

**PROGRAM TO SUPPORT DECENTRALIZATION OF THE
POTABLE WATER AND SANITATION SECTOR**

(VE-0111)

EXECUTIVE SUMMARY

BORROWER: Republic of Venezuela

GUARANTOR: Republic of Venezuela

EXECUTING AGENCY: HIDROVEN and decentralized companies

AMOUNT AND SOURCE: IDB: US\$100 million (OC)
Local contribution: US\$100 million
Total: US\$200 million

FINANCIAL TERMS AND CONDITIONS: Amortization period: 20 years
Grace period: 5 years
Disbursement period: 5 years
Interest rate: variable
Inspection and supervision: 1%
Credit fee: 0.75%
Currency: United States dollars
the Single Currency Facility

OBJECTIVES: The objective of the proposed operation is to improve the quality and increase the coverage of water and sanitation services by establishing efficient and functionally autonomous companies that deliver quality services to the public. The program's specific objectives are: a) to consolidate decentralization of the sector; b) to create and consolidate efficient and optimally sized service operator companies, and c) to promote private-sector participation in the newly created companies.

DESCRIPTION: This is an open program to which municipalities and states that create companies may apply. It consists of four components: two involving studies and activities aimed at creating companies, and two others whose purpose is to strengthen business and investment.

1. Decentralization of the services

This component will finance the activities involved in creating the operator companies. It includes the design of the service contract between the munici-

palities and the new companies, the program contracts, the preparation of a transition strategy and establishment of the new companies, and the initial financial statements.

2. Private sector participation

This component will finance the studies and documentation to engage the private sector in the systems' management. It includes drafting the terms and conditions and contracts between the new company and the private-sector operator, providing support in the selection of operators, and the transfer of services.

3. Business strengthening and immediate rehabilitation works

This component will finance administrative, financial, business-related (for example, master and individual metering systems, preparation of network and user surveys, collection systems, administrative-accounting systems, accounting and budget integration and computerization). It will also finance immediate rehabilitation works that have a direct, positive effect on the service's quality, reliability and financial sustainability in the short run and that can be carried out in less than one year (for example, dividing up networks into sectors and modernizing pumping stations).

4. Systems' rehabilitation and expansion

This is to finance major works to rehabilitate and expand water supply, sewerage and water treatment systems. Examples of such works are waste water treatment plants, sewage treatment plants, new sewer mains, storage tanks and filters.

PROJECT'S ROLE IN THE BANK'S COUNTRY AND SECTOR STRATEGY:

The Bank's strategy in Venezuela is geared toward, *inter alia*, supporting the State's modernization, especially with the decentralization process and more efficient and equitable social services. The proposed operation is an effort to consolidate decentralization within the sector by making the institutions that provide water and sanitation services at the decentralized level autonomous and efficient, while at the same time promoting private-sector participation. This operation is a continuation of the strategy introduced in the states of Lara and Monagas; in the case of the state of Lara, the strategy was financed by the Bank (loan 994/OC-VE). The Monagas company is run by a private

operator; a private operator will soon be running the Lara company as well.

**ENVIRONMENTAL/
SOCIAL REVIEW:**

Because of the nature of the operation, its Operating Regulations include environmental-management measures, among them the following: i) the companies' hiring of an environmental specialist; ii) establishment of environmental requirements for project eligibility; iii) preparation of manuals on how to perform the socio-environmental evaluations; and iv) hiring of evaluation firms to ascertain how valid the evaluations are and the extent to which socio-environmental requirements were met (see paragraph 3.24).

BENEFITS:

Expectations are that by program's end at least six administratively, technically and financially autonomous and efficient companies will have been established. The decentralization process will have been furthered, thereby serving to ensure that the public has adequate water supply and sanitation services.

RISKS:

Risk: That the companies will not introduce the rate increases required to qualify for the various program components. Mitigating factors: i) Current earnings levels are not sufficient to cover some inefficient cost structures in the companies. The measures included in the companies' growth strategies are intended to cut costs and make the companies more efficient, which means that the needed rate increase might not be so large; ii) the public companies created will be governed by program contracts, and the private companies by performance contracts (or contracts of other kinds). Either way, the contracts will stipulate that the companies are required to adopt tariff formulas and levels that cover the real costs of providing the service.

Risk: The complex scheme for carrying out the program will require an enormous effort on HIDROVEN's part. Mitigating factors: To minimize this risk, HIDROVEN's current executing unit will be strengthened. There are also plans to hire independent evaluation firms to assist HIDROVEN by certifying the companies' eligibility for the program's various components. A midterm review will be done at month 18 and month 36 to determine how much progress has been made and to make whatever adjustments are needed.

**SPECIAL
CONTRACTUAL
CONDITIONS:**

1. Precedent to the first disbursement, HIDROVEN is to have:
 - a. Put the program's Operating Regulations into force (see paragraph 3.4);
 - b. Prepared a list of firms qualified to do the evaluation of compliance with program requirements (see paragraph 3.13), and
 - c. Designated the staff needed to reinforce HIDROVEN's executing unit (see paragraph 3.2).
2. Mid-term meetings will be held 18 and 36 months after the date of contract signature to assess the rate of advance of the program.

**POVERTY-
TARGETING:**

This program does not qualify as a poverty-targeted investment.

**CONTRACTING OF
CONSTRUCTION WORK,
GOODS AND
SERVICES:**

The thresholds above which the procurement under this program will be done through international competitive bidding are: US\$3 million for construction works, US\$350,000 for related goods and services, and US\$200,000 for consulting services.

**EXCEPTIONS TO
BANK POLICY:**

None.

PROCUREMENT:

The plan is to do an ex post review of the procurement procedures at the time of the midterm reviews to be done 18 and 36 months from the date on which the operation is approved. The procedures to be reviewed will be selected at random.

I. FRAME OF REFERENCE

A. Macroeconomic framework

- 1.1 In April 1996, with the help of a standby loan from the International Monetary Fund (IMF), Venezuela undertook a stabilization program that involved a considerable number of reforms. The economy was liberalized by eliminating controls on the exchange rate, interest rates, and most prices. It also liberalized the oil sector, privatized banks that had been nationalized in the aftermath of the 1994 and 1995 financial crisis, and accelerated nationalization of other public enterprises, as in the case of the iron and steel companies in the Grupo Sidor of the Corporación Venezolana de Guayana (CVG). The labor laws in effect were reviewed and reform of the social security system got under way. At the same time, a process to modernize the system of financial and budgetary administration is still in the early stages.
- 1.2 After a favorable economic performance in 1997 thanks to increased oil revenues and an expansionist fiscal policy, the 1998 picture has taken a decided turn for the worse. A sharp drop in world oil prices disrupted macroeconomic management and performance in a year when elections would be held at both the national and local levels. The measures introduced by the government have consisted mainly of budget cuts, a restrictive monetary policy and a crawling peg. The policies introduced have been prudent, which enhanced the government's credibility to the point that a "shadow" agreement was concluded with the IMF in June of 1998.
- 1.3 The effects of negative oil price correction, however, has been far greater than had been anticipated in the shadow agreement. Hence, the programs introduced have not been enough. Although projected oil prices were revised downward three times (from US\$15.5 to US\$13 per barrel), the average for the first half of 1998 was US\$11.44 (compared with the 1997 average of US\$16.4). At the current exchange rate and volume of exports, a reduction of US\$1 per barrel in the price of oil represents a decline in fiscal revenues equivalent to 1.25% of the gross domestic product (GDP). The decline in exports following the agreements that the Organization of Petroleum Exporting Countries (OPEC), Mexico and Norway concluded to cut production has caused a decline of US\$1 billion in the country's fiscal revenues.
- 1.4 The impact of the decline in oil revenues is compounded by the indirect effects on the fiscal deficit: a decline in non-oil tax revenues with the contraction in the rate of economic growth; increases in interest payments, and the Central Bank's growing quasi-fiscal deficit owing to higher interest rates. This situation has redoubled the need for financing and fiscal adjustments.

