

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PERU

**SECOND-GENERATION SANITATION SECTOR REFORM
PROGRAM III**

(PE-L1140)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Edgar Orellana, Project Team Leader (WSA/CPE); Javier García Larumbe, Alternate Team Leader (INE/WSA); Efraín Rueda, Coral Fernández Illescas, and Henry Moreno (INE/WSA); Guillermo Antonio Eschoyez (LEG/SGO); María José Rodríguez, consultant (CAN/CPE); and Yolanda Galaz (INE/WSA).

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ANNEXES

PRINTED ANNEXES

Annex I	Summary Development Effectiveness Matrix (DEM)
Annex II	Policy Matrix

ELECTRONIC LINKS

REQUIRED (REL)

1. Policy Letter
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=39023523>
2. Means of Verification Matrix
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38967437>
3. Results Matrix
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38967553>

OPTIONAL (OEL)

1. Socioeconomic Analysis
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38968363>
2. Environmental and Social Factors
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38946178>
3. Monitoring and Evaluation
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38969109>
4. Project Completion Report
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=35123361>
5. Environmental Screening
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38967543>
6. Comparison of Previous and Current Policy Matrixes
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=39013237>
7. Lessons Learned
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=39018723>
8. Overall Concept and Planning for the Second-generation Program
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=39033966>

ABBREVIATIONS

ANA	Autoridad Nacional del Agua [National Water Authority]
DGETP	Dirección General del Endeudamiento Público [Public Debt Bureau]
DNS	Dirección Nacional de Saneamiento [National Sanitation Department]
EPSs	Empresas Prestadoras de Servicios Municipales de Agua y Saneamiento [Municipal Water and Sanitation Service Providers]
FONAVI	Fondo Nacional de Vivienda [National Housing Fund]
GDP	Gross domestic product
GIZ	German Agency for Technical Cooperation
IDB	Inter-American Development Bank
IRR	Internal rate of return
MAV	Maximum allowable value
MEF	Ministry of Economy and Finance
MVCS	Ministry of Housing, Construction, and Sanitation
PBL	Policy-based loan
PCR	Project Completion Report
PES	Pequeñas Empresas de Saneamiento [Small Sanitation Enterprises]
PNS	Plan Nacional de Saneamiento [National Sanitation Plan]
PNSR	Programa Nacional de Saneamiento Rural [National Rural Sanitation Program]
PPGR	Programa de Primera Generación de Reformas [First-generation Reform Program]
ProInversión	Agencia de Promoción de la Inversión Privada [private investment promotion agency]
PRS	Plan Regional de Saneamiento [Regional Sanitation Plan]
PRSGSS	Programa de Reformas de Segunda Generación del Sector Saneamiento [Second-generation Sanitation Sector Reform Program]
PSP	Private sector participation
SEDAPAL	Servicio de Agua Potable y Alcantarillado de Lima [Lima Water Supply and Sewerage Service]
SUNASS	Superintendencia Nacional de Servicios de Saneamiento [National Sanitation Services Regulatory Authority]
UCPS	Unidad Coordinadora de Programas Sectoriales [Sector Loan Coordination Unit]
VMCS	Office of the Deputy Minister for Construction and Sanitation
WWTP	Wastewater Treatment Plant

PROJECT SUMMARY

PERU SECOND-GENERATION SANITATION SECTOR REFORM PROGRAM III (PE-L1140)

Financial Terms and Conditions					
Borrower: Republic of Peru			Flexible Financing Facility^(a)		
			Amortization period:	8 years	
Executing Agency: Ministry of Economy and Finance (MEF)			Original WAL:	7.21 years ^(b)	
			Disbursement period:	12 months	
Source	Amount	%	Grace period:	6.5 years	
IDB: Ordinary Capital (OC)	US\$25 million	100	Interest rate:	LIBOR-based	
			Inspection and supervision fee:	(c)	
Total	US\$25 million	100	Credit fee:	(c)	
			Currency:	U.S. Dollars from the OC	
Project at a Glance					
Project objective:					
The program is the third and final operation in a programmatic policy-based loan series with the objective of improving the efficiency, equity, sustainability, and environmental conditions of water and sanitation service delivery in Peru, by adopting a set of measures including: (i) updating and integration of sector planning tools and instruments; (ii) a long-term financing scheme for the sector and more efficient and higher-impact use of resources for investment; (iii) a strengthened sector regulatory system capable of assuming new responsibilities; (iv) improvement of the governance system and transparency of service providers, enhanced management capacity, and improved performance of service provider personnel; and (v) strengthening of environmentally sustainable sector management, consistent with environmental and water resources policies and regulations.					
Special contractual clauses:					
The first and only disbursement of resources will be subject to fulfillment of policy reform conditions, as set forth in section B of chapter II, and in Annex II (Policy Matrix) (paragraphs 1.19 to 1.24).					
Exceptions to Bank policies: None					
Project qualifies as:					
	SEQ [X]	PTI []	Sector [X]	Geographic []	Headcount []

- (a) Under the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions, subject in all cases to the final repayment date and original weighted average life (WAL). The Bank will take operational and risk management considerations into account when reviewing such requests.
- (b) The weighted average life (WAL) may be shorter, depending on the actual signature date of the loan contract.
- (c) 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 policies.

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problems, and rationale

- 1.1 This loan operation is the third in a series of three interconnected operations financed independently under the programmatic policy-based loan (PBL) modality, pursuant to the provisions of document CS-3633-1. The framework for the programmatic series was established in operations 2449/OC-PE and 2604/OC-PE, approved on 3 November 2010 and 26 October 2011, respectively. This document serves to update, complement, and follow up on the preceding ones. A methodological process was developed to underpin the rationale for the second-generation programmatic series. The related report is attached ([OEL#9](#)).
- 1.2 **Second-generation Sanitation Sector Reform Program (PRSGSS).** This PBL is part of a program whose objective is to improve the efficiency, equity, and sustainability of the delivery of water and sanitation services by the Government of Peru. The PRSGSS was prepared through a process involving an analysis of the sector's problems, dialogue, and consultation and consensus-building with civil society, service providers, the donor community, and other stakeholders. The process was led by the Office of the Deputy Minister for Construction and Sanitation (VMCS) and the Sector Program Coordinating Unit at the Ministry of Economy and Finance (MEF). This process included a series of workshops with stakeholders, as well as numerous surveys and interviews with multiple agents. The reforms were identified and ranked according to priority, based on the sector diagnostic assessment, which analyzed the main challenges and their causes and was carried out with support from one of Peru's most prestigious universities and a group of consultants.
- 1.3 **Prioritizing of the reforms.** As a result of this process, the Government of Peru divided the reforms into five components: (i) institutional framework of the sector, with the goal of enhancing the capacity of the sector's entities and improving regional planning; (ii) financial policy, in order to establish a stable, clear, and equitable financing framework for public resources, while improving the financial conditions of the Municipal Water and Sanitation Service Providers (EPSs); (iii) rate policy, aimed at simplifying rate structures, targeting the subsidies, and incorporating the concept of environmental costs; (iv) management of the EPSs, seeking to apply good practices in corporate governance and accountability among providers, as well as promoting public-private partnerships; and (v) incorporation of integrated management criteria for water resources, the environment, and climate change in the sector's planning and in water and sanitation service delivery. This reform process is ongoing within the government, and its priority status has been confirmed through approval of the Sanitation Services Modernization Law (Law 30045 of June 2013) and its associated regulations (Supreme Decree 15-2013-VIVIENDA of November 2013).
- 1.4 With the adoption of policy measures in the first programmatic operation (2449/OC-PE), mechanisms were established to equitably and efficiently allocate investment resources. Policy instruments were also designed to provide

improvements in the governance, transparency, and accountability of service providers, while strengthening corporate decision making in order to promote long-term sustainability in the delivery of services. In addition, the operational capacities of the lead and regulatory agency were strengthened, as a means of promoting effective execution of government programs. Moreover, a regulatory framework for small cities and rural areas was developed and established. This involved formulating a regulatory framework and adjusting the rate system to improve efficiency and sustainability in the delivery of the services. To this end, more than six Optimized Master Plans and rate formulas were approved. Lastly, policy guidelines were established for linking specialized operators and for improving service delivery management.

