

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PERU

SANITATION SECTOR REFORM PROGRAM II

(PE-L1052)

LOAN PROPOSAL

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ABBREVIATIONS

DNEP	National Public Debt Department
DNS	National Sanitation Department
EPS	Municipal water and sanitation service provider(s)
FONAVI	National Housing Fund
IDB	Inter-American Development Bank
KfW/GTZ	Kreditanstalt für Wiederaufbau / German Agency for Technical Cooperation
LCF	Local Currency Facility
MEF	Ministry of Economy and Finance
MVCS	Ministry of Housing, Construction, and Sanitation
OC	Ordinary Capital
OMP	Optimized master plan
PBL	Policy-based loan
PCR	Project completion report
PRSS	Sanitation Sector Reform Program
PSP	Private sector participation
SEDAPAL	Servicio de Agua Potable y Alcantarillado de Lima [Lima Water and Sewer Utility Company]
SFC	National Water and Sanitation Capacity-building System
SME	Small- and medium-sized enterprises
SUNASS	Superintendencia Nacional de Servicios de Saneamiento [National Superintendency of Sanitation Services]
UCPS	Sector Loan Coordination Unit

PROJECT SUMMARY

PERU SANITATION SECTOR REFORM PROGRAM II (PE-L1052)

Financial Terms and Conditions				
Borrower: Republic of Peru Executing agency: Ministry of Economy and Finance (MEF)			Amortization period:	20 years
			Grace period:	5 years
			Disbursement period:	12 months
Source	Amount	%	Interest rate:	LIBOR
IDB (Ordinary Capital)	US\$130 million	100.0	Inspection and supervision fee:	*
			Credit fee:	*
Total	US\$130 million	100.0	Currency:	U.S. dollars from the Single Currency Facility
			Option to convert into Peruvian new soles: Local Currency Facility (LCF)	
Program at a Glance				
<p>Program objective:</p> <p>The program's objective is to improve the efficiency, equity, and sustainability of water and sanitation services in Peru. The specific purpose of this second operation is to move forward in adopting sector policy reforms of the Sanitation Sector Reform Program pertaining to the development of regional plans, the regulatory framework for small communities, the allocation of public investment resources, and the formulation of a policy of incentives for access to investment finance; as well as to build upon all the reforms instituted under the first operation (loan PE-L1025). This second operation will support structural, institutional, legal, and regulatory reforms in the following areas and for the following purposes: (i) <u>Macroeconomic stability</u>. To ensure a macroeconomic environment in keeping with program objectives and with the main points of the sector policy letter; (ii) <u>Institutional framework</u>. To improve sector planning and organizational instruments, and create incentives for the efficient management, operation, and administration of service providers in small- and medium-sized communities; (iii) <u>Financial policy</u>. To define objective criteria for allocation of public resources, and to restructure EPS financial liabilities; (iv) <u>Rate policy</u>. To contribute to the rate and subsidy framework promoting cost recovery, efficiency and equity, and streamlined procedures; (v) <u>Operator management</u>. To improve the institutional transparency and sustainability of water and sanitation operators; and (vi) <u>Private sector participation (PSP)</u>. To map out a national strategy for private sector participation and a process methodology that optimizes the use of preinvestment resources, processing time, and compliance with legal requirements by participating entities.</p> <p>The present program is consistent with the sector challenges and programs described in the Bank's water and sanitation initiative. The operator management component and the rate policy component will develop major areas to be included in the Efficient and Transparent Utilities program. The institutional framework component, by defining the regulatory system for small cities and rural areas, will develop areas linked to the 3,000 Rural Communities program. The rate policy component, by setting limits on the quality and quantity of industrial waste discharges, will develop areas linked to the Water Defenders program. Lastly, the investment planning component, by identifying areas of service and guidelines for prioritizing regional investments, and the private sector participation component, will develop areas linked to the 100 Cities program.</p> <p>Special contractual conditions:</p> <p>See Policy, Results, and Verification Matrixes, as well as the Policy Letter, Chapter V (see paragraph 5.1).</p>				
<p>Project consistent with country strategy: Yes [X] No []</p>				
<p>Project qualifies as: SEQ [X] PTI [] Sector [] Geographic [] Headcount []</p>				
<p>Procurement: Not applicable since this is a policy-based loan program.</p>				
<p>Verified by ESR on: Programmatic operation I, PE-L1025, CESI 09-24-07; Programmatic operation II, PE-L1052, ESR 11-22-08.</p>				

