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Report No: 39570-HN

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF SDR19.8 MILLION
(US\$30 MILLION EQUIVALENT)

TO THE

REPUBLIC OF HONDURAS

FOR A

WATER AND SANITATION SECTOR MODERNIZATION PROJECT

MAY 18, 2007

Sustainable Development Department
Central America Country Management Unit
Latin America and Caribbean Region

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CURRENCY EQUIVALENTS
(Exchange Rate Effective May 17, 2007)

Currency Unit = SDR
SDR 0.65876 = US\$1
US\$ 1.51801 = SDR 1

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AMDC	<i>Alcaldía Municipal del Distrito Central</i> (Municipality of Tegucigalpa)
AMHON	<i>Asociación de los Municipios de Honduras</i> (Honduras Municipalities Association)
APL	Adaptable Program Loan
CAS	Country Assistance Strategy
CATS	<i>Consultorías de Apoyo a la Transferencia de los Servicios</i> (Services Transfer Support Consultants)
CONASA	<i>Consejo Nacional de Agua Potable y Saneamiento</i> (National Council for Water and Sanitation)
COSUDE	Swiss Agency for Development and Cooperation
CQ	Consultant's Qualifications
CSO	Civil society organizations
EIRR	Economic Internal Rate of Return
ENHPM	<i>Encuesta Nacional de Hogares de Propósitos Múltiples</i> (National Household Survey)
ERSAPS	<i>Ente Regulador de los Servicios de Agua Potable y Saneamiento</i> (Water and Sanitation Sector Regulator)
FAD	<i>Fondo de Ayuda al Desarrollo</i>
FHIS	<i>Fondo Hondureño de Inversión Social</i> (Honduran Fund for Social Investment)
FIRR	Financial Internal Rate of Return
FM	Financial management
FMA	Financial management assessment
FMAR	Financial Management Assessment Report
GDP	Gross domestic product
GIC	<i>Grupo Interinstitucional de Coordinación</i> (Interagency Coordination Committee)
GoH	Government of Honduras
GPOBA	Global Partnership for Output-Based Aid
HIPC	Heavily Indebted Poor Country
IDA	International Development Association
IDB	Inter-American Development Bank
IFR	Interim financial report
INE	<i>Instituto Nacional de Estadísticas</i>
IPSAS	International Public Sector Accounting Standard
ISA	International Standards on Auditing
JMP	Joint Monitoring Program
LPS	Lempiras (Honduras' currency)
M&E	Monitoring and evaluation
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
NDF	Nordic Development Fund
NGO	Nongovernmental organization
NPV	Net Present Value
NRW	Non-Revenue Water
O&M	Operation and Maintenance
OBA	Output-Based Aid
PAHO	Pan-American Health Organization
PDO	Project development objective

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PEMAPS	<i>Plan Estratégico de Modernización del Sector de Agua Potable y Saneamiento</i> (Strategic Plan for Modernization of the Potable Water and Sanitation Sector)
PHRD	Policy and Human Resources Development Fund (Trust Fund) (Japan)
PIR	Rural Infrastructure Project
PIUs	Project Implementation Units
PNAPS	<i>Plan Nacional de Agua Potable y Saneamiento</i> (National Drinking Water and Sanitation Plan)
POA	Project annual work
PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public-Private Partnerships
PROMOSAS	<i>Proyecto de Modernización del Sector Agua y Saneamiento</i> (Water and Sanitation Sector Modernization Project)
PRRAC	<i>Programa Regional de Reconstrucción Para América Central</i> (Central America Regional Reconstruction Program)
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
RMS	Results Management System
SANAA	<i>Servicio Autónomo Nacional de Acueductos y Alcantarillados</i> (National Autonomous Water and Sewer Service)
SDR	Special Drawing Rights
SEFIN	Secretariat of Finance
SIL	Specific investment loan
SOE	Statement of Expenditures
SWAp	Sector Wide Approach
TA	Technical assistance
TORs	Terms of reference
UAP	<i>Unidad Administradora de Proyectos</i> (Project Administration Unit)
UEPEX	<i>Unidades Ejecutoras de Préstamos Externos</i> (External Loans Execution Unit)
UNDP	United Nations Development Programme
WSS	Water Supply and Sanitation

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REPUBLIC OF HONDURAS
Water and Sanitation Sector Modernization Project

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REPUBLIC OF HONDURAS

HONDURAS WATER AND SANITATION PROGRAM

PROJECT APPRAISAL DOCUMENT

LATIN AMERICA AND CARIBBEAN

LCSUW

Date: May 18, 2007	Team Leader: Gustavo Saltiel		
Country Director: Jane Armitage	Sectors: Water supply (100%)		
Sector Manager/Director: John Henry Stein	Themes: Other public sector governance (P);Decentralization (P)		
Project ID: P103881	Environmental screening category: Partial Assessment		
Lending Instrument: Specific Investment Loan			
Project Financing Data			
[] Loan [X] Credit [] Grant [] Guarantee [] Other:			
For Loans/Credits/Others: Total Bank financing (US\$m.): 30.00 Proposed terms: The Recipient is subject to IDA lending on hardened terms (10 years of grace period and a maturity of 20 years, with principal repayable at 10% per annum for years 11-20).			
Financing Plan (US\$m)			
Source	Local	Foreign	Total
BORROWER/RECIPIENT	5.00	0.00	5.00
International Development Association (IDA)	30.00	0.00	30.00
Total:	35.00	0.00	35.00
Borrower: Government of Honduras Tegucigalpa Honduras			
Responsible Agency: Finance Secretariat (SEFIN) Centro de Tegucigalpa, Edificio de la Se Frente a Quinchan Leon, Septimo piso. Tegucigalpa Honduras despacho@sefin.gob.hn			

Estimated disbursements (Bank FY/US\$m)									
FY	8	9	10	11	12	13	14	0	0
Annual	2.00	4.00	6.00	7.00	7.00	6.00	3.00	0.00	0.00
Cumulative	2.00	6.00	12.00	19.00	26.00	32.00	35.00	35.00	35.00

Project implementation period: Start End:
 Expected effectiveness date: October 30, 2007
 Expected closing date: October 30, 2013

Does the project depart from the CAS in content or other significant respects? Yes No
Ref. PAD A.3

Does the project require any exceptions from Bank policies? Yes No
Ref. PAD D.7
 Have these been approved by Bank management? Yes No
 Is approval for any policy exception sought from the Board? Yes No

Does the project include any critical risks rated "substantial" or "high"? Yes No
Ref. PAD C.5

Does the project meet the Regional criteria for readiness for implementation? Yes No
Ref. PAD D.7

Project development objective **Ref. PAD B.2, Technical Annex 3**

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.

Project description [one-sentence summary of each component] **Ref. PAD B.3.a, Technical Annex 4**

Component 1: Support to mid-size 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): this component will finance a combination of TA, efficiency improvements and larger-scale investments in order to support the decentralization and deconcentration of water and sanitation services to autonomous, municipal service providers.

Component 2: Tegucigalpa Non Revenue Water Reduction. Cost US\$4.5 million (IDA US\$ 4.1 million): this component will finance the design and implementation of a performance-based non-revenue water reduction contract in Tegucigalpa.

Component 3: Institutional strengthening of national and regional sector institutions. Cost US\$7.7 million (IDA US\$ 7.3 million): this component will finance the institutional strengthening of and TA to national institutions of the water and sanitation sector, as well as severance payments for entrenched workers of the national water utility.

Component 4: Project Management (US\$2.2m): This component will finance the cost of salary, travel and general operating costs of the project implementation agency, as well as monitoring and evaluation activities.

Which safeguard policies are triggered, if any? *Ref. PAD D.6, Technical Annex 10*

- Environmental Assessment
- Natural Habitats
- Physical Cultural Resources
- Indigenous People

Significant, non-standard conditions, **if any**, for:

Ref. PAD C.7

Board presentation: No Board conditions

Loan/credit effectiveness:

Effectiveness Conditions

- (a) An Inter-institutional Agreement has been signed between SEFIN, SANAA, ERSAPS, and CONASA defining the framework for the interagency collaboration.
- (b) The Operational Manual has been issued by Honduras and approved by the Bank.

Covenants applicable to project implementation:

Disbursement Condition:

- (a) For Expenditure Category 4 (Sub-Components 1B and 1C—municipal efficiency improvement and investments), for each eligible municipality (not for the whole component): signature of an agreement between SEFIN and the eligible municipality consistent with the model provided in the Operating Manual.
- (b) For Expenditure Category 5 (Sub-Component 3B / Severance payments): the Recipient has submitted to the Bank an analysis prepared by independent consultants: (i) describing the severance payments regime applicable to SANAA; (ii) demonstrating its compliance with all relevant local laws, regulations, and collective bargaining agreements; (iii) defining the amount of such payments per worker, based on an analysis that demonstrates the productivity and fiscal sustainability of the investment; and (iv) demonstrating that satisfactory oversight arrangements are in place.

I. STRATEGIC CONTEXT AND RATIONALE

A. Country and sector issues

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 is US\$1,170.¹ Honduras has one of the highest incidences of poverty and inequality in the western hemisphere and Hurricane Mitch in 1998 made it worse. After this massive loss of life and assets, Honduras embarked on a very ambitious Poverty Reduction Strategy (PRS) in consultation with civil society and other donors, agreeing to a set of actions aimed at reducing the incidence of extreme poverty by half by 2015.

Overall, the income of 50 percent of Hondurans remains below the poverty line. Poverty and inequality are widespread. Roughly one-half of the population resides in rural areas. Extreme poverty, while declining nationally, has actually increased in rural areas by about 10 percent (although this is mainly attributable to the devastating effects of Hurricane Mitch). Honduras reached the Heavily Indebted Poor Country (HIPC) Completion Point in April 2005 and benefited from the Multilateral Debt Relief Initiative (MDRI) in July 2006. Honduras's external debt will remain sustainable over the medium-term if fiscal deficits and rates of growth are maintained at their current levels.

In 2005 Hondurans elected José Manuel Zelaya as President in the seventh successive peaceful, democratic change of government since 1982. The Zelaya administration has made poverty reduction its top priority, endorsing the current Poverty Reduction Strategy Paper (PRSP). The four pillars identified by the President for his administrative mandate (January 2006 to January 2010) are:

- Equitable economic growth for employment generation;
- Good governance through state modernization and civic participation;
- Environmental protection and risk management; and
- Development of human capital.

Like many other developing countries, the Government of Honduras recognizes the limits of the centralized government system. The recent drive toward 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 toward decentralization was further reinforced in the PRSP, which underscored the role of the local government in its poverty reduction strategy.

Sector Issues

In 2001, only 81 percent of the Honduran population had access to potable water and 68 percent had access to sanitation. Understandably, rural coverage is significantly lower

¹ Atlas methodology.

than urban coverage. According to the Pan-American Health Organization, 23 percent of contagious diseases in Honduras are waterborne. The Government of Honduras's (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. The Water Supply and Sanitation (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, and 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 tradeoffs between affordability and expansion of coverage to poorer communities, with the sector's need for financial viability. Policymakers pursue multiple unaligned objectives, often leaning toward the attainment of the short-term political interests. Users have had little opportunity to hold utilities accountable. Customer orientation can help depoliticize and balance the accountability framework of utilities and help prevent political capture.

The National Autonomous Water and Sewer Service (*Servicio Autónomo Nacional de Agua y Alcantarillado*, SANAA), 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.

The GoH has also prepared (with World Bank and Public-Private Infrastructure Advisory Facility [PPIAF] assistance) the Strategic Plan for Modernization of the Potable Water and Sanitation Sector (PEMAPS) and the National Water and Sanitation Plan (PNAPS), which seek to implement the organization and reform of the sector, as mandated in the 2003 Drinking Water and Sanitation Sector Framework Law and its Millennium

Development Goals. This plan already has wide acceptance in Honduras and provides direction to donor interventions in the sector.

Decentralization (to the local level) and deconcentration (to autonomous service providers) should improve services by making providers more accountable to consumers. However, the reforms are a large task given limited capacity at the municipal level. Municipalities are looking to the few good practices of management of services such as Puerto Cortés and San Pedro Sula, as examples of creating an autonomous and accountable service provider. Designing and implementing good municipal management models that are accountable to their customers and function in a transparent manner is key to improving service.

After decentralization of service delivery, SANAA is expected to remain as a technical assistance agency supporting small service providers and 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 and CONASA, and to 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 amount of the severance payments necessary to release the employees that will no longer be necessary as the municipalities take on their own services.

With 57 percent of SANAA's connections, the most significant transfer of services from the national utility to municipalities will be that of Tegucigalpa. This is a complex and politically charged process that deserves special attention because of its political significance in the overall implementation of the sector vision. The Tegucigalpa Transfer is one of the 19 projects in PEMAPS and represents 41 percent of its total costs. The Tegucigalpa Transfer has a decisive influence on the execution of 12 of the other 18 PEMAPS projects—especially the re-engineering of SANAA, which would fail without this particular transfer. Given the level of progress in preparation, it is unlikely that the transfer in Tegucigalpa will take place by October 2008.

B. 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: (a) 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); (b) its comprehensive analytical work and presence in Honduras, including the development of PEMAPS, PNAPS, and 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 both its willingness to implement it in the coming years and its interest in additional Bank assistance to progress in the sector modernization process.

C. Higher-level objectives to which the project contributes

This project will support three of the four Strategic Objectives laid out in the Country Assistance Strategy. Strategic Objective 1 (*Accelerating Equitable Economic Growth and Employment Generation*) will be supported by an enabling environment that develops and strengthens service providers, thus helping Honduras become more competitive. Strategic Objective 2 (*Strengthen Governance through State Modernization and Participation*) will be supported by fostering transparency and access to information, improving the effectiveness and transparency of public spending, and fostering decentralization and increasing professional capacities in the water sector. Strategic Objective III (*Strengthen Environmental Protection and Risk Management*) will be supported by the development of autonomous and efficient water and sanitation service providers that will be in a better position to carry out the investments needed to reduce water pollution from the discharge of untreated wastewater.

II. PROJECT DESCRIPTION

A. Lending instrument

The proposed credit in the amount of SDR 19.8 million (US\$ 30 million equivalent) is designed as a specific investment loan (SIL), combining investment and TA financing.

The project can be seen as a first step in a Sector Wide Approach (SWAp), although without co-financing at this juncture. The project will build on the commitment of all donors to the PEMAPS and the centrality of the project in the sector going forward. Specific sectorwide activities will be financed (see Sub-Component 3A).

B. Project development objective and key indicators

The project development objectives are: (a) to improve the sustainability, efficiency, and reliability of the Recipient's WSS services in eligible municipalities; and (b) to improve the performance of the Recipient's national WSS sector institutions in the exercise of their respective roles in conformity with the WSS Sector Framework Law.

The success of the project will be measured using the following sets of indicators:

(a) The improvement in the sustainability, efficiency, and reliability of the Recipient's WSS services in Eligible Municipalities will be measured through:

<u>Sustainability:</u>	Cost recovery level measured as the ratio of total revenues to total operative cost.
<u>Efficiency:</u>	Revenues per volumetric unit of water produced.
<u>Reliability:</u>	Hours of service per day.

(b) The improvement in the performance of the Recipient's national WSS sector institutions in the exercise of their respective roles in conformity with the WSS Sector Framework Law will be measured for each institution:

<u>SANAA:</u>	Number of systems transferred ² to the municipalities.
<u>ERSAPS:</u>	Number of design proposals of autonomous service providers approved by ERSAPS.
<u>CONASA:</u>	CONASA issues the new financial policy of the sector.

C. Project components

Project components

The proposed operation would assist the GoH 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 investment funding³ 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.

The following paragraphs provide further details on the project's components and sub-components. More details are provided in Annex 4. Amounts show total component costs with loan proceeds in parentheses.

Component 1: Support to medium-size 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-size cities through a combination of technical assistance for reforms and

² As attested by a notary act.

³ Portions of it based on performance

investments for infrastructure. 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.

Municipalities with an urban population between 40,000 and 300,000 inhabitants, that intend to transfer their water supply or sanitation services to a municipal service provider as mandated by the *Ley Marco* are eligible to participate in this component.⁴ Groups of adjacent municipalities with smaller urban populations who unite to establish an aggregated service provider to serve a total urban population between 40,000 and 300,000 inhabitants can also participate.

This component uses a demand-based stepped approach to support municipalities during all reform steps. Hence, it is important to understand the proposed stepped approach as well as the various sub-components. The paragraphs below describe the project by outlining (a) the stepped approach, and (b) the sub-components. More details are provided in Annex 4.

Stepped approach

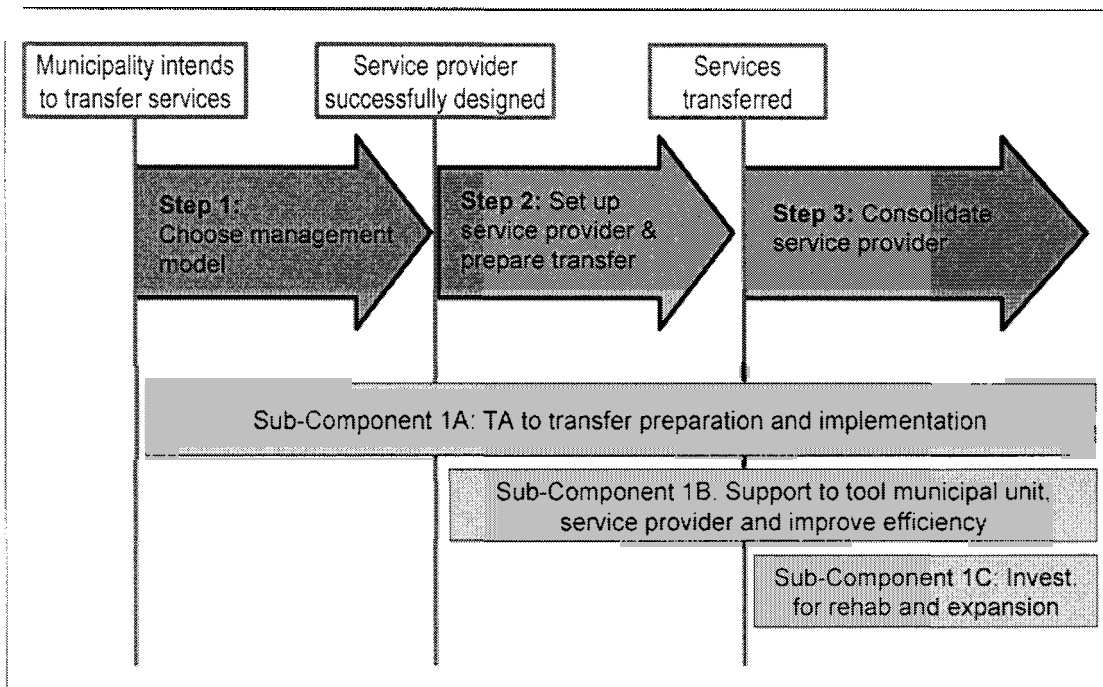
Figure 1 presents the stepped approach for medium-size municipalities. In Step 1, municipalities receive TA focused on designing a management model. Once the proposed model has been sent to and reviewed by ERSAPS (the regulator), municipalities qualify for Step 2 assistance including support to provide the service providers with tools (institutional and operational), and start improving the efficiency of service provision. Once services⁵ are transferred, municipalities move to Step 3, and qualify for investments in system rehabilitation and expansion.

It is expected that approximately 6 to 9 municipalities will participate in Component 1. While most will enter the process at Step 1, some might have already reached the qualification criteria to enter at Step 2 or even Step 3. However, not all municipalities entering at Step 1 are expected to reach Step 2 or Step 3. This will create a certain degree of competition among the municipalities.

Figure 1: Stepped Approach

⁴ According to the 2001 Census, cities within this population bracket are: Choloma, Choluteca, Comayagua, Danli, El Progreso, La Ceiba, La Lima, Puerto Cortes, and Siguatepeque. In addition, an association of municipalities around Villanueva has also announced some potential interest.

⁵ Either Water Supply or Sanitation is sufficient.



Sub-Components

Activities under Sub-Components 1A and 1B will be provided as in-kind grants without counterpart funding from the municipalities, while activities under Sub-Component 1C will require matching contributions from municipalities. The maximum amount per municipality under each sub-component will be capped based on its number of connections (Sub-Components 1B and 1C) and service provider performance (Sub-Component 1C only).

Sub-Component 1A: Technical assistance for transfer preparation (total US\$3.7 million, IDA US\$3.7 million)

Sub-Component 1A will consist of technical assistance to the participating municipalities while they design the new management model and plan and implement the services transfer process. This TA will be provided through teams of experts called the *Consultorías de Apoyo a la Transferencia de los Servicios* (Services Transfer Support Consultants, CATS). As the service provider design is reviewed by the regulator, the type of services the CATS provide will evolve to other areas, such as the improvement of commercial practices, the implementation of effective management systems, the planning of operations and maintenance, and the preparation of business plans. In addition, the project will finance the revision or preparation of a master plan for the service provider. The master plan will include a financial and economic analysis to ensure the soundness of the various activities being proposed. Finally, this sub-component will also finance the design and supervision of works conducted under Sub-Component 1C.

Sub-Component 1B: Support to tool service provider and improve efficiency (total US\$6.1 million, IDA US\$5.5 million)

Once a municipality has successfully⁶ identified and designed a management model, the municipality can start obtaining support in implementing the CATS' recommendations and creating the municipal WSS institutions and the service provider, as planned for in the *Ley Marco*.

This sub-component will finance activities such as the rehabilitation or construction of offices and the acquisition of basic management tools. This sub-component will also support rapid efficiency gains, including:

- Technical (such as leak detection, network sectorization, meter installation)
- Commercial (billing and collection, reduction of non-revenue water).

Municipalities and service providers will be free to propose activities of their choice within a maximum investment amount as long as they are consistent with the CATS recommendations.

Sub-Component 1C: Investment for system rehabilitation and expansion (total US\$11.4 million, IDA US\$8.0 million)

As a complement to the efficiency improvements reached under Sub-Component 1B, this sub-component will finance investments in infrastructure after the service providers start operating the system. This sub-component would enable service providers to expand and improve services.

Investments funded under this component would include rehabilitation, connection to and expansion of water supply and sewer networks, on-site sanitation facilities, and wastewater treatment systems. Water supply investments can include coverage extension, rehabilitation of existing networks, tanks and treatment plants, and the development of new water production capacity. Piped sewerage investment can include rehabilitation and expansion of standard, small-bore, and condominial systems. On-site sanitation investment will focus on creating supportive conditions for on-site solutions. Wastewater treatment investments will include simple treatment systems such as stabilization ponds, artificial wetlands, and communal septic tanks. Investments are limited to an agreed list of facilities and terms of implementation (see Annex 4). Service providers will have the freedom to decide which investments they would like to execute within the master plan. Investments outside of the master plan would need to be justified by an economic analysis.

Sub-Component 1C is designed using a “matching contribution” incentive scheme where municipalities or service providers must provide co-financing to obtain grants (in the forms of services, works, and goods). The ceiling of investments a municipality can receive will be determined by a formula taking into account the number of connections and the performance of the service providers (see Annex 4).

⁶ The *Ley Marco* stipulates that the regulator (ERSAPS) has to approve the design of the management model.

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 geographic 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.

This component aims to improve, in the short term, the operative situation of the WSS service provider in Tegucigalpa. By freeing up water production capacity, continuity of service delivery could be improved and water supply services expanded. International experience shows that good financial paybacks are possible with well-designed Non-Revenue Water (NRW) reduction programs. A performance-based service contract provides an efficient means to achieve significant improvements in operational and financial efficiency, thereby creating immediate benefits and fostering a positive dynamic to support further reform. Based on typical unit costs elsewhere, it is expected that NRW will be reduced considerably in a service area of approximately 200,000 people in Tegucigalpa at the end of the project.

The component will be implemented by the *Unidad Administradora de Proyectos* (Project Administration Unit, UAP). SANAA will initially provide the technical supervision in the understanding that this role will be transferred to the municipal service provider if and when services are transferred.

Component 3: Institutional strengthening of national and regional sector institutions – Cost US\$7.7 million (IDA US\$7.2 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), the regulating agency (ERSAPS), and the national utility (SANAA) to fulfill their new roles in a timely, efficient, and transparent manner. Activities under this component are derived from the PEMAPS.