- 1.5 The measures adopted in the second programmatic operation (2604/OC-PE) contributed to: the development of an updated diagnostic assessment and preliminary proposal of objectives, strategies, and policy guidelines for formulating the National Sanitation Plan; preparation of a program to strengthen capacities at the National Sanitation Department; a new system for compensating EPS personnel; and approval of intervention tools and a conceptual model for the sector's monitoring and tracking system in rural areas and small cities. A proposal for a long-term financing structure for the sector was also developed, to be discussed with the MEF and other major stakeholders. The regulatory and technical framework for implementing the new system of subsidies was also approved, and a system of governance and governability indicators for the EPSs was established. Also approved were regulations for maximum allowable values (MAV) and a payments system, as well as regulations for supervision, inspection, and sanctions of the EPSs, a protocol for monitoring the environmental quality of surface water, and initiation of improved procedures for environmental certification in the sector. At the same time, alternatives for optimizing the unit consumption of water were developed, along with a guide for formulating climate change adaptation plans.
- 1.6 **Macroeconomic context.** Peru has displayed robust economic performance in recent years. Between 2010 and 2013, the country was one of the fastest growing economies in Latin America. It was one of the few countries that did not experience a recession during the international financial crisis of 2008-2009, recovering rapidly over the course of 2010 (8.8%), 2011 (6.9%) and 2012 (6.3%). In 2013 growth slowed to 5.0%. Under the baseline scenario, GDP will increase in 2014 to a rate above that seen in 2013, beginning an acceleration that is expected to result in average growth, between 2015 and 2017, approximating the increase in potential output, currently estimated at 6.0%. Overall, medium-term macroeconomic prospects, including projections for public finance, the external sector, capital flows, and private investment, are consistent with official growth projections. Peru maintains investment-grade ratings by DBRS, Fitch, Standard & Poor's, and Moody's.
- 1.7 The country recorded an economic surplus of 0.6% of GDP in 2013, which, though lower than that of 2012 (2.1%), constituted the fourth consecutive fiscal year of

surpluses. The drop in the fiscal surplus is attributable almost exclusively to the expansion in spending, above all in capital expenditures, as part of the plan, launched at the start of 2013, to facilitate and unlock public investment. The Peruvian government's fiscal program expects a budget balance close to equilibrium in the near future. The Peruvian government's Multiyear Macroeconomic Framework anticipates a surplus of close to zero for the nonfinancial public sector in 2014. This additional decline in the surplus is due to lower terms of trade and higher subnational spending execution. Projections for 2015 point to a deficit of 0.3% of GDP.

- 1.8 Total public debt declined from 48.3% of GDP in 2002 to 19.8% of GDP at the close of 2013. The external public debt dropped from 37.8% of GDP to 8.9% of GDP during the same period, while domestic debt remained relatively stable, ending 2012 at 10.6% of GDP. For 2014, debt repayments are expected to be on the order of 0.8% of GDP, which, combined with the expected fiscal equilibrium for the year, produce gross financing needs of the same magnitude. For the subsequent years, gross financing needs are expected to average 1.1 points of GDP in 2015 and 2016. In 2013, total exports declined by 9.5% from 2012, owing primarily to lower prices for exportable raw materials, while imports grew by 2.6%. In 2013, the current account deficit grew, ending the year at -4.6% of GDP (-3.3% in 2012), with a trade balance at close to equilibrium for the first time since 2001 (surplus of 2.6% in 2012). The current account deficit was more than financed by the increased flows of long-term private capital, equivalent to 7.5% of GDP, mostly in the form of foreign direct investment (4.6% of GDP). The rate of inflation at the end of 2013 was within the monetary policy target range. At the end of the year, variation in the consumer price index was 2.86%, within the range of the Central Bank's direct inflation target. Underlying inflation and inflation expectations have remained anchored at around 2.4%. In 2014, effects from El Niño are expected to have a moderate impact on prices, according to official forecasts.
- 1.9 The balance of risks facing the Peruvian economy includes the effects of volatility in capital flows, in light of a change in the monetary policy bias of the United States and a marked deceleration in China. An analysis of the external sector, the fiscal track record, inflation, and the financial system indicate that in the short and medium terms the risks to Peru's economic sustainability are low. The country continues to experience strong economic expansion and, with positive prospects despite the global financial macro uncertainty, is maintaining an environment of fiscal stability, external equilibrium, and low inflation.
- 1.10 **The water and sanitation sector and its challenges.** According to the National Investment Plan,¹ 86.1% of households' water supply comes from the public system. In urban areas, water service coverage is at 93.4%, while in rural areas this figure is 63.2%. According to information from the EPS performance indicators

¹ National Investment Plan, developed by the Ministry of Housing, Construction, and Sanitation (MVCS) with support from the Water Group comprised of international cooperation agencies (PNI).

system, established by the National Sanitation Services Regulatory Authority (SUNASS),² 36.45% of the water was unaccounted for in 2013, with average continuity of 18.7 hours. This highlights the efforts made to achieve the Millennium Development Goals, as well as to improve indicators for service quality and business management. Micrometering remains low and the incidence of billing for nonexistent consumption is high. The majority of consumers are being billed for consumption levels dating back years, which is reflected in the high per capita allocation. Figures for the end of 2013 indicate that only 47.67% of total wastewater generated entered a treatment system before final disposal; the remaining 52.33% was dumped untreated into rivers, lakes, the ocean, or other receiving bodies of water, affecting their water quality and creating pollution hotspots at each of the points of discharge, as well as in the waters downstream, according to reports by SUNASS.³ The main factors affecting this situation relate to problems with institutional, financial, and rate-setting policies, the performance of the EPSs, the private sector participation strategy, and the requirements contained in environmental regulations, which are described below.

- 1.11 **Sector planning.** Recognizing the achievements of recent years, the diagnostic assessment concluded that the sector planning system needs to incorporate the environmental and water resource components of the Water Resources Act and other environmental regulations, along with measures to adapt to climate change and to advance the regional planning process, through the Regional Sanitation Plans (PRs). For the new government period beginning in 2016, an updated sector plan must be in place that reflects proposals in these areas and takes into account the achievements and lessons learned through programs such as “Water For All.”⁴ Another problem is the lack of a national PRS coordination and monitoring mechanism and of a master sector information system. Lastly, the VMCS needs to be strengthened in the areas of human resources and technical capacity to serve rural areas and small cities and to respond to environmental legislation.
- 1.12 **Financial policy.** Despite the financial efforts of recent years, the funds allocated to the sector are insufficient to achieve universal coverage, particularly with regard to sanitation. Conditions for allocating funds vary among the different government agencies and programs, with no differentiation between types of service providers receiving the funds (nonreimbursable resources are assigned without distinction in the same proportion to rural communities and EPSs), thus causing inequities. Lastly, there has been little success in improving the financial situation of the EPSs as envisioned in Law 29,740, which sets out the framework for refinancing the EPS

² SUNASS Annual Report 2012 ([SUNASS](#)).

³ The Lima Water Supply and Sewerage Service (SEDAPAL) will increase the level of wastewater treatment to 85% in 2014, as a result of the construction, through a concession, of the Taboada (ACS de España), and La Chira (Graña y Montero-Acciona) Wastewater Treatment Plants, with capacities of 14 m³/s and 7 m³/s, respectively, and an investment of US\$300 million and US\$145 million, respectively.

⁴ The objective of this program (PE-L1020) was to help attain the Millennium Development Goals of extending and improving access to water and sewer services for low-income groups in Metropolitan Lima.

debt assumed from the National Housing Fund (FONAVI) when the sanitation sector was being decentralized during the 1990s—obligations that in many cases have not been recognized by either the municipios or the EPSs.