- 1.5 The adjustments in the social safety network are indicative of the problems that cuts in total spending bring with them in a scenario in which earnings have unexpectedly declined. Spending on the network had increased from 0.5% of GDP in 1995 to 1.4% in 1997, but is expected to be at 0.8% for 1998. This is particularly disturbing, since 48% of the population lives in extreme poverty.

B. Venezuela's potable water sector

- 1.6 Venezuela began decentralization of the potable water and sanitation sector back in 1991, when the Instituto Nacional de Obras Sanitarias (INOS) [National Sanitation Works Administration] was sold off. It was part of the central government and in charge of providing potable water and sanitation services nation-wide. Although under the Ley Orgánica de Régimen Municipal (LORM) [Municipal Regulations Act] the municipalities are, by law, responsible for providing these services, they did not take over those functions in practice. Instead, this responsibility was temporarily transferred to 10 regional water utility companies (EHRs) that covered all the states with the exception of Bolívar, Amazonas and Delta Amacuro, which are administered by the Corporación Venezolana de Guayana. The EHRs, in turn, were attached to a parent corporation, Compañía Anónima Hidrológica de Venezuela (HIDROVEN), which comes under the Ministry of the Environment and Natural Resources (MARNR). Under the statute that created the HIDROVEN-water utility companies system, the arrangement will cease to exist once the municipalities take over their responsibilities in the sector.
- 1.7 At the outset, it was unclear what institutional and political support the decentralization process enjoyed. As a result, some functions that were intended to be transferred to the local level, such as execution of investments and financing thereof, remained the responsibility of HIDROVEN and the MARNR. Also, some responsibilities continued to be shared, such as the setting of rates; while the law stipulates that this is the municipal government's responsibility, in practice it is regulated by the MARNR and the Ministry of Industry and Commerce, which sets the maximum allowable rates. Similarly, while ownership of the water supply and sewage collection systems is in the hands of the municipal governments, the major production systems – reservoirs and appurtenant structures – continue to be owned by the central government, through the MARNR.
- 1.8 As it progressed, the decentralization process pointed up various problems in the transition plan. The municipal governments, which are by law responsible for the services, refused to take the systems because they were in poor condition and because the municipal governments were not making investments, which had been charged mainly to the national budget. As there were no proper incentives to charge for the service, the municipalities themselves

were against any rate hikes. The situation deteriorated into a vicious circle and the quality of the service suffered as a result.

- 1.9 The EHRs have chronic financial deficits and the sector is a heavy burden on public finances, since the companies's average coverage of operating costs with internally generated revenue has never averaged more than 70%. The high levels of unmetered water, which is over 50% of the water produced, an inefficient investments system, coupled with population growth, caused national coverage figures in urban areas to drop in the 1986-1993 period, from 81% to 76% in the case of potable water, and from 57% to 53% in the case of sewerage. Today, following a slight recovery, potable water coverage is 79% and sewerage 61%; in rural areas those figures are 80% in the case of water and 53% in the case of sewerage. The wastewater treatment figure for the country as a whole is 28%.

C. Venezuela's strategy vis-a-vis the sector

- 1.10 The recent financial crises in the country and this sector in particular have forced the various governments to carry the decentralization process even further, by adopting strategies centered around local initiative, under the leadership of the state governors and mayors. The idea is to create mixed autonomous companies, owned by both the municipalities and the states. This phase began when the responsibility for delivering these services in the states of Lara and Monagas was handed over, giving rise to the creation of the Empresa Hidrológica del Estado de Lara (HIDROLARA) [Lara State Water Utility Company] and the Empresa de Acueductos y Cloacas del Estado Monagas [Monagas Water and Sanitation Company] (Aguas de Monagas).
- 1.11 These two companies were prototypes for a sustainable decentralization strategy. Although they have not been in operation long enough to draw any definitive conclusions about their advantages, they do suggest that certain factors are crucial to the success of the process, namely the financial and technical support that can guarantee the delivery of the systems in minimum operating condition and the simultaneous leadership and participation of mayors and governors. Hence, Venezuela's most recent strategy for sector decentralization is based on three elements: i) local consensus and the participation of civil society, where the states, the municipalities, HIDROVEN and civil society are present; ii) technical assistance to support the transition from the center; and iii) financing of rehabilitation works to ensure that the new decentralized companies created will start up with functioning systems.

1. The strategy of local consensus-building and civil society's participation

- 1.12 The decentralization strategy must begin by creating an awareness at the local level of what the process means. To that end,

HIDROVEN helps set up a "development board", an ad hoc body whose members are representatives from the mayor's office, state governments and civil society organizations. Its basic purpose is creation of the companies responsible for supplying potable water and sanitation services.

2. The technical assistance strategy

- 1.13 Fulfilling one of its functions as a promoter of the decentralization process, HIDROVEN provides the support needed so that the work of the development boards will result in the creation of the decentralized water and sanitation companies. To that end, HIDROVEN conducts workshops with the development boards and various authorities such as state governments and the various town councils; it also provides technical and legal advisory services to help mayors and governors as they design, legalize and create the new company.

3. The financing strategy

- 1.14 The decentralization strategy is coupled with financial support to make possible the transition to sustainable companies. Accordingly, the financing has been planned in three phases. The first is financing for the creation of the companies and selection of the most suitable operator; the second is financing for the activities needed to ensure the service's basic operability during the company start-up. This includes emergency works or immediate repairs as well as measures in the operations, business and planning areas; the third phase of financing is for expansion of the water supply and sanitation systems once the companies have matured.

4. The decentralization strategy and the regulatory framework in the sector

- 1.15 The sector's present institutional structure is temporary and planning, regulation and delivery responsibilities are not clearly established; neither are the mechanisms and incentives for efficient service delivery. There are obvious conflicts of interest between the environmental regulator (the MARNR) and the principal user of water resources (the HIDROVEN-EHR system). The decentralization strategy undertaken is the first step toward more efficient organization of the sector, since it guarantees an autonomous and financially independent system of companies, with much clearer efficiency incentives and free of institutional conflicts of interest.
- 1.16 Venezuela is in the process of preparing the reforms that will be the legal underpinnings of the sector's new image. That image will evolve from a completely centralized and public model of service delivery where the regulatory, planning and service functions are invested in the same institutions, to a model where the service is

provided by autonomous and decentralized companies, where the service delivery functions are separate from regulatory functions, and where ample allowance is made for private sector participation. This new look will be realized by consolidating the decentralization process under way, and through a series of legal and institutional reforms that reinforce the strategy and guarantee its long-term sustainability.