Sub-Component 3A: Technical assistance to national institutions (total US\$3.1 million, IDA US\$3.1 million)

The sub-component will provide assistance to the strengthening of CONASA as a sector planning entity, through the creation of a specific PEMAPS unit. The PEMAPS unit will work closely with the CATS to strengthen local institutional arrangements. As such, the PEMAPS unit will act as the oil needed for good governance and transparency in the project. This will include Training of Trainers in the areas of management models. The support will include a national communication program supporting both the visibility of the sector and the project itself. Among others, the component will finance planning tools for CONASA, and the development of a sector financing policy aimed at guaranteeing the long-term sustainability of the sector. In the latter part of the project, the component will finance a status review and update of the PEMAPS and a review of municipal management models.

This Component will also support SANAA in defining and adapting to its new role under the *Ley Marco* as a technical assistance agency.

The subcomponent will also strengthen ERSAPS (the regulatory agency). Support will focus on defining and implementing its new relationship municipal oversight units—working closely with the regulatory experts in the CATS in Component 1. Also, ERSAPS' capacity to gauge management models will be enhanced.

Sub-Component 3B: Severance payments (total US\$3.3 million, IDA US\$3.0 million)

SANAA is overstaffed. It's total number of staff expressed per thousand connections is 10.4, while the regional average is 3.1.⁷ The transfer of services to the municipal level offers an opportunity to increase the efficiency of service delivery by rationalizing the number of staff and by improving the capacity of staff through selection.

The *Ley Marco* stipulates that all staff that will be retrenched or that change employers during transfer of services will receive severance payments. This sub-component will fund severance payments for the estimated 200 SANAA staff retrenched in the course of decentralization of WSS services to the participating municipalities. The severance payments will be grounded in an analysis of relevant laws, regulations, and collective bargaining agreements that determine the payment of statutory termination benefits and of ex gratia severance payments that is being carried out with Policy and Human Resources Development Fund (PHRD) financing. The component will also finance a study on rationalization staffing of SANAA during and after decentralization.

A complete justification and risk analysis of the payment of severance is included in the full project description in Annex 4.

Sub-Component 3C: Preparatory activities for Tegucigalpa transfer (total US\$1.3 million, IDA US\$1.1 million)

Tegucigalpa represents by far the largest city where water supply services are managed by SANAA, and the only city in which SANAA manages sanitation services. While the project does not finance the transfer itself, this sub-component will support preparatory activities for the transfer of service delivery from SANAA to the Municipality of Tegucigalpa (AMDC). This support will include activities such as updating inventories, installing consumer and asset management systems, and planning the transfer process. These activities are in continuation of the Bank's engagement through a PPIAF grant, and will be closely coordinated with the Inter-American Development Bank (IDB), which has also been involved in upstream activities.

Component 4: Project management – Cost US\$1.6 million (IDA US\$1.5 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 and transparency and strengthening of the implementing agencies, through participation in training and study tours, purchase of vehicles and equipment, and upgrading of the working environment.

⁷ Regional average from 2005 review of the Association of Water and Sanitation Regulatory Entities of the Americas (ADERASA).

Estimates of Project Costs, by Component (US\$ m)

Component	IDA	Borrower	Municip.	TOTAL
Component 1: Support to medium-size municipalities to create autonomous service providers and invest in efficiency, rehabilitation, and expansion of service delivery	\$17.2M	\$0.6M	\$3.4M	\$21.2M
Component 2: Tegucigalpa Non-Revenue Water Reduction Program	\$4.1M	\$0.4M	NA	\$4.5M
Component 3: National and Regional Institutional Strengthening	\$7.2M	\$0.5M	NA	\$7.7M
Component 4: Project Management	\$1.5M	\$0.1M	NA	\$1.6 M
Total	\$30M	\$1.6M	\$3.4M	\$35 M

Annex 4 contains a more detailed table with costs by sub-component.

Project Financing (US\$ m)

Institution	Amount
IDA	30.0
GOH	1.6
Municipalities of Honduras	3.4
TOTAL	35.0

D. Lessons learned and reflected in the project design

The project design incorporates lessons learned horizontally, from other similar projects in Latin American countries, and vertically, from earlier projects in Honduras.

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 Chile, Colombia, 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, policymaking, service provision, and so forth). 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: (a) the Bank may need to mediate the many, sometimes conflicting interests of diverse government institutions; (b) various Bank interventions must also be harmonized and coordinated with support of other donors; (c) ad hoc devolution of services to municipalities, privatization, and incentive structures may result in unsustainable coverage gains; (d) 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; and (e) attractive financing rules at the 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, and 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 policymaking process.

The project will closely coordinate with two ongoing 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, the geographic scope of which 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 the neighborhood level, using a similar implementation mechanism (matching grants and municipal execution conditional on procurement capacity). The Bank has been coordinating and will continue to

coordinate its work with the IDB, which has several ongoing operations in the WSS sector, to avoid duplication of work.

E. Alternatives considered and reasons for rejection

- **Continuing Assistance through Analytical and Advisory Activities (AAA).** The breadth of issues that demand urgent attention and sustained support required to work with key actors to install sound policies and programs exceed what different types of AAA could hope to provide. TA to reforms without investment will not improve services. The Honduran authorities have expressed a willingness and desire to borrow for this purpose, despite fiscal constraints. The engagement of the Bank through the development of the PEMAPS in the past two years has created a sound basis for an investment project closely aligned with the PEMAPS implementation.
- **Use of an Adaptable Program Loan (APL).** The APL would provide a framework for implementing a comprehensive medium-term investment program designed to achieve the provision of efficient and sustainable water and sanitation services throughout the country. However, given the uncertainty about the scope of the overall program and the ensuing outcomes, developing the APL would require a lengthy process, delaying implementation of urgent reforms.
- **Implementation of the entire project by CONASA.** Although CONASA is, by mandate, the sector planning entity and could have been a logical implementing agency, its current status as a committee without a legal identity, funding, and staff would have made it difficult to entrust CONASA with the implementation of the complete project. Rather, the team thought the project should seek to strengthen CONASA while the project is being implemented, giving it the technical leadership of the national component without overburdening it with fiduciary responsibility.
- **Complete alignment of the project with the ongoing Inter-American Development Bank (IDB) project.** The IDB is currently financing a project with goals and structure similar to this project. The IDB project has encountered some implementation difficulties (for example, lack of interest of municipalities, slow disbursement). This is mainly due to the fact that funds are lent only to the municipalities (the operation proposed here envisions grants). Given the large needs of the sector, it was agreed that the present project would best be designed as a complement to the IDB project, rather than as an augmentation of it. Therefore, the national component's TA activities of this proposed project complement the IDB's activities. The municipal component will work largely outside of the municipalities where the IDB is currently working. It uses matching contributions to make participation attractive to municipalities. Historically, IDB has been the leading donor in the sector, but since 2004 the GoH has requested the World Bank to join the IDB and other donors in their efforts to assist with implementing the institutional changes required by law and PEMAPS. Both institutions have been and presently are actively coordinating interventions in Honduras' water sector so as to achieve synergies and reduce duplication of efforts.
- **Implement the new WSS project through the *Fondo Hondureño de Inversión Social* (Honduran Fund for Social Investment, FHIS).** This was the option originally recommended by the team, given the experience of this institution in

implementing Bank projects and also the emphasis of the project on municipal investments. However, during the Review Meeting and as a result of fiduciary problems that FHIS is currently undergoing, the Meeting advised the team to propose different implementation arrangements.

III. IMPLEMENTATION

A. Partnership arrangements

Many donors are present in Honduras, but most of them focus on pilot interventions. Bilateral donors often do not have the Bank's capacity and experience to cover the totality of the sector needs, while nongovernmental organizations (NGOs) usually finance isolated system components (like tanks, pumping stations, latrines, and so forth). The development of the PEMAPS has provided the donors with an opportunity to come together under one national framework plan. The PEMAPS provides a basis for shared commitment among the donor community upon which the project can build.

The project can be seen as a first step in a Sector Wide Approach (SWAp), although without co-financing at this juncture. The SWAp will build on the donor commitment to the PEMAPS and the centrality of the project in the sector. Donor coordination is ongoing and will be rigorously pursued in specific areas of strengthening of CONASA through the establishment of a highly professional PEMAPS unit and support to the transfer of services in Tegucigalpa. Donor coordination will be pursued through the existing *Mesa Sectorial*. This is a group composed of government, civil society, and donor representatives that strategizes on how to implement necessary actions to meet sectoral goals, and takes a lead role in coordinating, disseminating, and developing the sector by integrating the national, municipal, and local perspectives.

In particular, it is worth mentioning that the Bank has been working closely with the IDB, which has several ongoing WSS projects in the country, and with the Swiss Agency for Development and Cooperation (COSUDE), which is currently providing support to SANAA/CONASA in its future role under the *Ley Marco*, and will coordinate with the Spanish *Fondo de Ayuda al Desarrollo* (FAD) on Component 2 (Non-Revenue Water reduction). More details on these collaborations are included in Annex 2.

B. Institutional and implementation arrangements

The following institutional and implementation arrangements are the results of a long process of evaluation of the capacity of several institutions to participate technically in the process and to assume fiduciary roles. Many different alternatives were evaluated, some of which are presented in the above "Alternatives considered" section. The arrangements proposed are deemed a good balance between using the technical capacity of existing sector institutions, ensuring that fiduciary processes are conducted to the satisfaction of the Bank, and minimizing implementation challenges.

The Republic of Honduras will be the borrower of the proposed credit. The Secretariat 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. In addition, the implementation arrangements warrant a sound project governance structure with checks and balances included in various areas.

SEFIN has requested that implementation responsibility fall on the *Unidad Administradora de Proyectos* (Project Administration Unit, UAP)⁸ given its previous experience with multilateral financing in the water and sanitation sector. The UAP was created as a consolidated Project Implementation Unit within SEFIN to manage financial resources from the International Development Association (IDA), the IDB, and the Nordic Development Fund (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 participating agencies (ERSAPS, 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. 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. In particular, the UAP will be strengthened on the sector, technical staff side. The Bank will co-finance the salaries and other operational recurrent costs required for the operation of the UAP from loan proceeds. In order to avoid unnecessary turnovers in the personnel affected to implement the project, both in UAP and in the agencies in charge of the various components, the financial agreement will make it necessary for any change of key staff to be made only if satisfactory to the Bank. This clause will apply not only to UAP staff, but also to key implementing staff in other agencies, in particular the PEMAPS unit.

The project would also count on the high-level support of the ad hoc *Grupo Interinstitucional de Coordinación* (GIC), comprising SEFIN, SANAA, CONASA, the *Asociación de los Municipios de Honduras* (Honduras Municipalities Association, AMHON), and the water sector regulator (ERSAPS). The GIC would monitor project progress and ensure institutional coordination.

Table 1 summarizes the responsibilities of various agencies in the project. 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. UAP will also be providing the technical supervision of Component 1, with CONASA and ERSAPS support. SANAA will be responsible for the technical supervision and corresponding

⁸ The UAP was created by Ministerial Agreement 0271 of 2004.

administrative and operational aspects in Component 2. CONASA, SANAA, and ERSAPS will be responsible for the technical leadership of Component 3. UAP would also provide 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.

The project team will review the implementation arrangements two years after the project's effectiveness to determine whether the conditions exist for the WSS sector institutions to take on more implementation responsibilities.

Table 1: Overview of Project Implementation Arrangements

Component	Technical Supervision^a	With Support from^b	Procurement	Management of Funds
1 – Support to municipalities				
<i>1A – Technical Assistance</i>	<i>UAP</i>	<i>CATS, CONASA, ERSAPS</i>	<i>UAP</i>	<i>UAP</i>
<i>1B – Tooling and efficiency improvement</i>	<i>UAP</i>	<i>Municipality, CATS</i>	<i>Municipality/ UAP^c</i>	<i>UAP</i>
<i>1C – Investments</i>	<i>UAP</i>	<i>Municipality, CATS</i>	<i>Municipality/ UAP^c</i>	<i>UAP</i>
2 – NRW reduction in Tegucigalpa	SANAA		UAP	UAP
3 – National Institutions Strengthening				
<i>3A – Technical Assistance</i>	<i>CONASA</i>	<i>ERSAPS</i>	<i>UAP</i>	<i>UAP</i>
<i>3B – Severance Payments</i>	<i>UAP</i>	<i>SANAA</i>	<i>UAP</i>	<i>UAP</i>
<i>3C – Preparation Transfer Tegucigalpa</i>	<i>SANAA</i>		<i>UAP</i>	<i>UAP</i>
4 – Project Management	UAP		UAP	UAP

a. Technical Supervision includes preparing TORs and bidding documents, reviewing the inputs of consultants, and so forth.

b. Support means the following institutions will be asked to prepare or review draft TORs and inputs from consultants but will not be making the final decision.

c. Depending on the capacity of the municipality, as defined by the Operating Manual.

Annex 6 contains more details about the component-by-component implementation arrangements.

C. Monitoring and evaluation of outcomes/results

The project-level monitoring and evaluation (M&E) framework will track progress in implementation, measure intermediate outcomes, and evaluate project impacts. The framework outlines key performance indicators, data collection methods, a timetable for collection, and responsible agencies. This framework will be used to supervise and monitor the implementation of the project. The UAP has monitoring and evaluation capabilities so it can assume this coordinating role.

The methodology for monitoring will be in line with the Law of Transparency and Access to Public Information that was approved by the GoH in December 2006. This law obliges public institutions to make effective mechanisms of transparency and to combat corruption and illegal activity in public policy matters. The UAP will build capacity in each implementation agency and establish accountability mechanisms to move toward compliance with the Law of Transparency and Access to Information under the scope of the project.

The following tools are to be used for monitoring and evaluation of the project:

- Progress Reports. A mechanism for annual progress reports will be established for describing the main achievements of the project.
- Results-based Monitoring and Evaluation. This tool will include information on results such as actual use of the services, user satisfaction, and affordability of the services, among other indicators. The main sources of information for this results-based M&E will be: (a) a baseline and follow-up, statistically non-representative household survey, (b) participatory focus group discussions, and (c) consumer satisfaction surveys.

The UAP will be responsible for the overall management and implementation of the Project Monitoring and Evaluation Framework. This will include maintaining the databases, managing the flow of information, and producing periodic monitoring reports. It will be directly responsible for the Progress reports and the results-based M&E. The consultants hired for the project will have a key role in providing timely monitoring reports with operational data. The social team in the UAP will be responsible for carrying out focus group discussions and participatory exercises, contracting and supervising the midterm and final surveys, and conducting the evaluation reports. Bank supervision teams will provide technical assistance for the implementation of the tools and for the design and analysis of the information.

D. 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 PEMAPS and the *Ley Marco*. The project supports the implementation of this strategy, ensuring alignment with the Government's vision.

Component 1: The activities under this 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, thus reducing the likelihood that operation and maintenance of the relatively small works would exceed the capacity of the utilities. In addition, 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. 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, especially those related to implementation of the PEMAPS.

E. Critical risks and possible controversial aspects

The overall risk rating for the project has been determined to be **Substantial**. This is an innovative project that offers significant rewards in terms of developing a more efficient water supply and sanitation sector, but carries a substantial level of risk, especially given the overall country risks in Honduras.

The key project risks and their mitigation measures are provided in the following risk matrix:

Risk	Risk Minimization Measure(s)	Rating
To PDO:		
Project implementation delays.	Project incorporates lessons learned from other Bank projects, including division of clear responsibilities among all key stakeholders; capacity building at all levels of project implementation; monitoring and evaluation to detect early-warning signals; and a focus on improved coordination among national sector institutions and between the local and the national level. At the local level, risks will be mitigated by first focusing on TA for reforms; the period up to the transfer of services will be used to prepare master plans, designs, specifications, and tender documents so that procurement can start immediately following participant eligibility for access to financing.	S
Vested interest groups delay implementation of reforms prescribed by law.	The pace of WSS reform in Honduras has picked up considerably in the past year. At the national level this is spurred on by the presidential benchmarks that provide incentives for SANAA to decentralize. Several municipalities will have created an autonomous service provider even before project effectiveness. The overall mitigation for the possible	M

Risk	Risk Minimization Measure(s)	Rating
	<p>delay of reforms is to combine reforms with investment in order to create rapid service improvements and improve the financial basis of the new service providers. To further mitigate this risk at the national level, the Bank is working closely with SANAA, CONASA, and ERSAPS, and with the <i>Mesa Sectorial</i>,^a in order to bring in various stakeholders who are more interested in increasing the efficiency of the sector. The project will also have a coordination group (<i>Grupo Interinstitucional de Coordinación</i>). The severance payment included in Component 3 will mitigate the risk of opposition from labor union and entrenched high-ranked officials in SANAA. The project will stay engaged in the transfer of service delivery in Tegucigalpa, but no unrealistic assumptions are made on the timeline of this transfer.</p>	
<p>Lack of transparency in the project implementation, including: (a) the capture of project benefits by politically influential stakeholders; (b) failure to apply a consistent approach to the selection of municipalities and investment projects, and, as a result of the above; (c) financing of technically and economically suboptimal investments.</p>	<p>The project has identified a clear strategy to address transparency-related concerns. First, the Bank team, jointly with government officials, has developed an objective methodology for a stepped approach with clear measurable benchmarks that must be met to move to the next step. Second, the technical and economic merit of investments will be assessed through municipal master plans. Third, civil society organizations (CSOs) and consumer representatives will be involved in the reforms, thus providing a counterweight to clientelistic interests. Fourth, mechanisms for improving communication and access to information will be designed and implemented during the process to guarantee transparency and enable consumer and civil society participation in the decisionmaking process. Fifth, a project implementation unit with extensive experience in implementation of Bank-financed projects will ensure that accounting, financial management, and procurement procedures are consistent with the Bank's requirements.</p>	S
<p>Lack of cooperation between the implementing agency (UAP) and the technical agencies (SANAA, CONASA, ERSAPS).</p>	<p>The project relies on several "technical" agencies to support the implementing agency (UAP). An interinstitutional agreement will be signed among those various agencies that will define the roles and duties of each of them and the processes for collaboration. In addition, incentives have been provided since every one of these agencies is also a beneficiary of the project (SANAA through Components 2 and 3B and C, ERSAPS and CONASA—including the PEMAPS unit—through Sub-Component 3A). The project is supporting them in exercising their legal mandate, rather than adding responsibilities they would not otherwise have had. Finally, the UAP will also be strengthened with a few high-level sector specialists that will act as back-up and oversight of the technical agencies.</p>	M
To Components:		
<p>To Component 1: Disinterest of the municipalities to participate in the stepped approach.</p>	<p>The stepped approach has been designed in order to provide incentives for a transfer process that is already mandated by the <i>Ley Marco</i>. Contrarily to other ongoing projects (Barrio-Ciudad, IDB), this project will extend grants, not loans, to municipalities, hence providing more attractive financing rules. A municipal counterpart funding requirement will</p>	M

Risk	Risk Minimization Measure(s)	Rating
	ensure that the municipalities commit to the process. A strategic communication campaign will also be included in Component 3 and should help promote the project, among others.	
To Component 1: Low capacity and an uneven pace of reform at the local level.	The proposed stepped approach is a way of mitigating the risk of uneven pace of reform implementation among municipalities. The approach is to open the first stage of the project to all municipalities in the targeted population bracket, but to focus on a smaller number of municipalities in the second and third stage, given the relatively small amount of investment available.	M
To Component 1: Weak implementation capacity at the local level could directly affect the quality of investments financed under the operation.	A significant effort has been made to put in place the appropriate capacity and support structures (including ongoing support to municipalities and municipal service providers by the CATS) to mitigate such risks. Procurement has been centralized and an experienced PIU has been selected to assist in execution of the project. The quality of investment will be a key focus of Bank supervision efforts.	S
To Component 2: Bad track record of SANAA on non-revenue water will continue.	The NRW reduction program will be implemented through the performance-based contracting of a firm.	M
To Component 3: SANAA remains de facto lead institution in sector due to reluctance of high-ranking officials in SANAA to let go and weak capacity of CONASA and ERSAPS.	The component will focus on empowering CONASA and ERSAPS. It will be implemented by a ringfenced PEMAPS unit in the CONASA Secretariat. Other donors will be encouraged to support this unit, which should develop into a center of excellence for the sector. The World Bank will stay engaged in dialogue considering the transfer of services to AMDC (Tegucigalpa).	S
To Component 4: Administrative changes / staff turnover after elections hamper project implementation.	The current President and administration will be in place through the end of 2009, meaning the project will be in full implementation by the time the government changes. The risk of high staff turnover that may affect project implementation will be mitigated by the use of legal clauses against unnecessary project staff changes in the loan agreement. The project will also address the lack of continuity through intensive dialogue with the new authorities at the central and decentralized levels to minimize disruptions.	S
Overall Financial Management Risk.	See detailed action plan in Annex 7.	S
Overall Procurement Risk.	See detailed action plan in Annex 8.	S
Overall Project Risk		S

H = High risk.

S = Substantial risk.

M = Modest risk.

N = Negligible or low risk.

Ratings are post-mitigation.

a. The *Mesa Sectorial* is a group composed of government, civil society, and donor representatives that strategizes on how to implement necessary actions to meet sectoral goals and takes a lead role on coordinating, disseminating, and developing the sector by integrating the national, municipal, and local perspectives.

F. Loan/credit conditions and covenants

Effectiveness Conditions:

- (a) An Inter-institutional Agreement has been signed between SEFIN, SANAA, ERSAPS, and CONASA defining the framework for the interagency collaboration.
- (b) The Operational Manual has been issued by Honduras and approved by the Bank.

Disbursement Condition:

- (a) For Expenditure Category 4 (Sub-Components 1B and 1C—municipal efficiency improvement and investments), for each eligible municipality (not for the whole component): signature of an agreement between SEFIN and the eligible municipality consistent with the model provided in the Operating Manual.
- (b) For Expenditure Category 5 (Sub-Component 3B / Severance payments): the Recipient has submitted to the Bank an analysis prepared by independent consultants: (i) describing the severance payments regime applicable to SANAA; (ii) demonstrating its compliance with all relevant local laws, regulations, and collective bargaining agreements; (iii) defining the amount of such payments per worker, based on an analysis that demonstrates the productivity and fiscal sustainability of the investment; and (iv) demonstrating that satisfactory oversight arrangements are in place.

IV. APPRAISAL SUMMARY

A. Economic and financial analyses

Economic analysis:

The project is based on a framework approach where specific sub-projects are not pre-defined. Rather, they will be identified based on the demand from the municipalities and technical assistance, and capacity-building activities will be provided to participating municipalities. The economic and financial analyses focuses on Sub-Components 1B and 1C (US\$17.5 million) and 2 (US\$4.5 million), which account for 63 percent of total project cost. Consultants hired for the development of the municipal water and sanitation efficiency improvement plans (Sub-Component 1B) and consultants hired for the development of master plans (Sub-Component 1C) will be responsible for conducting financial and economic feasibility studies, and to ensure that all proposed interventions will be at least economically feasible. Cost-benefit analyses will be used to assess the economic feasibility of the proposed plans. The Operational Manual will contain the methodology and detailed information on the development of the economic analysis for the investments to be financed by the project. The economic analysis principles to be applied are discussed below. Annex 9 contains more detailed explanation on the methodology to be applied for assessing economic costs and benefits.

Sub-Component 1B (efficiency improvement): Any eligible investment in efficiency improvement will have to be part of the efficiency improvement/master plan of the utility requesting it, in which case it would already have been evaluated for its economic feasibility. In case the proposed investment was not part of the efficiency improvement, the municipality will need to present its economic feasibility study based on the methodology specified under the Project Operational Manual. Investments that are not economically feasible will not be eligible for funding. During project preparation 3 potential sub-projects were evaluated. The results are presented in Annex 9.

Sub-Component 1C (investments): Any investment under this component will have to be justified as part of a master plan approach to WSS services development. In the process of appraising a national OBA fund for water and sanitation investments, a sample of projects was assessed. The methodology used for assessing the economic feasibility of those sub-projects will be used for assessing those to be financed through this proposed project. The results and methodology are ready, and are presented in Annex 9.

Component 2 (NRW campaign in Tegucigalpa): Component 2 will focus on Non-Revenue Water reduction campaigns. The design of such campaigns will be based on a strategic diagnostic that identifies the actions that lead to the best results for the money available. Economic and financial analysis will be an inherent part of this strategic diagnostic, hence ensuring that only actions that make economic and financial sense are funded.