- 1.13 **Regulatory policy.** It is important to note that the sector has made progress on the regulatory front in recent years. A cross-subsidy scheme was approved as was the methodology to determine which families would be eligible for the subsidies. However, the plan for implementing the methodology and its execution remained to be established. A regulatory accounting system needs to be instituted to supplement the regulatory framework, which in turn requires execution of the software development plan and its application in some of the EPSs, along with a training system and ongoing advisory support. At the same time, the regulatory and inspection system underwent changes in the first tranche of the Second-generation programmatic operation, establishing penalties for the EPSs that fail to comply with regulations. However, there were no incentives in place to rectify the sanctioned practices or to pay the penalties on time. To this end, a legal instrument was developed, which remains to be implemented.⁵ With regard to the protection of sewerage and wastewater treatment systems, the regulatory system lacks a mechanism for controlling discharges of industrial waste that deteriorates these systems. During the first operation, maximum allowable values for concentrations of corrosive contaminants were established, and a methodology for calculating penalties for exceeding those limits was developed. Payments have yet to be implemented. Lastly, further progress needs to be made in determining the scope of the Optimized Master Plans for small sanitation enterprises. This may include the possibility of minimum rates to cover operating expenses and of financing for the control and supervision process, because the inhabitants where these small enterprises will operate do not have the ability to pay, according to SUNASS.
- 1.14 **Promotion and development of service providers.** Despite the advances made in the First-generation Reform Program, certain obstacles still hinder more significant progress in this area. These include: (i) lack of financing for water supply and sanitation investment projects; (ii) poor implementation of corporate governance and governability frameworks by public providers, leaving them without independent and transparent management; (iii) lack of policy decision-making to provide for better private sector participation; and (iv) a lack of incentives to attract skilled personnel, a situation aggravated by intensive development in other sectors such as mining and infrastructure construction. Together, these conditions limit the ability of the EPSs to operate independently with a stable roster of qualified personnel, using sound business-management criteria that promote sustainability and efficiency.
- 1.15 **Water resources, environment, and climate change.** The country is developing and consolidating a climate change agenda, under the leadership of the Ministry of

⁵ Board of Directors Resolution 016-2011-SUNASS-CD, which modifies the General Regulations on Supervision, Inspection, and Sanctions of EPSs, published on 26 May 2011.

Environment, and has received assistance from the Program to Support the Climate Change Agenda (2456/OC-PE). In the area of water resources, driven in part by the Water Resources Reform Program III (2455/OC-PE), the National Water Authority (ANA) has established itself as the sector's governing body for the administration of water and its associated assets, as well as with regard to the socio-environmental management of that resource. Climate change and water resource conservation pose two challenges for the sector: first, they require an urgent adaptation process to be launched, to address current and future water availability both in terms of quantity and quality; second, they entail the obligation to improve how water is used so that, afterwards, it is returned to the source unpolluted, and to promote its reuse. Both of these challenges were reaffirmed by the government that took office in July 2011.

B. The country's strategy for the sector

- 1.16 The program will contribute to the financing priority of the Ninth General Capital Increase of the Inter-American Development Bank (GCI-9) (document AB-2764), namely, to: (i) "Protect the environment, respond to climate change, and increase food security," by improving the sector's environmental management, bringing it in line with current environmental and water resources policy and regulations; and (ii) "reduction of poverty and inequality," by implementing actions that will improve services in rural areas through the National Rural Sanitation Plan (with a focus on poverty) and by establishing a cross-subsidy mechanism targeting consumers living in poverty. It will also contribute to the regional goals of: (i) reducing the incidence of waterborne diseases (per 100,000 inhabitants); and (ii) enhancing countries' planning capacities for mitigating and adapting to climate change; and to the following outputs: (a) houses with new or improved water service; and (b) houses with new or improved sanitation service. In addition, the program will contribute to the sector priority of "Infrastructure for competitiveness and social welfare." The Government of Peru has made the water and sanitation sector a priority on its current agenda. The country's strategy for the sector is spelled out in the current National Sanitation Plan, the core objective of which is to efficiently and sustainably achieve the Millennium Development Goals, by pursuing five strategic lines of action and implementing this Second-generation Sanitation Sector Reform Program. Moreover, the Peruvian government believed that in order to reach these goals, there needed to be reforms to separate the functions of policy formulation, regulation and supervision, and service delivery. The specific reforms in the area of regulation in this program sought to target the subsidies to household consumers living in poverty and absolute poverty, inspect the small service enterprises, and improve monitoring and control of the enterprises or agencies providing the services. Thus, Peru's sanitation sector has an institutional and legal framework adapted to the principles established in the Public Utilities Policy (GN-2716-6) (OP-708), with a clear separation of the roles of policy, regulation, and service delivery. The framework is consistent with the financial sustainability condition, by supporting reforms of the regulations that will serve to estimate efficient expenditures and costs in the sector, to set rates and subsidies for the poorest consumers (paragraph 1.22), while ensuring that there are

long-term financing mechanisms in place (paragraph 1.21). The program is consistent with the Country Strategy with Peru (GN-2668), since it emphasizes “supporting the implementation of water and sanitation sector policy, with the aim of making progress in universalizing access to drinking water service, and thus reduce disparities between urban and rural zones.” At the same time, the program is aimed at laying the groundwork for improving quality of life in communities and is designed to foster competitiveness, improve the quality of public expenditure, and help modernize and decentralize the State, through the program’s five components, which focus on reforms and on new instruments, authorities, and regulations to be designed and approved.

- 1.17 **Coordination with other Bank operations and with other institutions.** The present operation is the result of ongoing joint efforts involving the Government of Peru, German Financial Cooperation (KfW), the German Agency for Technical Cooperation (GIZ), and the IDB, in the framework of sector policy. Preparation of the program has drawn on lessons learned in the first series of sector reforms financed by the Bank between 2008 and 2012 ([OEL#8](#)), parts of which are reflected in the Project Completion Report for first-generation reforms to the sanitation sector ([OEL#4](#)), demonstrating the importance of interventions of this type in furthering sector development. KfW will assist with the reforms envisaged in this programmatic operation through a parallel loan to the government. Complementing this assistance, the Bank approved loan 2269/OC-PE, which will contribute to consolidating the reforms agreed upon between the Government of Peru and the Bank under the First-generation Reform Program, and the nonreimbursable technical-cooperation operation “Preparation of Second-generation Sanitation Sector Reform Program I” (ATN/OC-12314-PE) to finance studies that will help the Government of Peru carry out the policy reforms associated with this programmatic series.

C. Objectives and components

- 1.18 The program is the third and final operation in a programmatic policy-based loan series with the objective of improving the efficiency, equity, sustainability, and environmental conditions of water and sanitation service delivery in Peru, by adopting a set of measures including: (i) updating and integration of sector planning tools and instruments; (ii) a long-term financing scheme for the sector and more efficient and higher-impact use of resources for investment; (iii) a strengthened sector regulatory system capable of assuming new responsibilities; (iv) improvement in the governance system and transparency of service providers, enhanced management capacity, and improved performance of service provider personnel; and (v) strengthening of environmentally sustainable sector management, consistent with environmental and water resource policies and regulations.
- 1.19 **Component I – Macroeconomic stability.** The objective of this component is to ensure a macroeconomic environment that is in keeping with program objectives. This condition will be fulfilled through implementation of the courses of action set

out in the Policy Letter, and the consistency of the borrower's macroeconomic framework with program objectives.

