

**PROJECT INFORMATION DOCUMENT (PID)  
APPRAISAL STAGE**

Report No.: AB3089

<b>Project Name</b>	Modernization of Water and Sanitation Sector Project
<b>Region</b>	LATIN AMERICA AND CARIBBEAN
<b>Sector</b>	Water supply (100%)
<b>Project ID</b>	P103881
<b>Borrower(s)</b>	GOVERNMENT OF HONDURAS
<b>Implementing Agency</b>	
	Government of Honduras Honduras
	Finance Secretariat (SEFIN) Centro de Tegucigalpa, Edificio de la Se Frente a Quinchan Leon, Septimo piso. Tegucigalpa Honduras despacho@sefin.gob.hn
<b>Environment Category</b>	<input type="checkbox"/> A <input checked="" type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> FI <input type="checkbox"/> TBD (to be determined)
<b>Date PID Prepared</b>	April 25, 2007
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1. Country and Sector Background

Honduras is the second largest country in Central America with 112,492 square kilometers of land and a population of about 7.4 million in 2005. Per capita income stands at US\$1,170.<sup>1</sup>

Honduras has one of the highest incidences of poverty and inequality in the western hemisphere and Hurricane Mitch in 1998 aggravated the situation. After this massive loss of life and assets, Honduras embarked on a very ambitious Poverty Reduction Strategy (PRS) in consultation with civil society and donors, agreeing to a set of actions aimed at reducing the incidence of extreme poverty by half by 2015.

As in many other developing countries, the Government of Honduras recognizes the limits of the centralized government system. The recent drive towards decentralization started in 1990 with a municipal law that conferred local service delivery responsibilities and fiscal autonomy to the country's 298 local governments, and established a fiscal transfer of 5 percent of the annual budget to the municipalities. The trend towards decentralization was further reinforced in the PRSP, which underscored the role of the local government in its poverty reduction strategy.

In 2001, only 81 percent of people had access to potable water and 68 percent had access to sanitation. Understandably rural coverage is significantly lower than urban coverage. According to the Pan American Health Organization, 23 percent of contagious diseases in Honduras are

<sup>1</sup> Atlas methodology

waterborne. The Government of Honduras' (GOH) Poverty Reduction Strategy ranks expanding water and sanitation services as a priority. However, drinking water and sanitation are just two of several pressing needs competing for scarce government resources. Central problems in the water and sanitation sector are intimately linked with the lack of strong governance and scarcity of financial resources.

A central issue and concern of the Government is governance. WSS sector institutions find themselves locked in a vicious cycle from which it is difficult to escape. This spiral combines weak performance incentives, low willingness of customers to pay cost recovery tariffs, insufficient funding for maintenance, ultimately leading to a deterioration of assets and a squandering of financial resources. The downward cycle attracts further political interference and regenerates the downward trend with increased velocity. The vicious spiral is largely a consequence of ineffective policies and lack of transparency, coupled with the monopolistic nature of the sector. Water is politically sensitive and the government has found it difficult to effectively balance the trade-offs between affordability and expansion of coverage to poorer communities, with the sector's need for financial viability. Policy makers pursue multiple unaligned objectives, often leaning towards the attainment of the short-term political interests. Users have had little opportunity to hold utilities accountable to their preferences. Customer orientation can help depoliticize and balance the accountability framework of utilities as well as help prevent political capture.

SANAA, the National Water and Sewer Service (*Servicio Autónomo Nacional de Agua y Alcantarillado*), has historically managed and provided water supply services in approximately 30 rural and urban centers. Municipalities provide sanitation services—and in some cases water supply services—through direct municipal provision. Water is rationed in most cities—two times a week or even less in the summer—under SANAA management. The situation is no better in those municipalities that are directly managing their WSS.

In 2003, Honduras passed the Drinking Water and Sanitation Sector Framework Law (*Ley Marco del Sector Agua Potable y Saneamiento*) that mandates the decentralization of SANAA and the transfer of assets to the municipalities by October 2008. The *Ley Marco* requires municipalities to set up autonomous service providers, but does not describe the management model of such a service provider. This law also established the sector planning body, the National Council for Water and Sanitation (CONASA), and the Water and Sanitation Sector Regulator (ERSAPS) which should assist in providing more effective governance of the sector.

After decentralization of service delivery, SANAA is expected to remain as a technical assistance agency supporting small service providers as well as serving as CONASA's technical secretariat. The regulatory, planning and operational functions are to be fully transferred from SANAA to the separate specialized institutions of ERSAPS, CONASA and the municipalities—promoting good governance. Since these institutions are new, they are relatively weak. In addition, one of the major issues with the re-engineering of SANAA is the issue of the amount of the severance payments necessary to release the employees that will no longer be necessary as the municipalities take on their own services.