Financial analysis:

As part of the efficiency improvement/master plans, financial models will be used to project the cash flows of the proposed plans. The work done as part of the OBA facility and the preparation of this proposed project show that many of the eligible sub-projects may be financially unfeasible. However, it is important to clarify that according to OP 10.04, sub-projects that are financially unfeasible may be eligible for World Bank/IDA financing as long as they are economically feasible. The financial analysis, however, is important for the utilities to take control of their own financial performance, to prioritize investments, and to see the impact of proposed interventions on their own financial health. Project funding will be used only to finance economically feasible interventions that were prioritized by the municipalities that will be co-financing these investments.

B. Technical

The project is designed on a demand-based approach. Therefore, the exact sub-projects will be defined during project implementation. The technical assessment of the project is based on the following principles:

The sub-projects will be part of a master plan. The project will finance the preparation of a master plan in each city that participates and does not have a recent master plan. In cities that already have a master plan, the plan will be revised and updated as needed. This master plan will ensure that individual works fit into a larger vision and efficiently contribute toward lasting improvement in service quality and coverage.

Project design and supervision will be supervised centrally to ensure quality standards are met. UAP, which will be the implementing agency for the execution of Component 1, will be strengthened on the technical aspects through the integration of a high-level technical specialist and other technical professionals, as needed. SANAA, which will be technically supervising Component 2, has traditionally been strong on the technical side. This will ensure that project designs and supervision are executed in a satisfactory manner.

The individual investments amounts are limited. While the project includes about US\$12 million of investments, this amount will be divided between 3 to 5 cities and 5 to 6 years. It is not expected that large sub-projects will be executed, so the risk of overwhelming local implementing capacity is limited.

All technologies considered for water supply, sanitation, and wastewater treatment are well established. Type of works and technologies used will not differ substantially from typical ones used in similar contexts (small towns). These will include traditional pipe laying, connections, simple water treatment plants, and so forth. Condominial or other types of low-cost technologies may be used in situations where deemed appropriate. In such cases, the Bank will provide all needed technical support, based on its experience in other Latin American countries (for example, Bolivia, Brazil, and Peru). When required, wastewater treatment plants using well-established, low-cost waste stabilization pond or artificial wetlands technologies will also be financed. When land costs or topography make waste stabilization ponds unfeasible, alternative technologies will be considered.

C. Fiduciary

Procurement: A Procurement capacity assessment of the proposed arrangements was carried out to determine if the procurement arrangements are acceptable to the Bank. A detailed assessment is provided in Annex 8. A summary of the conclusions is included below.

SEFIN requested that implementation responsibility fall on the *Unidad Administradora de Proyectos* (UAP) given its previous experience with multilateral financing in the water and sanitation sector.

The assessment reviewed the capacity of the UAP to carry out procurement. The assessment looked into (a) organization, (b) facilities and support capacity, (c) staffing, (d) professional experience, (e) record-keeping and filing system, (f) procurement planning and monitoring/control systems used, and (g) capacity to meet the Bank's procurement reporting requirements. The assessment also considered the capacity of alternative proposed agencies such as FHS to implement procurement for Component 1, SANAA for Component 2, and CONASA for Component 3. The findings led to rejecting the use of these agencies for project implementation, and embracing the UAP instead.

The procurement of goods and works under Component 1 will be executed by the municipalities under supervision from the UAP and in accordance with the procurement plan, provided that its capacity is deemed sufficient. A rigorous evaluation framework will be used to determine the municipalities' capacity to implement the works, based on the analysis conducted prior to the Barrio Ciudad project and the Rural Infrastructure Project (PIR). When the municipalities' capacity is found to be insufficient, the UAP will be implementing the works in close technical coordination with the municipality. In both cases, UAP will be (co-)signing the contracts and managing the flows of funds.

In addition, the procurement capacity assessment has identified a series of risk-mitigating measures incorporated into the design of the project and the procurement management implementation arrangements.

Financial Management. A Financial Management (FM) review of the proposed arrangements was performed in line with the guidelines issued by the Financial Management Board on November 3, 2005, to determine if the FM arrangements are acceptable to the Bank. A financial management assessment report (FMAR) is included in Annex 7. A summary of the conclusion is included below.

Since the UAP has ongoing experience managing externally financed projects, it has in place a basic administrative structure and FM systems, which puts it in a good position to take over the financial management functions of the proposed project. However, the FM capacity assessment (FMA) has identified project-specific actions in order to strengthen the FM capacity of the UAP and to enable it to effectively carry out the financial activities of the proposed project.

Importantly, the project is expected to use country systems (SIAFI and UEPEX) for accounting and reporting purposes, because these systems would provide adequate information for monitoring specific project expenditures. No additional system is expected to be needed. In addition to the use of country systems (SIAFI), the project will use a single treasury account to make project payments.

D. Social

The implementing agency, UAP, currently has insufficient capacity to carry out and supervise the activities related to social impacts. Therefore, the UAP will incorporate a social science professional to take on this role. This individual would supervise the social framework, the indigenous peoples' policy framework, and rapid social assessments as described below.

As mentioned, the target population for Component 1 will be defined during implementation, thus the universe of municipalities has been based solely on the delimitation of city size. Accordingly, a broad environmental and social framework has been prepared, which describes demographic and institutional characteristics of Honduras. This framework has contributed to the project design's social strategy focused on ensuring meaningful participation of key stakeholders including civil society

organizations, community representatives, indigenous and ethnic leaders, and municipal governments.

In terms of Component 1 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 and Afro-Honduran communities.

Given the nature and scale of the water and sanitation works to be implemented in urban areas, a proposed sub-project will be considered ineligible if it involves (a) the involuntary taking of land resulting in (i) relocation or loss of shelter; (ii) loss of assets or access to assets; or (iii) loss of income sources or means of livelihood, whether or not those affected must move to another location; or (b) the involuntary restriction of access to legally designated parks and protected areas resulting in adverse impacts on the livelihoods of the displaced persons.

In addition to social safeguards, the project will also be carrying out a rapid social assessment per city, once the municipalities have been identified. This assessment will include (a) an inclusion strategy, (b) desk review, (c) participatory focus groups, and (d) socioeconomic and consumer satisfaction surveys. These steps are further described in Annex 10.

The project will also develop some capacity in the implementation agencies to set up transparency and governance mechanisms to move toward compliance with the Law of Transparency and Access to Information. Training programs for municipal officials and civil society representatives will be delivered. They will focus on integrated approaches to water and sanitation planning based on stakeholder engagement. Upon completion of this activity, the project will work with these newly trained municipal officials to carry out participatory governance meetings with local citizens and organizations, with the aim of considering the feasibility and advantages of different possible management models and providing relevant citizen feedback. These activities will be part of the TA provided by the CATS in Component 1.

E. Environment

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 project has developed a Framework for Environmental and Social Management that builds on the smaller-scale Honduras OBA Water and Sanitation Conceptual Framework for Environmental and Social 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 Framework for Environmental and Social Management was originally prepared by FHIS and has been modified by UAP to reflect its (UAP's) role as the current implementing agency. This project will not finance works on any existing or future dams.

F. Safeguard policies

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

The implementing agency, SEFIN's UAP, already has in-house environmental and water engineers (one of each) and a technical specialist. The project will add additional capacity in terms of a specialist who will be responsible for the project's environmental and social needs. Other consultants may be hired to provide additional environmental capacity as needed.

The Framework for Environmental and Social Management and Indigenous People's Policy Framework were released to the InfoShop May 2, 2007 and were made available in-country on May 8, 2007.

G. Policy exceptions and readiness

This project complies with all applicable Bank policies.

Annex 1: Country and Sector or Program Background

HONDURAS: Water and Sanitation Sector Modernization Project

Country Issues

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 is US\$1,170.⁹ The capital of Honduras is Tegucigalpa, located in the highlands, and the most important cities are San Pedro Sula, on the northern coast, which is highly industrialized, and Choluteca on the southern coast, which is an agricultural center for diverse products such as shrimp, meat, and dairy products. The country has a diversified economy, based on international trading of agricultural commodities and manufactures, which makes it the most open economy in Central America: exports plus imports amounted to 106 percent of gross domestic product in 2005.

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

Overall, the income of 50 percent of Hondurans remains below the poverty line. Poverty and inequality are widespread. Roughly one-half of the population resides in rural areas. Extreme poverty, while declining nationally, has actually increased in rural areas by about 10 percent (although this is mainly attributable to the devastating effects of Hurricane Mitch).

Honduras reached the Heavily Indebted Poor Country (HIPC) Completion Point in April 2005 and benefited from the Multilateral Debt Relief Initiative (MDRI) in July 2006. Honduras's external debt will remain sustainable over the medium term if fiscal deficits and rates of growth are maintained at their current levels. Total external public debt fell from around 70 percent of GDP in 2000 to 52 percent in 2005 (before MDRI), while external debt service fell from 8.2 percent of exports in 2003 to an estimated 4.4 percent in 2005. Under those circumstances, the economy can withstand temporary external shocks such as those involving the terms of trade or adverse weather conditions. However, if the fiscal balance is allowed to deteriorate and growth falls significantly below 4.5 percent per year, the debt burden would become unsustainable again.

In 2005 Hondurans elected José Manuel Zelaya as President in the seventh successive peaceful, democratic change of government since 1982. The Zelaya administration has made poverty reduction its top priority, endorsing the current Poverty Reduction Strategy Paper (PRSP). The four pillars identified by the President for his administrative mandate (January 2006 to January 2010) are:

⁹ Atlas methodology.

- Equitable economic growth for employment generation;
- Good governance through state modernization and civic participation;
- Environmental protection and risk management; and
- Development of human capital.

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

Sector issues

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 waterborne.

The GoH Poverty Reduction Strategy ranks expanding water and sanitation services as a priority. This strategy is supported by the United Nations Development Programme's (UNDP's) recently released Millennium Development Goals (MDGs) Report for Honduras, which calls for a significant increase in access to water and sanitation services for the poor.

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.

Investment needs exceed the GOH's financial capacity, thereby requiring additional support in the form of donations, diverse subsidies, and/or loans. Some implications of this problem are:

- The aforementioned low service coverage vis-à-vis GOH's development goals and MDGs;
- Infrastructure with insufficient capacity to meet total demand;
- Centralized management with insufficient resources to meet municipal needs;
- Incomplete works, mainly due to lack of resources;
- Current project portfolios with extended development and execution timelines.

A central issue and concern of the Government is governance. The Water Supply and Sanitation (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, and 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 tradeoffs between affordability and expansion of coverage to poorer communities, with the sector's need for financial viability. Policymakers pursue multiple unaligned objectives, often leaning toward the attainment of short-term political interests. Users have had little opportunity to hold utilities accountable. Customer orientation could help depoliticize and balance the accountability framework of utilities and help prevent political capture.

The National Autonomous Water and Sewer Service (*Servicio Autónomo Nacional de Acueductos y Alcantarillados*, SANAA) 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. Two good practice examples of how services can be improved when autonomous service providers are established are Puerto Cortés and San Pedro Sula.

In 2003, Honduras passed the Drinking Water and Sanitation Sector Framework Law (*Ley Marco del Sector Agua Potable y Saneamiento*), which 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.

Decentralization (to the local level) and deconcentration (to autonomous service providers) should improve services by making providers more accountable to consumers. However, the reforms are a large task given limited capacity at the municipal level. Municipalities are looking to the few good practices of management of services such as Puerto Cortez and San Pedro Sula as examples of creating an autonomous and accountable service provider. Designing and implementing good municipal management models that are accountable to their customers and function in a transparent manner is key to improving service. Table 2 provides an overview of the current institutional and operational situation of the medium-size cities of the country.

Table 2: Summary of Institutional and Operational Situation in Medium-size Cities

	La Ceiba	El Progreso	La Lima	Choloma	Comayagua	Choluteca	Danli	Puerto Cortez	Siguatope que
Water Services Managed By:	SANAA	SANAA	Municipal Department	Municipal Department	SANAA	Mixed Company	SANAA	Mixed Company	SANAA
Decentralization Process Status	Ongoing	Ongoing	—	—	Ongoing	Complete	Ongoing	Complete	Ongoing
Current Coverage Level (water)	60%	NA	40%	NA	75%	65%	95%	96.5%	70%
Current Coverage Level (sewer)	38%	NA	10%	NA	50%	29%	65%	75%	35%
Number of Water Connections	15,000	12,800	NA	NA	9,832	11,941	10,450	10,412	7,056
Number of Sewer Connections	9,500	NA	NA	NA	6,039	5,586	7,150	6,000	3,876
Unaccounted -for-Water	60%	NA	65%	NA	30%	NA	NA	NA	15%
Water Availability	479 lcd	NA	480 lcd	NA	375 lcd	188 lcd	105 lcd	NA	93 lcd
Total Income (Expenses) MLPs	22.6 (25.2)		2.2 (3.0)		.445	22.26 (23.59)	NA	NA	4.115 (10.876)

Source: World Bank from utility data, to be confirmed during implementation.

After decentralization of service delivery, SANAA is expected to remain as a technical assistance agency supporting small service providers and 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, the structure of CONASA as a council instead of an agency is a challenge to its ability and purpose to provide direction to the sector. There is a need to strengthen CONASA to effectively assume its responsibilities. Simultaneously, there is a need to re-engineer SANAA and strengthen it in its new role to support CONASA technically. 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.

The Honduran Fund for Social Investment (*Fondo Hondureño de Inversión Social*, FHIS) has also been making investments in the sector over the past five years as part of the Government's efforts to build capacities at the municipal level in the WSS sector.

The GoH has prepared (with World Bank and Public-Private Infrastructure Advisory Facility [PPIAF] assistance) the Strategic Plan for Modernization of the Potable Water and Sanitation Sector (PEMAPS) and the National Water and Sanitation Plan (PNAPS), which all seek to implement the organization and reform of the sector, as mandated in the 2003 Drinking Water and Sanitation Sector Framework Law and its MDGs. This plan already has wide acceptance in Honduras and provides direction to donor interventions in the sector.

With 57 percent of SANAA's connections, the most significant transfer of services from the national utility to municipalities will be that of Tegucigalpa. This is a complex and politically charged process that deserves special attention because of its political significance in the overall implementation of the sector vision. The Tegucigalpa Transfer is one of the 19 projects in PEMAPS and represents 41 percent of PEMAPS' total costs. The Tegucigalpa Transfer has a decisive influence on the execution of 12 of the other 18 PEMAPS projects—especially the re-engineering of SANAA, which would fail without this particular transfer. Currently, the Transfer process is not progressing rapidly enough to meet the October 2008 deadline. Again, the high and still unconfirmed issue of the severance payments for SANAA is also a major issue to be resolved for this specific transfer. While loss reduction can improve services in Tegucigalpa in the short term, water scarcity in the capital will require high-cost solutions to sustain and expand services in the long run.

In December 2006, the GoH approved the Law of Transparency and Access to Public Information that governs the national public policy activity. This law obliges public institutions to create effective mechanisms that promote transparency in order to combat corruption and illegal activity in public policy. The law offers an opportunity to strengthen WSS sector institutions and represents an important framework for promoting transparency within the government and effective participation from stakeholders in project activities. However, significant work is still necessary to meet the new requirements since this law was recently approved. More transparency and citizen participation in the water sector can help to promote better service delivery. The supply of information and demand for transparency in the water sector in Honduras need to be strengthened.

Annex 2: Major Related Projects Financed by the Bank and/or other Agencies

HONDURAS: Water and Sanitation Sector Modernization Project

This proposed Bank project builds on earlier work that the Public-Private Infrastructure Advisory Facility (PPIAF) and the Bank have done in helping develop the *Plan Estratégico de Modernización del Sector de Agua Potable y Saneamiento* (Strategic Plan for Modernization of the Potable Water and Sanitation Sector, PEMAPS), the *Plan Nacional de Agua Potable y Saneamiento* (National Drinking Water and Sanitation Plan, PNAPS), and the preparation of Tegucigalpa for the transfer of services. In addition, the new Output-Based Aid (OBA) for Water and Sanitation Facility, financed by the Global Partnership for Output-Based Aid, will provide subsidies for new or improved water and sanitation household connections. Also, the Japanese Government has provided support to the development of this proposed Bank operation through the Policy and Human Resources Development grant to prepare the studies necessary to formulate this project.

The OBA Water and Sanitation Facility in Honduras is a US\$4.6 million grant that seeks to improve the access of low-income households in rural and peri-urban communities to water and sanitation services through one-time subsidies for increased connections and/or improved water quality received. Municipalities, *juntas de agua*, and private companies or other potential implementers must apply to the facility for inclusion and must obtain funding (bridge financing—before receiving the subsidy) to finance works and activities necessary to create the connections and/or improved water quality. Subsidies will be released only upon a verified already agreed-upon output. The Facility supports the *Ente Regulador de los Servicios de Agua Potable y Saneamiento* (Water and Sanitation Sector Regulator, ERSAPS) in its institutional role as regulator since it is responsible for verifying the outputs. Since this donation has just been approved and should have a signed grant agreement very soon, it has not yet started implementation and so there are no Implementation Progress or Development Objective ratings yet.

Current Bank projects still under implementation in Honduras that include water components include the Barrio Ciudad and Rural Infrastructure Projects. Both projects seek to increase or improve access to water and sanitation services among work in other sectors but Barrio Ciudad focuses on urban poor communities while the Rural Infrastructure Project (PIR) focuses on rural areas. Both projects also seek to improve municipal capacity for service delivery and promote decentralization, as does the proposed *Proyecto de Modernización del Sector Agua y Saneamiento* (Water and Sanitation Sector Modernization Project, PROMOSAS). Barrio Ciudad and PIR's current Implementation Progress and Development Objective ratings are both (for each project) moderately satisfactory.

The Honduras Sustainable Coastal Tourism Project, also a Bank project, closed in December 2005. This project focused on managing the environmental impacts of tourism on the North Coast (which has implications for water resource management) by increasing municipal capacity to sustainably manage impacts on the North Coast and supporting an enabling institutional environment. By strengthening local governance

institutions, this project also supported decentralization. This project's Implementation Completion Report rated the project as highly satisfactory.

Other related Bank projects include the Natural Disaster Management Mitigation Project for US\$12.6 million, the Copan Valley Development Tourism Project for US\$13.7 million, and the Land Administration Project for US\$26 million.

Many donors are active in Honduras and the Water Supply and Sanitation (WSS) sector is no exception. Other donor projects include: the Inter-American Development Bank's (IADB's) Potable Water and Sanitation Investment Program Loan, the Swiss Agency for Development and Cooperation's support to CONASA, the Spanish Fund for Assistance and Development's support to the *Servicio Autónomo Nacional de Acueductos y Alcantarillados* (National Autonomous Water and Sewer Service, SANAA), and the Japanese Government's support to Tegucigalpa to alleviate its current water woes.

As mentioned in the "Partnership Arrangements" section, the Bank is coordinating efforts in the sector with the other major donor, the IDB, to provide consistent and complementary technical advice and financial support for the reform process. The IDB currently has the Potable Water Supply and Sanitation (WSS) Investment Program Loan (US\$26 million) to provide assistance to utilities in small and medium-size municipalities, and an additional, US\$30 million financing was recently decided. The IDB has also committed limited funds (US\$2 million) for studies in Tegucigalpa.

On the other hand, the Bank project will be more comprehensive and promote the long-term sustainability of the modernization process by providing institutional strengthening assistance to the national agencies initiating the sector's reform and specific investments for selected projects. There is agreement that once a decision about reform in Tegucigalpa is made, both banks will develop consistent assistance for the process. Other IDB projects include the Program for Potable Water and Sanitation for US\$26 million, the Natural Resources River Basin Management US\$25 million project, the Lempa Trinational Watershed Management Project for US\$3.3 million, and the Stage II Environmental Management of the Bahia Islands Project for US\$12 million.

The Central American Bank for Economic Integration has five loans. The first is the Modernization of the Comayagua Valley River Basins for US\$12.8 million, the second is the Tegucigalpa Groundwater Water Supply Project for US\$13.6 million, the third is a US\$750,000 project for the Amapala Desalination and Drinking Water Project, and the last two are both Basic Infrastructure projects for Tela Bay for US\$6 million.

Other projects include the Nordic Development Fund's US\$2 million Water and Sanitation Program with the *Fondo Hondureño de Inversión Social* (Honduran Fund for Social Investment, FHIS), and the Organization of the Petroleum Exporting Countries' (OPEC's) Sula Valley Flood Protection project and its Potable Water and Sanitation investment with FHIS, each for US\$5 million. Finally, Kuwait has a Coyolar Dam and Irrigation System Improvement Project for US\$7 million with the *Secretaria de Recursos Naturales y Ambiente* (SERNA).

The Bank team is in contact with the Swiss Agency for Development and Cooperation (COSUDE), which is currently providing support to SANAA/CONASA in its future role under the *Ley Marco* and expects to coordinate interventions more extensively during project implementation.

The Spanish Fund for Assistance and Development has given a large (US\$27.3 million) loan to SANAA to improve the operation of Tegucigalpa's water network. Among other activities, this loan will finance the establishment of network plans, leak-reduction activities, the creation of a SCADA (Supervisory, Control and Data Acquisition) system, and the installation of macro- and micro-meters. The loan will also rehabilitate the water network for two Tegucigalpa neighborhoods. SANAA's *Unidad Ejecutora del Proyecto de Optimización Operativa de Tegucigalpa* will implement this loan expected to start mid-to-late 2007. In addition, this unit will also implement the leak-reduction component of PROMOSAS in Tegucigalpa, making it possible for the Bank to build on the results of the Spanish loan. Other Spanish projects include the US\$5.3 million Construction of Canal Calan and the US\$2.7 million Water Supply and Operation of Maintenance of the Sewer System, also with SANAA.

In another effort to improve Tegucigalpa's serious water situation, the Japanese Government has designed an emergency drinking water project that finances the replacement of water trunks and other urgent leak-reduction measures.

Finally, Italy has two related projects in Honduras. The first is a Water and Sewer Infrastructure Project for US\$26.4 million and the second is an Aqueduct Construction Project for Nacaome for US\$24 million.

Annex 3: Results Framework and Monitoring

HONDURAS: Water and Sanitation Sector Modernization Project

Methodology and Objectives

The project-level monitoring and evaluation (M&E) framework will track progress in implementation, measure intermediate outcomes, and evaluate project impacts. The framework outlines key performance indicators, data collection methods, a timetable for collection, and responsible agencies. This framework will be used to supervise and monitor the implementation of the project. The *Unidad Administradora de Proyectos* (Project Administration Unit, UAP) has monitoring and evaluation facilities and it can assume this coordinating role.

The methodology for monitoring will be in line with the Law of Transparency and Access to Public Information that was approved by the Government of Honduras (GOH) in December 2006 and that governs the national public policy activity. This law obliges public institutions to create effective mechanisms of transparency and to combat corruption and illegal activity in public policy matters. The UAP will establish accountability mechanisms in the different participating institutions to comply with the Law of Transparency and Access to Information under the scope of the project.

Tools and Data

The tools to be used for the monitoring and evaluation of the project are the following:

- ***Progress Reports.*** A mechanism for annual progress reports will be established for describing the main achievements of the project. They will include complete information on contracts, procurements, disbursements, detailed information on the project's financial status, inputs, number of beneficiaries, and other outputs, and a range of additional operational indicators to track project status. These reports will be produced by the UAP and they will be used by the Interagency Coordination Committee and the World Bank.
- ***Results-based Monitoring.*** The main sources of information for this Results-based M&E will be: (a) ***Baseline and Follow-up Household Survey.*** *The survey will use a non-representative household sampling methodology.* This survey will be designed mainly to collect information for the design and economic analysis of the master plans; in particular, it would assess the benefits of the interventions that are relevant for that evaluation. Additional indicators that allow measuring the overall performance of the project should also be included; (b) ***Participatory Focus Group Discussions:*** The household surveys will be complemented by participatory focus groups in project communities. Focus group discussions with beneficiaries in project communities will be held in order to build a profile of the project impact; and (c) ***Consumer satisfaction surveys:*** Sample consumer satisfaction surveys of beneficiaries in urban areas will be used to determine the

status of project implementation in the urban area. Consumers will also be quizzed on their perception of the transparency of sector agencies.