- 1.20 **Component II – Sector planning.** This component is designed to provide the sector with a planning instrument that links sector policies and strategies at the national, regional, and municipal levels, and to ensure that the VMCS has the human resources and technical capacity needed to meet the requirements of the sector. To this end, the program initially envisaged the following activities: (i) updating of the National Sanitation Plan, whose objective was to have an instrument linking sector policies and strategies at the national level that would include new topics and challenges, with links to a system for monitoring and updating them. In this third programmatic operation, and in order to develop the National Sanitation Plan, the following policy conditions have been met: (a) a Water and Sanitation Information System is in the process of being implemented; (b) the National Sanitation Plan is in the design process; and (c) a National Investment Plan has been approved, to be used as the principal input for updating the National Sanitation Plan. The National Sanitation Plan has not been updated, nor has the system for monitoring it been put in place, owing to delays in commissioning the necessary studies (which are now being conducted, with financing from KfW). However, with the current National Sanitation Plan effective until 2015, and the National Investment Plan approved by the Ministry of Housing, Construction, and Sanitation (MVCS)—not envisaged in the program's initial Policy Matrix and prepared using as a reference point the proposed policy objectives, strategies, and guidelines of the National Sanitation Plan, approved for the second programmatic series—the sector will be able to set its goals, pending approval of the new National Sanitation Plan. Approval of the latter is expected to occur in the first half of 2015, given that the new MVCS authorities view it as a high priority. This commitment is part of the Policy Matrix agreed upon between the Government of Peru and KfW for 2015; (ii) institutional strengthening of the VMCS, in order to ensure that, as the sector's lead agency, it will have the human resources and technical capacity that the sector requires; this is to be accomplished by improving the capacities of its personnel, strengthening its management capacity in rural areas and small cities, and allocating sector resources in rural areas based on results and equity criteria. In order to fulfill that objective, this third programmatic operation has met the following policy conditions: (a) an MVCS Personnel Development Plan has been approved; (b) the National Rural Sanitation Program (PNSR), including lines of intervention to be applied to rural areas, has been created and is currently being implemented; (c) a Medium-term Plan for the PNSR, including guidelines for monitoring sector performance in rural areas, has been approved and is currently being implemented; and (d) Rural and Urban Sanitation Budget Programs for regional and local governments are currently being implemented.
- 1.21 **Component III – Financial policy.** This component will promote a financial and budgetary policy that ensures a stable, sufficient, long-term place for the sector in national, regional, and local government budgets, while improving the debt profile

of the EPSs based on regularizing their debts with FONAVI. To this end, the program envisages the following activities: (i) sources of financing: here, the objective is to ensure that the sanitation sector has stable, long-term financing resources, with predictable amounts established in government budgets. In order to meet this objective in this third programmatic operation, the following policy conditions have been met: (a) the Sanitation Services Modernization Law, which allocates resources for water supply and sanitation works, is in effect; (b) a Financing Plan that will be part of the National Sanitation Plan is in the design process; and (c) regulations for the Sanitation Services Modernization Law, incorporating guidelines for prioritizing the distribution of resources to regional and local governments, is in effect; and (ii) regularization of EPS debts: the objective is to clear the debt of EPSs with FONAVI through reimbursable contributions, while developing a debt regularization plan through the regulatory provisions of Law 28,870. In order to meet this objective of the third programmatic operation, the regulatory provisions for regularizing the debts with FONAVI have been approved. Inasmuch as the new National Sanitation Plan is being formulated, it was not possible to approve the proposed institutional financing mechanism.

- 1.22 **Component IV – Regulatory policy.** The operation will support the implementation of the cross-subsidy system, including determining, for each EPS, the amount contributed by cooperating sectors (high-income strata, trade, industry), and each EPS's financial needs. A methodology for calculating and applying these amounts will be employed. The subsidies will be aimed at household consumers living in poverty or absolute poverty, based on the Household Targeting System. A subsistence consumption subsidy will be determined, according to World Health Organization guidelines. The rate to be applied will be based on the consumer's ability to pay, while ensuring that spending on drinking water does not exceed 3% of family income and, in cases where both water and sanitation services are provided, does not exceed 5% of family income. For this operation, the following policy conditions have been met: a new rate subsidies mechanism is currently being implemented. In terms of inspection and control, the regulatory provisions of the Sanitation Services Modernization Law are being modified, and a form of regulatory accounting that allows SUNASS to obtain uniform information on costs from all of the regulated enterprises is being implemented, in order to determine the efficiency costs and expenditures and thus provide a basis for rate-setting. In this third operation, regulatory accounting systems have been put in place and are in operation at 24 enterprises, while another 13 enterprises have approved plans to implement such systems. In addition, amendments to the regulations on supervision, inspection, and sanctions of EPSs were made, in order to reduce the time involved in inspection and sanctions, gain more precise information more quickly to aid in supervision, and provide incentives to correct problems encountered in the course of inspections or, alternatively, ensure payment of the applicable penalties. Thus, a reform of the regulations was achieved, including these amendments, the results of which are presented in the SUNASS Regulatory Benchmarking Report of 2013. As to regulation of the small sanitation enterprises,

the approval of legal management instruments for the formation of management units within small communities envisioned for this program did not come to pass. This is because, at the end of 2013, the Peruvian government, through the Sanitation Services Modernization Law and its associated Regulations, decided to integrate these services at the regional level, while at the same time making the procedures aimed at forming small sanitation enterprises inoperative. Lastly, in terms of discharges of wastewater with nondomestic contaminants, MAV regulations were developed for concentrations of contaminants that are discharged into the sewer systems, and a payment or penalty scheme for exceeding the MAV was established. For purposes of the present operation, the MAV for three EPSs (Sedacusco, Emapica, and Emapisco) was calculated and a plan was formulated to implement supervision and payments for exceeding the MAV at these EPSs, which is now being implemented.

- 1.23 **Component V – Promotion and development of service providers.** The objective of this component is to establish policies and have legal provisions and regulations in place that enable the EPSs to increase their operational efficiency and become financially sustainable. The first line of action promotes comprehensive industry reform, creating new and modern conditions for the EPSs to provide efficient and sustainable sanitation services. The second line of action promotes measures to improve corporate governance, in order to foster independent, transparent management of utilities.⁶ The third line of action promotes measures for developing the regulatory framework in a way that facilitates the application of other private sector participation (PSP) modalities, while also strengthening institutional capacity within the VMCS to coordinate and monitor PSP processes. The fourth line of action promotes measures to stimulate and stabilize the supply of and demand for skilled personnel, by creating the possibility of better pay and developing competency profiles for service provider personnel, as well as by developing a funding mechanism to underpin the financial sustainability of the EPSs. This third operation will include: (i) a process for modernizing the management system for providing sanitation services, established through the Sanitation Services Modernization Law and its associated regulations, currently in effect; (ii) a system of governance and governability indicators to optimize the management of EPSs, currently being implemented; there is now a report on results concerning governance and governability at 30 EPSs; (iii) an approach based on job skills of EPS personnel, established through the Sanitation Services Modernization Law's regulations, currently being implemented; and (iv) a compensation system for EPS personnel, under the responsibility of the sanitation sector and based on the provisions of the Sanitation Services Modernization Law's regulations. With regard to the commitments concerning the use of complementary instruments for facilitating the application of new or improved PSP mechanisms and the proposal for making institutional adjustments in the VMCS in order to improve management

⁶ In other words, management that minimizes political interference, which works against the efficiency and financial sustainability of the enterprises.

of PSP processes (already approved), it was determined jointly with the Peruvian government that these instruments were unnecessary, and that what was instead required was the political will to promote PSP.