## 2. Objectives

The proposed project development objective is to improve the sustainability, efficiency and reliability of Honduras's water supply and sanitation (WSS) services in the participating municipalities through implementing the Strategic Plan to Modernize the WSS Sector (PEMAPS). The specific objectives are to:

- Establish and strengthen municipal service providers and support good governance in WSS services provision through increasing transparency and accountability;
- Reinforce the national sector actors (ERSAPS, CONASA, SANAA) to fulfill their new roles—a necessity for successful decentralization of the services;
- Reduce non-revenue water in selected areas of Tegucigalpa to provide immediate impact on the service quality.

### 3. Rationale for Bank Involvement

The Bank is well-positioned to assist GOH in improving the institutional framework in the sector and in strengthening utilities based on: (i) its global experience in water and sanitation sector reform, poverty targeting and its ability to integrate across these diverse and related topics and interests (including government, donors and civil society); (ii) its comprehensive analytical work and presence in Honduras, including the development of PEMAPS, PNAPS, Output-Based Aid (OBA) Water and Sanitation Facility, and its support of the Tegucigalpa Transfer of Services. In recognition of these assets, GOH has requested Bank support to implement PEMAPS.

Although there are many donors in Honduras, the Bank's involvement has been and would be comprehensive focusing on implementing GOH's overall strategy (the PEMAPS) in the form of institutional reform, decentralization and strengthening of municipalities in addition to infrastructure works. The preparation of the Strategy and National Water Plan united numerous and diverse key players—including the donor community—to discern key issues for transforming the sector and implementing the Water Sector Framework Law. Its implementation could continue to do so with the widely accepted PEMAPS providing the basis for harmonization of donor efforts in the sector. The current Administration has endorsed PEMAPS and indicated its willingness to implement it in the coming years as well as its interest in additional Bank assistance to progress in the sector modernization process.

### 4. Description

The proposed operation would assist the Government of Honduras in implementing the Strategic Plan for the Modernization of the WSS Sector (PEMAPS) through activities at the national and municipal level. The project will support municipalities with urban population between 40,000 and 300,000 to adopt autonomous service provider models by providing a combination of free technical assistance for creating the service providers, short-term efficiency improvement measures, and performance-based investment funding once services are transferred (Component 1). The project will finance efficiency improvements in Tegucigalpa to provide immediate impact on the service quality, while the transfer from the national utility to the municipality is being discussed (Component 2). Institutional strengthening actions will help fortify and establish the national sector actors (Component 3). Component 4 will finance project management activities.

*Component 1: Support to mid-sized municipalities to create autonomous service providers and invest in efficiency, rehabilitation and expansion of service delivery – Cost US\$21.2 million (IDA US\$ 17.2 million)*

The component will support the implementation of the Ley Marco and the PEMAPS in medium-sized cities through a combination of technical assistance for reforms and investments for efficiency improvement and infrastructure rehabilitation and extension. This “learning-by-doing” approach is expected to lead to service improvements – and thus will help to build solid public and political support for decentralization. The component will provide incentives for reforms, given that municipalities will have to substantially implement some reforms in order to receive support for investments for rehabilitation and expansion.

*Component 2: Tegucigalpa Non Revenue Water Reduction – Cost US\$4.5 million (IDA US\$ 4.1 million)*

The component will support a performance-based service contract with a private company to reduce technical and commercial losses in a limited geographical area of the municipality of the Metropolitan District. In addition to the contract itself, this component will finance the design and supervision of the contract. The component will conclude with an evaluation of the performance-based contract and its outcome.

*Component 3: Institutional strengthening of national and regional sector institutions – Cost US\$7.7 million (IDA US\$ 7.3 million)*

Decentralization and other reforms change or establish the functioning of the national sector institutions. This component will provide support for the water sector planning entity (CONASA), a regulating agency (ERSAPS) and a national utility (SANAA) to fulfill their new roles in a timely, efficient and transparent manner. This component will also finance severance payments for the SANAA staff directly affected by the transfer of services to participating municipalities.

*Component 4: Project Management – Cost US\$1.6 million (IDA US\$ 1.4 million)*

This component will finance the cost of salary, travel and general operating costs of the project management unit. In addition, this component would also finance monitoring and evaluation (M&E) activities, audits and other project management activities on governance.