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

I. DESCRIPTION AND RESULTS

A. Frame of reference

- 1.1 This operation is the second of three consecutive, independently financed but technically interrelated programmatic one-tranche policy-based loans (PBLs), pursuant to documents CA-450-1 and CS-3633. On 20 November 2007 the Bank's Board of Executive Directors approved the first of the three programmatic operations (loan 1920/OC-PE) in the amount of US\$100 million, which was disbursed in June 2008. The proposal for that loan is the framework document for the programmatic series (document PR-3202). This document updates, supplements, and follows on that proposal in accordance with memorandum EVP/1/2006 (PO-LO-2006) of 6 March 2006. The programmatic structure of this operation is warranted by: (i) the complex nature of the reforms; (ii) the amount of time required to implement them; (iii) the need to explain and publicize the reforms; (iv) the need to ensure continuity; (v) the complexity of the institutional setting; and (vi) the flexibility required to adjust the policy reforms and commitments of subsequent programmatic operations on the basis of progress achieved.¹
- 1.2 *Status of first programmatic operation.* The policy measures adopted under the first programmatic operation contributed significantly to the establishment of mechanisms that will enable optimum, equitable use of investment resources, and maximize return on the investment. This was achieved by beginning five regional plans that made it possible to define a methodology for the entire country, and by establishing eligibility criteria for the allocation of resources. Policy instruments were also designed that contributed to improvements in governance, transparency, and accountability of service providers, and strengthened corporate decision-making to ensure the long-term sustainability of service delivery. This was achieved through the signing of more than 15 operation contracts incorporating criteria of corporate governance and accountability. The operational capacities of the apex agency and regulatory authority were also strengthened in order to support effective execution of government programs, with the creation of the "Water for All" program, as well as to move forward in establishing a regulatory framework for small cities and rural areas, and improve the rate system and its transparency so as to make service delivery more efficient and sustainable, through the approval of over 16 optimized master plans (OMPs) and rate formulas. Lastly, policy guidelines

¹ "The programmatic approach is based on a mutual intent to support a medium-term reform program, rather than being an explicit agreement embodied in one Loan Contract spanning the entire program like traditional multi-tranche PBLs. Programmatic PBLs present the advantage of promoting ongoing policy dialogue and fine-tuning of the implementation strategy during a dynamic reform process, which aims to support the Government's ownership of the reform and the Bank's responsiveness, as well as to strengthen the focus on developmental impact. Because Bank support is given in phases, this instrument leaves room for adaptation to evolving country circumstances. The programmatic modality may be the best fit if the operation responds to unfolding events/new knowledge during implementation, if implementation capacity is uncertain, or if political support for certain elements of the program might shift." (Operations Processing Manual, section PR-301).

have been established for linking specialized operators in order to improve service provider management. This, to a great extent, has made it possible to develop four private participation processes.

B. Socioeconomic framework

- 1.3 Peru's economic indicators point to a high degree of economic stability, sustained by responsible fiscal management and political consensus on the importance of maintaining a sustainable macroeconomic environment. In recent years GDP has grown steadily, reaching 9% in 2007, the highest rate since 1994. Economic performance had a favorable impact on employment, which recorded a 10% annual increase in May 2008. Fiscal consolidation continued during 2007 (the fiscal surplus was 3.1% of GDP). A fiscal surplus of 2.7% of GDP is projected for 2008, with a year-end external public debt-to-GDP ratio of 13.9%. Inflation reached 3.9% in 2007, above the target ceiling of 3.0%. Inflationary pressures have continued in 2008 as a result of the rising prices of food and imported intermediate products (cumulative inflation for January-August was 4.7%). Country risk trended up from mid-2007 onward, closely tracking the region's performance, but trended back down in 2008 to 208 basis points as of 29 August.
- 1.4 Total public debt at year-end 2007 was US\$31.772 billion, of which US\$20.081 billion was external public debt and US\$11.691 billion was domestic. The overall public debt-GDP ratio fell from 44.3% at end-2004 to 29.18% at end-2007, due primarily to growth in dollar GDP. External public debt continued to decline (18.4% of GDP). Fitch Ratings gave Peru an investment grade rating in April, followed by Standard & Poors' in July. The country's long-term foreign currency debt rating rose from BB+ to BBB-, while Moody's upgraded its debt rating in August from Ba2 to Ba1, one notch below investment grade. The third review of the precautionary stand-by arrangement with the International Monetary Fund (IMF) concluded satisfactorily in June 2008.

C. The water and sanitation sector

- 1.5 **Sector institutional structure.** Policymaking, planning, and sector governance, including environmental issues, are the responsibility of the Ministry of Housing, Construction, and Sanitation (MVCS), acting through the Office of the Deputy Minister of Construction and Sanitation (VMCS) and its National Sanitation Department (DNS). Economic and quality-of-service regulation is delegated to the National Superintendency of Sanitation Services (SUNASS), a task that is complemented by the Ministry of Health, through the Environmental Health Department and the Basic Sanitation Division, in terms of quality, as well as by the National Natural Resources Institute, for water resources management. Services in urban and rural areas are provided by 45 decentralized municipal water and sanitation service providers (EPS), except in Lima, where the service is administered by a State-owned company, Servicio de Agua Potable y Alcantarillado de Lima (SEDAPAL). This scenario is complemented by the sanitation administration boards and municipalities serving rural areas with fewer

than 2,000 inhabitants, and municipalities that directly administer services to between 2,000 and 30,000 inhabitants.