- 1.24 **Component VI – Water resources, environment, and climate change.** This component will give continuity to efforts to strengthen sector management in a sustainable manner, as was initiated in the first programmatic operation, in the technical, social, and environmental realms, under two main pillars: (i) protecting water quality, water sources, and receiving bodies of water, with the goal of restoring water quality in natural sources, through the approval and use of environmental quality standards and maximum permissible limits; and (ii) dealing with climate change, with the goal of adapting the sector to water availability—both quantity and quality—as it is affected by climate change. To accomplish this, under this third operation the commitments envisaged were fulfilled as follows: (i) Regulations for Environmental Protection in the sector, approved;⁷ (ii) scaling of financing needs of wastewater treatment plants (WWTP) included in the National Investment Plan, approved; (iii) a comprehensive guide for developing plans for environmental adaptation and management, developed;⁸ (iv) a protocol for monitoring WWTP effluents, approved;⁹ (v) measures for formalizing discharges, currently being implemented; (vi) management procedures and instruments to improve the environmental certification process in the sector, currently being implemented; (vii) regulations to simplify the environmental evaluation of rural projects, approved;¹⁰ (viii) a guide for preparing and evaluating plans for mitigating and adapting to climate change in the sanitation sector, developed; and (ix) modification of rates for drinking water used for irrigation of parks and gardens, in order to provide the most efficient consumption of water used for this purpose, as part of the effort to adapt to climate change, approved.¹¹
- 1.25 With the commitments fulfilled in each of the components, the proposed objectives for this third and final operation of the programmatic series were attained; moreover, substantive instruments such as the Sanitation Services Modernization Law and its implementing regulations, which were not included in the original matrix, contributed to reinforcing and supplementing sector reforms. The changes in the conditions originally presented in each of the components did not involve risk with respect to fulfillment of the objectives. In order to help visualize the policy commitments that were modified in this third operation—with respect to the original Policy Matrix—as well as those commitments that were eliminated or were included because of their importance to the sector, a comparative matrix has been

⁷ Supreme Decree 15-2012-VIVIENDA, of 14 September 2012.

⁸ Document 366-2014-VIVIENDA-VMCS.

⁹ Ministerial Resolution 273-2013-VIVIENDA.

¹⁰ Ministerial Resolution 300-2013-MINAM.

¹¹ Board of Directors Resolution 008-2012-SUNSASS-CD.

prepared, reflecting these changes, available at [REL#7](#). This matrix details the rationales or reasons for these changes.

D. Key outcome indicators

- 1.26 **Expected results and benefits, and socioeconomic analysis.** The measures adopted with program support are expected to generate substantial economic benefits by improving the efficiency, equity, and sustainability of water and sanitation services. The proposed program is expected to provide the EPSs with an institutional and financial framework that will enable them to allocate resources based on objective criteria, financial self-sustainability, and efficient service delivery and on infrastructure investment. The gradual implementation of structural reforms will alter the incentive system and support the EPSs in implementing governance and planning reforms to help them provide quality services at the lowest possible cost, with the prospect of expanding coverage to the entire population within their jurisdiction. The measures adopted are expected to help increase water coverage from 86.1% in 2013 to 100% by 2021, while increasing sanitation coverage from 67.9% in 2013 to 100% by 2021. Thus, 7 million people will gain access to water service, and 13 million will obtain sanitation service; this increase will require an investment of 8.4 billion nuevos soles (nearly US\$3 billion) in water, and 34.9 billion nuevos soles (approximately US\$12.5 billion) in sewerage and wastewater treatment. According to the poverty study,¹² 40% of poor families and 20% of non-poor families lack water and sanitation services; thus, the changes in policy resulting from the present program will mostly benefit poor families.
- 1.27 In order to carry out a cost-benefit analysis of the increased coverage objective, the flow of incremental costs and benefits as a result of the reform was generated. For this purpose, the coverage scenarios with and without the reform were projected. As a result of the reform, 2.5 million people (600,000 families) will obtain water services, while 6.6 million people (1.7 million families) will obtain water and sanitation services earlier than would otherwise be the case. The investment costs for serving these families amounts to US\$1 billion for water and US\$5.1 billion for sanitation over the next eight years. These investments would produce socioeconomic benefits amounting to US\$4.4 billion for water and US\$8.4 billion for sanitation, with an internal rate of return (EIRR) of 19.4% for water and 4.5% for sanitation.
- 1.28 In addition, poor users will receive a service that will make it possible for them to enjoy proper hygiene at a price they are able and willing to pay. Similarly, non-poor users with the ability to pay (1.6 million connections) will stop receiving subsidies and, as a result, 50 EPSs regulated by SUNASS are expected to increase their revenues by US\$150 million per year (S/. 420 million). In the alternative, however, the loss in well-being amounts to US\$142.5 million annually, for an elasticity of minus 0.2, representing an EIRR of 5.3%. There would be net benefits of

¹² Trends in Monetary Poverty 2009-2013, Technical Report, INE, Lima, May 2014.

- US\$7.5 million per year, amounting to a present value of US\$62.5 million. These new revenues would allow 50,000 new connections to be built (for 250,000 people).
- 1.29 In terms of financially sustainable and efficient service delivery by the EPSs, the measures adopted as part of Components IV and V are expected, in combination, to reduce average operating costs per billed cubic meter by 3.6% between 2009 and 2015, and increase the average net margin of the group of small, medium-sized, and large EPSs from 10% to 12% in 2015. Details of the evaluation may be viewed at electronic link [OEL#1](#).
- 1.30 **Conceptual overview of the program and vertical logic.** Given that this is a programmatic policy-based loan (PBL), the Policy Matrix and Means of Verification represent the program outputs that will make it possible to achieve the proposed outcomes, and these, in turn, will serve to secure the expected impacts for the programmatic series. These outcomes and impacts are set out in the Results Matrix. The proposed reforms included in the matrixes have emerged from a process of collaborative work among the different sector agencies, which helped to prioritize the actions to be carried out in the context of this programmatic series, based on an evaluation of the lessons learned from executing the First-generation Reform Program and an examination of the situation in the sector and its main challenges.

II. FINANCING STRUCTURE AND RISKS

- A. Cost and financing instrument**
- 2.1 Conceived as a programmatic policy-based loan, this operation will consist of a single disbursement in the amount of US\$25 million and is expected to be carried out in the fourth quarter of 2014. Given that it is a programmatic operation, the single disbursement will be made once the loan contract is signed and the special and general conditions precedent to the disbursement set out in the contract have been fulfilled, through presentation of the means of verification described in the Means of Verification Matrix ([REL#3](#)).
- 2.2 **Peru's external financing needs.** Pursuant to Directive CS-3633-1, paragraph 3.27, the present operation is justified by the fact that the Peruvian government's fiscal program anticipates budget performance close to equilibrium in the near future. According to the government's Multiyear Macroeconomic Framework for 2014, a surplus of close to zero is expected for the nonfinancial public sector. For 2014, debt repayments are expected to be on the order of 0.8 points of GDP, which, together with the expected fiscal equilibrium for the year, would entail gross financing needs of a similar magnitude. This suggests that the country's financing needs for 2014 will be approximately US\$1.7 billion, of which 75% will be covered by external debt and the remainder by domestic debt. In this context, the US\$25 million from the program represents 1.5% of total financing needs and 2.0% of total external borrowing projected for the year.

B. Environmental and social risks and mitigation measures

- 2.3 As a programmatic policy-based loan, this operation triggered Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703) ([OEL#5](#)). Consequently, it does not require environmental classification. The policies to be adopted as part of this operation are expected to have a positive effect on the society's well-being, by improving water supply and sanitation services and the environmental quality of drinking water sources and natural bodies of water into which wastewater is discharged, while making available tools for adapting to climate change. This operation is consistent with the strategic sector priorities for Bank activities, as defined in the Report on the Ninth General Capital Increase of the IDB, in that it qualifies as a program aimed at improving infrastructure for competitiveness and social welfare and protecting the environment in response to climate change. Given the nature of this operation, no adverse environmental or social impacts associated with the operation are expected. Moreover, environmental sustainability is one of the objectives of the operation.

C. Fiduciary risk

- 2.4 The Bank is supporting this program with a programmatic policy-based loan, which will provide unrestricted funds based on the existence of a responsible fiscal policy framework. No significant fiduciary risk is deemed to exist.

D. Execution risk

- 2.5 The Ministry of Economy and Finance (MEF) and the Ministry of Housing, Construction and Sanitation (MVCS) have the capacity and authority to carry out this program. The MEF will play a coordinating role through its Sector Loan Coordination Unit (UCPS), which has extensive experience managing programmatic operations. The MVCS will contribute its knowledge and sector leadership. The consulting services financed with IDB and KfW resources are expected to help the sector comply with and carry forward the planned reforms, and to assist in obtaining the required technical support and societal buy-in needed for the reforms being promoted.