## 5. Financing

<b>Institution</b>	<b>Amount</b>
IDA	30.0
GOH	5.0
<b>TOTAL</b>	<b>35.0</b>

## 6. Implementation

The Government of Honduras will be the borrower of the proposed credit. The Secretary of Finance (SEFIN) will be responsible for the execution of the proposed project and as such will be the Program’s Executing Entity. The overarching approach to project implementation would be to use existing capacity in the Honduran institutions involved, rather than creating a new

Project Implementation Unit. Additionally, the implementation arrangements warrant a sound project governance structure with checks and balances included in various areas.

SEFIN has requested that implementation responsibility falls on the *Unidad Administradora de Proyectos (UAP)*<sup>2</sup> given its previous experience with multilateral financing in the water and sanitation sector. The UAP was created as a consolidated PIU within SEFIN to manage financial resources from IDA, the IDB and the NDF, among others, to assure timely implementation of projects using the fiduciary capacity of SEFIN, which would involve several institutions or agencies in innovative areas. UAP has been managing 18 projects so far, including two IDA projects.

Under this arrangement, other implementing agencies (Municipalities, CONASA and SANAA) fulfill mostly technical roles, while coordinating with the UAP on the flow of funds, procurement of works, goods and services, financial reporting, and other required activities. SEFIN, operating through the UAP, will be acting as the project coordination unit and will serve as permanent link between the Bank and the Government throughout the Project life cycle. With respect to this Project, the UAP will be assisted by professional staff with qualifications and experience acceptable to the Bank according to the Project's Operational Manual. The Bank will co-finance the salaries and other operational recurrent costs required for the operation of the UAP from loan proceeds.

UAP will be responsible for the fiduciary and safeguards aspects of the whole project, with the exception of parts of Component 1 to be executed by the municipalities (see below). CONASA will be responsible for the technical leadership of components 1 and 3 and for the corresponding administrative and operational aspects in components 3 (i.e. preparing Terms of Reference and bidding documents, participating in the bidding processes, and supervising the works and services they commissioned). SANAA will be responsible for the technical leadership and corresponding administrative and operational aspects in components 2. UAP would be responsible for Overall Project Management and would provide special support in procurement activities carried out by the sub-executing agencies as well as overall monitoring of the implementation of the Project. It will develop timely and credible information mechanisms regarding the project activities, especially the financial statements on the Project as a whole, the justification of expenditures and the withdrawal requests to the Bank. Moreover, it will implement transparency and governance mechanisms for the project, including the capacity building in each implementation agency to comply with the Law of Transparency and Access to Information.

## 7. Sustainability

The question of long-term sustainability in the provision of WSS services is at the core of the Government's strategy, expressed through the *Ley Marco*. The project supports the implementation of this strategy, ensuring alignment with the Government's vision.

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<sup>2</sup> The UAP was created by the Ministerial Agreement 0271 of 2004.

Component 1: The activities under the first component are designed to create autonomous municipal utilities and to strengthen the financial, technical and commercial capacity of the participating utilities and are thus designed with sustainability. The overall level of investments foreseen under Component 1 is fairly small compared to the investment needs of the participating utilities, thus reducing the likelihood that operation and maintenance of the relatively small works would exceed the capacity of the utilities. Additionally, the risk of poor sustainability of the investments at the local level is mitigated by the implementation of a series of TA activities included under the same component.

Component 2: This component has similar considerations as Component 1.

Component 3: The WSS sector is in the midst of a reform process where new national institutions are being created while another already-existing institution has an altered mandate, and new are created. The project seeks to strengthen these institutions in their new roles in order to help them tackle the challenges of the sector in an efficient manner. All activities planned are being closely coordinated with already existing initiatives,

## 8. Lessons Learned from Past Operations in the Country/Sector

### **Lessons learned in the Region**

**Importance of the policy context of WSS projects.** While the ultimate objective of most water and sanitation projects is to provide quality water and sanitation services to the beneficiary population, this objective cannot be reached by brick-and-mortar solutions only. Experience has shown the importance of a well-structured sector, with clearly defined institutional responsibilities and financing mechanisms, to ensure a long-term impact of infrastructure investments. Countries such as Colombia, Chile, and Mexico have found very different solutions to the same problem – but all point to the importance of taking into account the policy dimension of WSS services in order to achieve dramatic service improvements. Within the project, one component will therefore focus on strengthening the national sector institutions in the functions that the framework law gives them, and implementing the long-term vision for the sector developed within the PEMAPS.

**Need to involve all key stakeholders.** The water and sanitation sector is characterized by a multitude of institutional, civil and private actors exerting various functions (investment, regulation, policy-making, service provision, etc.). Coordination and consultation is of paramount importance in the sector. Contradicting financing policies or community participation policies, for example, can undermine the effectiveness of an innovative project. Several countries have attempted to improve this situation through the creation of coordination bodies which, in the case of Honduras, is CONASA. Component 3 will include activities to continue the consensus-building and role assignment exercise developed under the PEMAPS. Component 1 will include activities to consult on sector reform at the local level and empower local institutions (municipalities, civil society groups and service providers) to make their voice heard and to interact with national institutions.