- 1.6 **Conditions in the sector** Based on the most recent population and housing census in 2004, water (76%) and sanitation (57%) service coverage in Peru are below the regional average (91% and 77%, respectively), according to WHO-UNICEF. The diagnostic assessment of the National Sanitation Plan (PNS) shows that water service continuity is on average 17 hours/day, while 37% of service providers report continuity below 12 hours/day. In rural areas, of a sample of 1,630 systems analyzed, 59% do not disinfect water because they lack the necessary system or inputs. Service providers nationwide report a high level of unmetered water (46%), inactive connections of approximately 23%, average payment arrears of 5 months, and rates not high enough to cover the actual costs of service (17% operating margin, not including SEDAPAL). In this context, service is unreliable and unsustainable, and the likelihood of failing to meet the Millennium Development Goals is high. This situation is caused mainly by problems relating to the sector's institutional framework, financial policy, rate policy, and EPS performance.
- 1.7 **The Sanitation Sector Reform Program (PRSS)** The purpose of this reform program is to improve the efficiency, equity, and sustainability of water and sanitation service delivery through a *sturdier sector framework, more efficient investment, and more equitable public resource allocation*. The PRSS was based on a structured process of sector analysis, dialogue, consultation, and consensus on the diagnostic assessment, and actions with civil society, service providers, the donor community, and the various stakeholders and beneficiaries. This effort was led by DNS in broad consultation with stakeholders. After the sector diagnostic assessment identified the sector's main challenges, the problems and causes were analyzed, reforms prioritized, and the overarching reform concept was designed.
- 1.8 **The main challenges of the sanitation sector** The sector diagnostic assessment identified the following main challenges: (i) strengthen systems for investment planning and quantification of regional needs, (ii) institute a regulatory system for small cities and rural areas; (iii) strengthen the operating and management capacities of the DNS and SUNASS; (iv) devise government financing and intervention arrangements through transparent and uniform rules that promote efficient management; (v) strengthen the financial capacity of service providers by restructuring their liabilities; (vi) promote a rate policy that enables service providers to cover their operating costs and finance long-term capital investments, (vii) target subsidies to poor users; (viii) educate and train service providers in how to formulate OMPs; (ix) strengthen the technical and administrative capabilities of service providers to deliver services efficiently; (x) formalize contractual obligations between service providers and the municipios for service delivery; (xi) strengthen the operational autonomy of service providers that may be vulnerable to political interference, and (xii) promote the development of private sector participation (PSP) arrangements so that specialized operators can provide efficient services.

- 1.9 **Prioritization of reforms:** As a result of this process, the Peruvian government prioritized a series of reforms in five areas: (i) the *sector's institutional framework*, which requires definition of regional and EPS investment targets and priorities, technical and management capacity-building for the DNS and SUNASS, and the development of a regulatory framework for services in small communities; (ii) *financial policy*, to establish objective criteria for the allocation of public resources and the effective consolidation of EPS financial liabilities; (iii) *rate policy*, to simplify rate structures, target subsidies, adjust rates to inflation, and incorporate the concept of environmental costs; (iv) *EPS management*, requiring good corporate governance practices and reporting by operators, as well as strengthening the training system for operational and management issues; and (v) *private sector participation*, requiring the development of a single promotion strategy, a methodology for raising awareness and communication in each process, and optimization of the structuring process.

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

- 1.10 **The Bank's sector strategy.** The Bank has provided support for the sector in the form of eight investment programs whereby the Bank helped the Peruvian government implement major institutional reforms, and finance basic infrastructure expansion and EPS strengthening. This program in particular supports implementation of the PRSS through a programmatic loan.
- 1.11 **Coordination with other financing and cooperation agencies** This operation is the result of joint work between the Peruvian government, Kreditanstalt für Wiederaufbau (KfW), the German Agency for Technical Cooperation (GTZ), and the Bank within the sector policy framework. During program preparation, both KfW and the Bank financed consulting projects to support fulfillment of the commitments corresponding to this second programmatic operation. KfW will also support the reforms planned under this program with a parallel loan to the Peruvian government (see paragraph 3.1). The results of the PRSS were shared with the community of bilateral and multilateral agencies.

II. THE PROGRAM

A. Objectives

- 2.1 The objective of the program is to improve the efficiency, equity, and sustainability of water and sanitation services in Peru through support for a series of actions. These actions are calculated to achieve resource allocation based on efficiency criteria that maximize the benefits to the country while observing equity criteria, to achieve greater efficiency in service management by service providers, to bring about self-sufficiency for these entities, and to lay the foundations of equitable, universal coverage. The specific purpose of this second operation is to move forward in adopting sector policy reforms of the Sanitation Sector Reform Program (PRSS) pertaining to the development of regional plans, the regulatory framework

for small communities, the allocation of public investment resources, and the formulation of a policy of incentives for access to investment finance.

- 2.2 This program is consistent with the sector challenges and programs described in the Bank's Water and Sanitation Initiative. The operator management component and the rate policy component will develop major areas to be included in the Efficient and Transparent Utilities program. The institutional framework component, by defining the regulatory system for small cities and rural areas, will develop areas linked to the 3,000 Rural Communities program. The rate policy component, by setting limits on the quality and quantity of industrial waste discharges, will develop areas linked to the Water Defenders program. Lastly, the investment planning component, by identifying areas of service and guidelines for prioritizing regional investments, and the private sector participation component, will develop areas linked to the 100 Cities program.