Institutional Arrangements

The UAP will be responsible for the overall management and implementation of the Project M&E Framework. This will include maintaining the databases, managing the flow of information, and producing periodic monitoring reports. It will be directly responsible of the Progress reports and the results-based M&E.

Monitoring the progress toward Millennium Development Goals (MDGs) and national sectoral goals:

Since Honduras is an International Development Association (IDA) country and this is a water and sanitation operation, the project will comply with IDA14 Results Management System (RMS), and therefore World Health Organization/United Nations Children's Fund (UNICEF) Joint Monitoring Program (JMP) definitions of improved drinking water¹⁰ and improved sanitation services¹¹ will be used.

The GoH has two instruments to monitor with reasonable frequency the country's progress toward the water supply MDG (halving the percentage of the population without access to safe drinking water). The first one is the *Sistema de Información de la Estrategia para la Reducción de la Pobreza* (SIERP) (<http://www.sierp.hn>), which systematically monitors the indicators of the Country Poverty Alleviation Strategy. The water supply and sanitation MDGs are included among those indicators. The source of information for the system is the National Household Survey (*Encuesta Nacional de Hogares de Propósitos Múltiples*, ENHPM), which is taken biannually by the *Instituto Nacional de Estadísticas* (INE).

The second instrument is the *Sistema de Gerencia Basado en Gestión por Resultados*, which is carried out by the GoH. This system builds on the MDGs and the sectoral goals. There are four objectives to achieve by 2010 in the water and sanitation sector: (1) increase to 89 percent the population with access to water, (2) increase to 74 percent the population with access to drinking water, (c) achieve 80 percent coverage in sanitation, and (4) achieve 35 percent of sewerage systems with installed purification. The first three indicators have a baseline already computed in 2005, and a system to monitor them is already defined.

Importantly, CONASA/SANAA, with financial support from ACDI (Canada International Development Agency) and with technical assistance from the World Bank, is developing an information system for the sector that will provide quality information on sectoral investments and will enable measuring progress toward the water supply and sanitation MDG.

¹⁰ Piped water into dwelling, plot, or yard; public tap/standpipe; tube well/borehole; protected dug well, protected spring, rainwater collection.

¹¹ Flush or pour-flush to: piped sewer system, septic tank, pit latrine; ventilated improved pit latrine, pit latrine with slab, composting toilet.

The preliminary assessment of the capacity of the country to measure progress toward the water supply and sanitation MDG indicates that the indicators are reasonably monitored. The project will work with INE and the National Government to ensure that the MDG monitoring system remains in place and properly working, and to ensure the indicators' definition is in line with JMP standards.

The matrix that follows provides a results framework for measuring project outcomes.

Results Framework

Project Development Objective	Project Outcome Indicators	Use of Project Outcome Information
The project development objectives are: (a) to improve the sustainability, efficiency, and reliability of the Recipient's WSS services in Eligible Municipalities; and (b) to improve the performance of the Recipient's national WSS sector institutions in the exercise of their respective roles in conformity with the WSS Sector Framework Law.	<ul style="list-style-type: none"> • 5 of the WSS utilities reach cost recovery (ratio total income/total operative cost equal to one). • 5 of the WSS utilities increase by 20% the ratio of revenues per volumetric unit of water produced. • 5 of the participating WSS utilities increase service continuity (hours of service per day) by 6 hours or more • At least 90% of the SANAA systems are transferred to the municipalities. • At least 6 design proposals of autonomous service providers approved by ERSAPS. • CONASA issues the new financial policy of the sector. 	<ul style="list-style-type: none"> • To assess the extent to which the project effectively contributed to improving the water supply and sanitation services and supporting national institutions. • To prepare a possible follow-up operation.
Intermediate Outcomes	Intermediate Outcome Indicators	Use of Intermediate Outcome Monitoring
Component 1: Support to medium-size municipalities to create autonomous service providers and invest in efficiency, rehabilitation, and expansion of service delivery		
Efficient and autonomous municipal service providers established.	<ul style="list-style-type: none"> • At least 7 municipalities have signaled their intention to create an autonomous service provider in the spirit of the <i>Ley Marco</i> by a letter to the implementing agency in order to enter this component. • At least 10,000 additional people with access to improved sanitation services.^a • Improved customer rating of water supply and sanitation as expressed in increase by TBD(*)^b percent in population rating service as satisfactory in participating towns. 	<ul style="list-style-type: none"> • To assess whether project design is producing intended institutional results and determine any changes for further advisory support, training, and other technical assistance. • To inform the ongoing process of strengthening institutional arrangements at the municipal level.
Investment in system efficiency rehabilitation and expansion.	<ul style="list-style-type: none"> • At least 4 utilities in participating 	<ul style="list-style-type: none"> • To showcase the potential

	municipalities reduce levels of Non-Revenue Water (including apparent losses, real losses, and unbilled authorized consumption) by 10 percentage points.	for NRW reduction and spur further investments by GoH and other donors.
Component 2: Tegucigalpa Non-Revenue Water Reduction Program		
Reduced Non-Revenue Water in service area of 200,000 people in Tegucigalpa.	<ul style="list-style-type: none"> • Non-Revenue Water (including apparent losses, real losses, and unbilled authorized consumption) reduced by 15 percentage points in service area. • Ratio of total income/m³ produced in targeted area increases by 20%. 	<ul style="list-style-type: none"> • To assess whether project design is producing intended results and determine any changes for further investments. • To showcase the potential for NRW reduction and spur further investments by GoH and other donors. • To pilot and test performance-based contracting as an instrument to reduce NRW.
Component 3: National and Regional Institutional Strengthening		
Improve institutional and technical capacity at the national level reinforcing the sector actors (ERSAPS, CONASA, SANAA) to fulfill their formal roles.	<ul style="list-style-type: none"> • The 3 sector agencies (SANAA, CONASA, ERSAPS) have substantially complied in applying the <i>Ley de Transparencia y Acceso a la Información</i>. • SANAA / Tegucigalpa has complied with legal requirements for transfer to municipality. 	<ul style="list-style-type: none"> • To assess whether project design is producing intended institutional results and determine any changes for further advisory support, training, and other technical assistance. • To inform the ongoing process of strengthening institutional arrangements at the national and regional levels.
Component 4: Project Management		
Effective project management in place to ensure quality project implementation.	<ul style="list-style-type: none"> • Cumulative percentage of disbursement targeted according to disbursement plan is met. 	<ul style="list-style-type: none"> • To monitor project implementation and provide early warning about implementation capacity.

a. At least having improved sanitation as per JMP definition.

b. The percentage will be determined after baseline survey is taken approximately six months after expected effectiveness date.

Indicators	Baseline	YR1	YR2	YR3	YR4	YR5	YR6	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
Project Outcome Indicators										
5 of the WSS utilities reach cost recovery (ratio total revenue / total operative cost equal to one).	04/30/08 (*) ^a	—	—	3	3	4	5	Annually	Providers' annual report	Municipalities collect the information from providers and report to UAP
5 of the WSS utilities reach a rate of revenues per volumetric unit of water produced of at least 80%.	04/30/08 (*)	—	—	3	3	4	5	Annually	Providers' annual report	Municipalities collect the information from providers and report to UAP
5 of the WSS utilities increase service continuity (hours of service per day) by 6 hours or more	04/30/08 (*)	—	—	3	3	4	5	Annually	Providers' annual report	Municipalities collect the information from providers and report to UAP
At least 90% of the SANAA systems are transferred to the municipalities.	27%	30%	45%	60%	70% ^a	80%	90%	Annually	Annual Progress Report	UAP
At least 6 design proposals of autonomous service providers approved by ERSAPS.	2	2	2	3	4	5	6	Annually	Annual Progress Report	UAP
CONASA issues the new financial policy of the sector.	NO	—	—	—	YES	YES	YES	Annually	Annual Progress Report	UAP
Intermediate Outcome Indicators										
COMPONENT 1										
At least 7 municipalities have signaled their intention to create an autonomous service provider in the spirit of the <i>Ley Marco</i> by a letter to the implementing agency in order to enter this component.	2	2	5	7	7	7	7	Annually	Annual Progress Report	UAP
At least 10,000 additional	04/30/08	—	—	—	+5,000	+7,500	+10,000	Annually	Provider's annual	Municipalities

Indicators	Baseline	YR1	YR2	YR3	YR4	YR5	YR6	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
people with access to improved sanitation services. ^b	(*)								report	collect the information from providers and report to UAP
Improved customer rating of water supply and sanitation as expressed in increase by TBD(*) percent in population rating service as satisfactory in participating towns.	04/30/08 (*)							Baseline & YR5	Consumer satisfaction Survey	UAP
At least 4 utilities in participating municipalities reach levels of Non-Revenue Water (including apparent losses, real losses and unbilled consumption) by 10 percentage points.	04/30/08 (*)	--	--	--	1	2	4	Annually	Providers' annual report	Municipalities collect the information from providers and report to UAP
COMPONENT 2										
Non-Revenue Water (including apparent losses, real losses and unbilled authorized consumption) reduced by 15% points in service area.	40% 04/30/08 (*)	40%	40%	40%	35%	30%	25%	Annually	Provider's annual report	Municipalities collect the information from providers and report to UAP
Ratio total income/m ³ produced in targeted area increases by 20%	0%	0%	0%	0%	10%	15%	20%	Annually	Provider's annual report	Municipalities collect the information from providers and report to UAP
COMPONENT 3										
The 3 sector agencies (SANAA, CONASA, ERSAPS) have substantially complied in applying the <i>Ley de Transparencia y Acceso a la Información</i> .	NO	NO	YES	YES	YES	YES	YES	Annually	Annual Progress Report	UAP
SANAA / Tegucigalpa has	NO	NO	NO	NO	YES	YES	YES	Annually	Annual Progress	UAP

Indicators	Baseline	YR1	YR2	YR3	YR4	YR5	YR6	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
<p>complied with legal requirements for transfer to municipality.</p> <p>COMPONENT 4</p> <p>Cumulative percentage of disbursement targeted according to disbursement plan is met.</p>	0%	6%	17%	34%	54%	74%	100%	Annually	UAP annual report	UAP

a. 04/30/08 (*) To be determined or confirmed after baseline survey is taken approximately 6 months after expected effectiveness date.

b. At least having improved sanitation as per JMP definition.

Annex 4: Detailed Project Description

HONDURAS: Water and Sanitation Sector Modernization Project

The project development objectives are: (a) to improve the sustainability, efficiency, and reliability of the Recipient's WSS services in eligible municipalities; and (b) to improve the performance of the Recipient's national WSS sector institutions in the exercise of their respective roles in conformity with the WSS Sector Framework Law.

The success of the project will be measured using the following sets of indicators:

(a) The improvement in the sustainability, efficiency, and reliability of the Recipient's WSS services in Eligible Municipalities will be measured through:

<u>Sustainability:</u>	Cost recovery level measured as the ratio of total revenues to total operative cost.
<u>Efficiency:</u>	Revenues per volumetric unit of water produced.
<u>Reliability:</u>	Hours of service per day.

(b) The improvement in the performance of the Recipient's national WSS sector institutions in the exercise of their respective roles in conformity with the WSS Sector Framework Law will be measured for each institution:

<u>SANAA:</u>	Number of systems transferred ¹² to the municipalities.
<u>ERSAPS:</u>	Number of design proposals of autonomous service providers approved by ERSAPS.
<u>CONASA:</u>	CONASA issues the new financial policy of the sector.

Project components

The proposed operation would assist the Government of Honduras (GOH) 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 quality of service, 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.

The following section provides further details on the project's components and sub-components. Amounts show total component costs with loan proceeds in parentheses.

¹² As attested by a notary act.

Component 1: Support to medium-size 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-size cities through a combination of technical assistance for reforms and investments for infrastructure. 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 create a number of good practices as a basis to scale-up at a later date. The component will provide incentives for reforms, given that municipalities will have to substantially implement some reforms and have completed relevant and quality master plans in order to receive support for investments for rehabilitation and expansion.

Municipalities with an urban population between 40,000 inhabitants and 300,000 inhabitants,¹³ that intend to transfer their water supply or sanitation services to a municipal service provider as mandated by the *Ley Marco* are eligible to participate in this component.¹⁴ Groups of adjacent municipalities with smaller urban populations who unite to establish an aggregated service provider to serve a total urban population between 40,000 and 300,000 inhabitants can also participate.

This component uses a demand-based, stepped approach to support municipalities during all reform steps. It will finance investments in municipalities that are not pre-defined. Hence, it is important to understand the proposed stepped approach and the various sub-components. The paragraphs below describe the project by outlining (a) the stepped approach, and (b) the sub-components including key inputs and outputs and how they address sector issues.

Stepped approach

Figure A4.1 presents the stepped approach for medium-size municipalities. All municipalities within the targeted population bracket that intend to transfer their services can participate in the project.¹⁵ In Step 1, municipalities receive technical assistance focused on designing the service provider’s structure and responsibilities. Once the design proposal has been sent to and reviewed by ERSAPS (the regulator), municipalities qualify for Step 2 assistance including support to provide the municipal supervision units and the service providers with the fundamental tools to conduct its activities, and start improving the efficiency of service provision. Once services¹⁶ are transferred, municipalities move to Step 3. In Step 3, municipalities qualify for investments in system rehabilitation and expansion.

It is expected that approximately 6 to 9 municipalities will participate in Component 1. While most will enter the process at Step 1, some might have already reached the qualification criteria

¹³ According to the 2001 Census.

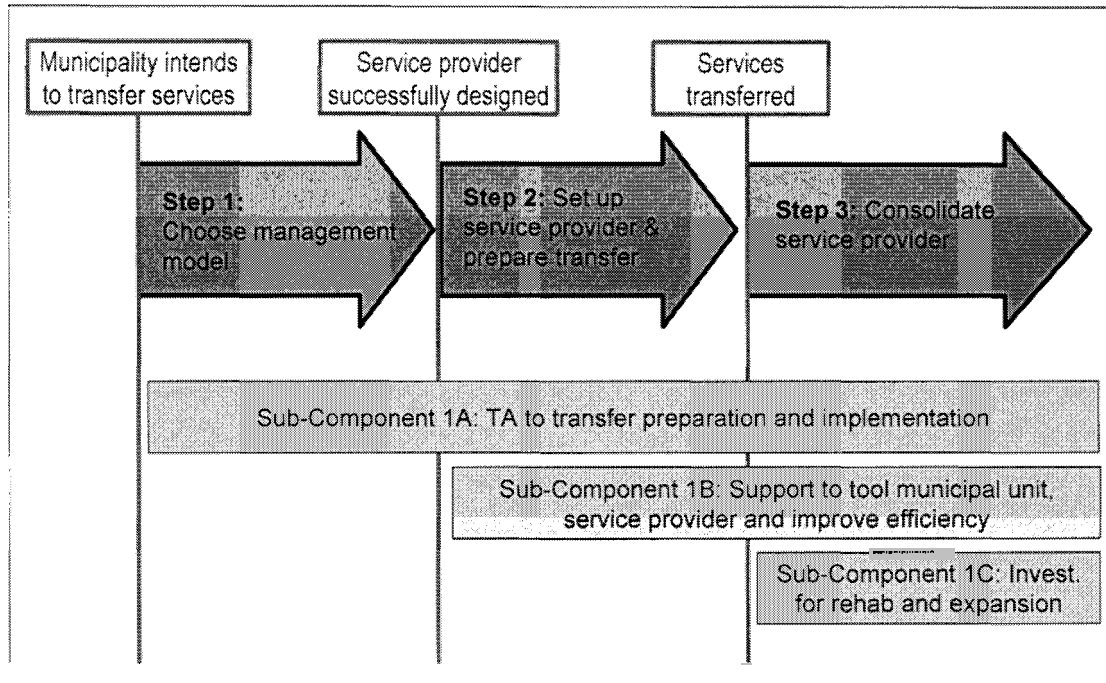
¹⁴ The cities within this population bracket are: Choloma, Choluteca, Comayagua, Danli, El Progreso, La Ceiba, La Lima, Puerto Cortes, and Siguatepeque. In addition, an association of municipalities around Villanueva has also announced potential interest.

¹⁵ Municipalities will signal their intention to create an autonomous service provider in the spirit of the *Ley Marco* by a letter to the Implementing Agency in order to enter this component.

¹⁶ Either water supply or sanitation is sufficient.

to enter at Step 2 or even Step 3. However, not all municipalities entering at Step 1 are expected to reach Step 2 or Step 3. This will create a certain degree of competition among the municipalities.

Figure A4.1: Stepped Approach



Sub-Components

Activities under Sub-Components 1A and 1B will be provided as grants without counterpart funding from the municipalities, while activities under Sub-Component 1C will require matching funds from municipalities. The maximum amount that a given municipality can receive under each sub-component will be capped based on its number of connections¹⁷ (Sub-Components 1B and 1C) and the performance of its service provider (Sub-Component 1C), in order to ensure that enough investment funding is available for those municipalities that reach Step 3 to have a significant impact on service quality and coverage.

Table A4.1 presents a summary of Component 1. A more detailed description of the subcomponents follows below.

¹⁷ The sum of the number of water and sewer connections of the entity to be transferred.

Table A4.1. Summary of Component 1

	Sub-Component 1A: Technical Assistance for Transfer Preparation	Sub-Component 1B: Support to Tool Municipal Unit and Service Provider, and Improve Efficiency	Sub-Component 1C: Investment for Rehab and Expansion
Eligible Expenditure	<ul style="list-style-type: none"> • Technical assistance to municipalities and service providers. • Preparation of business plans and master plans. • Design and supervision of works of Component 1C. 	<ul style="list-style-type: none"> • Goods / works to establish service provider. • Goods / works to establish municipal supervision and control unit. • Technical and commercial efficiency improvement investments (including design / supervision if needed). 	<ul style="list-style-type: none"> • Water supply: Coverage extension, rehabilitation of existing networks or plants, increase in water production capacity. • Sanitation: On-site improved sanitation (as per Joint Monitoring Program definition), piped sewerage (standard, small-bore, and condominal). • Wastewater treatment: Simple treatment systems such as stabilization ponds, artificial wetlands, and communal septic tanks.
Ceiling of Investments Financed	Not applicable (services provided centrally through the <i>Consultores de Apoyo a la Transferencia de los Servicios</i> [CATS]).	<ul style="list-style-type: none"> • US\$50,000 plus US\$10 per connection before autonomous service provider starts operating. • US\$5 per year and connection after autonomous service provider starts operating. 	Using formula based on number of connections and performance.
Financing Arrangement and Municipal Participation	No municipal matching funds.	No municipal matching funds.	<ul style="list-style-type: none"> • Water supply and sewerage: Municipality pays one-third of total cost of works. • On-site sanitation and wastewater treatment: Municipality pays 20% of works.^a

a. In municipalities that choose to extend coverage through on-site sanitation, the Project will focus on financing activities, equipment, and works that allow the utility to promote such a technology (for example, multifamily septic tanks, tankers to empty septic tanks, sludge-processing facility, and so forth). Direct subsidies to on-site sanitation facilities construction will be supported only if it is established that this can be done in a sustainable manner.

Sub-Component 1A: Technical Assistance for transfer preparation (total US\$3.7 million, IDA US\$3.7 million)

Sub-Component 1A will consist of providing technical assistance to the participating municipalities while they design the new service provider and plan and implement the services transfer process (whether from SANAA or from a municipal department).

When municipalities request TA from this component, teams of consultants (*Consultorías de Apoyo a la Transferencia de los Servicios*, CATS) will be hired by the UAP in conjunction with the municipalities. CATS will (a) help municipalities identify an appropriate management model; (b) prepare the legal, financial, technical, and social instruments required to implement them; (c) assist in planning the systems transfer process from SANAA to the municipalities (when relevant) and service provider creation; (d) plan the efficiency improvement measures under Sub-Component 1B; and (e) coach new service providers in their new task. A consulting team would typically be led by a senior sector specialist and include a business and financial analyst, an engineer, and a social and communication specialist.

The TA will include support mechanisms to improve governance in municipal water management, to promote transparency and access to information, and to ensure civil society and consumer participation throughout the decentralization process. The CATS, with support from CONASA, will also assist the municipalities in setting up a municipal WSS policy committee and developing a municipal WSS policy. In addition, the CATS, with support of ERSAPS, will assist municipalities in setting up a municipal unit to supervise the autonomous service provider and define tariffs (*Unidad de Supervisión y Control*). Particular attention will be given to the design of management models that reflect the need to establish local accountability mechanisms and channels between the consumers and the newly formed service provider. The project will draw on the experience of the *Asociación de los Municipios de Honduras* (Association of Municipalities of Honduras, AMHON) and the outcome of ongoing activities in this field in the country.¹⁸ This would help to promote a change in attitude and behavior among consumers, providers, and municipalities toward more participatory processes toward better governance, transparency, and accountability in the water sector.

As the service provider design is reviewed by the regulator and moves toward its establishment, the type of services the CATS provide will evolve to other areas, such as the improvement of commercial practices, the implementation of effective management systems, the financial and technical planning of operations and maintenance, and so forth. At this stage, the CATS will also help the service provider establish a business plan to implement its responsibilities under the municipal WSS policy.

In addition, the project will finance the revision or preparation of a master plan for the service provider. This master plan will include activities aimed at improving efficiency, service quality, and coverage levels, and will include a financial and economic analysis to ensure the soundness of the various activities being proposed. Only activities that make economic sense and for which financing can realistically be expected will be integrated in the master plans. Finally, this sub-component will also finance the design and supervision of works conducted under Sub-Component 1C.

This sub-component is administered centrally by the UAP and consists of consultant services provided through the CATS and others. There is no pre-established maximum investment amount for each city.

¹⁸ The “Consumer Accountability in Urban Water Supply Delivery” study, funded by the World Bank Water Anchor; and the “Gobierno Abierto y Participativo,” funded by World Bank Institute and the Bank-Netherlands Water Partnership Program (BNWPP).

Sub-Component 1B: Support to tool service provider and improve efficiency (total US\$6.1 million, IDA US\$5.5 million)

Once a municipality has successfully¹⁹ identified and designed a management model, the municipality can start accessing this sub-component to obtain support in implementing the CATS' recommendations and creating the municipal WSS institutions (supervision unit and policy committee) and the service provider, as planned for in the *Ley Marco*.

This sub-component will finance activities such as the rehabilitation or construction of offices, the acquisition of basic management tools, such as office inventory, acquisition of a commercial system, information systems, vehicles, equipment, and so forth. Other activities such as communication campaigns are also possible.

This sub-component will also finance rapid efficiency gains. Whenever possible, the investments will be executed in a manner to encourage the municipality to experiment with innovative, cost-effective approaches (performance-based contracts, outsourcing of non-core activities, and so forth). The following types of investments are included:

- Technical (such as leak detection, network sectorization, meter installation)
- Commercial (billing and collection, reduction of Non-Revenue Water).

The investment ceiling for a given city will be US\$50,000 plus US\$10 per connection before the services are transferred to the autonomous service provider, and US\$5 per connection per year after the services are transferred to the new service provider. Municipalities and service providers will be free to propose efficiency improvement activities of their choice within these maximum investment amounts as long as they are consistent with the CATS recommendations (in terms of technical and economic viability).

Sub-Component 1C: Investment for system rehabilitation and expansion (total US\$11.4 million, IDA US\$8.0 million)

As a complement to the efficiency improvements reached under Sub-component 1B, this sub-component will finance investments in infrastructure after the service providers start operating the system. This sub-component would enable service providers to expand and improve services. It will serve as an incentive for municipalities to create autonomous service providers as suggested in the *Ley Marco* and the PEMAPS, instead of assuming the operation of the services directly.

Investments funded under this component would include rehabilitation, connection to and expansion of water supply and sewer networks, on-site sanitation facilities, and wastewater treatment systems. Water supply investments can include coverage extension; rehabilitation of existing networks, tanks, and treatment plants; and the development of new water production capacity. Piped sewerage investment can include rehabilitation and expansion of standard, small-bore, and condominal systems. On-site sanitation investment will focus on creating supportive conditions for on-site solutions (acquisition of municipal tankers to empty septic tanks, sludge

¹⁹ The *Ley Marco* stipulates that the regulator (ERSAPS) has to approve the design of the management model.

treatment facilities, and so forth) and will subsidize on-site solutions only when it is deemed appropriate. Wastewater treatment investments will include simple independent treatment systems such as stabilization ponds, artificial wetlands, and communal septic tanks. Investments are limited to an agreed list of facilities and terms of implementation.