E. Other special considerations and risks

- 2.6 During the preparation of the program, with participation by Peruvian government officials, two medium-level risks were identified: (i) the institutional complexity represents a risk, given the need for close coordination to carry out the reforms without delay; and (ii) the multiplicity of program stakeholders makes for difficulties in collecting information on results and in monitoring and tracking activities. To mitigate these risks, it is suggested that the UCPS and the Bank support and monitor the VMCS, SUNASS, and other actors responsible for attaining the indicators listed in the Results Matrix. To this end, monthly work meetings will be held with those responsible for attaining the indicators, and a consultant will be hired to assist the executing units in collecting and preparing the necessary information.

- 2.7 The commitments for this programmatic operation were reviewed with the entities involved, which have reiterated their respective responsibilities. The means of verification were prepared with support from consulting firms financed by the Bank and KfW.

III. IMPLEMENTATION AND ACTION PLAN

A. Borrower and executing agency

- 3.1 The borrower is the Republic of Peru, and the executing agency will be the Ministry of Economy and Finance (MEF), through the Public Debt Bureau (DGETP), in coordination with the respective sector agencies. The MEF will monitor the commitments with the various entities involved, as set forth in the Policy Matrix (Annex II).
- 3.2 The GDETP will be in charge of: (i) coordinating the efforts of the different MEF offices and public sector agencies charged with adopting measures or executing technical aspects of activities; (ii) monitoring and promoting completion of activities to ensure successful program execution; (iii) maintaining official communication with the Bank on technical matters; (iv) preparing the required reports, submitting them on time and with the expected quality; (v) collecting, filing, and delivering to the IDB all information, indicators, and parameters that will enable the Government of Peru and the IDB to monitor, measure, and evaluate outcomes; and (vi) anticipating and effectively resolving strategic, technical, and coordination risks and problems. An institutional capacity assessment was not performed for this operation because of the IDB's considerable experience working with the executing agency.
- 3.3 This is a policy-based program of reforms addressing technical competencies within the MVCS, SUNASS, the MEF, and the private investment promotion agency ProInversión. The MVCS, through the VMCS, is responsible for financial policy and planning, as well as for the regulatory framework for small localities, the strengthening of sector capacities, the formulation of management instruments, and the definition of the strategies, criteria, and methodologies for promoting PSP in the sector. SUNASS is responsible for rate policies, oversight of PSP contracts, and eventual regulation of small sanitation enterprises. ProInversión is charged with carrying out any PSP assigned to it. For purposes of execution, the participation of these entities will be needed to support the MEF in fulfilling the policy commitments. On environmental matters, the coordination will be done by the EPS, the ANA, and the MVCS's Environment Division. The UCPS has a specialist assigned to coordinate with the various institutions responsible for fulfilling policy commitments, for which purpose monthly and special meetings will be held with each entity. Consultants have also been contracted with resources from the Bank and from KfW, who will be tasked with supporting the agencies responsible for meeting these commitments. In the final stage of preparation of the operation, these work sessions become more frequent, and are coordinated with the VMCS. It

should be noted that the highest officials at the institutions involved have participated from the start of this operation.

B. Monitoring and evaluation

- 3.4 During preparation, the project team analyzed the reform agenda for the medium term, which is the timeframe for this operation, determining the general objective and the indicators for each expected outcome, a process that helped determine the program rationale, its cost, and the type of intervention.
- 3.5 The MEF will coordinate efforts to verify timely fulfillment of the commitments related to this third programmatic operation and of the other commitments and scopes of reform. It will be responsible for providing information on progress with respect to the Policy and Results Matrixes, and for submitting evidence to the Bank of the means of verification. Due to the complexity of the reforms, the Bank's project team will carry out various missions for monitoring purposes. The Results Matrix, with indicators up to 2016, will serve to frame the evaluation of progress during implementation, and will make it possible to evaluate the operation at the conclusion of this final programmatic operation. The borrower and the Bank have agreed to monitor program execution through monitoring meetings, for which the dates will be determined jointly by the executing agency and the Bank. Since programmatic operations are designed to produce results in the medium and long terms, the project completion report (PCR) will be prepared when this third operation ends and will be completed within six months after the reforms of the third operation have been implemented. It will evaluate impacts and the degree to which the objectives of the program's three operations were achieved. The borrower has agreed in advance with the Bank on the indicators and baseline for the final evaluation ([REL#4](#)).
- 3.6 The borrower will compile information on an annual basis for the monitoring and evaluation of the program, and will collect, file, and make available to the Bank all information, indicators, and parameters needed by the Bank to prepare the PCR.

IV. POLICY MATRIX AND MEANS OF VERIFICATION

- 4.1 **Policy letter.** The IDB has agreed with the Government of Peru on the macroeconomic and sector policies described in the updated Policy Letter submitted by the MEF. That letter covers the principal components of the government's strategy for this program, and reaffirms its commitment to implement the activities agreed on with the IDB, which are attached to this document in the form of an electronic link ([REL#2](#)).
- 4.2 The Bank approved the Policy Matrix, attached as Annex II, describing the policy commitments for this third operation. The Means of Verification and Results Matrixes for this operation are attached as required electronic links 3 and 4, respectively, and set forth the conditions governing the disbursement of funds for

this third operation. The final version of the Policy Letter will be submitted by the Government of Peru prior to the loan contract negotiation.

Development Effectiveness Matrix			
Summary			
<i>I. Strategic Alignment</i>			
1. IDB Strategic Development Objectives	Aligned		
Lending Program	(i) Lending for poverty reduction and equity enhancement, (ii) Lending to support climate change initiatives, renewable energy and environmental sustainability.		
Regional Development Goals	(i) Incidence of waterborne diseases (per 100,000 inhabitants), (ii) Countries with planning capacity in mitigation and adaptation of climate change.		
Bank Output Contribution (as defined in Results Framework of IDB-9)	(i) Households with new or upgraded water supply, (ii) Households with new or upgraded sanitary connections, (iii) National frameworks for climate change mitigation supported.		
2. Country Strategy Development Objectives	Aligned		
Country Strategy Results Matrix	GN- 2668	Universalize access to water and sanitation services.	
Country Program Results Matrix	GN-2756-2	The intervention is included in the 2014 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
<i>II. Development Outcomes - Evaluability</i>			
	Evaluable	Weight	Maximum Score
	7.3		10
3. Evidence-based Assessment & Solution	6.2	33.33%	10
3.1 Program Diagnosis	3.0		
3.2 Proposed Interventions or Solutions	2.4		
3.3 Results Matrix Quality	0.8		
4. Ex ante Economic Analysis	10.0	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	4.0		
4.2 Identified and Quantified Benefits	1.5		
4.3 Identified and Quantified Costs	1.5		
4.4 Reasonable Assumptions	1.5		
4.5 Sensitivity Analysis	1.5		
5. Monitoring and Evaluation	5.6	33.33%	10
5.1 Monitoring Mechanisms	1.5		
5.2 Evaluation Plan	4.1		
<i>III. Risks & Mitigation Monitoring Matrix</i>			
Overall risks rate = magnitude of risks*likelihood	Low		
Identified risks have been rated for magnitude and likelihood	Yes		
Mitigation measures have been identified for major risks	Yes		
Mitigation measures have indicators for tracking their implementation	Yes		
Environmental & social risk classification	B.13		
<i>IV. IDB's Role - Additionality</i>			
The project relies on the use of country systems			
Fiduciary (VPC/PDP Criteria)			
Non-Fiduciary			
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment	Yes	Supports national frameworks for the adaptation to climate change.	
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project			
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan			

The results matrix does not have vertical logic given that it does not include the outputs of the operation. The matrix includes impact indicators that have baselines, targets and sources of information and are SMART. Although the outcome indicators have baselines, targets and sources of information, the way the results matrix is structured, does not allow to see a clear link between the outcomes presented and the indicators that are supposed to measure them, therefore it is not clear if all outcomes have indicators.