- 1.17 At the present time, studies are in progress on the legal reforms needed in the sector. These include: i) preparation of a water and sanitation service bill to be introduced in the next session of Congress. This law provides for a set of institutions and standards that will guarantee efficient delivery of water and sanitation services in the country, within the framework of an autonomous sector decentralized to operate at the state level. This law will call for organization of a central-government regulatory agency and will establish, *inter alia*, the sector's financial policy; ii) amendment of the LORM, the law governing service contracts by private parties, which was submitted to Congress in September of this year; iii) an addition to the earlier reforms, calling for a new national policy on tariffs and subsidies, which is expected to be implemented in January 1999; and iv) user service regulations.
- 1.18 Although a clear and well-defined regulatory framework would be good for the process of decentralization and company consolidation, decentralization should move ahead without it for three reasons: i) a political consensus now exists in favor of the process; ii) the gaps in the regulations can be filled in with the program contracts between the companies and the municipalities, as was done in the Lara and Monagas cases; iii) the inclusion of the private sector may shed light on a clearer and more politically acceptable design to address the need for a regulatory framework and point up any gaps it may have. Judging from experience in other countries, a regulatory framework put together before the services are decentralized may ignore important relationships between the central government and the decentralized companies, such as the relationship between the central government's financial support and the pricing policies that the decentralized companies will put into effect.

5. Policy on rates

- 1.19 Under the LORM, municipalities in Venezuela have the authority to set rates, with the one restriction mentioned in paragraph 1.20. In the specific cases of Lara and Monagas, the municipalities, under the program contract, gave the companies the authority to set rates and also authorized them to use automatic indexing. In this operation, the new companies will set rates in accordance with the provisions stipulated in the program contracts and guarantee that they will be established according to technical and economic-efficiency criteria.

- 1.20 The water and sewerage services are regarded as primary necessities in presidential decree 2786 of 1988. This means that the central government can set a limit on the maximum allowable rates, as happened recently with presidential decree 2372 of January 1988, which set a 25% limit on the rate hike in 1988.

D. Actions of the Bank and other entities

1. Previous Bank programs

- 1.21 Since 1987, the Bank has approved three loans in the water supply and sanitation sector, totaling US\$233.4 million and intended to: increase the supply of potable water in the central region (loan 538/OC-VE, for US\$153.4 million); build sewers and treatment plants for the clean up of Lake Valencia (loan 557/OC-VE, for US\$50 million), and support modernization and rehabilitation of the water supply and sanitation sector (loan 994/OC-VE, for US\$30 million).
- 1.22 The central region potable water project (loan 538/OC-VE) included works to expand water supply in the central region (Carabobo, Aragua and Cojedes states) and impoundment and pumping works. As of October 1998, the works to put the water supply system into service and the first phase of institutional development had been completed. The remaining rehabilitation works and the meter installation programs are behind schedule but will be completed with local resources. With the loan proceeds and HIDROVEN's support, the institutional design (including the method by which the private sector will participate) of the decentralized companies that will administer the systems is being devised. The program is expected to be completed by late August 1999.
- 1.23 The sewage treatment system project for the Lake Valencia basin (loan 557/OC-VE) is the second phase of the program for comprehensive sanitation of the basin, which includes two wastewater treatment plants. Construction work began in mid-1991 and the project is 55% complete, with the equivalent of US\$7.8 million remaining to be disbursed. Construction work came to a halt between early 1996 and June 1997 because of insufficient counterpart funding. Since June 1997, however, the resources have been made available, and the construction work has resumed, and is expected to be finished by September 1999.
- 1.24 As for institutional matters, a decision is needed on the business arrangement for operating and maintaining the systems. The view is that whichever company is in charge of running the Central Region Water Supply System should also operate the wastewater treatment plants. As in the case of the central region potable water project, with HIDROVEN's support the institutional organization of the company that will administer the systems is being devised.

- 1.25 The program to support modernization and rehabilitation of the water supply and sanitation sector (loan 994/OC-VE) involves the design and introduction of the national regulatory framework; the hiring of a private sector integrated management services company for HIDROLARA, and minor rehabilitation and improvement works to HIDROLARA's existing water supply and sewerage systems. The loan contract was signed in November 1997; the loan was declared eligible for disbursements in August 1998.
- 1.26 The hiring of a private-sector integrated management services company is at a very advanced state. The evaluation of the offers has been completed and the contracts are expected to be awarded shortly, and the contracts negotiated. As for the works, bids have been taken on the first group of rehabilitation works and for procurement of the first package of individual meters. As for rates, HIDROLARA is using the new rate structure planned at the time the loan was approved, which increased average rates by 63%. The current rate, US\$0.28 per m³, is sufficient to cover operating and maintenance costs.
- 1.27 This operation's sector component includes activities to prepare an operation for decentralization of the systems, and to develop and introduce a regulatory framework suited to the new decentralized structure. The first group of activities, i.e., to expand decentralization, include the creation of the development boards in six states and contracting of consultants to prepare the services strategy for the states of Barinas and Portuguesa. As for the second group of activities, funds from this loan are being used to pay for the consultants that are designing the elements of the new regulatory framework and the legal amendments necessary to establish the framework. These studies will be completed in early 1999 for submission to the Congress.

2. Actions of other international organizations

- 1.28 In the case of the World Bank, the country negotiated a loan for an operation in Monagas similar to the one with HIDROLARA. The private operator has been contracted and investments are currently being made to rehabilitate the systems.
- 1.29 HIDROCAPITAL is now in the final stages of executing a loan from the Andean Development Corporation (CAF) for the sum of US\$25 million for rehabilitation of the water production and distribution systems. A loan of US\$50 million has been approved to continue with the installations' rehabilitation.

E. The Bank's strategy in the sector

- 1.30 The purpose of the Bank's strategy in the sector is to improve efficiency, decentralize responsibility for management, and make the water supply and sanitation services financially self-

sufficient. This strategy is to establish autonomous companies whose equity is owned by the municipalities and state governments; the private sector can be drawn into these companies by a number of arrangements.

- 1.31 The financial and institutional problems the sector faces are structural in nature. Hence, introduction of this strategy will take time to mature and must be developed gradually. In this sense, this program expands and builds upon the strategy initiated by the Bank under the Lara loan, which was a pilot experiment through which the viability of the strategy was ascertained.
- 1.32 The Lara experience made it clear that decentralizing the services, i.e., having the municipalities take over responsibility for operating these systems, requires a commitment from local and central authorities and financial support so that the services are delivered under acceptable conditions. The Lara experience also demonstrated the legal and political capacity that the municipalities have to commit to a rate policy driven by the principle of financial self-sufficiency.

II. THE PROGRAM

A. Objectives

- 2.1 The objective of the operation is to improve the quality and increase the coverage of the water and sanitation services in Venezuela, by establishing independent companies that promote efficient operation and quality services to the public. In this way, the decentralization of the water sector that began in the states of Lara and Monagas, and more recently in Mérida, will be expanded and consolidated.
- 2.2 The program's specific objectives are to: i) consolidate the sector's decentralization; ii) create and consolidate efficient and optimally sized operator companies; and iii) promote private sector participation in the newly-created companies.
- 2.3 The goals of the program are to have strategies prepared for two companies by month six, four companies created by month 12, and six companies operating with the necessary systems to ensure efficiency by the end of the program (see logical framework, in Annex II-1).

B. Description of the program

- 2.4 The operation comprises four components: two involving studies and activities associated with setting up companies, and two others for business strengthening and investments. The program is configured as an open program that new companies may join provided they meet the conditions to qualify for the program, as outlined in the Operating Regulations, which are described in detail in chapter III. The five-year program is expected to help develop and consolidate some six companies in the water and sanitation sector.