Service providers will have the freedom to decide which investments they would like to execute within the master plan. Investments outside of the master plan would need to be justified by an economic analysis.

Sub-Component 1C is designed using a “matching grant” incentive scheme where municipalities or service providers must provide co-financing to obtain grants (in the form of services, works and goods, rather than in monetary form). The total amount a municipality can receive, in the form of works and goods, will be determined by the following formula:

$$I = C \times \left(G + \sum_1^n B \right)$$

where I represents total incentive ceiling (excluding municipal counterpart funding), C represents the number of connections served by the service provider (water supply + sewer/septic tanks connections²⁰), G represents general incentive value (US\$30 per connection), B represents investment bonus value (US\$3 per connection each), and n represents the number of additional bonuses obtained for the current incentive payment.

Additional investment bonuses can be earned for:

- Every typical activity outsourced (billing and collection, meter reading, and so forth, one bonus for each activity);
- Every 10 percent or fraction thereof of operation and maintenance (O&M) cost recovery above 80 percent (for example, 95 percent cost recovery earns 2 bonuses);
- Reaching 90 percent metering;
- Incorporating additional municipalities in the service provider (one bonus per additional municipality);
- Every 6 hours or fraction thereof of service provision a day above 12 hours (for example, 20 hours earns 2 bonuses).

Every municipality can receive a new incentive investment after 2 years or after 75 percent of the previous incentive has been invested, whichever happens last. Municipalities will be free to propose an investment program for an amount not higher than the total incentive payment, provided that every activity is included in the master plan (TA for the preparation of master plans is provided under Sub-Component 1A) or otherwise economically justified in conformity with the operating manual. The design and supervision costs will be financed out of Sub-Component 1A and will not be counted as part of the incentive amount.

²⁰ Only septic tanks financed by the municipality/service provider qualify.

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 geographic area of the municipality of the Metropolitan District (*Alcaldía Municipal del Distrito Central* [AMDC], or Tegucigalpa). This component aims to improve, in the short term, the operative situation of the WSS service provider in Tegucigalpa. By freeing up water production capacity, continuity of service delivery could be improved and water supply services expanded.

The component will use the results of an operational improvement campaign by SANAA with bilateral Spanish financing to identify possible pilot sites with high losses, planned to start in late 2007. Based on typical unit costs elsewhere, it is expected that Non-Revenue Water (NRW) will be reduced considerably in a service area of approximately 200,000 people in Tegucigalpa at the end of the project.

International experience shows that good financial paybacks are possible with well-designed NRW reduction programs. A performance-based service contract provides an efficient means to achieve significant improvements in operational and financial efficiency, thereby creating immediate benefits and fostering a positive dynamic to support further reform. While a utility remains under public management, it uses the private sector's skills and incentives to carry out such work. In that regard, performance-based service contracting has considerable potential in situations where introducing the private sector through deeper forms of Public-Private Partnerships (PPP) such as a concession, lease, or management contract is not considered a politically viable option.

The performance-based NRW contract will be an opportunity to showcase innovative approaches to leak-reduction campaigns. Compared with other approaches to reduce losses (for example, the Spanish-financed activity includes classical, input-based, leak-reduction actions), it will permit a testing of the relevance and effectiveness of performance-based contracting in tackling the large operational challenges encountered in Tegucigalpa. 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.

The component will be implemented by UAP. SANAA will initially provide the technical supervision with the understanding that this role will be transferred to the municipal service provider if and when services are transferred. The Non-Revenue Water Reduction program will give the municipal service provider a head start in improving services. This will help increase the goodwill toward a transfer of the services and improve the financial basis of the utility.

Component 3: Institutional strengthening of national and regional sector institutions – Cost US\$7.7 million (IDA US\$7.2 million)

The institutional framework for WSS in Honduras consists of the water sector planning entity (CONASA), a regulating agency (ERSAPS), and a national utility (SANAA). Decentralization and other reforms change or establish the functioning of each of these agencies. This component

will provide support for each of these agencies to fulfill their new roles in a timely, efficient, and transparent manner. Activities under this component are derived from the PEMAPS.

Sub-Component 3A: Technical Assistance to national institutions (total US\$3.1 million, IDA US\$3.1 million)

The sub-component will provide assistance to the strengthening of CONASA as a sector planning entity, through the creation of a specific PEMAPS unit attached directly to CONASA (and housed in its Secretariat in SANAA). The PEMAPS unit will oversee the implementation of the PEMAPS. Among others, the component will finance preparation of the policy and legal instruments to clarify CONASA's governance structure, mandate, and financing, and the development of a sector financing policy aimed at guaranteeing the long-term sustainability of the sector. In the latter part of the project, the component will finance a status review and update of the PEMAPS.

The PEMAPS unit will work closely with the CATS to strengthen local institutional arrangements. As such, the PEMAPS unit will act as the oil needed for good governance and transparency in the project. This will include Training of Trainers drawing on national and international experts in the areas of management models, including stakeholder participation and legal arrangements. The support will include a national communication program, including awareness and education campaigns about sector needs and options, promotion of social accountability and building trust between government and civil society, and information for sector stakeholders regarding the future of the sector. Legal support will include advice to municipalities on transfer of assets, service provision agreements with service providers, and establishment of autonomous providers. All these activities will be linked to municipal-level activities in Component 1 in order to promote a sound institutional framework grounded in a broad-based stakeholder dialogue on the decentralization process in the water sector. Some years into the project, a review of municipal management models will be funded to further steer national and local policies.

This sub-component will also support SANAA in defining and adapting to its new role under the *Ley Marco* as a technical assistance agency. Among others, the sub-component may finance studies helping to define the demands for technical assistance and an optimal business model for SANAA to provide this assistance. These activities are a continuation of on-going studies financed by the Swiss Development Agency (COSUDE) as well the PHRD grant associated with the preparation of this operation.

The sub-component will also strengthen ERSAPS (the regulatory agency). ERSAPS' present capacity does not suffice to fulfill its role of setting tariffs, "vetting" municipal service providers, and supporting municipal oversight units for the larger number of service providers after decentralization. Support will focus on defining and implementing its new relationship with municipal oversight units—working closely with the regulatory experts in the CATS in Component 1. Also, ERSAPS' capacity to gauge management models will be enhanced.

Finally, this sub-component will also finance donor coordination activities, among others, through the sector's donors table, in order to continue progressing toward a harmonization of support to the country's WSS sector. These activities will build on the PEMAPS as a common platform of the government and the donors, and can be seen as part of the development of a Sector Wide Approach (SWAp) approach to aid in Honduras.

Sub-Component 3B: Severance Payments (total \$3.3 million, IDA \$3.0 million)

Context

The Honduras Country Assistance Strategy (CAS) identifies the lack of restructuring of public utilities and of professionalizing public institutions as an obstacle to improving services, and it identifies professionalization of the public sector as one important action to enhance governance. It recognizes that while an updated and improved legal framework to govern human resource management in the Honduran public sector is needed, the passage of new legislation may not be feasible. The CAS thus focuses on executive measures focusing on pilot institutions and key functions.

SANAA is overstaffed. Its total number of staff expressed per thousand connections is 10.4, while the regional average is 3.1.²¹ The transfer of services to the municipal level offers an opportunity to increase the efficiency of service delivery by rationalizing the number of staff per thousand connections and by improving the capacity of staff through selection. However, there is a cost associated with this because the *Ley Marco*, which in its Chapter XI (final resolutions) governs the process of transferring the services from SANAA to the municipalities, stipulates that all staff that will be retrenched or changes employer during the transfer of services will receive severance payments. Severance, retrenchment, early retirement, or termination of employment is determined by the collective bargaining agreements between SANAA and the trade union.

The amount of severance financing is relatively low in absolute terms (US\$3 million). It is also a relatively small proportion of the credit amount; it represents only 10 percent of the proposed Bank financing for the operation.

The severance financing can be seen as a pilot for the larger retrenchment needs in the further restructuring of SANAA. In order to learn lessons from this retrenchment and to design future staffing, the subcomponent also contains a study on future staffing of the remaining of SANAA, which will design a broader retrenchment program that combines disciplinary staff reductions, addresses payroll fraud arising from ghost workers and improper hirings, and will determine future retrenchment needs. The study will include data gathering on alternative employment found by retrenched in the on-going retrenchments, and on changes in staff employment totals in SANAA and other service providers.

Rationale for financing severance payments under the present project

This sub-component will fund severance payments for SANAA staff laid off in the course of decentralization of WSS services to the participating municipalities. It is estimated that 200 staff will be retrenched during the course of the project due to transfer of services to participating municipalities—representing all the staff in the related SANAA regional offices. The severance payments will be grounded in an analysis of relevant laws, regulations, and collective bargaining agreements that determine the payment of statutory termination benefits and ex gratia severance

²¹ Regional average from 2005 review of the Association of Water and Sanitation Regulatory Entities of the Americas (ADERASA).

payments that are being carried out with Policy and Human Resources Development Fund (PHRD) financing.

The payment of severance to all SANAA staff working on operations in participating municipalities, together with the support received through component 1, represents a unique opportunity for the new service provider to start a clean sheet:

- The regional offices of SANAA are loaded with significant financial liabilities that will need to be settled before the transfer can be done. In particular, the existence of a generous pension/severance payment²² plan creates an important liability for the future service provider. By paying off severance, the project will allow the newly formed service provider to start operating on a much more solid financial basis and free of past liabilities.
- The payment of severance to the entire affected staff also means that the newly formed service providers will be free to select their staffing level and staff profile based on a factual analysis of the needs of the new utility, instead of inheriting it from SANAA. There is no risk of adverse selection because the *Ley Marco* prescribes that all staff (regardless of performance) is laid off.
- As part of their work, the *Consultorías de Apoyo a la Transferencia de los Servicios* (Services Transfer Support Consultants [CATS]); see Component 1A) will support the municipalities in the preparation of a business plan for the new service provider. This plan will outline the staffing needs and profiles, and will be backed by an economic and financial cash-flow analysis in order to ensure that efficiency gains from the transfer process are actually obtained.

Risks and mitigating measures

The political economy of retrenchment in Honduras is typified by overstaffing in public institutions combined with powerful public sector trade unions. These considerations affect the risk-mitigation measures. The following risks and mitigating measures have been identified with regard to the payment of severance to SANAA staff in participating municipalities:

Risk	Mitigating Measure	Qualification
Noncompliance with Bank rules on payment of severance.	One of the difficulties in assessing the compliance of severance payments with Bank rules is the fact that the SANAA regional offices that will participate in the project will only be identified during project implementation (see Component 1 description). Similarly to the approach taken in an environmental assessment, the evaluation of the payment of severance to retrenched SANAA staff will confirm, prior to any	M

²² The term severance is not entirely correct in this case since every staff is entitled to this payment at the time they leave or retire from the institution; this explains why all staff affected by a transfer would be receiving it regardless of whether they are re-hired or not. It is a de facto pension system.

Risk	Mitigating Measure	Qualification
	disbursement, that such payment would be in accordance with the principles detailed in OP 6.00 (Bank Financing) of productivity, sustainability and oversight requirements.	
Overpayment of severance.	As part of the ongoing PHRD, a respected and independent auditing company is being hired to validate existing severance estimates and to outline the options at hand for their payment. The study will in particular analyze the legal basis for payments (national law and collective contracts). The Bank will only finance payments that have been verified and certified by a credible, neutral entity. A limited national counterpart funding has been included under severance payments to ensure negotiations between the Government and the syndicates are conducted under the right incentives. The Ministry of Finance will be required to maintain sufficient information on the number of employees retrenched and average severance payments to enable independent audit.	S
Adverse selection of staff.	Because all affected staff will be paid severance regardless of whether the new service provider chooses to hire them, there is no perverse incentive for staff when choosing to leave or not. It is expected that very few staff will remain within SANAA.	M
Moral Hazard.	The largest moral hazard is that the newly formed municipal service providers will be free to select their entire staff based on actual needs. It is expected that only the most-effective staff of the existing SANAA will be hired by the new service provider. The project will be financed through the CATS, the preparation of business plans that will help the service provider in choosing suitable staffing levels and profiles; the business plans will be backed by cash-flow analysis. In addition, data on alternative employment found by retrenchees, and on changes in staff employment totals will be publicly available.	M
Risk of discontent and social impact on retrenched staff.	The project will comply with the decision agreed upon by SANAA's labor union organization and the central government and make its severance payments accordingly,	M

Risk	Mitigating Measure	Qualification
	provided that they comply with the requirements set forth in the “Noncompliance with Bank rules” risk above.	
Negative financial impact on SANAA central.	In the short term, overstaffing in SANAA will increase as it transfers systems: a large central department will depend on income from fewer connections. Staffing issues are critical to further improvements in the sector, at both the national and the local level. The component will therefore finance a study on rationalization staffing of SANAA during and after decentralization.	S

Sub-Component 3C: Preparatory activities for Tegucigalpa transfer (total US\$1.3 million, IDA US\$1.1 million)

Tegucigalpa represents by far the largest city (in terms of population) where water supply services are managed by SANAA, and the only city in which SANAA manages sanitation services. The transfer of services will not be complete until a solution is found to the current difficulties linked with this specific transfer. While the project does not finance the transfer itself, this sub-component will support preparatory activities for the transfer of service delivery from SANAA to the Municipality of Tegucigalpa (AMDC). This support will include activities such as updating inventories, installing consumer and asset management systems, and planning the transfer process. These activities are in continuation of the Bank’s engagement through a Public-Private Infrastructure Advisory Facility (PPIAF) grant, and will be closely coordinated with the IDB, which has also been involved in upstream activities.

Component 4: Project Management – Cost US\$1.6 million (IDA US\$1.5 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, including the collection of information and development of reports for continued evaluation throughout the project cycle by both project management and the Bank’s supervision team. It will also cover audits and other project management activities that involve the governance and transparency aspects of the overall project, including monitoring the good governance mechanisms implemented in each implementation agency to guarantee transparency in each of the processes implemented according to the *Ley de Transparencia y Acceso a la Información Pública* and the Bank’s anti-corruption guidelines. Finally, this component will finance the strengthening of the implementing agencies, through participation in trainings and study tours, purchase of vehicles and equipment, and upgrading of the working environment.

Estimates of Project Costs, by Component and Sub-Component (US\$ million)

Component	IDA	Borrower	Municip.	TOTAL
Component 1: Support to medium-size municipalities to create autonomous service providers and invest in efficiency, rehabilitation, and expansion of service delivery	\$17.2M	\$0.6M	\$3.4M	\$21.2M
<i>Sub-Component 1A: Technical Assistance for transfer preparation</i>	\$3.7M	\$0.0M	\$0.0M	\$3.7M
<i>Sub-Component 1B: Support to tool service provider and improve efficiency</i>	\$5.5M	\$0.6M	\$0.0M	\$6.1M
<i>Sub-Component 1C: Investment for rehab and expansion</i>	\$8.0M	\$0.0M	\$3.4M	\$11.4M
Component 2: Tegucigalpa Non-Revenue Water Reduction Program	\$4.1M	\$0.4M	NA	\$4.5M
Component 3: National and Regional Institutional Strengthening	\$ 7.2M	\$0.5M	NA	\$ 7.7M
<i>Sub-Component 3A: TA to National Institutions</i>	\$3.1M	\$0.0M	NA	\$3.1M
<i>Sub-Component 3B: Severance Payments</i>	\$3.0M	\$0.3M	NA	\$3.3M
<i>Sub-Component 3C: Preparation Transfer Tegucigalpa</i>	\$1.1M	\$0.2M	NA	\$1.3M
Component 4: Project Management	\$1.5M	\$0.1M	NA	\$1.6 M
Total	\$30M	\$1.6M	\$3.4M	\$35 M

Project Financing (US\$ m)

Institution	Amount
IDA	30.0
GOH	1.6
Municipalities of Honduras	3.4
TOTAL	35.0

Annex 5: Project Costs

HONDURAS: Water and Sanitation Sector Modernization Project

Project Cost by Component and/or Activity	Local US\$ Million	Foreign US\$ Million	Total US\$ Million
Component 1: Support to medium-size municipalities to create autonomous service providers and invest in efficiency, rehabilitation, and expansion of service delivery	15.4	5.8	21.2
Component 2: Tegucigalpa Non-Revenue Water Reduction Program	3.2	1.3	4.5
Component 3: National and Regional Institutional Strengthening	6.2	1.5	7.7
Component 4: Project Management	1.4	0.2	1.6
Total Baseline Cost	26.3	8.7	35.0
Physical Contingencies ^a			
Price Contingencies			
Total Project Costs	26.3	8.7	35.0
Interest during construction			
Front-end Fee			
Total Financing Required	26.3	8.7	35.0

a. Due to the fact that sub-projects in Component 1 will only be determined during project implementation and investments are capped at a ceiling per municipality, the inclusion of physical contingencies is not relevant at this stage.

Annex 6: Implementation Arrangements

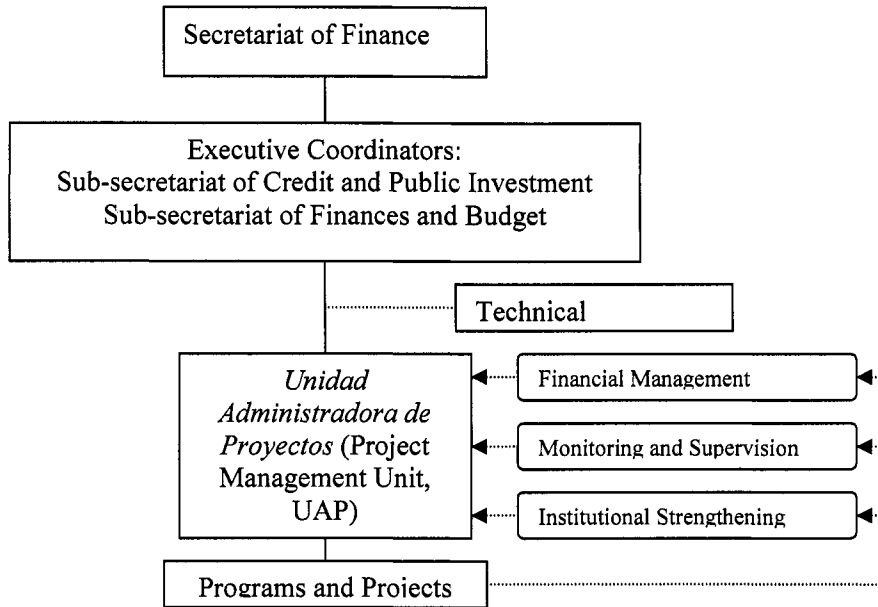
HONDURAS: Water and Sanitation Sector Modernization Project

The Government of Honduras will be the borrower of the proposed credit. The Secretariat 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 (PIU). In addition, the implementation arrangements warrant a sound project governance structure with checks and balances included in various areas.

SEFIN has requested that implementation responsibility fall on the *Unidad Administradora de Proyectos* (Project Administration Unit, UAP)²³ 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 the International Development Association (IDA), the Inter-American Development Bank (IDB), and the Nordic Development Fund (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. At the time of its creation, the UAP was in charge of managing 18 investment projects (two of which were directly involved in the water and sanitation sector) under the direct supervision of both the Vice Ministers of SEFIN for Public Credit and for Finances and Budget, who preside over the Technical Board that oversees the specific operations. The two IDA operations that worked under this scheme were the Economic and Financial Management Credit (IDA 3414-HO) and the Poverty Reduction Strategy Technical Assistance Credit (IDA 3939-HO). Under this arrangement, the other implementing agencies (Municipalities, *Consejo Nacional de Agua Potable y Saneamiento* [National Council for Water and Sanitation, CONASA], and *Servicio Autónomo Nacional de Acueductos y Alcantarillados* [National Autonomous Water and Sewer Service, 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 (Figure A6.1).

²³ The UAP was created by Ministerial Agreement 0271 of 2004.

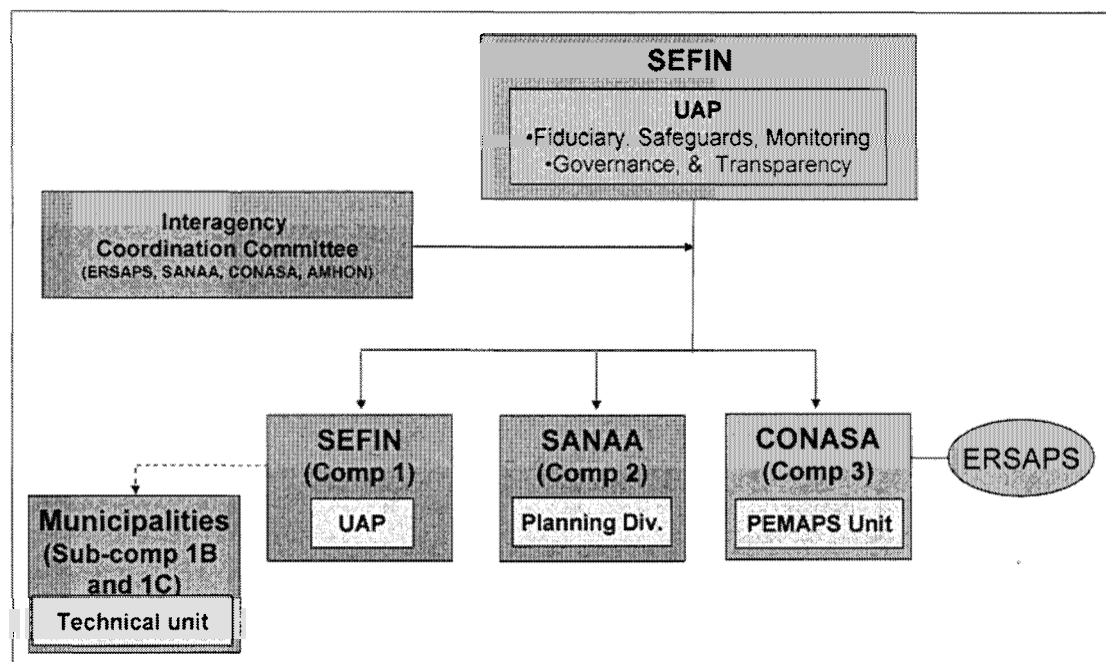
Figure A.6.1.



Hence, 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. 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. In particular, the UAP will be strengthened on the sector, technical staff side. The Bank will co-finance the salaries and other operational recurrent costs required for the operation of the UAP from loan proceeds.

The project would count on the high-level support of the *Grupo Interinstitucional de Coordinación* (GIC), comprising SEFIN, SANAA, CONASA, the *Asociación de los Municipios de Honduras* (Honduras Municipalities Association, AMHON), and the water sector regulator (*Ente Regulador de los Servicios de Agua Potable y Saneamiento*, Water and Sanitation Sector Regulator, ERSAPS). The GIC would monitor project progress (Figure A6.2).

Figure A6.2: Implementation Arrangements



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). UAP would be responsible for Overall Project Management and would provide special support in procurement activities carried out by the municipalities and overall monitoring of the implementation of the Project. It will develop timely and credible information mechanisms regarding 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. Table A6.1 presents an overview of the implementation arrangements, which are summarized in further paragraphs.

Table A6.1: Overview of Project Implementation Arrangements

Component	Technical Supervision ^a	With Support from ^b	Procurement	Management of Funds
I – Support to Municipalities				
<i>1A – Technical Assistance</i>	<i>UAP</i>	<i>CATS, CONASA, ERSAPS</i>	<i>UAP</i>	<i>UAP</i>
<i>1B – Tooling and Efficiency Improvement</i>	<i>UAP</i>	<i>Municipality, CATS</i>	<i>Municipality/ UAP^c</i>	<i>UAP</i>
<i>1C – Investments</i>	<i>UAP</i>	<i>Municipality,</i>	<i>Municipality/</i>	<i>UAP</i>

Component	Technical Supervision^a	With Support from^b	Procurement	Management of Funds
		<i>CATS</i>	<i>UAP^c</i>	
2 – NRW reduction in Tegucigalpa	SANAA		UAP	UAP
3 – National Institutions Strengthening				
<i>3A – Technical Assistance</i>	<i>CONASA</i>	<i>ERSAPS</i>	<i>UAP</i>	<i>UAP</i>
<i>3B – Severance Payments</i>	<i>UAP</i>	<i>SANAA</i>	<i>UAP</i>	<i>UAP</i>
<i>3C – Preparation Transfer Tegucigalpa</i>	<i>SANAA</i>		<i>UAP</i>	<i>UAP</i>
4 – Project Management	UAP		UAP	UAP

a. Technical Supervision includes preparing TORs and bidding documents, reviewing the inputs of consultants, and so forth.

b. Support means the following institutions will be asked to prepare or review draft TORs and inputs from consultants but will not be making the final decision.

c. Depending on the capacity of the Municipality.