B. Components

- 2.3 **Component I – Macroeconomic stability.** The objective of this component is to ensure a macroeconomic environment in keeping with program objectives and with the main points of the sector policy letter.
- 2.4 **Component II – Institutional framework of the sector.** The objective of this component is to improve sector planning and organizational instruments, and to create incentives for the efficient management, operation, and administration of service providers in small- and medium-sized communities. This component includes the following activities:
- 2.5 *Investment planning.* The objective of this activity is to provide the government with a region-based sector planning instrument, based on a needs analysis of each service, and a tool for prioritizing interventions efficiently and equitably, so that the country can move forward in meeting the Millennium Development Goals. To meet these objectives, the following actions were identified for this second programmatic operation: (a) a methodology will be developed for formulating Regional Sanitation Plans, and (b) implementation of the Water and Sanitation Information System (SIAS) will be under way. To this end, the National Sanitation Department (DNS) (a) developed a methodology for preparing the plans,² which is expected to be adopted by ministerial resolution in late 2008. Using that methodology, the DNS began preparing four regional plans for the regions of La Libertad, Cajamarca, San Martín, and Lambayeque; the plans for San Martín and Cajamarca have been completed. The DNS also (b) approved the conceptual design of the SIAS, including the system's software and database, and the conceptual framework, general structure, and content for training to implement it. It also signed six regional agreements for pilot programs that received international cooperation funding, to meet its commitments to conduct the activities identified. The regions

² The methodology was based on the National Sanitation Plan (PNS) guidelines for prioritizing investments, which were developed under the first programmatic operation.

participating in this pilot are Arequipa, Cajamarca, Huancavelica, Lambayeque, Ucayali, and Cusco. For the third programmatic operation it was agreed that the National Sanitation Plan would be updated, and the Regional Sanitation Plans implemented, and that the SIAS would be in operation. The expected development outcome is that the government will have sector planning by region and service, based on a needs analysis that prioritizes its interventions efficiently and equitably.

- 2.6 *Legislative framework for operators in small communities.* The objective of this activity is to create conditions for efficient, sustainable sanitation services in small communities and rural areas through the establishment of a system for regulation, supervision and rates, and minimum criteria for the contracting of small- and medium-sized enterprises (SMEs). To meet the objectives, it was agreed that the second programmatic operation would need to apply these regulatory arrangements to at least 50 providers, and the system for contracting specialized operators for small- and medium-sized communities to 20 new operators. This strategy was based on the assumption that the supreme decree submitted to the DNS by SUNASS—a means of verification of the first programmatic operation—would be approved in the first quarter of this year. The decree was not approved, however, because adjustments were made in the new regulatory system for small communities and rural areas, and SUNASS could not be guaranteed all the necessary funding for 2008 and 2009 to perform this task in line with the new proposed regulations,³ which call for the regulation of 30 new EPSs. It was therefore agreed with the DNS and SUNASS that the draft supreme decree would state that the transition would be gradual and implemented to the extent that SUNASS has sufficient financial resources to meet that obligation. The Peruvian government is about to approve the supreme decree to create the new regulatory system, which will enable the DNS to (i) approve the conceptual design of regulations for communities of less than 15,000 inhabitants, including performance measures, and (ii) establish the procedure for engaging specialized operators for service delivery in small communities; and enable the SUNASS to (iii) approve the draft regulations for the regulatory system, including a system for rate-setting and service provider supervision in communities with 15,000 to 40,000 inhabitants. For the third programmatic operation, it was agreed to apply the contracting system to new operators and institute the procedure for engaging specialized operators for small and medium-sized communities. The expected development outcome is to improve the efficiency and sustainability of service delivery through a system of

³ For communities of more than 30,000 inhabitants, the regulatory framework was designed on the basis of the EPS management model. The current regulatory system includes, among other things, preparation of OMPs by the EPSs, and meeting a series of obligations related to the preparation and delivery of information to SUNASS so it can effectively perform its enforcement work. This regulatory system is being employed satisfactorily by large and medium-sized EPSs, but with considerable difficulty by small EPSs, which is why a specific regulatory framework was designed for small EPSs. The proposal to reorganize the sanitation sector was agreed upon, in order to develop broader and more efficient regulations, and to cover the entire sanitation services market.

regulation and supervision, management and rates, and minimum criteria for SME contracting.

- 2.7 *Institution-strengthening.* The objective of this activity is to improve the management capacity of the apex agency (DNS) and the operational capacity of the regulatory authority (SUNASS). The actions identified for this second programmatic operation are for implementation of the DNS restructuring plan and the “Water for All” program to be under way. For the third programmatic operation, it was agreed that these actions would be completed. Accordingly, the “Water for All” program has been consolidated as an investment project execution unit with its own administrative management office. This will enable it to focus on and streamline the development of investment projects and the transfer of investment resources. The DNS, in turn, will concentrate on sector planning, policy development, investment program design, and monitoring and supervision. SUNASS has strengthened its institutional capacities in the areas of supervision, enforcement and sanctions, rate-setting, consolidation of its institutional image; and administrative and human resources management. The expected development outcome is for the DNS and SUNASS to have the organizational structures to perform their functions efficiently.
- 2.8 **Component III – Financial policy.** The objective of this component is to establish objective criteria for allocation of public resources, and to restructure EPS financial liabilities. The component includes the following activities:
- 2.9 *Investment financing.* This activity would improve the public resource allocation and incentive system for operators, contributing to service efficiency and sustainability. For this second programmatic operation it was agreed that implementation of these systems should be under way. To this end: (i) the criteria for prioritization and the incentive policy will be approved; (ii) the steering committee of the Sanitation Investment Fund (INVERSAN) was established, with two representatives appointed by the MVCS, one director appointed by Corporación Financiera de Desarrollo (COFIDE), and two representatives from local and regional governments named by the Decentralization Department of the Presidency of the Council of Ministers; and (iii) it was agreed that the INVERSAN steering committee will commission development of its rules of procedure and conceptual design of the operations manual. The expected development outcome is a transparent, efficient, and equitable public resource allocation system that maximizes the economic return on government investments and helps operators to become efficient and provide sustainable services.
- 2.10 *EPS debt profile.* The objective of this activity is to improve EPS debt profiles so that they are able to provide quality services, properly operate and maintain their infrastructure, and become creditworthy. It was agreed for the second programmatic operation that two EPS would have begun to restructure their debt with FONAVI and SUNASS. This strategy assumed that the legal framework of Law 28870, the “Sanitation Service Provider Management Optimization Act,” would be sufficient to begin restructuring these liabilities. However, it was found that this law does not