### **Lessons learned in the Country**

Lessons from previous studies, Bank-assisted projects and partner activities have yielded the following lessons: 1) the Bank may need to mediate the many, sometimes conflicting interests of diverse government institutions; 2) various Bank interventions must also be harmonized and coordinated with support of other donors; 3) *ad hoc* devolution of services to municipalities, privatization and incentive structures may result in unsustainable coverage gains; 4) experience from the passage of the 1990-91 Municipal Law shows the need to promptly develop and apply the legislation's tools in order to visibly demonstrate benefits of the modernization; 5) attractive financing rules at municipal level are key to ensure buy-in of the municipalities in the process and success of the stepped approach.

The work done by the Bank team with the Government, as well as with other stakeholders during preparation of the PEMAPS, shows the importance of steady Bank engagement in the sector, especially for the implementation of the sector modernization process. Bank assistance during the initial stages of the reform allowed the previous Administration to develop a shared vision about the sector and put together a clear strategy that has been endorsed by the current Administration. The Government values the association with the Bank particularly for its current work as an "honest broker" and its capacity to bring state of the art knowledge to the policy making process.

The project will closely coordinate with two on-going Bank projects with water supply and sanitation components in Honduras - the Rural Infrastructure Project (PIR) and the Barrio Ciudad Project - and benefit from the implementation experience gained in those projects. In particular, the Barrio Ciudad project, which geographical scope partly overlaps with this project, will be an excellent complement to this project's focus on service providers, since it finances small WSS works at neighborhood level, using a similar implementation mechanism (matching grants and municipal execution conditional on procurement capacity). The Bank has been and will continue to coordinate its work with the IDB, which has several on-going operations in the WSS sector, to avoid duplication of work.

## 9. Safeguard Policies (including public consultation)

*Social assessment:* In terms of physical interventions, the pertinent social safeguard instruments have been prepared. The project foresees targeting a geographically diverse set of municipalities, raising the probability of working with the country's heterogeneous indigenous and ethnic communities. For that reason, the government has prepared an Indigenous Peoples Framework, also referred to as an Ethnic Communities Policy Framework in reference to the inclusion of both native indigenous groups as well as afro-Honduran communities.

*Environmental Assessment:* Given the nature of the works to be financed by this project, no significant or irreversible environmental impacts are foreseen. Therefore, the project is classified as Category B according to World Bank Operational Guidelines. Since individual sub-projects and locations have not yet been identified, the government has developed a Framework for Social and Environmental Management. This operation's Framework will include all relevant Honduran laws, World Bank environmental safeguards and procedures for reviews needed to ensure that the project will meet Bank and Honduran guidelines for environmental protection. This project will not finance works on any existing or future dams.

<b>Safeguard Policies Triggered by the Project</b>	<b>Yes</b>	<b>No</b>
<a href="#">Environmental Assessment (OP/BP 4.01)</a>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Natural Habitats ( <a href="#">OP/BP 4.04</a> )	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Pest Management ( <a href="#">OP 4.09</a> )	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Physical Cultural Resources (OP/BP 4.11)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Involuntary Resettlement ( <a href="#">OP/BP 4.12</a> )	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Indigenous Peoples ( <a href="#">OP/BP 4.10</a> )	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Forests ( <a href="#">OP/BP 4.36</a> )	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Safety of Dams ( <a href="#">OP/BP 4.37</a> )	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Projects in Disputed Areas ( <a href="#">OP/BP 7.60</a> )	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Projects on International Waterways ( <a href="#">OP/BP 7.50</a> )	<input type="checkbox"/>	<input checked="" type="checkbox"/>

#### 10. List of Factual Technical Documents

1. Plan Estrategico de Modernizacion del Sector Agua Potable y Saneamiento (PEMAPS), Government of Honduras (2005)
2. Encuestas Permanentes de Hogares, Instituto Nacional de Estadisticas de Honduras (2003)
3. The Need for Wastewater Treatment in Latin America: A Case Study of the Use of Wastewater Stabilization Ponds in Honduras, Stewart M. Oakley, Ph.D. (2005)
4. "Implementation Completion Report on a Loan to the Republic of Honduras for Sustainable Tourism Development Project," Report No. 35651. World Bank (2006).
5. Honduras Country Assistance Evaluation, Report No. 37861, World Bank (2006)
6. Country Assistance Strategy for the Republic of Honduras, Report No. 37280-HN (2006)

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