1. Decentralization of services (US\$6 million)

- 2.5 Under this component, the following activities will be financed:
 - a. Induction workshops to train governors, mayors, regional organizations, and organizations of civil society in the characteristics of the decentralization process and formation of development boards.
 - b. Preparation of the general strategy for the services with a view to setting up the company. The plan will include a thorough analysis of the services' present condition, an identification of demand, analysis of the potential for private sector participation, a business strengthening program and a five-year investment plan.

- c. Preparation of business-viability studies, including financial, legal, rates-related and other studies needed for the municipalities to sign the service contract with the new company.
- d. Design of the program contracts and the contract oversight units.
- e. Preparation of the final designs for the immediate rehabilitation works and their environmental evaluations.

2. Private sector participation (US\$6 million)

2.6 Under this component, financing will be provided for activities concerned with establishing linkages with the private sector for the delivery of water and sewer service under different contractual arrangements such as concessions, management, leasing, or through the involvement of the private sector as a shareholder in the companies. The activities eligible for financing are:

- a. Technical, financial and legal studies of alternative forms of private-sector participation in service operations.
- b. Promotional work and identification of potentially interested parties within the private sector.
- c. Preparation of technical specifications and those related to rates, the law, quality, fulfillment of indicators, supervision and determination of costs, for purposes of integrated management service contracts or service delivery contracts.
- d. Inducements to reduce overstaffing.

3. Business strengthening and immediate rehabilitation works (US\$84 million)

2.7 This component will finance:

- a. Actions to either improve or establish the business-related, administrative-financial and operating areas, such as master and individual metering systems, surveys of systems and users, collection systems, administrative-accounting systems and computerized accounting and budgeting;
- b. Immediate rehabilitation works (including their supervision) that have a direct positive impact in the short term on the quality, reliability, and technical and financial sustainability of the service and that can be carried out in less than one year, such as dividing systems into sectors, modernizing pumping stations, and others; and

- c. Studies and designs of the major works projects involving rehabilitation and expansion of the water supply and sanitation systems.

4. Systems' rehabilitation and expansion (US\$72 million)

- 2.8 This component will finance the major rehabilitation and expansion works for the water supply and sanitation systems, including supervision costs. These include:

- a. Water impoundment works.
- b. Construction of water mains.
- c. Expansion and construction of water purification and wastewater treatment plants and outflow sewers.
- d. Pumping stations and sewers.
- e. Construction of water storage tanks.
- f. Construction of water distribution networks and sewer systems.
- g. Environmental control and mitigation works.

C. Scale of the program

- 2.9 The premise used to scale the program was that at least six companies (one third of the potential candidates for the program) will join, all requiring studies and investments similar to those identified in the processes carried out in the states of Lara and Monagas. This would be a first step to induce other companies to become part of the decentralization process. The hope is that this operation will generate demand for new Bank operations in the future.

D. Cost of the program

- 2.10 The program's total cost was estimated at the equivalent of US\$200 million. The breakdown, by source of financing and investment category, is shown in the following table:

**TOTAL COST AND FINANCING
(US\$ 000)**

CATEGORY	IDB-OC	LOCAL	TOTAL	%
1. Supervision and administration	5,000	10,000	15,000	7.5%
1.1 Central executing unit	2,000	0	2,000	1.0%
1.2 Decentralized executing units	3,000	6,000	9,000	4.5%
1.3 Evaluation firms	0	4,000	4,000	2.0%
2. Direct costs	87,000	81,000	168,000	84.0%
2.1 Decentralization of services	6,000	0	6,000	3.0%
2.2 Private sector participation	3,000	3,000	6,000	3.0%
2.3 Immediate strengthening and rehabilitation	42,000	42,000	84,000	42.0%
2.4 Rehabilitation and expansion	36,000	36,000	72,000	36.0%
3. Financial expenses	8,000	9,000	17,000	8.5%
3.1 Interest	7,000	7,000	14,000	7.0%
3.2 Credit fee	0	2,000	2,000	1.0%
3.3 Inspection and supervision	1,000	0	1,000	0.5%
TOTAL	100,000	100,000	200,000	100.0%
	50.0%	50.0%	100.0%	

E. Financing of the program

- 2.11 The Bank will contribute to the program's financing a sum equivalent to US\$100 million (50% of the program's total cost). The financing will be disbursed in United States dollars, and charged against the Bank's ordinary capital under the Single Currency Facility.
- 2.12 The terms of the Bank's loan will be as follows: (i) amortization period: 20 years; (ii) interest rate: variable; (iii) disbursement period: 5 years; (iv) commitment fee: 0.75% on the undisbursed portion; and (v) inspection and supervision: 1% of the loan amount.
- 2.13 The local counterpart, for the equivalent of US\$100 million, will be covered, in its entirety, by the companies, the municipalities and the states. For purposes of the eventual loan contract concluded with the Bank, the government will guarantee the local counterpart contribution and will conclude agreements with each state and its respective municipalities whereby the states and the municipalities undertake to contribute the local counterpart, with this commitment being forged as the states and municipalities enter

into agreements formally establishing their participation in the program.

III. EXECUTION OF THE PROGRAM

A. Borrower and executing agencies

- 3.1 The borrower will be the Republic of Venezuela. HIDROVEN will execute the *Services Decentralization* component through a project executing unit (PEU). The participating services and companies will carry out the *Private Sector Participation, Business Strengthening and Immediate Rehabilitation, and Systems' Rehabilitation and Expansion* components through a company executing unit (CEU) to be created within each company.

B. The program's executing units

1. In HIDROVEN

- 3.2 The PEU will function within HIDROVEN under the supervision of its president and will be in charge of the program's general administration, which includes processing the disbursements with the Bank, preparing the reports requested by the Bank, and keeping the accounts and books on the use of the resources. The PEU will be built upon the executing unit created for loan 994/OC-VE, now being executed; another four professionals - one engineer, one financial analyst, and two specialists in companies' institutional growth and private sector participation - will be added. The appointment of the additional staff will be a condition precedent to the first disbursement.

2. In the companies

- 3.3 With the help of the PEU, each decentralized company participating in the program is to create a CEU as part of its organizational structure. The CEUs will handle the physical and financial monitoring and control of the studies and works contracted and take partial and final acceptance thereof, approve the reports and records of delivery of works, and process disbursements with HIDROVEN. The CEU is to be made up of the following specialists: a coordinator, an engineer, an environmental expert, a procurement specialist, a financial analyst, an attorney, and support personnel.

C. Operating Regulations

- 3.4 The operation will be governed by a set of Operating Regulations that elaborate upon the program's guidelines, including, *inter alia*, the procedures, criteria and terms, as well as the supporting documentation that the services and companies have to complete to have access to the program's resources. The Operating Regulations form an annex to the loan contract and its terms and requirements are an integral part of the contract. One of the conditions

precedent to the first disbursement is that the Operating Regulations be in effect. The following is a summary of those regulations:

1. Program eligibility criteria

- 3.5 All water and sanitation services created as part of the sector's decentralization will be eligible to participate in the program. They will be added to the program when they apply and if they show that they meet the eligibility requirements established for each component. The eligibility requirements for the components are as follows:

a. Decentralization of the services

- 3.6 To participate in this component, a framework agreement must have been signed between the municipalities and the state government, where appropriate, HIDROVEN and the respective EHR, to begin the formal transfer of the services. The development board must have been formed and will facilitate the new company's creation and start-up. Up to US\$1 million will be assigned to each company for this component.

b. Private sector participation

- 3.7 In addition to the requirements stipulated for the preceding component, it will also be required that the new company be constituted and that the board of directors authorize private sector participation in the company. Each company will be assigned up to US\$1 million for this component.