clearly address the necessary areas of debt forgiveness and operating mechanisms, so the Peruvian government had to draft a supplemental bill to fill the gaps in the law. Accordingly, it was agreed that for this second programmatic operation, the MVCS and the Ministry of Economy and Finance (MEF) would prepare a bill to approve the supplemental rules to Law 28870. With this framework in place, the MVCS expects the process of restructuring EPS financial liabilities to be under way for the third programmatic operation. The expected development outcome is for the EPS to have better debt profiles, strengthened financial capabilities, and greater access to credit.

- 2.11 **Component IV – Rate policy.** The objective of this component is to contribute to the rate and subsidy framework promoting cost recovery, efficiency and equity, and streamlined procedures. This component includes the following activities:
- 2.12 *Rate structure and level.* This activity would enable companies to become financially self-sustaining in the long term with rates based on real costs that include environmental costs, and universal service delivery. For the second programmatic operation it was agreed: (a) to introduce regulations for inflation rate adjustments for service providers without rate formulas; (b) to reorganize the rate structure for EPSs into five categories; (c) to present an action plan for implementing a subsidy system; (d) to design a regulatory accounting system for segregating charges for different services; (e) to approve regulations on the quality and quantity of industrial waste discharges into the sewer system; and (f) to draft regulations on fees based on a pollution factor; and (g) to approve a formula for calculating water and sewer service rates that explicitly includes the concept of economic cost for use of water sources, environmental services, and polluting discharges. For the third programmatic operation, it was agreed to apply the subsidy system and regulatory accounting, and to introduce regulations governing fees for industrial discharges based on a pollution factor. The expected development outcome is to promote a universal service with rates that reflect the cost of service, and for the subsidy system to contribute to universal service.
- 2.13 In performance of the actions identified: (a) SUNASS has confirmed that automatic adjustments for inflation have been fully implemented as established in the regulations, and all companies that have approved rate formulas have implemented this automatic readjustment;⁴ (b) the 14 EPSs that have submitted optimized master plans (OMPs) have reorganized their rate structures in accordance with current regulations; and (c) SUNASS will approve the methodological framework for developing and implementing a subsidy policy, including a series of workshops to introduce and review the policy prepared by a consulting firm financed under operation ATN/WP-9606-PE; (d) SUNASS has approved the conceptual design of the regulatory accounting system, and the final design is expected to be ready by late October 2008. To meet this commitment, a consulting firm and an adviser will

⁴ For EPSs that have not yet implemented this adjustment, SUNASS has commissioned, under this programmatic operation, the design of proposed alternatives for implementing rate readjustments.

provide support for technical review of the outputs to be developed by the consulting firm financed under operation ATN/WP-9606-PE; (e) the MVCS will set limits for discharges into sewer systems, which are expected to be approved by supreme decree toward the end of this year; and (f) SUNASS will approve guidelines on charging for discharges into the sewer system based on a pollution factor. It was also agreed that regulations would be prepared on fees for industrial discharges, and that the concept of economic cost for use of water sources, environmental services, and polluting discharges would be incorporated into the formula for calculating water and sewer rates. This strategy encountered a setback with the recent creation of the Ministry of Environment in May 2008, which made it unclear whether this new ministry or the MVCS was responsible for setting the limits. This, in turn, delayed contracting of the consultant to draft the fee regulations. For this reason, these commitments will be added to the policy matrix of the third programmatic operation.

- 2.14 *Rate approval process.* The purpose of this activity is to streamline the processing of the EPS optimized master plans (OMPs). The actions identified for this second programmatic operation were that 15 service providers would have approved OMPs, and the parameters for OMP preparation would be reviewed. In performance of the actions identified: (a) the SUNASS steering committee approved 14 OMPs as agreed to originally, and (b) by supreme decree, the MVCS approved a simplified procedure for approving the rate formula for sustainable investment projects. For the third programmatic operation, it is expected that the subsidy system and the regulatory accounting system will be functioning, and 25 OMPs will be approved via the simplified procedure. The expected development outcome is to have service providers that are financially self-sustaining in the long term since rates will be based on actual costs, including environmental costs.
- 2.15 **Component V – Operator management.** The objective of this component is to improve the institutional transparency and sustainability of water and sanitation operators. This component includes the following activities:
- 2.16 *Institution-strengthening.* The objective of this subcomponent is to improve the management, operational, and administrative capacity of water and sanitation services through a National Water and Sanitation Capacity-building System (SFC). The actions identified for this second programmatic operation were that eight cooperation agreements, under the SFC framework, would be signed with training institutions, and implementation of an action plan to build capacity under the “Water for All” and “Investment Shock” programs would be under way. In performance of the actions identified: the MVCS plans to sign eight cooperation agreements with institutions under the SFC framework, and to approve the action plan to build capacity under the “Water for All” and “Investment Shock” programs, as well as the SFC financial plan (the resources necessary to fully implement the plan have been included in the 2008 and 2009 budgets). For the third programmatic operation, it was agreed the SFC will be in operation. The expected development