The project was analyzed using a cost-benefit analysis. The economic benefits were adequately quantified and the costs reflect real resource costs to the economy. The assumptions used were presented and a sensitivity analysis was performed.

The project has a monitoring and evaluation plan. The evaluation plan does not follow the DEM guidelines since it includes outcome indicators that are not included in the matrix and vice versa. The operation will be evaluated using a reflexive methodology and an ex-post cost-benefit analysis.

POLICY MATRIX

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
Component 1 – Macroeconomic stability						
Macroeconomic environment consistent with the program objectives.	The resources disbursed under the program contribute to closing the gap in external financing and, thus, to medium- and long-term fiscal stability.	Ministry of Economy and Finance (MEF)			Macroeconomic framework consistent with the program's objectives and with the guidelines established in the sector policy letter.	Peru continues to show robust macroeconomic performance, with rapid growth and an environment of fiscal stability, external equilibrium, and low inflation.
Component II – Sector planning: The sector plan is updated and integrates the different elements						
National Sanitation Plan (PNS) The PNS becomes a guiding instrument for sector policies and strategies at the national level.	The PNS is updated and approved, and includes new issues and challenges.	National Sanitation Department (DNS)	Conceptual guidelines and a work plan for updating the PNS are approved.	The diagnostic assessment (including regional coverage, management of services, investments and institutional analysis) is updated and the preliminary proposal of objectives, strategies, and policy guidelines for the PNS is presented.	The Water and Sanitation Sector Information System (SIAS) is being implemented. The PNS is being designed. The National Investment Plan, to be used as the main input for preparing the PNS, is approved.	The approved PNS is the sector's planning instrument.

¹ 2010. Year of the first operation of the reform program.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
	The system for monitoring and updating the PNS is implemented.	DNS		The conceptual model for the system to monitor the PNS (including indicators, sources, and frequency) is approved.		The system is operating and includes annual PNS monitoring and control reports.
Regional Sanitation Plans (PRS) The PRSs are guiding instruments for sector policy at the regional level, and are consistent with the vision of the PNS.	Mechanisms are introduced that encourage the development and approval of PRSs linked to the PNS.	DNS		Regional governments, local governments, and service providers participate in formulating new PRSs.		The PRSs are the outcome of active participation by the national government, regional and local governments, and service providers.
Institutional strengthening of the sector The human resources and technical capacities of the Office of the Deputy Minister for Construction and Sanitation (VMCS) are in line with the sector's needs.	The capacities of VMCS personnel are strengthened.	DNS	The VMCS capacity-building program is being designed.	The capacity-building program for the DNS, consistent with efficient work profiles, ranks, and compensation, is developed.	The VMCS personnel development plan is approved.	The technical and human resource capacities of the VMCS are in line with the sector's needs and development objectives.
	Sector management in rural areas and small cities is strengthened.	DNS- National Rural Sanitation Program (PNSR)	The mechanism for evaluating the water and sanitation service intervention models in use in rural areas and small cities is in the design stage.	Intervention tools (for formulating programs and projects and forming communal organizations) and regulations (calculation of rates and supervision of management) applicable to the sector in rural areas and small cities are approved.	The PNSR, including lines of intervention to be applied to rural areas, have been created and are being implemented.	Sustainable development of the rural and small cities subsector.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
		DNS		The conceptual model (including the definition of the responsibilities of personnel, indicators, sources of and timelines for information) for the system to monitor and track the sanitation sector's performance in rural areas and small localities is approved.	PNSR medium-term Plan, including guidelines for monitoring the performance of the sector in rural areas, is approved and is being implemented.	
	The sector's resources for rural areas are allocated on the basis of results and equity criteria.	Ministry of Housing, Construction and Sanitation - Ministry of Economy and Finance (MEF) (Public Budget Department - DGPP)		The Budget Program (using MEF methodology for incorporating it in the budget law), using a results-based approach, aimed at providing "Water and sanitation for the rural population," is formulated.	Rural and Urban Sanitation Budget Programs of regional and local governments are being implemented.	
Component III – Financial policy: The sector has a stable, long-term financial system						
Funding sources² The sanitation sector has stable, long-term funding sources and predictable amounts allocated in government budgets.	A funding and budgetary policy is applied that is conducive to the sector's having a stable, sufficient,	DNS	A long-term funding arrangement is being designed for the sector, based on the	A proposal for a general, long-term funding mechanism is developed that ensures a stable, sufficient funding source for financing the sector's	The Sanitation Services Modernization Law, in which resources are allocated for water supply and sanitation	Sector planning and development are based on multiyear resource programming,

² Drafting of the Outputs of Reform, 2011 and 2012 commitments, and long-term objectives ("Funding Sources") are subject to approval by the Public Budget Department (DGPP) and the Multiyear Programming Department (DGPM).

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
	long-term share in national, regional, and local government budgets.		targets and commitments in the national and regional sanitation plans, with the participation of the MEF and other stakeholders.	investments.	works, is in effect.	consistent with national and regional sanitation plan targets and commitments, and inputs from stakeholders.
		DNS			A financing plan that will be part of the PNS is in the design stage. Regulations for the Sanitation Services Modernization Law, incorporating guidelines for prioritizing the distribution of resources to regional and local governments is in effect.	
	The institutional mechanism for sector funding operates effectively.	DNS		A proposed institutional funding mechanism (defining the entities responsible for channeling, distributing, and executing the resources and for monitoring execution) is developed.		

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
Debt regularization for sanitation service providers (EPSs). Improve EPSs' debt profile by regularizing debts.	EPS debts are regularized.	MVCS-MEF		A regulatory framework for implementing options to regularize EPS debts with the National Housing Fund (FONAVI), in order to improve their debt profile, is approved.	Regulations for regularizing debts with FONAVI are approved.	EPSs have more and better access to resources in local financial markets.
Component IV – Regulatory policy: The sector's regulatory system is able to take on its new responsibilities						
Subsidy system Improve targeting of cross-subsidies for rates, in the context of the principle of equity.	The new rate subsidy system, based on poverty levels, is applied.	National Sanitation Services Regulatory Authority (SUNASS)	Adjustments to the regulatory and technical framework for implementing the new rate subsidy system are being prepared.	The adjusted regulatory and technical framework for implementing the new cross-subsidy rate system is approved (identifying poor households using the Household Targeting System, and calculating their ability to pay).	The new rate subsidy system is being implemented.	The rates charged by EPSs and small sanitation enterprises take into account users' poverty level.
Maximum allowable value (MAV) regulation and payment system Protect sewerage infrastructure and wastewater treatment systems from nondomestic discharges.	A regulatory structure for nondomestic discharges into sewerage systems is implemented.	SUNASS/ DNS	The payment schedule for levels exceeding the MAVs is in the design stage. MAV regulations are in the design stage.	The payment schedule (rate calculation formulas) for levels exceeding the MAVs is approved. MAV regulations (acceptable concentrations of pollutants, to avoid harm to the infrastructure) applicable to nondomestic wastewater discharges into the	The payment schedule for levels exceeding the MAV is being implemented.	Sewerage infrastructure is maintained and environmental hazards are minimized.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
				sanitary sewerage systems are approved.		
EPS supervision and control systems Strengthen the EPS supervision and control system.	EPSs are using the regulatory accounting system.	SUNASS	The legal framework for implementing the regulatory accounting system is prepared. The plan for implementing the regulatory accounting system is approved.	The regulatory accounting system is being developed, including guidelines for instituting SUNASS-required accounting at EPSs and for formulating plans to deliver the relevant information.	The regulatory accounting system is being implemented.	The sector uses tools that increase the effectiveness of EPS supervision and control functions.
	Tools are being used to improve the SUNASS supervision and control system and make it more effective.	SUNASS	Alternatives, procedures, and tools needed to improve and increase the effectiveness of the supervision and control system are in the design stage.	General regulations on supervision and inspection of, and sanctions for, EPSs are modified, thus reducing the time required for action to be taken.	Tools to improve EPS supervision and inspection are being implemented.	

