRAS may decide on different review arrangements. The Bank will place special emphasis on verifying that investment projects with significant risks, such as involuntary resettlement or impacts on critical natural areas, comply with Bank rules and regulations and are properly supervised.

3.22 In addition to the semiannual progress reports to be submitted by BANOBRAS, annual review meetings will be held with the Bank to discuss such matters as: (i) operations approved and committed; (ii) progress on CAP implementation and status of disbursements; (iii) analysis of investments financed, broken down by SNG; and (iv) topics of interest for program operation.

3.23 As has been the practice for previous phases of FORTEM, external consultants will be contracted to perform an evaluation of Phase II, once at least 75% of the loan proceeds have been committed and approximately 50% of those resources have been disbursed. The evaluation will analyze the indicators/triggers set out in paragraph 3.25. The evaluation findings will serve as the basis for preparing the request to the Board of Executive Directors for Phase III. An annual financial audit of the program will also be conducted by a consulting firm acceptable to the Bank.

F. Supervision by the Bank

3.24 The project team will be responsible for supervising the program's performance. It has been agreed to hold quarterly monitoring and supervision meetings, to track overall execution of each of the program activities.

G. Activation of Phase III

3.25 According to the operational guidelines for multiphase programs, in order for Phase III to be submitted to the Bank's Board of Executive Directors for consideration, 50% of the Phase II resources must have been disbursed, 75% committed, and the following targets and indicators met:

a. For SNGs:

(i) that they have earned, from risk rating agencies, a credit rating that is the same or higher than at the time they joined the program;

(ii) that they have basic investment planning guidelines that ensure investment projects are subject to a financial, economic, and environmental evaluation;

(iii) that they have an integrated financial management system with modules for accounting, budgeting, cash management, and internal control;

(iv) that they have adequately separated environmental regulation and enforcement functions; and

(v) that they present and publish financial statements audited each year by an independent external firm.

b. For BANOBRAS:

(i) that it has moved forward in its process of financial and institutional strengthening;

(ii) that it is making significant headway in implementing its information technology plan;

(iii) that it continues to earn ISO certification for its processes;

(iv) that it report its experience with implementation of environmental safeguards in the Phase II investment projects.

(v) that it report the spread calculation method it uses and changes in the spread, which is expected to trend downward.

3.26 Phase III will continue to pursue the main lines of Phase II, making necessary changes to adjust, improve, and consolidate the new criteria, mechanisms, and products, so that adjustment is ongoing and the FORTEM program's coverage continues to expand.

IV. VIABILITY AND RISKS

A. Institutional viability

4.1 BANOBRAS has been the executing agency for a number of Bank-funded operations, including those directly related to FORTEM (loans 1213/OC-ME, 1214/OC-ME and 1383/OC-ME, Phase I), and has the qualified technical staff to execute the proposed Phase II.

4.2 Since implementation of the institutional modernization program at BANOBRAS during the first phase of FORTEM (loan 1214/OC-ME), the institution has grown stronger. It has continued to implement a reform and modernization program that focused on promoting private participation in investment and financing for infrastructure projects, while fostering and financing the modernization and institutional strengthening of the SNGs.

B. Technical and economic viability

4.3 Use of the program guidelines and instruments (DGPM, CAP, POM, and investment plans) will promote the technical and economic viability of projects to be financed with program resources.

C. Environmental considerations

4.4 Given that any type of infrastructure works in 32 states and 2,500 municipios can be financed under the investment plan, the potential for environmental impacts, both positive and negative, is great. As in Phase I, Mexico's federal **Environmental Protection Act** [Ley General del Equilibrio Ecológico y la Protección al Ambiente] will continue being enforced. Chapter 11 of the act states that "[t]he Federation, States, Federal District, and Municipios shall exercise their authority with regard to preservation and restoration of the ecological balance and environmental protection, in accordance with the delegation of responsibilities in this and other laws and regulations." To be considered eligible for financing under FORTEM, any activity included in the investment plan of an SNG must be supported by an environmental impact statement.

4.5 The DGPM contains specific clauses on the environment. The Bank will review the inclusion of clauses on stewardship of the environment and natural resources in preparation of the CAP. The environmental variable is also a key factor in the preparation of an SNG's investment plan (which requires the Bank's approval), and must be reflected in the agreement to be signed with BANOBRAS. The Bank's project team will verify that investment projects with significant risks, such as involuntary resettlement or impacts on critical natural areas, comply with the

Bank's rules and are properly supervised. Annex IV describes in detail how environmental evaluation, monitoring, and oversight activities are to be carried out.