To avoid unnecessary turnover in the personnel affected by implementing the project, both in UAP and in the agencies in charge of the various components, the financial agreement will make it necessary for any change of key staff to be made only if satisfactory to the Bank. This clause will apply not only to UAP staff, but also to key implementing staff in other agencies, in particular the PEMAPS unit.

The project team will review the implementation arrangements two years after the project's effectiveness to determine whether the conditions for WSS sector institutions to take on more implementation responsibilities are provided.

Arrangements for Component 1 (UAP and Municipalities)

SEFIN, through the UAP, would be directly in charge of the implementation of Component 1. UAP has been managing the Inter-American Development Bank's Water Supply and Sanitation (WSS) project since its inception and will be strengthened with regard to technical supervision of the component. In addition, sector institutions would be providing technical support on aspects relevant to them (ERSAPS on utility governance questions, CONASA on policy and communication).

UAP would also procure the services in Sub-Components 1A, while the municipalities (through their technical unit) would be procuring works and goods under Sub-Components 1B and 1C under the supervision of UAP for those Municipalities that are determined to have sufficient capacity (as established through a methodology to be detailed in the Operating Manual). For those municipalities that do not demonstrate sufficient procurement capacity, UAP will be executing the procurement process in close technical coordination with the Municipalities. In both cases, UAP will be managing the funds.

A specific agreement would be signed with each participating municipality prior to any investments being executed to establish the rules of the intervention.

Arrangements for Component 2 in SANAA

SANAA would supervise technically this component through the existing *Unidad Ejecutora del Proyecto de Optimización Operativa de Tegucigalpa* within the *División de Planeación*, which currently implements a large loan by the Spanish Fund for Assistance and Development to SANAA that includes network plans, leak reductions, metering, and so forth. The supervision will be transferred to the Tegucigalpa municipal service provider when services are transferred. UAP will remain in charge of the procurement, contracting, and financial management aspects of this component.

Arrangements for Component 3 in ERSAPS, CONASA, and SANAA

CONASA would create a PEMAPS Unit that would be in charge of technically supervising project activities and carrying out CONASA responsibilities under the PEMAPS. This Unit would be staffed by a group of current SANAA managers and by external consultants who would be associated with this Unit throughout the project implementation period. SANAA would be providing technical supervision to Sub-Component 3C. UAP will remain in charge of the procurement, contracting, and financial management aspects of this component and will also assume technical supervision of Sub-Component 3B (severance payments) to avoid conflicts of interest.

Governance Framework and Communication Strategy

In December 2006, the Government of Honduras approved the Law of Transparency and Access to Public Information that governs national public policy activity. This law requires public institutions to establish effective mechanisms to promote transparency in order to combat corruption and illegal activity in public policy matters. The law, in alignment with the Anti-corruption Guidelines from the World Bank Group applied to this project, (the GoH has already been informed of the Anti-Corruption guidelines in a letter sent on March 26, 2007, by the Bank's Country Office—see Attachment 1 to this annex), offers an opportunity to strengthen the WSS Sector. Although this law represents an important framework for promoting transparency within the Government and effective participation from stakeholders in project activities, significant work is still necessary in this area. Since this law was recently approved, understandably this project may face challenges in meeting the new requirements.

More transparency and citizen participation in the water sector will lead to better public policies and better service delivery, so the supply of information and demand of transparency in the water sector in Honduras need to be strengthened. On one side the project aims to educate the consumers and civil society organizations to generate coherent, persistent, and technically capable demand of transparency, information, and active participation (capacity building on the demand side). On the other side, the UAP will build capacity in each implementation agency to comply with the fiduciary and procurement arrangements, the Law of Transparency and Access to Information, and to promote the culture that public servants working under the scope of the project are accountable for their own activities and that their activities are transparent (capacity building on the supply side, both government and service providers).

In order to meet the good governance standards mentioned above, the team of the UAP will include professionals responsible for designing and implementing activities aimed to: (a) build capacity in each implementing agency and establish transparency and accountability mechanisms

to comply with the Law of Transparency and Access to Information under the scope of the project; (b) promote an active civil society that will be invited to become partners, not only for project identification and implementation, but also for the long-term sustainability of the sector; (c) educate and engage the media in a transparent and credible process; (d) improve coordination and harmonization within the public institutions, nongovernmental organizations, and development partners involved in the sector and PEMAPS implementation; and (e) strengthen and train civil society and other actors at the municipal level, to promote local government transparency and accountability, and encourage social and environmental responsibility by the main implementing agencies.

As part of this strategy, a sound and thoughtful **communication strategy** (Component 3A) will act as the catalyst needed for good governance and transparency in the project. The communication strategy goes beyond the mere transmission of information. It implies the engagement of the stakeholders involved in the process and the establishment of mechanisms and messages that motivate a sustainable change. Some of the main activities included in the communication strategy for the project include: (a) identification of stakeholder information needs and perceptions (opinions/attitudes) regarding the sector and the main implementation agencies (also aimed at defining the governance and communication indicators for the project); (b) developing consistent messages to be conveyed to all stakeholders (including contractors, suppliers, and so forth) regarding the project itself and the good governance approach it takes (including raising awareness on the anticorruption guidelines); (c) informing and educating civil society, the government, and the public—especially customers—about the challenges faced by the sector, the project contribution to the sector, and the transparent and good governance approach it will implement (some communication activities have been designed but the implementation has been very weak due the lack of funds); (d) strengthening the credibility of the project by informing and educating internal stakeholders (SANAA workers, CONASA, and so forth) regarding the overall process; and (e) developing on-time and credible information mechanisms regarding the project activities, especially those related to procurement and financial management. Although a strategic communication will be designed at the UAP level with the participation of each implementing agency, the implementation of the governance and communication plans will be done by each agency so they will be accountable for the results of the overall process.

Attachment 1 – Letter Sent to GOH Regarding New Sanctions’ Regime

Misión Residente del Banco Mundial en Honduras

BANCO INTERNACIONAL DE RECONSTRUCCIÓN Y FOMENTO
ASOCIACIÓN INTERNACIONAL DE FOMENTO

CENTRO FINANCIERO UNO, TEGUCIGALPA, HONDURAS
TEL: 504-239-4551 FAX: 504-239-4555

26 de marzo del 2007

Lic. Rebeca Santos
Ministra de Finanzas
Secretaría de Finanzas
Tegucigalpa, Honduras

Ref.: Nuevo Régimen de Sanciones del Banco Mundial

Estimada Sra. Ministra:

Desde 1996, las Normas sobre Adquisiciones y las Normas para la Selección y Contratación de Consultores del Banco Mundial, le han permitido al Banco sancionar firmas e individuos por verse envueltos en fraude o corrupción en relación a la adquisición de bienes o servicios, la selección de consultores, o la ejecución de cualquier contrato resultante.

Como parte de esfuerzos actuales para avanzar el desarrollo de procedimientos y prácticas de anticorrupción, el Banco Mundial en 2006 reforzó el marco de trabajo con la inclusión de Normas de Anticorrupción específicas, las cuales detallan definiciones de faltas sancionables específicas de: fraude, corrupción, colusión, coacción y obstrucción.

Estas nuevas Normas de Anticorrupción han sido adoptadas como parte del marco legal de trabajo para las operaciones de inversión del Banco. Al igual que las Normas sobre Adquisiciones y las Normas para la Selección de Consultores, las Normas de Anticorrupción serán incorporadas como referencia en los acuerdos legales para cada proyecto de inversión. Los remedios contractuales relacionados al fraude y la corrupción en las Condiciones Generales del Banco Internacional de Reconstrucción y Fomento (BIRF) y la Asociación Internacional de Fomento (AIF) también han sido reforzadas.

Además, como parte de estos esfuerzos, el Régimen de Sanciones del Banco Mundial ha sido reforzado a través de la adopción de un nuevo régimen aprobado por los Directores Ejecutivos el 1 de agosto del 2006 (ver Anexo 2: Nota de Información).

Las reformas al régimen de sanciones incluyen:

1. La ampliación del régimen de sanciones más allá de la esfera de las adquisiciones a fin de abarcar en forma más general los casos de fraude y corrupción que pudieran surgir en relación con el uso de los fondos de los préstamos del Banco durante la preparación y/o ejecución de proyectos de inversión financiados por el Banco Mundial; y
2. Adopción de "prácticas obstructivas" como una falta sancionable por sí misma.

El nuevo régimen de sanciones y cambios relacionados al marco legal de las operaciones del Banco se aplicará a todos los proyectos de inversión a financiar por el Banco en el ámbito de la Estrategia de Asistencia al País, presentado a la Junta Directiva del Banco en Noviembre del 2006.

Los gerentes de equipos del Banco que se encuentren trabajando en proyectos actualmente en preparación le brindarán información más detallada acerca de las consecuencias que las reformas tendrán sobre esos proyectos.

Le ruego no dude en contactarme a mí, a Dante Mossi o a Pilar González, Abogado del País, para mayor información general sobre el nuevo régimen de sanciones.

Le saluda muy atentamente,

Adrian Fozzard
Representante Residente

C.C. Hugo Castillo, Secretaría de Finanzas

Orlando Garner, Secretaría de Finanzas

Yani Rosenthal, Secretaría de la Presidencia

Ricardo Arias, Secretaría de la Presidencia

Annex 7: Financial Management and Disbursement Arrangements

HONDURAS: Water and Sanitation Sector Modernization Project

Summary Conclusion of Financial Management Assessment

In summary, the proposed project has been designed as follows:

- (i) The Secretariat of Finance (SEFIN) will be responsible for the execution of the proposed project and as such will be the project's executing agency. Implementing agencies (*Servicio Autónomo Nacional de Acueductos y Alcantarillados*, National Autonomous Water and Sewer Service, SANAA), *Consejo Nacional de Agua Potable y Saneamiento* [National Council for Water and Sanitation, CONASA], and *Ente Regulador de los Servicios de Agua Potable y Saneamiento* [Water and Sanitation Sector Regulator, ERSAPS]) will fulfill technical roles, while coordinating with SEFIN. SEFIN has requested that project coordination and administration fall under the *Unidad Administradora de Proyectos* (UAP), an existing, integrated unit within SEFIN experienced in managing administrative and financial aspects of projects financed by the World Bank. Therefore, the UAP will be directly in charge of financial management (FM) tasks for all the components of the proposed project and will manage the Designated Account.

On the basis of the assessments performed, the financial management team presents the following conclusions:

- (i) The FM capacity assessment (FMA) has identified project-specific actions in order to strengthen the FM capacity of the UAP and enable it to effectively carry out the financial activities of the proposed project (action plan presented in this annex).
- (ii) Importantly, the project is expected to use country systems (SIAFI and the *Unidades Ejecutoras de Préstamos Externos* [External Loans Execution Unit, UEPEX]) for accounting and reporting purposes, because these systems would provide adequate information for monitoring specific project expenditures. No additional system is expected to be needed. In addition to the use of country systems (SIAFI), the proposed project will also use the single treasury account to make project payments. The project envisions the participation of certain municipalities; thus, transfers to municipalities have been considered as part of financial arrangements for the project, once municipalities have been assessed and possess sufficient capacity, as described below.
- (iii) The UAP will be making contract payments in close technical coordination with the municipality.

Organizational Arrangements and Staffing

The Government of Honduras will be the borrower of the proposed Bank loan. The Secretariat 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 new Project Implementation Units (PIUs). In addition, the implementation arrangements would warrant a sound project governance structure with checks and balances included in various areas. SEFIN has requested that project coordination and administration fall under the UAP. Therefore, the UAP will be directly in charge of financial management (FM) tasks. These will include: (a) budget formulation and monitoring, (b) cash-flow management (including processing payments and submitting loan withdrawal applications to the Bank), (c) maintenance of accounting records, (d) preparation of in-year and year-end financial reports, (e) administration of underlying information systems, and (f) arranging for execution of external audit. In addition, the UAP will be responsible for implementing the governance and transparency aspects of the overall project, including monitoring the good governance mechanisms implemented in each implementation agency, especially the participating municipalities, to guarantee transparency in each of the processes implemented according to the *Ley de Transparencia y Acceso a la Información Pública* (part of Component 4).

The UAP was created in 2004 by a decree (Decree No. 271-2004) with the objective of creating a single unit within SEFIN to administer projects with external financing executed by this Ministry. Since its creation, the UAP has administered 6 loans and 8 trust funds from the Inter-American Development Bank, and 2 credits (IDA 3414-HO and IDA 3939-HO) and 1 trust fund from the Bank. Therefore, the unit already has the capacity necessary to administer the financial aspects of the proposed project, including a basic administrative structure and FM systems in place. Under this arrangement, the implementing agencies (CONASA, SANAA, and ERSAPS) will fulfill technical roles, while the UAP will be responsible for the flow of funds, procurement of works, goods and services, making project payments, financial reporting, and other related fiduciary activities. The UAP will carry out its functions with its existing staff and be required to maintain professional staff in numbers and with qualifications and experience acceptable to the Bank according to the Project's Operational Manual. It is expected that no additional staff will be necessary for financial management, as the person currently responsible for IDA 3939-HO, which is expected to close on June 15, 2008, will be able to carry out the financial activities of the proposed project.

Budget Planning

During April and May of each year, the UAP will prepare its tentative investment program for the next year (including the investment program for the proposed project) and submit it to the Ministry of Finance (SEFIN) for review and approval. The program should be consistent with the budget policy provided by the Ministry of Finance, and be incorporated into the national budget for its submittal to Congress in September.

On the basis of the approved budget, the UAP will adjust as needed its project annual work (POA) and procurement plan, which will be reviewed by the World Bank (WB).

Accounting and Financial Reporting

Accounting Policies and Procedures. The main FM regulatory framework for the project will consist of: (a) Honduras' laws governing budget management, (b) SEFIN's operating manuals, and (c) the Unit's operating norms.

These documents will be complemented by project-specific FM arrangements documented in a concise FM section of the project's operational manual. Among others, specific reference will be made to: (a) the internal controls appropriate for the project, (b) the formats of project financial reports, (c) auditing arrangements, and (d) criteria for participation of the municipalities.

Information Systems. The proposed project will use country systems for accounting and financial reporting. The financial activities of the project (especially budget and budget execution) will be recorded in SIAFI. In addition, to meet the reporting requirements of the proposed project, the project team is contemplating the use of UEPEX, which is a module of SIAFI specifically designed for the accounting and reporting of externally financed projects. The team will continue to work with SEFIN to ensure the proper implementation and operation of UEPEX for the proposed project.

Treasury System. It is important to note that with the use of country systems (SIAFI) comes the use of the single treasury account. As expenditures/commitments arise, they will be recorded in SIAFI, and once approved, funds will be converted into local currency by the National Treasury in the Ministry of Finance (SEFIN) and channeled through the single treasury account to make payments to suppliers, contractors, and consultants.

Municipalities. It was decided that the UAP will be making contract payments in close technical coordination with the municipality. Specific procedures for contract payments from the UAP and municipality contributions will be described in the Operational Manual.

Financial Reports. On a *semi-annual basis*, the UAP will prepare and submit to the WB an unaudited interim financial report (IFR) containing at least: (a) a statement of sources and uses of funds and cash balances (with expenditures classified by subcomponent), and (b) a statement of budget execution per subcomponent (with expenditures classified by the major budgetary accounts). The interim reports will be submitted not later than 45 days after the end of each semester. In this case, the IFRs are not expected to be used for disbursement purposes (at least at the beginning). If at a later date, the IFRs are used for disbursement purposes, the following annexes would be required: (a) a Special Account activity statement (including a copy of the bank statement); (b) a summary statement of Special Account expenditures for contracts subject to prior review, and (c) a summary statement of Special Account expenditures for contracts not subject to prior review.

On an *annual basis*, the UAP will prepare project financial statements including cumulative figures, for the year and as of the end of that year, of the financial statements cited in the previous paragraph. The financial statements will also include explanatory notes in accordance with the Cash Basis International Public Sector Accounting Standard (IPSAS), and UAP's assertion that loan funds were used in accordance with the intended purposes as specified in the

Loan Agreement. These financial statements, once audited, will be submitted to the WB not later than six months after the end of the Government's fiscal year (which equals the calendar year).

The supporting documentation of the semi-annual and annual financial statements will be maintained on the Unit's premises, and made easily accessible to WB supervision missions and to external auditors.

Flow of Funds

WB Disbursement Method. Loan proceeds will be withdrawn by the UAP using the advance method supported by documentation showing that the loan proceeds previously withdrawn were used to finance eligible expenditures. Supporting documentation will be in the form of Statements of Expenditures (SOEs), at least initially, with the exception of payments related to contracts above the SOE threshold, which will be reimbursed against full supporting documentation. The SOE threshold for the project has been set at US\$100,000 for goods, works, non-consultants services, consultants, training, and operating costs for the various components of the project. Once the system for producing IFRs has been tested and found satisfactory to the Bank, the supporting documentation may be changed to interim unaudited financial reports.

Other Procedures. By appraisal, no need has been identified for the use of special commitment procedures. Should the need arise during implementation, the Bank will evaluate it and if granted, agree to their use via an amendment to the Disbursement Letter. The project may use reimbursement or direct payments.

WB Designated Account. The UAP will open a segregated Designated Account in *Banco Central de Honduras* in U.S. dollars, to be used exclusively for deposits and withdrawals of loan proceeds for eligible expenditures. After the conditions of effectiveness have been met, and the designated account has been opened, the UAP will submit its first disbursement request to the WB, together with the expenditure and financing needs forecast for the next six months. For subsequent withdrawals, the UAP will submit the disbursement request, along with the supporting documentation (SOEs or IFRs). At any time, the undocumented advance to the designated account cannot exceed the authorized ceiling, which has been established at US\$2.5 million.

Disbursement Deadline Date. Four months after the closing date specified in the Loan Agreement.

Audit Arrangements

Internal Audit. In the course of its regular internal audit activities vis-à-vis the institutional budget, internal auditors for SEFIN may include project activities in their annual work plans. If such audits occur, the UAP will provide the Bank with copies of internal audit reports covering project activities and financial transactions.

External Audit. As stated earlier, the UCP in MINSA managed the recently closed part of the Economic and Financial Management project (credit 3414) and is currently managing part of the Poverty Reduction Support Technical Assistance project (credit 3939), for which no audit

compliance issues have been identified. Overall, the audit reports for the fiscal years 2002 to 2005 for the above-mentioned projects have been received on time and presented unqualified opinions.

The annual project financial statements prepared by the UAP will be audited following International Standards on Auditing (ISA), by an independent firm (or the Controller General of Accounts, subject to prior agreement with the Bank) and in accordance with terms of reference (TORs), both acceptable to the Bank. The audit opinion covering project financial statements will contain a reference to the eligibility of expenditures.

The audit work described above can be financed with loan proceeds. The UAP will arrange for the first external audit within three months after Credit Effectiveness. Each audit engagement is expected to cover at least two years.

Disbursement Schedule

Category²⁴	Amount of the Financing Allocated (expressed in USD)	Amount of the Financing Allocated (expressed in SDR)	Percentage of Expenditures to be Financed
(1) Consultants' services under Parts 1.A, 2, 3.A, 3.B.2, and 4 of the Project	8,200,000	5,400,000	100%
(2) Consultants' services under Part 3.C of the Project	1,100,000	750,000	85%
(3) Goods and works under Parts 2, 3.A and 4 of the Project	3,700,000	2,400,000	90%
(4) Goods, works, consultants' services, non-consultant services and Training under Parts 1.B and 1.C of the Project	13,500,000	8,900,000	100% except for those costs covered by the municipalities
(5) Severance Payments under Part 3.B.1 of the Project	2,700,000	1,800,000	90%
(6) Operating Costs under Parts 3.A and 4 of the Project	500,000	350,000	90%
(7) Training and non-consultant services under Parts 3.A and 4 of the	300,000	200,000	100%

²⁴ The numbering of the components and subcomponents reflects the numbers used in the Financing Agreement. In particular, 3(b)(i) refers to severance payments.

Category ²⁴	Amount of the Financing Allocated (expressed in USD)	Amount of the Financing Allocated (expressed in SDR)	Percentage of Expenditures to be Financed
Project			
TOTAL AMOUNT	30,000,000	19,800,000	

Country Issues

As stated in Governance Strategy Note (2006), significant improvements have been made in strengthening public financial management systems in Honduras, with the launch of a comprehensive reform program to support implementation of the 2004 Finance Law, the implementation of SIAFI at the central level of government, and the National Payment System. However, corruption remains a serious concern, which impedes growth and development. Therefore, as an effort to support improvements in governance in Honduras, accelerate growth, and make sustained progress in poverty reduction, the Bank has produced a Governance Strategy Note that provides a framework for the Bank's involvement in Honduras. This note recommends specific actions to strengthen transparency accountability and the demand for good governance across the portfolio through among others, extensive disclosure of project procurement information, strengthened partnerships with civil society and beneficiaries in project design and monitoring, regular risk assessments and enhanced supervision where needed, and continuity of project staffing. This assessment has taken into account the conclusions of the Governance Strategy Note.

Risk Assessment Summary

The FM risk for this project has been assessed at *Substantial* and once there is evidence that the mitigating measures have been implemented and are working as intended, the level of FM risk for this project will be re-assessed and revised accordingly. Table A7.1 presents the risk assessment and the risk-mitigating measures incorporated into the design of the project and the financial management implementation arrangements.

Table A7.1. Risk Assessment and Risk-Mitigating Measures

Risk	Risk Rating	Risk-Mitigating Measures Incorporated into Project Design	Condition of Negotiations/Board or Effectiveness (Y/N)?
Inherent Risk			
Country Level	S	In part because of the poor rating of Honduras in Transparency International's Corruption indexes, and despite recent measurable improvements in the country's public financial management systems, inherent risk is still considered to be substantial.	
Entity Level	S		
Project Level	S	Because the project includes various implementing agencies, the FM aspects of the project will be	

		<p>concentrated in a unit (institutionalized within the Secretariat of Finance) responsible for overseeing the fiduciary aspects of externally funded projects, staffed with personnel possessing adequate qualifications.</p> <p>The Credit Agreement will include a covenant that SEFIN will be required to maintain adequate implementation arrangements at all times.</p> <p>The UAP will make all payments in connection to works of sub-projects in Municipalities.</p>	
Control risk			
Budgeting, Accounting, Internal Control	M	<p>Project budget and accounting will be registered in the national system (SIAFI), and the UAP will use UEPEX (module of SIAFI developed especially for projects).</p> <p>The project will prepare an operational manual.</p>	Effectiveness: Y
Funds Flow	M	<p>The Project will use the single treasury account to make payment to suppliers, contractors, and consultants.</p> <p>There will be no transfer of funds to municipalities, because the UAP will make all payments.</p>	
Financial Reporting, Auditing	M	<p>The project will use country systems (SIAFI and UEPEX) for accounting and financial reporting.</p> <p>SEFIN will furnish audit reports to the Bank.</p>	
FM Risk	S		

Financial Management Action Plan

Action	Responsible Entity	Completion Date ^a
1. Finalize the draft format of unaudited financial reports (IFRs).	SEFIN-UAP	By negotiations
2. Finalize draft audit TORs and short list.	SEFIN-UAP	By negotiations
3. Finalize the draft FM section of the project operational manual.	SEFIN-UAP	By negotiations
4. Finalize and incorporate in the operating manual the proposal in relation to the chart of account and incorporation of the project into SIAFI's structure and the implementation of UEPEX.	SEFIN-UAP	By effectiveness
5. Contract external auditors, based on short list satisfactory to the Bank.	SEFIN-UAP	3 months after effectiveness

a. This column presents only the estimated completion date, not an indication of legal conditions.

World Bank Financial Management Supervision Plan. A World Bank Financial Management Specialist may perform a supervision mission prior to effectiveness to verify the implementation of the unit and the FM system. After effectiveness, the FM Specialist must review the annual audit reports, should review the financial sections of the semi-annual IFRs, and should perform at least one to two supervision missions per year.