c. Business strengthening and immediate rehabilitation works

- 3.8 The companies must be duly constituted to qualify for this component. They must have signed, a service contract with the municipalities and a program contract, and must have balance sheets and financial statements and have prepared a strategy. Where tariffs are concerned, the companies must show that their tariffs cover at least 70% of their operating and maintenance costs (except in cases where rates have been increased by over 50% in the year previous to the request, in which case rates need cover only 60%). By the end of the activities planned under this component, companies must be covering 100% of their operating and maintenance costs and be generating sufficient funds to repay the loans received.
- 3.9 The resources of this component total US\$14 million per company. The portion corresponding to the loan (US\$7 million) is subject to contingent reimbursement. In other words, the company is to repay it by the end of the period of execution unless it qualifies for the component involving *Systems' Rehabilitation and Expansion*. To guarantee repayment, the company will make an arrangement with a

financial institution whereby a portion of its earnings are withheld automatically. Formal establishment of the repayment mechanism will be a condition precedent for accessing the component; however, the withholding will only kick in if the company does not apply for the *Systems' Rehabilitation and Expansion* component.

d. Systems' rehabilitation and expansion

- 3.10 The requirements will be the same as those stipulated for the preceding component, although the company must also show that it has succeeded in covering 100% of its operating and maintenance costs and is complying with the efficiency goals established in the strategy. The sum available for each company under this subcomponent is US\$12 million; the portion corresponding to the loan proceeds (US\$6 million) are reimbursable. The guarantees demanded for the preceding component will be required for this component as well.

2. The projects' eligibility criteria

- 3.11 The works to be financed under the components for *Business Strengthening and Immediate Rehabilitation* and *Systems' Rehabilitation and Expansion* must fulfill the requirements of economic, technical and environmental viability agreed upon with the Bank and that are spelled out in detail in the Operating Regulations and in the manuals attached thereto.

3. Verification of fulfillment of the criteria for acceding to and qualifying for the project

- 3.12 Each company's strategy will define the management scheme (public or private, specifying the recommended method), the business strengthening investments, the immediate rehabilitation work and expansion work and their timetable for completion, the efficiency indicators, and the rate structure. The resulting financial projections will show how viable the company is. This plan will be the basis for monitoring and controlling the water and sanitation services added to the program.
- 3.13 To help HIDROVEN evaluate the requirements for access to the components and ensure that project eligibility requirements stipulated in the Operating Regulations have been met, the companies will submit the required information, duly confirmed by an independent evaluation firm. To that end, HIDROVEN must put together a Bank-cleared list of consulting firms that specialize in technical, economic, financial and environmental evaluations of businesses and projects. Creation of this list will be a condition precedent to the first disbursement. The companies, for their part, are to engage the services of one of these firms as a requirement precedent to filing a financing request.

D. Flow of funds

- 3.14 The Ministry of Finance will arrange to have a special account opened with the Central Bank of Venezuela where proceeds from loan disbursements will be deposited. Under a transfer agreement, it will authorize HIDROVEN to access those funds. HIDROVEN will use part of this funding to make the payments for the *Decentralization of Services* component.
- 3.15 As for the payments for the *Private Sector Participation, Business Strengthening and Immediate Rehabilitations and Systems' Rehabilitation and Expansion* components, HIDROVEN will transfer the resources from the aforementioned special account to an account in a trust that each of the participating companies will have opened and that will be separate from their other accounts. The Ministry of Finance, HIDROVEN and each company will conclude a subsidiary transfer agreement to effect the transfer. The local counterpart contributions will be also be deposited in an account opened with the trust fund. The company will use the funds in this account to pay for the consulting services and works that these three program components involve.
- 3.16 In those cases in which the companies are required to reimburse the loan proceeds, the grace period and repayment period will be the same as the grace and amortization periods established for the Bank's loan to the Republic of Venezuela in accordance with the Operating Regulations. As the companies will not join the program until some time after the loan contract is signed, their repayment deadlines will not exactly coincide with the amortization period and will amortize some years later. This method was chosen in order to make it easier for companies to join the program and to ensure that they will be able to repay the loan proceeds. The variable interest rate will be calculated by the Central Bank of Venezuela on the basis of the average lending rate charged by the country's six largest commercial banks. The Republic of Venezuela will bear the exchange risk. These conditions are similar to those established in loan 994/OC-VE.
- 3.17 The automatic repayment mechanism to ensure repayment of loan proceeds is an agreement signed with one or more financial institutions whereby the latter will collect a significant percentage of the bills sent out by the company. The agreement stipulates irrevocably that a percentage of the receipts are to be set aside for transfer to the account set up by the Ministry of Finance. The percentage will be computed by one of the program's evaluation firms to ensure that loan proceeds are repaid.

E. Execution period and investment timetable

- 3.18 The disbursement period for the loan proceeds has been estimated at five years from the entry into force of the loan contract. This time frame is deemed sufficient for the companies that decide to

join the program to take advantage of the resources earmarked for each component.

F. Status of program preparation

- 3.19 As for services that currently qualify for the program, companies have been formed in the states of Lara, Monagas and Mérida that have already signed their service contract with the respective municipalities. Two companies have already been constituted but have not yet signed the contract; there are nine development boards that should eventually lead to new companies and two framework agreements concluded that should eventually lead to development boards. Also, in the states of Barinas and Portuguesa, proceeds from loan 994/OC-VE are being used to finance preparation of the strategies.

THE PROGRAM'S INVESTMENT TIMETABLE
in millions of US\$

YEAR	IDB	LOCAL	TOTAL	%
1	3.0	1.0	4.0	2.0%
2	14.6	11.4	26.0	13.0%
3	29.8	33.2	63.0	31.5%
4	35.1	39.4	74.5	37.3%
5	17.5	15.0	32.5	16.2%
TOTAL	100.0	100.0	200.0	100.0%
%	50%	50%	100%	

G. Procurement procedure and amounts

- 3.20 The procurement of goods and related services and the awarding of contracts for construction works are to be done in accordance with the procedures set forth in Annex B of the loan contract. International competitive bidding will be mandatory for procurement of goods and services valued at more than US\$350,000 and for construction contracts valued at more than US\$3 million. Procurement in amounts under the specified thresholds will be done pursuant to national law. The consulting contracts will be awarded in accordance with the procedures stipulated in Annex C of the loan contract. International competitive bidding will be required when the contract is for over US\$200,000. The Preliminary Procurement schedule is shown in Annex III-1.
- 3.21 Works corresponding to the same component and for the same company will be let as a package, unless the nature of the works and the execution period are such that two or more packages would be more

advisable. The contract to supervise the works package will be let separately.

H. Infrastructure operation and maintenance

- 3.22 The works built under the program will become part of the respective company's system and the company will be responsible for operating and maintaining them properly. The program contract that the new companies will conclude with the municipalities for operation of the services will stipulate the requirements vis-a-vis the systems' operation and maintenance and their reporting obligations to the entity overseeing the contract. The program contract will also indicate the contributions that the parties are required to make to offset any shortfalls the companies incur until they are able to cover their full operating and maintenance costs.

I. External audit

- 3.23 The financial statements of participating companies that have already received funds for consulting services and construction works are to be submitted to the Bank during the program execution period, duly audited by a firm of independent public accountants acceptable to the Bank. That audit will include certification of financing for the trust created to transfer the loan proceeds to the companies. These statements will be submitted to the Bank by way of HIDROVEN within 120 days after the end of each fiscal year.
- 3.24 Within the first 120 days of each year, HIDROVEN is to submit the program's audited financial statements to the Bank, and will include the auditors' opinion of the degree to which the procedures established in the Operating Regulations have been followed.