- outcome is for the SFC to offer training to sector agents: DNS, EPSs, and operators and service providers in small- and medium-sized cities and in rural areas.
- 2.17 *Management tools.* The objective of this activity is to improve governance, accountability, and institutional sustainability in water and sanitation service management and operation, in order to ensure efficient service delivery based on the transparent allocation of responsibility and accountability, thus reducing EPS vulnerability to adverse political influence. The actions identified for this second programmatic operation were: (a) to develop guidelines for dissemination of service delivery reporting and performance by local and regional governments; and (b) to sign at least five operating contracts, including targets, incentives and penalties, reporting mechanisms, and a corporate governance code. In performance of the actions identified: (a) the MVCS will approve the guidelines for dissemination of reporting and performance by local governments;⁵ and (b) ten operating contracts have been approved by board resolution. The expected development outcome is for service providers to be less vulnerable to political change, and EPS management and performance to become more transparent.
- 2.18 **Component VI – Private sector participation (PSP).** The objective of this component is to map out a national strategy for private sector participation and a process methodology that optimizes the use of preinvestment resources, processing time, and compliance with legal requirements by participating entities. This component includes the following activities:
- 2.19 *PSP promotion criteria and methodology.* The objective of this activity is to promote the sanitation sector's national PSP strategy and to develop a methodology for promoting PSP processes that defines the roles and responsibilities of participating entities. The actions identified for this second programmatic operation were to complete three PSP processes for water and sanitation service delivery: two outside Lima, and one in Lima. In performance of those actions, the Provincial Municipality Councils of Barranca and Coronel Portillo authorized the launch of the PSP processes, and the Provincial Municipality of Chiclayo is expected to do so very soon. In addition, private initiative processes are under way for the La Taboada Wastewater Treatment Plant and the La Chira Wastewater Treatment Plant in Lima. For the third programmatic operation, it was agreed that the PSP process for water and sanitation service delivery at EPSs will be under way. The expected development outcome is to have private sector participation developed on the basis of a process methodology that optimizes compliance with current legal requirements.
- 2.20 *PSP processes.* The objective of this activity is to optimize PSP processing (streamline and expedite), i.e. the processes for compliance with all legal requirements for the processing and approval of PSP arrangements. The actions identified for this second programmatic operation were: (a) to implement the operational and functional processes and procedures necessary to optimize PSP

⁵ Regional governments were not included because they do not play an active role in service delivery.

processes in the promotional stage; and (b) to implement regulations establishing adjustment criteria for processing private initiatives. In performance of those actions, the legal framework to streamline processes to promote private sector investment was approved by legislative decree. For the third programmatic operation, it was agreed that regulations implementing the new operational and functional processes and procedures will be issued and in effect. The expected development outcome is for PSP processes to employ a methodology that optimizes compliance with current legal requirements.

III. FINANCING STRUCTURE AND RISKS

A. Costs and financing

- 3.1 The present operation has been designed as a programmatic policy-based loan (PBL) of up to US\$130 million, drawn from resources of the Single Currency Facility of the Bank's Ordinary Capital. This amount is expected to be disbursed in the last quarter of 2008. As a programmatic policy-based loan, the proceeds will be disbursed in a single tranche once the loan agreement has been signed and the policy conditions have been met, according to the means of verification presented in the Verification Matrix. As with the first programmatic operation, this second tranche will be supplemented with up to €19.5 million in German cooperation financing through Kreditanstalt für Wiederaufbau (KfW), as specified in the preliminary agreements.
- 3.2 The Peruvian government approached the Bank for use of the Local Currency Facility (LCF). The program would be financed with United States dollars from the Single Currency Facility of the Bank's Ordinary Capital, subject to the Operational Framework for Lending in Local Currency (document GN-2365-2). To minimize the exchange risk, under the provisions of the LCF the Peruvian government would be entitled to convert the disbursements and amounts outstanding to Peruvian new soles.

B. Borrower and executing agency

- 3.3 The borrower is the Republic of Peru, and the executing agency is the Ministry of Economy and Finance (MEF), acting through the National Public Debt Department (DNEP), which is responsible for negotiating the operation, and the Sector Loan Coordination Unit (UCPS), which is responsible for technical coordination in connection with program preparation and supervision. The MEF is the key executive branch agency that regulates and coordinates all activities concerned with economic and financial matters. Its mission is to formulate, supervise, and evaluate sector policies and plans in line with overall government policy. The present program supports the structural policy reforms to enhance the technical capacity of: (i) the Ministry of Housing, Construction, and Sanitation (MVCS), which is responsible for all aspects of investment planning, financial policy, the regulatory framework for small communities, sector capacity-building, management tools, strategies, and criteria and methodologies for promoting public sector participation

in the sector; (ii) the National Superintendency of Sanitation Services (SUNASS), which is responsible for all aspects of rate policy, concession agreement supervision, and future regulation of small communities; and (iii) the Private Investment Promotion Agency (ProInversion), which is responsible for carrying out the PSP projects within its purview, in order to have specialized operators for efficient water and sanitation system management. The involvement of these entities is required for program execution, and they will receive technical support from the MEF in order to meet the policy commitments.