4.6 The POM calls for a separation of functions between the entities responsible for project promotion and the agency responsible for environmental regulation, review, and oversight. For municipios with over 200,000 inhabitants, there must be an environmental affairs office responsible for designing and reviewing the environmental studies before they are submitted to the regulatory agency. For states, the main indicator of compliance is the existence of a procedures manual stating that the projects are reviewed by an environmental regulation agency before execution, and that such agency must be different from the project promoter. For municipios with under 200,000 inhabitants, a required indicator is that there be an environmental engineer to design and review environmental studies before they are submitted to the regulatory agency.

4.7 Accordingly, Phase II will continue to require compliance with the Environmental Protection Act, which will be reflected in the POM. Chapter 11, Article 70, of the act defines the powers delegated to the states by the Ministry of the Environment and Natural Resources (SEMARNAT) and states that compliance is mandatory. The same principle is applied to the municipios under Chapter 11, Article 80, since the act does not distinguish between states and municipios by number of inhabitants. With regard to compliance indicators, the POM will enforce the provisions of national law, rather than simply the manuals or specific regulations for each participating SNG. Chapter 11 and Articles 70, 80 and 100 of the Environmental Protection Act have been incorporated into the POM and DGPM, and will be used as environmental measurement criteria in Phase II, as was done in Phase I.

D. Social equity and poverty reduction classification

4.8 Phase II qualifies as a social equity enhancing (SEQ) operation as described in the report on the Eighth General Increase in Resources (document AB-1704). Phase II does not qualify as a poverty targeted investment (PTI).

E. Benefits

4.9 Strengthening of the financial and institutional capacity of SNGs and their ability to provide services will help them to maintain economic stability in their areas of influence and make significant progress on other important development challenges, such as greater access and efficiency in the delivery of basic social services, as more and more responsibilities are being turned over to the states and municipios; greater private sector competitiveness at the local level; and better positioning of local economies in the national and global economy.

F. Risks

4.10 A list of potential risks and the corresponding actions to mitigate them is presented below for the proposed Phase II.

Risk	Level	Mitigation
Priorities shift when a new administration takes office	Low	Because of the importance of Mexico's decentralization process and strengthening needs in the SNGs, the proposed program is expected to remain a priority.
Dissemination is not sufficient to attract an SNG to participate in the program and to reach a consensus on strengthening measures.	Medium	The project team will become directly involved in disseminating the program at the state and municipal level, and specific targets will be used for evaluation. BANOBRAS will continue relying on its 32 state delegations across the country for this process.
Preparation and processing of diagnostic assessments and CAPs are not tailored to the requirements of SNG political timelines.	Medium	An explicit objective of the project team and BANOBRAS will be for the diagnostic assessments and CAPs to be prepared within less than one month from the date formally requested.
The SNGs do not have the capacity to prepare investment plans in accordance with the program requirements.	Medium	The Bank, in conjunction with BANOBRAS, will make every effort to provide technical assistance for preparation of investment plans. To the extent necessary, those resources may be supplemented with Infrastructure Fund resources.
Needs presented by the SNGs are not currently eligible for financing.	Low	FORTEM's program guidelines and instruments (the DGPM, POM, and investment plan) will be reviewed during execution of Phase II to incorporate new activities that are eligible for financing.
Access to local currency financing.	Low	Given Mexico's market conditions and the experience gained during execution of Phase I, no short- or medium-term problems for obtaining local currency under acceptable terms and conditions are anticipated for the borrowers.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/__

Mexico. Loan ____/OC-ME to Banco Nacional de Obras y Servicios Públicos, S.N.C.
Multiphase Investment Program for the Institutional and Financial Strengthening
of States and Municipalities, Phase II

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 Banco Nacional de Obras y Servicios Públicos, S.N.C., as Borrower, and the United Mexican States, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of a multiphase investment program for the institutional and financial strengthening of states and municipalities, Phase II. Such financing will be for the amount of up to US$200,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Evaluation Report.

(Adopted on __ _______ 200_)

LEG/OPR/RGII/IDBDOCS#746336
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