J. Environmental aspects

- 3.25 The program's Operating Regulations describe the environmental management measures required for projects to qualify for the program. Salient among these are the following:
- a. The companies are to hire an environmental expert to work on environmental-management measures.
 - b. Technical seminars are to be held for information purposes and to make the executing units' teams aware of environmental-protection laws and institutions, standards and procedures for evaluating projects from the environmental standpoint, and works and other environmental-management measures under the program.
 - c. Eligibility requirements for the program's works components are to include environmental evaluations of projects, public surveys and all authorizations and permits required by law.

The Operating Regulations also include guidelines for the environmental evaluations of projects.

- d. If a low-income population group has to be relocated in order to build the works, the compensation and resettlement plan is to be consistent with Bank policy and include project eligibility requirements.
- e. The environmental analysis of the systems to be transferred is to be included in the companies' general strategy, in order to identify the most obvious environmental harm already done. The costs of the program's projects will include the costs of the measures needed to correct the damage so identified.
- f. Under the service contract, systems to monitor the quality of the water supplied to the public and any discharged sewage will be mandatory, and the results are to be reported to the public and to the competent government authorities on a monthly basis.
- g. Contracts for rehabilitation and expansion of the systems will require that any socio-environmental measures called for in the projects' environmental evaluations be introduced.

K. Program monitoring

- 3.26 Bank supervision of the program will be handled by the Country Office in Venezuela, with the project team's support. To help get the program under way, the project team will conduct an initial mission once the operation is approved, and two midterm review missions at month 18 and month 36 of the program, to check on the progress made and make any necessary adjustments.

IV. THE BORROWER AND THE EXECUTIVE AGENCIES

A. Participating entities

- 4.1 The borrower is the Republic of Venezuela. The program will be executed by HIDROVEN and the participating companies.

B. HIDROVEN

- 4.2 The duties, responsibilities and powers of the various ministries in the executive branch of government are apportioned in accordance with the Central Government Statute of December 30, 1986. Under this law, the MARNR's general mission is to plan and conduct executive-branch measures to improve the quality of life, of the environment and of renewable natural resources, and to prepare and carry out the programs to conserve, protect, improve, regulate, exploit and use water, forests, land and soil.
- 4.3 HIDROVEN was created in 1991 as a corporation under the Commercial Code. Its mission is to carry out the MARNR's policies and programs in the water supply and sanitation sector. Under its by-laws, HIDROVEN's main functions are: (i) to develop policies and programs established by the MARNR on water supply and sewage collection and treatment; (ii) establish guidelines and policies for the sector's development; (iii) coordinate the administrative, technical and legal arrangements related to the sector's restructuring process; (iv) monitor regional companies so that they can become financially self-sustaining; (v) foster the transfer of services to regional entities, and (vi) assist in obtaining funds for sector investments.
- 4.4 In this arrangement, HIDROVEN is the parent company of the EHRs operating in the sector and, on the MARNR's behalf, plans and promotes the decentralization process. Although as the EHRs' sole shareholder it has absolute control over them and may propose their merger, association, restructuring or liquidation, its true function is geared more toward defining the structure of the sector.
- 4.5 HIDROVEN does not function, therefore, as a corporation in the strict sense of the word; instead, it functions more like a unit in the MARNR's central organizational structure, which in fact owns 95% of the shares in HIDROVEN.

C. The participating companies

- 4.6 The companies participating in the program are the newly created, decentralized companies that will be formed by the municipalities and/or states, with private sector participation to take charge of

the water and sewerage services that, by law, are the responsibility of the municipalities.

- 4.7 One problem that has delayed the creation of these companies is that the municipalities do not have the financial means to take over these services. Therefore, inasmuch as the states are partners in the new companies, the existing regulations allow state governments, like any other national or state agency, to participate in the construction work and delivery of services, once an agreement has been concluded with the municipalities. Because the state governments are better off financially than the municipalities thanks to the transfers they receive from the central government and because they are more experienced in administrative management, the transfer process is based on the premises that companies owned jointly by the municipalities and the state governments be created, with the latter owning a large portion of the companies' equity.

D. Challenges the new companies will face

- 4.8 While a detailed analysis of companies that do not yet exist is hardly possible, the major management- and finance-related challenges such new companies will face can be anticipated.
- 4.9 As for the systems' management, the main indicators of the low level of water supply and sewerage services are the lack of coverage, the high percentage of unmetered water and the low percentage of metering, billing and collection. The existence of the new companies will mean that decisions on these problems will be taken where they occur -i.e., at the local rather than central level; they will afford an opportunity to break the vicious circle whereby poor service begets an unwillingness to pay and hence a low level of receipts, leaving the service even worse off due to lack of funds. However, the company must be able to insulate itself from political influences, which are very strong since the shareholders are public, so that the decisions taken are informed by sound business practices and any advantage gained is not lost.
- 4.10 From a financial standpoint, the water and sewerage rates that the EHRs now charge are generally not high enough to generate the revenues needed to cover operating costs and be able to make investments. This necessitates action on two fronts: on the one hand, rates and the effective collection percentages must be raised, which means that evidence is needed that service has improved; at the same time, costs have to be trimmed to get the most from the rates charged.

V. PROGRAM FEASIBILITY AND RISKS

- 5.1 The program being proposed is a comprehensive and rational solution to the need to improve the quality and coverage of the country's water and sanitation services, while also improving operating efficiency and the quality of the services delivered to the public through the autonomous companies that will be created. The program is considered feasible from the various angles analyzed below.

A. Technical feasibility

- 5.2 The program's technical feasibility is basically a function of three factors: the investments a company will make will be planned as part of its strategy; the program will finance definitive designs; and project eligibility will be certified by evaluation firms using Bank standards.
- 5.3 Apart from serving as a blueprint for company growth, each company's strategy will identify measures to improve its operations and a set of rehabilitation works and expansion works spread out over a five-year horizon. At the present time, the regional water companies have some projects whose studies and designs have either already been done or are on the drawing board. They can be used to develop a series of works to be built under the program. The strategy will include a technical evaluation of those engineering studies and the corresponding cost estimates.
- 5.4 In the case of final designs, the component for *Decentralization of Services* will finance the designs for the works that will be financed under the component for *Business Strengthening and Immediate Rehabilitations*; the latter, in turn, includes financing of eligible works under the component for *Systems' Rehabilitation and Expansion*.
- 5.5 The Operating Regulations use the Bank's criteria for project eligibility to guarantee that the technical and engineering details for the works eligible for financing are properly analyzed. Also, the involvement of evaluation firms ensures that technical compliance with these criteria is verified.
- 5.6 The five-year time frame proposed for the program is sufficient to carry out the planned activities, taking into account, on the one hand, the possible pace at which companies will join the program, and on the other, the time needed to carry out the bulk of the projects, most of which involve business strengthening actions and rehabilitation works.