C. Environmental and social impact, key issues, and risks

- 3.4 A description of the program's **environmental and social impact, key issues, and risks** is attached as an annex.

IV. IMPLEMENTATION AND MANAGEMENT PLAN

A. Program execution and management

- 4.1 Although the technical coordination necessary for the success of the program is the responsibility of the MEF, the reforms and their implementation are the responsibility of the sector entities. The DNEP is the unit in charge of financial matters, including the processing of disbursements, and the UCPS will be the technical unit within the MEF whose responsibilities cover: (i) coordinating efforts between the different MEF and public sector units responsible for adopting measures or for the technical execution of activities; (ii) monitoring and promoting program activities to ensure successful completion; (iii) maintaining official communications with the Bank on technical matters; (iv) presenting reports of acceptable quality by the agreed deadlines; and (v) anticipating and satisfactorily addressing any risks and problems of a strategic or technical nature or relating to coordination that might arise during program execution.

B. Plan of activities for programmatic operation III

- 4.2 The budget for meeting the commitments associated with the third programmatic operation is approximately US\$5.5 million. The sources of financing include a total of US\$3 million in bilateral financing (KfW, GTZ, and others), and a local counterpart contribution of US\$2.5 million. Both amounts will need to be budgeted.

C. Monitoring and evaluation

- 4.3 During preparation of this operation, the project team reviewed the consistency of the medium-term framework of reforms for this operation. The MEF will coordinate efforts to meet the commitments relating to this second programmatic operation, as well as all other commitments and the progress of the reforms. The MEF will be responsible for providing information on the progress of the policy matrix and results matrix, as well as for providing the means of verification to the Bank. The indicators of the results matrix will be used to evaluate progress in implementing the program, making it possible to perform an evaluation upon completion of the last programmatic operation. The borrower and the Bank have

agreed to track the program by means of monitoring meetings on dates to be determined by the executing agency and the Bank. Based on this monitoring and the agreed triggers, the Bank and the executing agency will decide on an appropriate time for the third programmatic operation.

- 4.4 The project completion report (PCR) will be prepared at the end of the third operation, within six months after the reforms for the third operation are concluded, to evaluate the impact of the program and the extent to which the objectives envisaged for the three operations making up the program as a whole have been met. The borrower previously agreed with the Bank on the indicators and baseline for this final evaluation (see the **Results Matrix**, attached as an annex). The borrower will assemble all information necessary for tracking and evaluating the program, and will collect, file, and make available to the Bank all information, indicators, and parameters used by the Bank to prepare the PCR.

V. POLICY MATRIX

- 5.1 The Bank has reached agreement with the Peruvian government on the attached Policy Letter outlining the government's commitment to the objectives and actions of the entire series of programmatic loans, and reaffirming its commitment to the reforms and activities agreed upon with the Bank. The Bank agreed on the Policy Matrix attached as Annex I, which describes the policy commitments for this program (programmatic operation II), and the triggers for the next programmatic operation. In addition, the program's Results Matrix was reviewed, and the attached Verification Matrix for the second programmatic operation was agreed upon.

SANITATION SECTOR REFORM PROGRAM II
(PE-L1052)

POLICY MATRIX

Objectives	Commitments: Programmatic I	Commitments: Programmatic II	Commitments: Programmatic III
I. GENERAL MACROECONOMIC POLICY FRAMEWORK			
General macroeconomic policy framework	Macroeconomic framework consistent with program objectives and with the guidelines established in the sector policy letter.	Macroeconomic framework consistent with program objectives and with the guidelines established in the sector policy letter.	Macroeconomic framework consistent with program objectives and with the guidelines established in the sector policy letter.
II. INSTITUTIONAL FRAMEWORK OF THE SANITATION SECTOR			
Investment planning: To adopt a regional and local investment planning system based on coverage, efficiency, social, and environmental criteria.	a. The National Sanitation Plan's areas of service and guidelines for prioritizing investments for the overall quantification of viable regional targets and investment amounts are defined. b. The water and sanitation information system has been created for sector planning.	a. A methodology for formulating Regional Sanitation Plans is developed. b. The water and sanitation information system is being implemented.	a1. National Sanitation Plan updated to include magnitude of investments, service coverage and quality targets for 2015, consistent with investment priorities. a2. Regional sanitation plans are being implemented. b. The water and sanitation information system is operating.
Regulatory framework for small communities: To introduce a regulatory framework for small communities and rural areas, and to improve the transparency of management models for small and medium-sized enterprises.	A regulatory system for small cities and rural areas and a system for contracting specialized operators for small and medium-sized communities are defined and designed.	a. A regulatory system for service providers in small communities and rural areas is approved. b. Design of the procedure for engaging specialized operators for service delivery in small communities has begun.	a. A regulatory system for service providers in small communities and rural areas is being implemented. b. The procedure for engaging specialized operators for small and medium-sized communities is in effect.