Annex 8: Procurement Arrangements

HONDURAS: Water and Sanitation Sector Modernization Project

A. General

The Secretariat of Finance (SEFIN), through its *Unidad Administradora de Proyectos* (UAP), will carry out procurement for the proposed project in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits," published by the Bank in May 2004 and revised in October 2006; the "Guidelines: Selection and Employment of Consultants by World Bank Borrowers," published by the Bank in May 2004 and revised in October 2006; and the provisions stipulated in the Credit Agreement. The general description of various contracts under different expenditure categories is below. The specific arrangements will be further detailed in the Procurement Plan and the Project's operational manual.

B. Procurement Arrangements by Project Component

B.1. Component 1: Support to medium-size municipalities to create autonomous service providers and invest in efficiency, rehabilitation, and expansion of service delivery

- ***Sub-Component 1A: Technical Assistance for transfer preparation and implementation.*** This sub-component will finance procurement of consultants (*Consultorías de Apoyo a la Transferencia de los Servicios*, CATS) by the UAP in conjunction with the municipalities. CATS will be used to (a) help municipalities identify appropriate models; (b) prepare the legal, financial, technical, and social instruments required to implement them; and (c) assist in planning the transfer process. This component will also finance the procurement of other consultants to prepare master plans and designs and supervise works.
- ***Sub-Component 1B: Support to tool municipal units and service providers and improve efficiency.*** This sub-component will finance procurement of: (a) advisory in specific areas, such as improvement of commercial practices, design of effective management systems, and financial and technical planning of operations and maintenance; (b) basic management tools for the service provider, such as office inventory, commercial information systems, vehicles, and (c) other activities such as communication campaigns and training of staff. This sub-component will also finance procurement of small works, and goods and services for innovative, cost-effective approaches (performance-based contracts, outsourcing of non-core activities) for rapid efficiency gains. Procurement will include: (a) technical, such as leak detection, network sectorization, meter installation; and (b) commercial, such as billing and collection, and reduction of non-revenue water.
- ***Sub-Component 1C: Investment for system rehabilitation and expansion.*** This sub-component will finance procurement of works and goods and services to enable service providers to expand and improve services. Procurement will include: (a) rehabilitation, connection to, and expansion of water supply and sewer networks; (b) on-site sanitation facilities such as municipal tankers to empty septic tanks and sludge treatment facilities; and (c) wastewater tanks and treatment plants such as stabilization ponds, artificial wetlands, and communal septic tanks.

B. 2. Component 2: Tegucigalpa Non-Revenue Water Reduction

This sub-component will finance procurement of a private company under a performance-based service contract to reduce technical and commercial losses in a limited geographic area of the municipality of the Metropolitan District (*Alcaldía Municipal del Distrito Central*, Municipality of Tegucigalpa, AMDC). Procurement under this component will be implemented by UAP in coordination with the *Servicio Autónomo Nacional de Acueductos y Alcantarillados* (National Autonomous Water and Sewer Service, SANAA) with the understanding that the contract will be transferred to the municipal service provider if and when services are transferred. This sub-component will also finance the contracting of consultant services for the design and supervision of the performance-based service contract.

B.3. Component 3: Institutional Strengthening of National and Regional Sector Institutions

- ***Sub-Component 3A: Technical Assistance to national institutions.*** This sub-component will finance procurement of consulting services for the strengthening of the *Consejo Nacional de Agua Potable y Saneamiento* (National Council for Water and Sanitation, CONASA) as a sector planning entity. Procurement will include advisory services on: (a) policy and legal instruments to clarify CONASA's governance structure, mandate, and financing; (b) the development of a sector financing policy aimed at guaranteeing the long-term sustainability of the sector; (c) a national communication program, including awareness and education campaigns about sector needs and options, promotion of social accountability, and building trust between government and civil society, and information for sector stakeholders regarding the future of the sector; (d) strengthening of the *Ente Regulador de los Servicios de Agua Potable y Saneamiento* (Water and Sanitation Sector Regulator, ERSAPS) capacity for setting tariffs, vetting municipal service providers, municipal oversight of service providers after decentralization, and benchmarking of service providers.

- ***Sub-Component 3C: Preparatory activities for Tegucigalpa transfer.*** This sub-component will finance procurement of small works and goods and services for preparatory activities for the transfer of service delivery from SANAA to the Municipality of Tegucigalpa (AMDC). Procurement will include advisory services and goods for: (a) updating inventories, (b) installing consumer and asset management systems; and (c) planning the transfer process.

C. Assessment of UAP's Capacity to Implement Procurement

A procurement capacity assessment of UAP was carried out. SEFIN requested that implementation responsibility fall on the UAP given its previous experience with multilateral financing in the water and sanitation sector.

The UAP was created as a consolidated Project Implementation Unit within SEFIN to manage financial resources from the International Development Association (IDA), the Inter-American Development Bank (IDB), and the Nordic Development Fund (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. At the time of its creation, the UAP was in charge of managing 18 investment projects (two of which were directly involved in the water and sanitation sector) under the direct supervision of both Vice Ministers of SEFIN for Public

Credit and for Finances and Budget, who preside over the Technical Board that oversees the specific operations. Two IDA operations have been implemented satisfactorily under this scheme: the Economic and Financial Management Credit (IDA 3414-HO) and the Poverty Reduction Strategy Technical Assistance Credit (IDA 3939-HO). Under this arrangement, the UAP will coordinate on the flow of funds, procurement of works and goods and services, financial reporting, and other required activities.

The assessment reviewed the capacity of the UAP to carry out procurement, looking into (a) organization, (b) facilities and support capacity, (c) staffing, (d) professional experience, (e) record-keeping and filing system, (f) procurement planning and monitoring/control systems used, and (g) capacity to meet the Bank’s procurement reporting requirements. The assessment also considered the capacity of alternative proposed agencies such as the *Fondo Hondureño de Inversión Social* (Honduran Fund for Social Investment, FHIS) to implement procurement for Component 1, and SANAA and CONASA for Components 2 and 3. The findings led to rejection of the use of these agencies for project implementation and to embracing the UAP instead.

D. Risk Assessment

The overall project risk for procurement is substantial. Once there is evidence that the mitigating measures have been implemented and are working as intended, the level of risk for this project will be reassessed and revised accordingly. Table A8.1 presents the risk assessment and the risk-mitigating measures incorporated into the design of the project and the procurement management implementation arrangements.

Table A.8.1: Risk Assessment and Risk Mitigation

Action	Responsible	Completion ^a
1. Finalize the Procurement Plan.	SEFIN-UAP	By negotiations
2. Finalize the draft procurement section of the project operational manual.	SEFIN-UAP	By negotiations
3. Finalize draft CATS TORs and short list.	SEFIN-UAP	By effectiveness
4. Finalize and incorporate in the operating manual the evaluation framework that will be used to determine the municipalities’ capacity to implement the works and manage the procurement aspects of Component 1, including the system of thresholds.	SEFIN-UAP	By effectiveness
5. Finalize the draft TORs and short-list consultants for the design of the performance-based contract and bidding documents for Component 2.	SEFIN-UAP	By effectiveness
6. Contract external auditors, based on short-list satisfactory to the Bank.	SEFIN-UAP	3 months after effectiveness

a. This column presents only the estimated completion date, not an indication of legal conditions.

E. Procurement Processing of Goods and Works

E.1. Component 1

All procurement packages will be prepared by the municipalities directly, and will be carried out in accordance with the Procurement Plan as agreed with the Bank. The UAP will forward the procurement plan to the Bank for prior review and no objection.

The UAP will be solely responsible for the terms of reference and procurement of the consultants needed as permanent staff to the UAP, for the CATS to support the municipalities, for the consultants preparing the master plans and designs and works supervision, and for contract supervision and monitoring and verification of works.

The procurement, contracting, and supervision of works and goods in the municipalities will be executed by the proper municipality under strict supervision from UAP, provided that its capacity is deemed sufficient. A rigorous evaluation framework, to be detailed in the operating manual, will be used to determine the capacity of municipalities to implement the works, based on the analysis conducted prior to the Barrio Ciudad project and the Rural Infrastructure Project (PIR). When the capacity of the municipality is found to be insufficient, the UAP will implement the works and make contract payments in close technical coordination with the municipality.

Procurement of works and goods for Component 1 will be conducted as follows: If the implementer is a municipality of category A, it will use their existing procurement practices below agreed thresholds. If the implementer is a municipality of category B, it will follow UAP's operational guidelines for project procurement. A system of thresholds will be outlined in the Procurement Plan and in the Operational Manual.

For the assessment of the implementer's procurement procedures, the following methods may be used for procurement of goods and works for the execution of the sub-projects: (a) shopping; (b) direct contracting; and (c) national competitive bidding, which have been found acceptable to the Bank following the selection criteria established in the Operational Manual.

As part of the overall review of each sub-component implementer's capacity to implement the proposed project, UAP will review and certify that all appropriate procurement procedures are consistent with Bank procurement guidelines. A no objection from the Bank will be required prior to the award of each sub-component request.

E.2. Component 2

The management operators will be procured using International Competitive Bidding (ICB) procedures as described in the Procurement Guidelines. Prior to starting the ICB procedures, bidder prequalification will take place in accordance with paragraphs 2.9 and 2.10 of the Guidelines. Prequalified bidders would be invited to submit technical and financial proposals using bidding documents in accordance with Bank procurement guidelines.

Detailed procurement procedures, standard bidding documents for contracting of operators, and planning approach toward their contracting will be described in the Operational Manual. The technical specifications for the performance-based contracts will be written by appropriate specialists that the UAP will employ and which will be housed in the UAP.

E.3. Components 3 and 4

The Goods in Components 3 and 4 will be procured using shopping.

F. Procurement Processing of Consultants' Services

Consulting Services under this Project will be procured exclusively by the UAP. This will include services to be provided by firms and individual consultants such as: (a) auditing services, (b) CATS, (c) UAP staff and consultants to support Component 1, and (d) advisory services under Components 1, 2 and 3. The following selection procedures would be used for Consultants' Services:

(a) Quality and Cost-Based Selection: QCBS will be the mainstream method for contracts estimated to cost \$100,000 equivalent or more.

(b) Consultant's Qualification Selection: CQS may be used for contracts estimated to cost less than US\$100,000 equivalent for auditing, monitoring, and verification of works, and small and simple assignments for advisory and training services under the project.

(c) Other consultant selection methods: Fixed-Budget Selection, Least-Cost Selection, Single-Source Selection and Quality-Based Selection may be used when duly justified in accordance with the Bank's consultant services guidelines.

(d) Individuals. Consultant contracts for specialized advisory services for the Project to be provided by individual consultants and with estimated cost below than \$30,000 shall be selected through comparison of qualifications of three consultants. Consultant services contracted with individual consultants shall meet the requirements set forth in paragraphs 5.1 through 5.3 of the Consultant Guidelines.

To ensure that priority is given to the identification of suitable and qualified national consulting firms, short-lists for contracts may be comprised entirely of national consultants, provided that at least three qualified firms or individual consultants are available. However, if foreign firms or individual consultants have expressed interest, they would not be excluded from consideration.

G. Procurement Plan

The UAP developed an 18-month procurement plan for project implementation, which provides the basis for contract grouping and identification of procurement methods.

The procurement and consultant selection methods, estimated costs, prior review requirements, and time frame have been agreed upon between UAP and the Bank on the procurement plan

during project preparation, and will be reviewed and cleared by the project procurement specialist at negotiations.

During project implementation, UAP and the Bank agreed to meet periodically to review and assess progress achieved on the execution of the procurement plan. The plan will be updated and submitted to the Bank for prior review and no objection every six months of each year of project implementation.

Upon delivery of no objection, UAP shall advertise the agreed plan in *Development Business*, newspapers, and other publishing sources.

H. Frequency of Procurement Supervision Missions

The Bank will assist UAP in the upstart activities by providing training to key staff in procurement under Bank procedures, particularly in relation to relatively innovative features of the project such as service performance-based contracts.

Nevertheless, it is recommended that the Bank carry out frequent procurement supervision, especially during the first year of project implementation. In addition to prior review supervision tasks to be carried out by Bank staff, the capacity assessment of the UAP has recommended one supervision mission every six months. The supervision mission will not be limited to UAP but will also extend to selected municipalities executing the procurement processes.

Annex 9: Economic and Financial Analysis

HONDURAS: Water and Sanitation Sector Modernization Project

The proposed project is based on a framework approach where specific sub-projects are not pre-defined. Rather, they will be identified based on the demand from the municipalities supported with technical assistance and capacity building activities to ensure its successful implementation. Given this demand-driven approach, it was not possible to have for appraisal a representative sample of well-identified, eligible sub-projects to be fully analyzed economically. The team however, has identified appropriate methodologies for conducting the economic analysis of the eligible investments during project implementation. In order to test the methodology and have an idea of the possible economic returns that could be achieved through the implementation of this proposed project, a small sample of possible interventions was analyzed.

This annex presents the results of the economic and financial analyses that concentrated on Subcomponents 1B and 1C (US\$17.5 million) and Component 2 (US\$4.5 million), which account for 63 percent of total project cost. Consultants will be hired for the development of the municipal water and sanitation efficiency improvement plans (Subcomponent 1B) and for the development of master plans (Subcomponent 1C). These consultants will be responsible for conducting financial and economic feasibility studies, and to ensure that all proposed interventions will be economically feasible. Cost-benefit analyses will be used to assess the economic feasibility of the proposed plans. The Operational Manual will contain the methodology and detailed information on the development of the economic analysis for the investments to be financed by the project. The economic analysis principles to be applied are discussed below.

Subcomponent 1B (efficiency improvement): Any eligible investment in efficiency improvement will have to be part of either the efficiency improvement plan or the master plan of the utility requesting it, in which case it would already have been evaluated for its economic feasibility. In case the proposed investment was not part of the efficiency improvement plan, the municipality will need to present its economic feasibility study based on the methodology specified under the Project Operational Manual. Investments that are not economically feasible will not be eligible for funding.

Subcomponent 1C (investments): Any investment under this component will have to be justified as part of a master plan approach to Water Supply and Sanitation (WSS) services development. In the process of appraising a national Output-Based Aid (OBA) fund for water and sanitation investments, a sample of projects was assessed. The methodology used for assessing the economic feasibility of those sub-projects will be used for assessing those to be financed through this proposed project. The results and methodology are ready and are presented in this Annex.

Component 2 (Non-Revenue Water Reduction in Tegucigalpa): Component 2 will focus on Non-Revenue Water reduction for Tegucigalpa. The design of such program will be based on a strategic diagnostic that identifies the actions that lead to the best results for the money available. Economic and financial analysis will be an inherent part of this strategic diagnostic, hence ensuring that only actions that make economic and financial sense are funded.

Methodology

A cost-benefit analysis will be used to assess the economic feasibility of the sub-projects to be financed by the proposed project. To determine the net incremental financial costs and benefits, “with” and “without” project scenarios will be constructed.

For Subcomponent 1B and Component 2: The “with” project situation will assume that all targets expected for each proposed investment plan would be met. Conservatively, the “without” project situation will assume that the performance indicators of the utility would remain unchanged (instead of deteriorating) that is, current performance, coverage, Non-Revenue Water levels, and other operational indicators. In the case of Component 2, it will only refer to the reduction of Non-Revenue Water. On the basis of these scenarios, the incremental financial benefits and costs of the proposed investment programs will be assessed. The stream of financial flows will be adjusted for the impact of taxes, subsidies, and externalities to arrive at the economic flows of costs and benefits, with the use of the conversion factors calculated during project preparation. Because this component does not foresee any expansion in coverage, the main economic benefits are resource savings for the economy resulting from a better use of those within the utility, and some increase in consumption for connected users that will benefit from improvement in service reliability and continuity.

Subcomponent 1C: In the process of appraising a national Output-Based Aid (OBA) fund for water and sanitation investments, a sample of projects was assessed. The methodology used to assess the economic feasibility of these sub-projects that aim at expanding water and sanitation services is presented here as an example of possible results that could be obtained from the financing of this type of project.

Assumptions

Investment Costs. The “with” project scenario includes all associated investment costs including labor and the necessary equipment, including those not directly financed by the Project, but are necessary for the expected benefits to materialize.

Operation and Maintenance (O&M) Costs. The O&M costs for both the “with” and “without” project scenarios include the cost of labor, chemicals, electricity, and all administrative recurrent costs. It is expected that the incremental O&M costs resulting from the project will be considerably lower, resulting in resources savings for the utility/municipality and the economy of Honduras.

Economic costs. For the economic cost-benefit analysis, shadow prices will be used. During project preparation the team estimated the conversion factors for the main inputs of the typical sub-projects to be used for the actual analysis of eligible business and investment plans: unskilled labor, skilled labor, national and imported goods, and the standard conversion factor. Details of the calculations can be found in the project files.

Incremental Benefits. Incremental benefits identified include the following:

- Increased consumption of water supplied by the utilities and increased revenues resulting from higher volume of water billed;
- Increased revenues resulting from the reclassification of the customer database and cadastre updates (financial);
- Resource savings to the economy due to reduced operating costs resulting from the reduction of system operational losses and to efficiency improvements;
- Cost savings to the economy due to the reduction of expenses associated with waterborne diseases;
- Cost savings to the economy associated to time saved associated with fetching water.

The sub-projects under these components will generate additional economic benefits, including intangible and more difficult-to-measure environmental benefits and increased customer satisfaction. Improved reliability and leakage management will reduce the level of illegal tampering and so reduce the cost of distribution maintenance. The Project will also have an impact on increasing the flexibility in the operational handling of the systems and improved pressure management. This will reduce the level of current pipe burst-out—and therefore leakages—while increasing the economic life of pipelines and therefore reducing the cost of distribution maintenance. These additional benefits have not been considered in the analysis, so the results will be a conservative estimate of the economic impacts of the financed investments.

Collection Efficiency. Collection efficiency was assumed to remain constant.

Unaccounted for water. This is defined as volume of water not billed over volume of water supplied. Its value has been projected according to project targets.

The implementation schedule of each sub-project varies from 1 to 3 years depending on the type of project.

Discount rate. The cash flows will be discounted using a discount rate of 12 percent for the financial analysis, which is estimated to be a proxy of Honduras's opportunity cost of capital.

The costs and benefits will be projected for 20 years.

Results

Initial results for Subcomponent 1B

Cost-benefit analyses were conducted on a small sample of sub-projects from the first group of potentially participating municipalities, La Ceiba (138,000 inhabitants), Choluteca (82,000 inhabitants), and Siguatepeque (45,000 inhabitants). These were based on preliminary efficiency improvement plans and the results are presented as an example of the type of investments that could be financed and their associated economic feasibility. To determine the net incremental costs and benefits, “with” and “without” project scenarios were constructed based on the results and observations from the preliminary efficiency improvement plans developed for those three

communities, which were then adjusted for the impact of taxes, subsidies, and externalities to arrive at the economic flow of costs and benefits.

The main benefits of the sub-projects include resource savings generated by the optimization of the system and introduction of efficiency gains supported by the technical assistance and investment program supported by the project; improved water supply and sanitation services, including a reduction or elimination of supply rationing and intermittent services and ultimately improved health conditions, estimated by resource savings related to expenditures in health costs associated to treating waterborne diseases.

The main expected benefit from the interventions to be financed under this component is the resource savings generated to the economy by the utility, as it is assumed that operating costs will be reduced, commercial efficiency improved, and Non-Revenue Water reduced.

Other important benefits to the economy that accrue from the reduction of Non-Revenue Water results from the reduction of rationing, allowing an increase in water consumption and generating resource savings associated with the substitution of water sources for cheaper and better-quality utility water. In the case of La Ceiba, it was assumed that 35 percent of users are rationed; in the case of Cholulteca, 40 percent; and in the case of Siguatepeque, 60 percent; in the computed project scenario those are being gradually served.

Preliminary results show that the component is expected to be highly feasible, as can be seen in Table A9.1.

Table A9.1: Results from Sample Economic Analysis for Component 1C (000)

Sub-project	Population	ENPV	EIRR
La Ceiba	138,000	LPS204,322.1	61%
Cholulteca	82,000	LPS10,939.8	17%
Siguatepeque	45,000	LPS19,122.7	24%

Initial Results for Component 1D

Eligible sub-projects to be financed under this component by the proposed project will be evaluated based on a cost-benefit analysis that will be conducted as part of the master plans. Household surveys will be used to define the “without” project situation. A detailed methodology specifying how to estimate economic costs and benefits will be part of the operations manual and of the terms of reference for the consultants responsible for the development of the master plans.

For the purposes of a preliminary assessment, the following sub-projects were identified as potential candidates for funding through the OBA fund, which will have the same criteria as the proposed operation and the same scope in terms of size of municipalities (Table A9.2).

Table A9.2. Projects Analyzed under by GP-OBA Fund

Sub-project Name	Number of Households	Total Investment (US\$)	Average Household Cost (US\$)
PRAAC – EU Barrios en Desarrollo Water	17,843	12,230,510	685
Barrios en Desarrollo (Tegucigalpa) Water Kiosks	6877	1,263,106	184
La Masica – Water	438	905,322	2,067
La Esperanza – Water	469	414,566	884
La Esperanza – Wastewater	216	521,105	2,413
Total	25,843	15,334,611	593

These sub-projects were subject to detailed economic and financial analysis by the Global Partnership for Output-Based Aid (GPOBA) Fund. The economic analysis was based on estimates of current consumption and on cost of water purchased from vendors (currently, the charge for a 19-liter container is US\$0.40, which roughly equates to US\$21/m³). Data on tariffs and operation and maintenance costs were provided by the respective utilities/municipalities. For all projects, the analysis was based on a discount rate of 12 percent and a useful life of 20 years.

Barrios en Desarrollo, Water (Programa Regional de Reconstrucción Para América Central, Central America Regional Reconstruction Program, PRRAC): The analysis was undertaken for a population of 107,058 inhabitants growing at 3.2 percent per year and where the household size is 6 people. The economic Net Present Value (NPV) of the project is US\$6,351,238 and the Economic Internal Rate of Return (EIRR) is 20 percent. At 62 percent, expenditure savings are the largest proportion of economic benefits followed by time benefits (31 percent) and health benefits (7 percent). A sensitivity analysis showed that the results are robust: The EIRR with expenditure savings is 12 percent. It increases to 18 percent with the addition of time savings and to 20 percent with the addition of health benefits.

Barrios en Desarrollo, Water Kiosks (Tegucigalpa): The analysis was undertaken for a population of 41,262 inhabitants growing at 3.5 percent per year. The household size is 6. The project has an economic NPV of US\$1,793,261 and an EIRR of 31 percent. Expenditure, time, and health benefits are 49 percent, 35 percent, and 16 percent of total benefits, respectively. A sensitivity analysis showed that including expenditure savings alone yields an EIRR of 16 percent; it increases to 27 percent with time savings added and to 31 percent with health benefits also included.

La Masica, Water: The analysis was undertaken for a population of 2,628 growing at 3.2 percent per year. The household size is 6 people. The economic NPV of the project is US\$2,119,571 and the EIRR is 43 percent. Expenditure, time, and health benefits are 48 percent, 36 percent, and 16

percent, respectively. Results from a sensitivity analysis showed that the EIRR is 22 percent with expenditure savings. It increases to 36 percent when time savings are added and to 43 percent when health benefits are also added.

La Esperanza, Water: The analysis was undertaken for a population of 1,893 inhabitants growing at a rate of 3.2 percent per year and a household size of 6. The project has an economic NPV of US\$34,931 and an EIRR of 13 percent. Time savings constitute the largest proportion of economic benefits at over 50 percent. Expenditure savings constitute 41 percent while health savings are less than 10 percent of the benefits. For this project a sensitivity analysis showed that the EIRR with expenditure savings is 2 percent, but when time savings are added it increases to 12 percent, and to 13 percent when health benefits are also added.

La Esperanza, Wastewater: The analysis has been done for a population of 950 growing at a rate of 3.2 percent per year and a household size of 4. The project has a very low EIRR (1 percent) and a negative economic NPV (US\$256,553). This project will therefore not be considered eligible for funding under OBA or under the proposed project.