B. Institutional and financial feasibility

1. Institutional feasibility

- 5.7 The program's institutional feasibility is attributed to the strong combination of mechanisms and institutions planned for its operation and development, and to the political willingness of the actors involved, especially at the local level. The experiences with the states of Lara and Monagas, where the services were transferred from the water utility companies to the municipalities, demonstrated to the states the benefits of decentralization when civil society and the private sector are involved. These experiences not only created a bias at the local level in favor of decentralization, but also paved the way for HIDROVEN to play an active role in the process by building up its technical capacity, which this program further reinforces. It has an experienced technical team to assist with the decentralization process.
- 5.8 To illustrate how far along the process is, five companies have already been constituted and nine development boards installed. In the state of Barinas, the strategy is ready and the private sector's involvement recommended. In the state of Portuguesa, the strategy is being drawn up. These measures illustrate that in at least six states, the basic conditions are there to ensure that the process will be favorably received at the local level.
- 5.9 Because of the way the program organizes the financing to the new companies, the municipalities will have a considerable incentive to take over the new service. In other words, each company could receive as much as US\$2 million in non-reimbursable loan proceeds to establish itself, and thus be able to attract private-sector participation. Also, the US\$7 million in loan proceeds that each company can receive for business strengthening and immediate rehabilitations would also be nonreimbursable provided the company ultimately qualifies for the next component. The incentive represented by the nonreimbursable contribution, coupled with the availability of long-term financing, the political commitment of the state governments and municipalities, and HIDROVEN's technical support guarantee the feasibility of the program as a whole.

2. Financial feasibility

- 5.10 From a financial standpoint, the contributions from the loan proceeds and local counterpart must be available on time if the program is to function smoothly. The new companies must achieve long-term financial self-sufficiency.
- 5.11 As for the authorization to borrow, the Venezuelan authorities have reported the reprogramming of the 1998 Umbrella Bill, whereby US\$100 million is being appropriated to the present operation.

- 5.12 The entire local counterpart, which is the equivalent of US\$100 million, will be covered with revenues from the companies, the municipalities and the states. For purposes of the eventual loan contract that it would sign with the Bank, the Venezuelan government will guarantee the local counterpart contribution and, in turn, will conclude an agreement with each state and its respective municipalities whereby the states and the municipalities undertake to contribute the local counterpart. To this end, a local counterpart contribution commitment will be required when the participation of the municipalities in the program has been formally established.
- 5.13 The principal source of funds for the local counterpart would be the revenue sharing that states are constitutionally entitled to receive from the central government by virtue of the Decentralization, Delimitation and Transfer of Competencies Act. Under this law, in 1990 16% of the all regular income in the national budget was to be transferred to the states; that figure went up 1% each year, until it reached 20%. For their part, the states are to include municipal revenue share-outs in their respective budget laws. In 1990 revenue sharing from a state to its municipalities was 10% of the state's regular revenues; that figure, too, increased 1% per annum up to 20%. State/municipality revenue sharing has averaged some US\$3.5 billion per year for the last three years.
- 5.14 In addition to revenue sharing, states receive income from two other sources: the Intergovernmental Decentralization Fund [Fondo Intergubernamental para la Descentralización] (FIDES) and the special appropriations resulting from exploitation of mines and hydrocarbons. FIDES receives between 15% and 20% of the proceeds from the luxury and wholesale taxes, and finances investment projects in the states and municipalities. The Special Appropriations Act stipulates that up to 30% of the revenues received in the form of petroleum and mineral royalties must be divided up among the states, mainly the producer states. Average revenues from these two sources have been around US\$500 million per year for the last three years.
- 5.15 As for the companies' financial self-sufficiency, under the program they will evolve from their original condition wherein operating and maintenance costs are not covered, to a very different one where a capacity to finance investments is being generated. The change is to be reflected in the strategy and will be tracked by way of the evaluations done when the company applies for the various components.
- 5.16 At the base level, to qualify for the component for *Business Strengthening and Immediate Rehabilitations* a company must already be covering at least 70% of its operating and maintenance costs, or 60% if it has had a rate increase of over 50% within the previous 12 months. The activities financed under this component are

expected to have a near-term positive impact on the quality, reliability and financial sustainability of the service, such that the company will be able to cover all of those costs upon completion of the component and also be able to generate sufficient income to repay the loan. To keep the company financially sound, any temporary shortfall that may occur while these works are under way and until the operating and maintenance costs are fully covered, will have to be covered by the partners.

- 5.17 Once a company is covering all of its operating and maintenance costs and generating a surplus for investment, the company can apply for the component for *Systems' Rehabilitation and Expansion*, in which case it need not repay the loan proceeds received under the previous component. This mechanism serves a twofold purpose: on the one hand it helps sustain the company during the difficult period when the services are being launched; on the other hand, it is intended to reward a company for having achieved the degree of financial self-sufficiency that allows it not only to operate independently but to undertake an investments program as well.
- 5.18 Throughout this process, the relationship between rates, investments and quality of service will be determined in the strategies and will depend upon where each company started from. The guidelines for the program contract that are included as part of the Operating Regulations stipulate not only the company's responsibility to introduce rates that enable it to recoup the costs of the service, but also the economic and financial criteria that must inform their design.

C. Environmental feasibility

- 5.19 The projects involving works to rehabilitate and expand water supply and sanitation systems under the program result in a substantial range of positive socio-environmental impacts that directly translate into improved hygiene and health conditions.
- 5.20 The most obvious potential negative socio-environmental impacts are associated with the construction of new facilities. Considering the nature of the program, it is anticipated that the likely socio-environmental impacts can be either avoided or controlled with well defined mitigation measures.
- 5.21 The conditions established for the program's execution will serve to ensure that the environmental evaluations of the projects, the authorizations necessary for their execution and the monitoring and control of the environmental measures introduced will be done properly and with specialized consultants participating.
- 5.22 The program serves the environmental and social sustainability objectives of the Bank's strategy for integrated management of water resources. The following are some of the most salient features:

- a. The participation of the service users is one of the commitments made by HIDROVEN and the MARNR, which are endeavoring to create within the states and municipalities that the program benefits, regional and local advisory boards made of up representatives of civil society, to involve the communities in monitoring water quality and other actions.
- b. The program's actions and works will prioritize activities intended to reduce unmetered water before tapping new water sources.
- c. The studies that will be done as part of the *Business Strengthening and Immediate Rehabilitations* component include designing a rate structure that takes into account the economic levels of the target public, and the means and willingness to pay for the services.
- d. The country's environmental laws are adequate for environmental control of the works and introduction of the natural resource planning, management and conservation system; measures are planned under the program that will improve the enforcement of environmental standards and bolster the regulations, primarily with regard to water use concessions.
- e. The components and actions planned under the program show that sanitation systems can be combined with water supply systems and both systems can be developed concomitantly.

D. Socioeconomic analysis

- 5.23 The socioeconomic analyses of the projects will be done according to the following criteria:
- a. The projects are to represent a comprehensive solution to the problem identified and are to be scaled to conform to the least-cost analysis. For purposes of this analysis, the proposed works are to be part of a comprehensive plan for expansion of the systems and be the technical alternative of least economic cost. A complete cost benefit analysis will be done of the alternative selected, which will include an estimate of the project's social rate of return. The project's benefits will be about the willingness to pay of the project beneficiaries, which will be reckoned by using the SIMOP model in the case of the water projects and the contingent value method in the case of the sewerage projects. The costs that will be used in the analysis are to be corrected to reflect the opportunity costs of the resources in Venezuela.
 - b. Cost efficiency criteria can be used in the case of projects intended to meet the needs of communities of fewer than 5,000 people. In this case, a test sample of projects is to be used to develop cost-efficiency indicators for projects with

the Bank's required social rate of return of 12% per annum and that are at least 90% statistically reliable. Such indicators will function as cut-off points for accepting or rejecting projects and need to be updated periodically.