Objectives	Commitments: Programmatic I	Commitments: Programmatic II	Commitments: Programmatic III
Institution-strengthening: To improve the management capacity of the apex agency and the operational capacity of the regulatory authority.	a. The reorganization plan for the DNS and the “Water for All” program are defined and created, respectively, in accordance with the new sector policies. b. The institutional strengthening plan for SUNASS is approved.	a. The reorganization plan for the DNS and the “Water for All” program is being implemented. b. The institutional strengthening plan for SUNASS is being implemented.	a. The organizational structure for the DNS and the “Water for All” program is implemented. b. The institutional strengthening plan for SUNASS is implemented.
III. SECTOR FINANCIAL POLICY			
Investment financing: To improve the public investment resource allocation system to generate efficient investments and sustainable services. EPS debt profile: To improve the EPS debt profile.	Regulations are approved for the allocation of investment resources in sanitation projects. The legal framework for restructuring the debts of FONAVI and SUNASS is approved.	a. The public investment resource allocation system for financing investments is being implemented. b. The policy of incentives for access to investment finance is being implemented. The supplemental legal framework for restructuring EPS debt is prepared.	a. The public investment resource allocation system for financing investments is implemented. b. The policy of incentives for access to investment finance is in operation. The process of restructuring EPS debt is being implemented.
IV. SECTOR RATE POLICY			
Rate structure and level: To allow enterprises to become financially self-sustaining in the long term, by having a rate based on actual costs, including environmental costs.	a. Regulations are approved for inflation rate adjustments for service providers without rate formulas. b. Reorganization of the rate structure for EPSs into the following categories: residential, social, commercial, industrial, and government, approved. c. Guidelines for the subsidy system are approved.	a. Regulations are introduced for inflation rate adjustments for service providers without rate formulas. b. Reorganization of the rate structure for EPSs into the following categories: residential, social, commercial, industrial, and government, being implemented. c. The methodological framework is approved for implementing the subsidy system for the water and sanitation sector.	Regulations for inflation rate adjustments for service providers without rate formulas are reviewed. The subsidy system is being implemented.

Objectives	Commitments: Programmatic I	Commitments: Programmatic II	Commitments: Programmatic III
	<ul style="list-style-type: none"> d. Regulatory accounting guidelines to segregate charges for water, sewer, and wastewater treatment services are approved. e. Regulations on the quality and quantity of industrial waste discharges are developed. 	<ul style="list-style-type: none"> d. Regulatory accounting system to segregate charges for water, sewer, and wastewater treatment services is framed. e. Maximum admissible values for wastewater discharge into the sewer system are proposed. f. Guidelines on charging for discharges into the sewer network based on a pollution factor are approved. 	<ul style="list-style-type: none"> d. Regulatory accounting system to separate collections for water, sewer, and wastewater treatment services is designed. e. Maximum admissible values for wastewater discharge into the sewer system are approved. f. Regulations on charging for discharges into the sewer network based on a pollution factor are approved. g. Water and sewer rate-calculation formula that explicitly incorporates the concept¹ of economic cost for use of water sources, environmental services, and polluting discharges is approved.
Rate approval process: To improve the rate approval process by adapting the OMP to the type of EPS and increased EPS capacity.	<ul style="list-style-type: none"> a. Simplification of the OMP approval procedure, approved. b. Six EPSs with approved OMPs. 	<ul style="list-style-type: none"> a. Simplified rate procedure for self-sustaining investments is approved. b. 15 service providers with approved OMPs. 	<ul style="list-style-type: none"> a. Simplified rate procedure for self-sustaining investments is being implemented. 25 EPSs with approved OMPs.
V. MANAGEMENT OF SERVICE PROVIDERS			
Institution-strengthening: To improve the management, operational, and administrative capacity of water and sanitation services.	Capacity-building system (SFC) is being implemented.	<ul style="list-style-type: none"> a. Capacity-building system is being implemented. 	Capacity-building system is in operation.

¹ The cost concept does not involve determination of the value of the cost.

Objectives	Commitments: Programmatic I	Commitments: Programmatic II	Commitments: Programmatic III
Management tools: To improve governance, reporting, and institutional sustainability in water and sanitation service management and operation.	Model operating contract, including targets, incentives and penalties, reporting mechanisms, and a corporate governance code, approved.	a. Guidelines are approved on the dissemination of information on local government accountability and performance related to direct service delivery. b. 10 operating contracts are signed, including targets, incentives and penalties, reporting mechanisms, and a corporate governance code.	New operating contracts are signed, including targets, incentives and penalties, reporting mechanisms, and a good corporate governance code.
VI. PRIVATE SECTOR PARTICIPATION			
PSP promotion criteria and methodology: To promote the sanitation sector's PSP strategy nationally. PSP processes: To optimize PSP processing.	National PSP strategy in the sanitation sector, including financing policies for government investments, is being implemented. a. The operational and functional processes and procedures necessary to optimize PSP processes in the promotional stage are defined. b. Regulations establishing adjustment criteria for processing private initiatives are being implemented.	PSP program for water and sanitation service delivery at EPSs is in its initial stage. a. The operational and functional processes and procedures necessary to optimize PSP processes in the promotional stage are approved. b. Processing of private initiatives is being implemented.	PSP program for water and sanitation service delivery at EPSs is in execution. a. The operational and functional processes and procedures necessary to optimize PSP processes in the promotional stage are in effect

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

RESOLUTION DE-____/08

Peru. Loan ____/OC-PE to the Republic of Peru
Sanitation Sector Reform Program 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 Republic of Peru, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a sanitation sector reform program II. Such financing will be for an amount of up to US\$130,000,000 from the Single Currency Facility of the Ordinary Capital resources of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

PE-L1052