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
Regulation system for small cities Small cities are brought under VMCS regulation.	The regulation system is introduced in small cities.	DNS		Legal and management instruments for creating management units for the delivery sanitation services in small cities, including a regulatory framework, are in the design stage.	Integration of service delivery at the regional level (to take advantage of economies of scale, reduce costs, and bring about more technical and efficient administration), provided for in the Sanitation Services Modernization Law and its associated regulations, is in effect.	The services market in small cities is effectively managed and regulated.
Component V– Promotion and development of service providers: The governance and transparency systems of service providers are improved						
Sanitation Services Modernization Law. Comprehensive reform of the industry to create new and modern conditions for the delivery of efficient and sustainable sanitation services by EPS.	A process of modernizing sanitation service delivery management is being established.	DNS			The process of modernizing sanitation service delivery management, established through the Sanitation Services Modernization Law and its associated regulations, is in effect.	Water supply and sanitation services for urban areas are provided efficiently and sustainably, and meet the sector development targets included in the PNS.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
<p>Governance of EPSs and other providers The governance system provides clear independence for the management of EPSs and other providers.</p>	Governance of service providers is strengthened.	DNS	The study of the service providers' governance and governability system and alternatives for optimizing them are in the design stage.	A system of governance and governability indicators to optimize EPSs' management that includes sources of information and frequency of collection is approved.	A system of governance and governability indicators to optimize EPSs' management is being implemented.	Autonomous, transparent management of EPSs and other providers.
<p>Capacity-building for service providers Improve the performance of service provider personnel.</p>	A sustainable financing mechanism is in place for the capacity-building system.	DNS	A proposal is submitted for the establishment of a private fund and other mechanisms for contributions to the capacity-building system.	Guidelines for promoting and harmonizing contributions to the capacity-building system from the private sector and/or international cooperation are approved, including a protocol to guide needs-based contributions.		Personnel of the EPSs and other service providers are competent and committed to service management.
	EPS personnel have an appropriate compensation system, which includes a system of work incentives.	Sanitation Department (DS) ³	Competency profiles for service provider personnel are in the design stage. A technical proposal is approved for the	A competency-based approach for service provider personnel is being developed, containing a functional map and a description of key service provider positions, by market segment.	A competency-based approach for EPS personnel, established through the regulations of the Sanitation Services Modernization Law, is being implemented.	

³ The DNS was replaced by the Sanitation Department (DS), pursuant to Supreme Decree 010-2014-VIVIENDA of 18 June.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
			<p>new compensation system, including the system of work incentives.</p> <p>The proposed legal framework for the new compensation system for EPS personnel has been submitted.</p>	<p>A system for compensating key EPS personnel, with a pay scale based on minimum experience, is being implemented.</p>	<p>A compensation system for EPS personnel, with oversight by the sanitation sector.</p>	
<p>Private-sector participation (PSP) in the sector Different PSP arrangements are applied efficiently in the sector.</p>	<p>A strengthened legal and institutional framework improves PSP processes in the sector.</p>	MEF (Investment Policy Bureau - DGPI)	<p>A comprehensive diagnostic assessment of PSP is being prepared.</p>	<p>A proposal for supplemental instruments (concession and management contracts) for facilitating the application of improved PSP arrangements in the sanitation sector is being prepared.</p>		<p>The private sector contributes to developing the sanitation sector.</p>
		VMCS		<p>Proposed institutional changes to the DNS for improving management of PSP processes (defining minimum team profiles and compensation) have been submitted to the VMCS.</p>		

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
Component VI – Water resources, climate change, and environment: Environmental management in the sector is improved by bringing it in line with current environmental and water resource policies and regulations.						
Protection of quality of water, sources, and receiving bodies of water Service providers apply regulatory instruments to implement Environmental Quality Standards (EQS) and Maximum Permissible Limits (MPL).	EQSs and MPLs are being implemented by service providers.	Office of Environment (OMA)	A proposed protocol for monitoring the environmental quality of water is in the design stage.	A protocol for monitoring water quality, by establishing physical, chemical, and biological EQSs for receiving bodies of water and a plan for monitoring them is approved.		Service providers contribute to restoring the quality of water in natural sources.
		OMA		Sector environmental protection regulations that address the needs of the sector and that include detailed standards to be observed have been submitted to the Ministry of Environment.	Sector environmental protection regulations are approved.	
		Sanitation Department (DS)	The baseline diagnostic assessment and the proposed work plan for carrying out Peru's strategic wastewater treatment intervention are in the design stage.		Scaling of the financing needs for Wastewater Treatment Plants (WWTPs) is approved as part of the National Investment Plan.	

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
		OMA	Proposed guidelines for preparing Environmental Improvement and Management Plans (PAMAs) are in the design stage.	Minimum guidelines for formulating sanitation PAMAs are submitted.	Complete guidelines for formulating PAMAs have been prepared.	
		OMA	A proposed protocol for monitoring effluents from WWTPs is in the design stage.	A protocol for monitoring effluents from WWTPs that includes monitoring the physical, chemical, and biological parameters for treated water is in the design stage.	The protocol for monitoring effluents from WWTPs is approved.	
Wastewater discharges Wastewater is discharged in accordance with the Water Resources Act.	Service providers are in the process of formalizing discharges, in line with the Water Resources Act.	DS	The discharge formalization plan for priority watersheds is being designed based on a status assessment of discharges and degree of compliance with current regulations.	The discharge formalization plan regulating quality of effluents to be discharged into receiving bodies of water is in the design stage.	Measures for formalizing discharges are being implemented.	Service providers contribute to preserving the quality of water resources.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
	The MVCS has an optimized management system for environmental certification.	Environmental Affairs Bureau (DGAA) ⁴	Optimized procedures and tools for the management of environmental certification are being designed.	Procedures and instruments are approved to minimize the amount of time required for the Office of Environment to provide environmental certification of projects in the sector.	Optimized procedures and tools for the management of environmental certification are being implemented.	Investment projects are being formulated and executed subject to environmental certification and authorization of discharges by the National Water Authority (ANA).
Tools for the preparation and environmental assessment of projects under investment programs of importance to the sector Improved environmental assessment of projects in sector investment programs.	Tools are being used to facilitate the preparation and environmental assessment of projects in investment programs of importance to the sector.	OMA	Tools for the preparation and evaluation of environmental impact assessments (EIAs) for projects included in investment programs are in the design stage.	Proposed tools for the preparation of EIAs for similar projects carried out in similar situations and that are part of the government program in the sanitation sector are submitted.	Regulations to simplify environmental assessment of sanitation projects in rural areas are approved.	Sector investments are executed in compliance with current environmental standards.
Climate change Sector management includes a climate change adaptation plan.	EPSs have climate change adaptation plans included in their optimized master plans.	OMA		Basic guidelines for service providers to formulate climate change adaptation plans are in the design stage	Guidelines for service providers to formulate and evaluate climate change mitigation and adaptation plans for the sanitation sector have been prepared.	Service providers are prepared to cope with the effects of climate change.

⁴ The OMA was replaced by the Environmental Affairs Bureau (DGAA), pursuant to Supreme Decree 010-2014-VIVIENDA of 18 June.

Policy reform and outcome	Reform outputs	Responsible party	Tranches/Agreed actions			Long-term objective
			Commitments under the first programmatic operation ¹	Trigger commitments under the second programmatic operation	Commitments under the third programmatic operation	
		SUNASS/DNS		Alternatives for optimizing unit consumption of water as part of climate change adaptation, including proposed required standards, have been developed.	Changes in rates for the use of drinking water for irrigation of parks and gardens are approved.	

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/___

Peru. Loan ___/OC-PE to the Republic of Peru
Second-Generation Sanitation Sector Reform
Program III

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 second-generation sanitation sector reform program III. Such financing will be for an amount of up to US\$25,000,000 from 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.

(Adopted on __ _____ 20__)

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