- 5.24 Another factor to be weighed is income distribution based on the socio-economic survey and present and projected rate levels, as well as any other hook-up change provided for in the rate structure. The impact that the projects under study will have on low-income groups should be presented, done according to the established Bank method. It must also be shown that the subsidized service method is in keeping with the sector's current legal framework. These points are part of the program's Operating Regulations.

E. The program's benefits

- 5.25 The program's chief benefit will be the improved quality of the services and the lower cost of delivering them. These improvements will be quantified in the companies' strategies by establishing a set of efficiency targets. The program will also lower the costs of delivering the services by introducing goals for reducing unbilled water and streamlining operation and maintenance.
- 5.26 By the end of the program, six efficient and administratively, technically and financially autonomous companies will have been established, thus freeing up funds to invest in expansion without resorting to the traditional fiscal costs. Because the services will be run by different companies, comparisons can be made of the various management styles. They can be regulated by comparing the companies' efficiency relative to the others.
- 5.27 The involvement of the private sector in some of the services will introduce new production and management technologies that other services can then assimilate. This will lower costs and improve quality across the board.

F. The program's risks

- 5.28 From the financial standpoint, the lack of political support may make it impossible for the companies to introduce the rate increases they need to cover costs and make themselves financially self-sustaining. To mitigate this risk, the service contracts and the program contracts of the new companies will delegate authority in rate-related matters and outline the criteria for computing rates, in a clause contained in the program contracts to be entered into between the municipalities, states and the new companies.
- 5.29 The complex program-execution scheme will require a major effort on HIDROVEN's part, because it is also carrying out the program of support for modernization and rehabilitation of the water and sanitation sector (loan 994/OC-VE). To alleviate this risk, plans

have been made to reinforce HIDROVEN's executing unit. Also, to assist HIDROVEN in its efforts, independent evaluation firms will be contracted to certify the new companies' qualifications and eligibility for the various components and conditions of the program. A midterm review is planned at months 18 and 36 to check the progress made and to make any necessary adjustments.

LOGICAL FRAMEWORK

OBJECTIVE	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
GOAL			
To improve the quality and increase the coverage of water supply and sewerage services in Venezuela.	Improvements in the service quality indicators and higher service coverage rates.	Information periodically supplied by the companies and required under the service contracts signed with the municipalities.	
PURPOSE			
Establish decentralized, autonomous companies that operate efficiently and provide quality service.	At least six companies qualify for the major rehabilitation and expansion works component or successfully enlist private-sector participation.	Semi-annual monitoring reports that HIDROVEN is to prepare.	A regulatory framework developed simultaneously with proceeds from loan 994/OC-VE establishes clear rules and standard criteria for the sector.
OUTPUTS			
1. Companies are formed and ready to take over service.	1.1 Legal validity of the company's by-laws, of the concession agreement and of transfer of the service to the companies participating in the program. 1.2 A business strategy is in place for the companies participating in the program.	1. Documentary evidence.	The new companies are interested in joining the program.
2. The private sector has become involved in the delivery of services.	2. Legal validity of the contract associating the private sector with some of the companies participating in the program.	2. Documentary evidence.	
3. The services' financial situation has improved.	3. The companies that qualified for the component gradually pay more and more of their operating and maintenance costs, until they finally cover 100% of those expenses and are in a position to return the borrowed funds received.	3. Opinion of evaluation firms.	

OBJECTIVE	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
4. Measures have been taken to adapt the systems' physical infrastructure to the demand.	4. The works carried out have made it possible to accomplish the quality and coverage objectives set in the strategy for the companies that qualified for the component.	4. Opinion of evaluation firms.	
ACTIVITIES			
1.1 Creation of the companies' development boards 1.2 Formation of the companies and signature of concession agreements. 1.3 Preparation of the strategies and performance of business viability studies 1.4 Establishment of a services contract oversight unit in each company's service area.	1. Contracting of studies and consulting services for up to US\$1 million per company and US\$6 million total.	1. Final products of the studies and consulting services; delivery of works contracted; the program's audited financial statements	1. The municipalities and the states are willing to take charge of the service.
2.1 Selection of the private-sector participation model. 2.2 Preparation of the documents needed for the process whereby the private operator is selected. 2.3 Selection of the private operator. 2.4 Formation of a unit to supervise the contract with the private operator.	2. Contracting of studies and consulting services for up to US\$1 million per company and US\$6 million total.	2. Final outputs of the studies and consulting services; the program's audited financial statements.	2. The private sector is interested in participating in management of the services and the incorporation process is successfully concluded.

OBJECTIVE	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>3.1 Improvement of the business, administrative-financial and operating areas of the companies.</p> <p>3.2 Performance of immediate rehabilitation works that have an impact on the companies' financial situation</p> <p>3.3 Studies and designs done for the larger-scale rehabilitation works and for expansion works.</p>	<p>3. Contracting of studies, consulting services and works for up to US\$14 million per company and US\$84 million total.</p>	<p>3. Final products of the studies and consulting services; delivery of works contracted; the program's audited financial statements.</p>	<p>3. The users notice and appreciate the company's efforts to improve service.</p>
<p>4.1 Other large-scale rehabilitation works</p> <p>4.2 Expansion works</p>	<p>4. Contracting of works for up to US\$12 million per company and US\$72 million total.</p>	<p>4. Delivery of contracted works; the program's audited financial statements.</p>	<p>4. The companies operate the new systems properly and efficiently.</p>

VENEZUELA
PROGRAM FOR DECENTRALIZATION OF THE WATER AND SANITATION SECTOR (VE-0111)
PRELIMINARY PROCUREMENT PLAN

CONSULTANTS AND WORKS BY COMPONENT	DIRECT COST (US\$ millions)	FINANCING	METHOD	PRE- QUALIFICATION	ESTIMATED PUBLICATION DATE
A. CONSULTANTS					
- design of business strategies	1.8	IDB 100%	ICB	YES	I/99
- studies of business viability	0.6	IDB 100%	ICB	YES	I/99
- financial analysis	0.6	IDB 100%	ICB	YES	I/99
- design of water and sanitation project	3.0	IDB 100%	ICB	YES	I/99
- study of alternatives for private-sector participation	0.6	IDB 50%	LCB	YES	I/99
- development of bidding documents for various types of private-sector participation	5.4	IDB 50%	ICB	YES	I/99
B. WORKS					
- upgrading of water impoundment works	45	IDB 50%	ICB	YES	II/2000
- upgrading of water mains	20	IDB 50%	ICB	YES	II/2000
- rehabilitation of storage tanks and pumping systems	10	IDB 50%	LCB	YES	II/1999
- rehabilitation of water and sewer distribution systems	9	IDB 50%	LCB	YES	II/1999
- construction of new water impoundment systems	20	IDB 50%	ICB	YES	I/2001
- construction of new water systems	10	IDB 50%	ICB	YES	I/2001
- construction of pumping systems	10	IDB 50%	ICB	YES	II/2001
- construction of water systems	12	IDB 50%	ICB	YES	II/2001
- construction of wastewater treatment plants	20	IDB 50%	ICB	YES	II/2002

PROPOSED RESOLUTION

VENEZUELA. LOAN /OC-VE TO THE REPUBLICA DE VENEZUELA
(Water Sector Decentralization 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 Venezuela, as Borrower, for the purpose of granting a financing to cooperate in the execution of the Water Sector Decentralization Program. Such financing will be for the amount of up to one hundred million dollars of the United States of America (US\$100,000,000) from the Single Currency Facility of the Ordinary Capital Resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.