Incremental net cash-flow methodology was used for rate-of-return calculations:

The methodology confines quantified economic benefits to expenditure savings, time savings, and value-of-health savings. Since detailed household surveys were not available, the economic benefits of time savings and health savings were quantified based on adjusted World Health Organization (WHO)²⁵ estimates. Specifically, valuation of health benefits has been restricted to those due only to direct patient treatment costs saved and adult working days gained as a result of reduced instances of diarrhea. Workdays lost per year per case of adult illness are taken as the average of the WHO range (1–4). Illness treatment costs are discounted to account for only 50 percent of cases being formally treated. Time savings, that is, water collection time saved per household, is taken at the lower end of the WHO range of 0.25 to 1.00 hour. The methodology also assumes one productive adult wage earner per household and minimum wage earnings as the opportunity cost of time. The minimum wage is adjusted downward for high self-employment and unemployment.

The financial internal rate of return (FIRR) was calculated based on the income/revenue and expenditure streams of the project. This calculation was needed because the OBA subsidies will be directed only to those sub-projects with a positive economic NPV and a negative financial NPV. The value of the OBA subsidy will cover the financial deficit to the utilities of serving these poor neighborhoods (Table A9.3).

²⁵ Guy Hutton and Laurence Haller, "Water, Sanitation and Health Protection of the Human Environment, Evaluation of the Costs and Benefits of Water and Sanitation Improvements at the Global Level," World Health Organization, Geneva, 2004.

Table A9.3. Net Present Value of Cash Flows

	PRAAC – EU Barrios en Desarrollo Water	Barrios en Desarrollo Tegucigalpa Water Kiosks	La Masica - Water	La Esperanza - Water	La Esperanza – Wastewater^a
Financial NPV	-\$10,438,057	-\$849,014	-\$804,646	-\$377,594	-\$478,613
Economic NPV	\$6,351,238	\$1,793,261	\$2,119,571	\$34,931	-\$138,649

a. The project for La Esperanza Wastewater yields a negative Economic NPV and therefore will not be considered eligible for funding under OBA or under the proposed project.

Financial analysis

As part of the efficiency improvement plans/master plans, financial models will be used to project the cash flows of the proposed plans. The work done as part of the OBA facility and the preparation of this proposed project show that many of the eligible sub-projects may be financially unfeasible. However, it is important to clarify that according to OP 10.04, sub-projects that are financially unfeasible may be eligible for World Bank/IDA financing as long as they are economically feasible. The financial analysis, however, is important for the utilities to take control of their own financial performance, to prioritize investments, and to see the impact of proposed interventions on their own financial health. Project funding will be used only to finance economically feasible interventions that were prioritized by the municipalities that will be co-financing these investments.

In the case of the OBA Fund, the financial assessment is part of the eligibility criteria and for the estimate of the subsidy amount to be allocated to the specific utility. The OBA fund will finance only sub-projects that yield a negative present value but that are economically feasible. In the case of this proposed project, the sub-projects will be assessed only by their economic returns.

Annex 10: Safeguard Policy Issues

HONDURAS: Water and Sanitation Sector Modernization Project

This project will trigger the Environmental Assessment, Natural Habitats, and Physical Cultural Resources and Indigenous Peoples Safeguards, and is rated as Category B, given the small scale of physical investments and that no significant impacts are predicted for the environment. In fact, given the possibility that some sub-projects may be increased wastewater treatment, in those cases there will be net benefits to the environment.

Since sub-projects and specific locations have not yet been identified, a Framework for Environmental and Social Management (which will also encompass measures to ensure that the Physical Cultural Resources and Natural Habitats Safeguards will be addressed) and Indigenous Peoples Framework has been prepared. This project will not finance dams or involuntary resettlement according to the Bank's definition.

Environmental Impacts

Environmental implications issue only from Sub-Component 1C on Investment for System Rehabilitation and Expansion, and Component 2, Tegucigalpa Non-Revenue Water Reduction activities.

Investments funded under Component 1 would include rehabilitation, connection to and expansion of water supply and sewer networks, on-site sanitation facilities, and wastewater treatment systems. Water supply investments can include coverage extension, rehabilitation of existing networks, tanks and treatment plants, and the development of new water production capacity. Piped sewerage investment can include rehabilitation and expansion of standard, small-bore, and condominal systems. On-site sanitation investment will focus on creating supportive conditions for on-site solutions (acquisition of municipal tankers to empty septic tanks, sludge-treatment facilities and so forth), and will only subsidize on-site solutions when it is deemed appropriate. Wastewater treatment investments will include simple independent treatment systems such as stabilization ponds, artificial wetlands, and communal septic tanks. Since some projects may be located on the north coast of Honduras, a known ecotourism zone, the Natural Habitats Safeguard is triggered. Measures to ensure compliance with this safeguard are located in the Framework for Environmental and Social Management.

For Component 1, the main possible environmental impacts resulting from the execution of and later operation of works to extract and convey water may include construction waste, dislocated soil, and contamination of water sources, but all of these impacts will be handled through the guidelines governing the work of construction contractors. All works during construction usually increase levels of noise and particulate matter (dust); the sub-project implementors will use measures as detailed in the Framework for Environmental and Social Management to prevent, mitigate, and reduce these impacts. On the other hand, the rehabilitation and expansion of distribution networks could also cause negative impacts for inhabitants that live near such networks and for users of waterways.

Investments under Component 2 Leak Reduction will include works-related activities such as detecting leaks and repair or replacement of pipes—all very benign rehabilitation activities without many environmental consequences. Such activities are classified as category B.²⁶ Leak detection has negligible and very temporary environmental implications such as temporary air quality reduction from the smoke used to detect leaks or illegal connections, for example, if that particular method is used (there are others). The repair or replacement of leaky pipes will generally mean removal of dirt from digging and its eventual replacement. Resulting minor environmental impacts (proper disposal of construction waste, erosion control, protection of spring catchments, and so forth) will be addressed by appropriate guidelines that will be incorporated into the technical specifications governing the work of construction contractors.

Although the project does not foresee working in culturally or archeologically sensitive areas, any physical cultural property that may be found during the course of conducting works will be handled according to Honduras's already established laws for handling chance finds in compliance with the Bank's Physical Cultural Property Safeguard.

Arrangements for funding, a schedule for implementation (as necessary), and monitoring arrangements will be located in the Framework for Environmental and Social Management.

Social Impacts

1. Positive Social Impacts: The project's potential for delivering positive social impacts is high. The proposed decentralization of water and sanitation services is intended to improve service delivery, facilitate local accountability by tailoring infrastructure services to the needs of local constituencies, and promote good governance by municipalities and communities taking the lead toward more transparent and efficient decisionmaking. These positive benefits will be heightened by increased stakeholder participation in decisionmaking, which will in turn strengthen ownership among municipal constituents and water and sanitation service consumers.

2. Safeguards frameworks prepared: In terms of Component 1 physical interventions, the pertinent social safeguard instruments have been prepared. Regarding involuntary resettlement, given the nature and scale of these water and sanitation works to be implemented in urban areas, a proposed sub-project will be considered ineligible if it involves (a) the involuntary taking of land resulting in (i) relocation or loss of shelter; (ii) loss of assets or access to assets, or (iii) loss of income sources or means of livelihood, whether or not the affected persons must move to another location; or (b) the involuntary restriction of access to legally designated parks and protected areas resulting in adverse impacts on the livelihoods of the displaced persons.

Although sub-projects will not be determined before project implementation, the project does foresee 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); including the input it received through individual

²⁶ Safeguards Management and Review Team (SMART), *Simplifying Safeguards: Addressing Environmental and Social Issues in Water Supply and Sanitation Projects*, 2004.

consultations with key indigenous and Garifuna organization directors. This framework reflects the values embodied in the Bank’s policy, by recognizing that the identities and cultures of Honduran indigenous groups and Afro-Honduran communities are inextricably linked to the lands on which they live and the natural resources on which they depend, which exposes them to different types of risks and levels of impacts from development projects, including loss of identity, culture, and customary livelihoods, and exposure to disease. For this reason, the framework has highlighted the appropriate social inclusion mechanisms, corroborated with national indigenous and Afro-Honduran leaders, to be implemented throughout the project cycle.

3. Rapid social assessments to be carried out during implementation: Once the cities have been selected, a rapid social assessment will be carried out per city, serving a double purpose. First, in terms of project preparation, these assessments will provide the implementing agency with valuable information about the population, ranging from basic demographic data to customer needs and satisfaction levels, which will guide the design of the project interventions. As a result, the project will be more responsive to social development concerns, including seeking to enhance benefits for poor and vulnerable people while minimizing or mitigating risk and adverse impacts. Second, the assessments will enable the optimal use of the project’s monitoring and evaluation indicators by providing a substantial baseline with valuable qualitative and quantitative data.

The assessment process will include the following activities during Steps 1 and 2 of Component 1:

	Activity	Which Stage of the Process	Responsible Party	Description
1.	Inclusion Strategy agreed with municipality	Step 1	CATS	The consultants will discuss the inclusion strategy for vulnerable groups with the municipality (including non-indigenous, indigenous, and Afro-descendant groups). The municipality will send an official note to each household in the neighborhood, introducing the project and its benefits, costs to be incurred by the community, and inviting community participation.
2.	Desk Review	Step 1	CATS	The desk review will include the analysis of secondary data regarding: the demographic and socioeconomic conditions of the selected city, current supply of infrastructure and access to services, presence of local institutions and civil society organizations, technical capacity of the municipal team, and status of municipal and neighborhood development plans.
3.	Participatory	Step 2	UAP –	Participatory focus groups will be conducted

	Activity	Which Stage of the Process	Responsible Party	Description
	Focus Groups		social consultant	with the identified stakeholders of the project. These workshops aim to (a) complete the construction of the baseline by validating and enhancing the quantitative results of the household surveys; and (b) further discuss community needs, priorities, and expectations regarding results.
4.	Socioeconomic and consumer satisfaction survey	Step 2 As part of the Master Plans	Consulting firm	Socioeconomic household survey will be used to collect data in each participating municipality, to include socioeconomic aspects such as (a) social, cultural, and economic characteristics (level of social and human capital, income); (b) access to and perceptions of water and sanitation services; (c) incidence of waterborne diseases and respiratory infections in the community; (d) social problems including crime and violence, problems caused by migration or immigration from rural areas, and consumer satisfaction dimensions such as (a) water consumption patterns, (b) use of sanitation facilities, (c) existing hygiene habits, and (d) willingness toward infrastructure improvement and cost recovery.

Annex 11: Project Preparation and Supervision
HONDURAS: Water and Sanitation Sector Modernization Project

	Planned	Actual
PCN review		03/08/2007
Initial PID to PIC		02/16/2007
Initial ISDS to PIC		02/16/2007
Appraisal		04/09/2007
Negotiations	05/17/2007	
Board/RVP approval	06/21/2007	
Planned date of effectiveness	12/31/2007	
Planned date of midterm review	12/31/2010	
Planned closing date	12/31/2013	

Key institutions responsible for preparation of the project: SANAA, SEFIN, Municipalities.

Bank staff and consultants who worked on the project include:

Name	Title	Unit
Gustavo Saltiel	Senior Water Engineer	LCSUW
John V. Kellenberg	Sector Leader	LCSSD
Dante Ariel Mossi Reyes	Country Operations Officer	LCCHN
Pilar Elisa Gonzalez Rodriguez	Senior Counsel	LEGLA
Maria Angelica Sotomayor Araujo	Senior Economist	LCSUW
Meike van Ginneken	Senior Water & Sanitation Specialist	ETWWA
David Michaud	Water and Sanitation Specialist	LCSUW
Rafael Vera	Senior Water & Sanitation Specialist	ETWAN
Luis Tineo	Procurement Specialist	LCSPT
Fabienne Mroczka	Financial Management Analyst	LCSFM
Nicole Maywah	Operations Analyst	LCSUW
Luis Alberto Andres	Infrastructure Economist	LCSSD
Miguel Vargas-Ramirez	Water & Sanitation Specialist	LCSUW
Karla Chaman	Communications Officer	EXTCD
Ana Consuelo Funes Rosales	Team Assistant	LCCHN
Rosa Elena Bellido	Language Program Assistant	LCSUW
Fernanda Ruiz Nunez	Consultant	LCSUW
Kimberly Vilar	Consultant	LCSTR
Arturo Jimenez	Consultant	LCSUW
Jose Eduardo Mestre	Consultant	LCSUW

Bank funds expended to date on project preparation:

1. Bank resources: US\$156,771.69
2. Trust funds: US\$14,481.00
3. Total:US\$171,252.69

Estimated Approval and Supervision costs:

Remaining costs to approval: US\$30,000
Estimated annual supervision cost: US\$150,000

Annex 12: Documents in the Project File
HONDURAS: Water and Sanitation Sector Modernization Project

Bank Documents

- Aide Memoire Preparation Mission, February 12, 15, 2007.
- Aide Memoire Identification Main Findings of Preparation Mission, March 19–22, 2006.
- Aide Memoire Pre-Appraisal Mission, April.
- Project Concept Note.
- Project Information Document (Appraisal Stage).
- Integrated Safeguards Data Sheet (Appraisal Stage).
- Minutes of Decision Package Meeting.
- PAD Water and Sanitation Sector Modernization Sector Project.
- “Implementation Completion Report on a Loan to the Republic of Honduras for Sustainable Tourism Development Project,” Report No. 35651, World Bank, 2006.
- Honduras Country Assistance Evaluation, Report No. 37861, World Bank, 2006.
- Country Assistance Strategy for the Republic of Honduras, Report No. 37280-HN, 2006.

Studies

- Reporte De Actividades De Formulación de Planes de Negocios Para Localidades en el Norte de Honduras, (04 Al 10 De Febrero De 2007).
- “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.

Government Documents

- “Plan Estratégico de Modernización del Sector Agua Potable y Saneamiento (PEMAPS)”, Government of Honduras, 2005.
- Marco de Políticas de Comunidades Indígenas y Afrohondureñas del PROMOSAS.
- Marco Conceptual para el Manejo Ambiental y Social del Proyecto de Modernización del Sector de Agua y Saneamiento (PROMOSAS).
- Encuestas Permanentes de Hogares, Instituto Nacional de Estadísticas de Honduras, 2003.

Laws and Regulations

- LEYES de Municipalidades y Reglamento.
- Ley Marco de Agua y Saneamiento.
- Reglamento Ley Marco Sector Agua Potable y Saneamiento.

Annex 13: Statement of Loans and Credits
HONDURAS: Water and Sanitation Sector Modernization Project

Project ID	Project Name	Fiscal Year	Original Amount in US\$ Millions				Undisb.	Difference Between Expected and Actual Disbursements ^{4/}	
			IBRD	IDA	GRANT	Cancel.		Orig.	Frm Rev'd
P086775	HN Rural Infrastructure Project	2006		47.00			44.75		
P088319	HN Barrio-Ciudad Project	2006		15.00			13.56	0.28	
P007397	HN Community-Based Education Project	2001		41.50			4.59	5.21	
P064913	HN Emergency Disaster Management	2000		10.82			0.10	(0.57)	
P064914	HN Forests and Rural Productivity	2004		20.00			10.85	5.50	
P040177	HN Financial Sector Technical Assistance	2003		9.90			7.34	6.32	
P083311	HN First Prog Fin Sec Dev Pol Credit	2005		25.00			11.91	26.96	
P090113	HN GEF Rural Electrification	2006			2.35		2.35	0.25	
P081516	HN Judicial Branch Modernization	2006		15.00			14.19	1.51	
P055991	HN Land Administration Program	2004		25.00			6.96	3.43	
P083244	HN Nuestras Raices Program	2004		15.00			13.46	11.30	
P082242	HN Nutrition and Social Protection	2006		20.00			17.81	7.80	
P083851	HN Poverty Reduction Strategy Technical Assistance Credit	2004		8.00			5.58	4.80	
P057538	HN Road Reconstruction and Improvement	2001		66.50			0.49	(5.47)	
P081172	HN Regional Dev in the Copan Valley	2003		12.00			3.54	1.40	
P070038	HN Trade Facilitatio & Productivity Enha	2004		28.06			21.72	15.92	10.68
P053575	HN- Health System Reform Project	2002		27.10			8.70	3.22	
Overall Result				385.88	2.35		187.90	84.66	10.68

STATEMENT OF IFC's
Held and Disbursed Portfolio, in Millions of US Dollars, As of 07/31/2006

FY Approval	Company	Held				Disbursed			
		Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
	Granjas								
1999	Marinas	2.45	0	0	0	2.45	0	0	0
	International...	9	0	0	0	9	0	0	0
Total Portfolio:		11.45	0	0	0	11.45	0	0	0

FY Approval	Company	Approvals Pending Commitment			
		Loan	Equity	Quasi	Partic.
Total pending commitment:		0.00	0.00	0.00	0.00

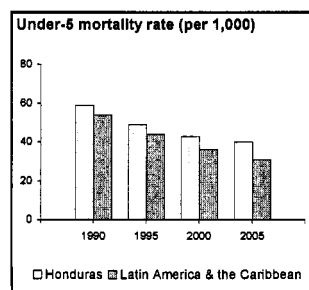
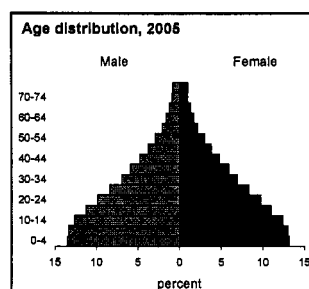
Annex 14: Country at a Glance

HONDURAS: Water and Sanitation Sector Modernization Project

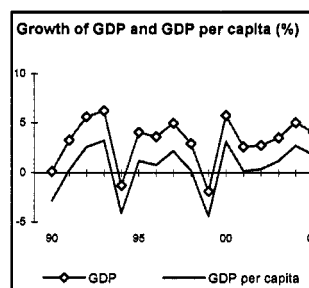
Honduras at a glance

5/9/07

Key Development Indicators	Honduras	Latin America & Carb.	Lower middle income
<i>(2006)</i>			
Population, mid-year (millions)	7.4	551	2,475
Surface area (thousand sq. km)	112	20,420	39,955
Population growth (%)	2.1	1.3	1.0
Urban population (% of total population)	47	77	50
GNI (Atlas method, US\$ billions)	8.8	2,228	4,760
GNI per capita (Atlas method, US\$)	1,200	4,045	1,923
GNI per capita (PPP, international \$)	..	8,129	6,399
GDP growth (%)	6.1	4.5	7.0
GDP per capita growth (%)	3.9	3.1	6.0
<i>(most recent estimate, 2000–2006)</i>			
Poverty headcount ratio at \$1 a day (PPP, %)	15	9	..
Poverty headcount ratio at \$2 a day (PPP, %)	36	22	..
Life expectancy at birth (years)	69	72	71
Infant mortality (per 1,000 live births)	31	26	31
Child malnutrition (% of children under 5)	17	..	12
Adult literacy, male (% of ages 15 and older)	80	91	93
Adult literacy, female (% of ages 15 and older)	80	89	85
Gross primary enrollment, male (% of age group)	113	120	117
Gross primary enrollment, female (% of age group)	113	116	114
Access to an improved water source (% of population)	87	91	82
Access to improved sanitation facilities (% of population)	69	77	57



Net Aid Flows	1980	1990	2000	2006 ^a
<i>(US\$ millions)</i>				
Net ODA and official aid	102	448	449	681
<i>Top 3 donors (in 2005):</i>				
Japan	7	85	50	103
Spain	..	6	35	95
United States	19	215	110	88
Aid (% of GNI)	4.2	16.0	7.7	8.6
Aid per capita (US\$)	29	92	70	94



Long-Term Economic Trends	1980	1990	2000	2006 ^a
Consumer prices (annual % change)	..	23.3	11.0	5.2
GDP implicit deflator (annual % change)	13.2	21.2	9.7	5.2
Exchange rate (annual average, local per US\$)	2.0	4.1	15.0	19.0
Terms of trade index (2000 = 100)	..	129	100	..

1980–90 1990–2000 2000–06
(average annual growth %)

Population, mid-year (millions)	3.6	4.9	6.4	7.4	3.1	2.8	2.3
GDP (US\$ millions)	2,566	3,049	5,956	9,235	2.7	3.2	4.0
<i>(% of GDP)</i>							
Agriculture	23.7	22.4	16.2	13.5	2.7	2.2	3.5
Industry	24.3	26.4	31.6	30.5	3.3	3.6	4.0
Manufacturing	15.0	16.3	19.6	19.5	3.7	4.0	4.3
Services	52.0	51.2	52.2	56.1	2.5	3.8	4.6
Household final consumption expenditure	69.4	66.8	70.6	76.8	2.6	3.0	5.5
General gov't final consumption expenditure	12.7	12.9	12.5	18.0	3.3	2.0	5.7
Gross capital formation	24.8	23.0	30.7	30.3	3.0	6.9	2.9
Exports of goods and services	37.2	37.2	41.3	41.0	1.1	1.6	6.4
Imports of goods and services	44.1	39.9	55.2	66.8	1.2	3.8	8.7
Gross savings	13.2	21.7	26.8	32.1	..	..	..

Note: Figures in italics are for years other than those specified. 2006 data are preliminary. Group data are for 2005. .. indicates data are not available. a. Aid data are for 2005.

Development Economics, Development Data Group (DECDG).

Balance of Payments and Trade 2000 2006

(US\$ millions)	2000	2006
Total merchandise exports (fob)	1,436	1,927
Total merchandise imports (cif)	2,856	5,415
Net trade in goods and services	-840	-2,377
Workers' remittances and compensation of employees (receipts)	416	1,796
Current account balance as a % of GDP	-232 -3.9	-55 -0.6
Reserves, including gold	1,319	2,776

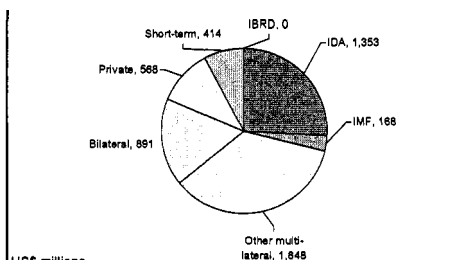
Consolidated Non-Financial Public Sector Finance 2000 2005

(% of GDP)	2000	2005
Revenue	29.2	28.1
Tax revenue	17.3	17.0
Expenditure and Net Lending	30.0	32.0
Overall surplus/deficit	-0.8	-3.9
Highest marginal tax rate (%)		
Individual	25	25
Corporate	15	25

External Debt and Resource Flows

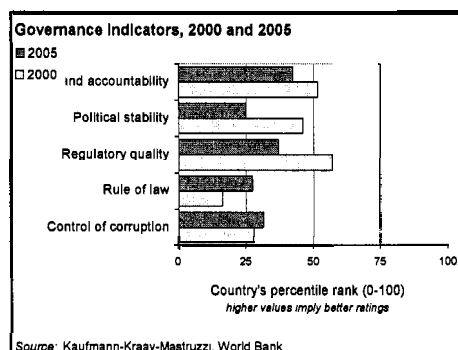
(US\$ millions)	2000	2005
Total debt outstanding and disbursed	5,360	5,242
Total debt service	389	381
HIPC and MDRI debt relief (expected; flow)	1,053	..
Total debt (% of GDP)	90.0	63.2
Total debt service (% of exports)	12.3	7.3
Foreign direct investment (net inflows)	282	464
Portfolio equity (net inflows)	0	0

Composition of total external debt, 2005



Private Sector Development 2000 2006

Time required to start a business (days)	-	44
Cost to start a business (% of GNI per capita)	-	60.6
Time required to register property (days)	-	36
Ranked as a major constraint to business (% of managers surveyed who agreed)		
Corruption		62.7
Access to/cost of financing		62.4
Stock market capitalization (% of GDP)	8.8	..
Bank branches (per 100,000 people)		0.7



Technology and Infrastructure 2000 2005

Paved roads (% of total)	20.4	
Fixed line and mobile phone subscribers (per 1,000 people)	71	246
High technology exports (% of manufactured exports)	0.3	2.2

Environment

Agricultural land (% of land area)	26	26
Forest area (% of land area, 2000 and 2005)	48.5	41.5
Nationally protected areas (% of land area)	..	21.0
Freshwater resources per capita (cu. meters)	..	13,311
Freshwater withdrawal (% of internal resources)	0.9	..
CO2 emissions per capita (mt)	0.78	0.94
GDP per unit of energy use (2000 PPP \$ per kg of oil equivalent)	5.3	4.8
Energy use per capita (kg of oil equivalent)	469	548

World Bank Group portfolio 2000 2005

(US\$ millions)	2000	2005
IBRD		
Total debt outstanding and disbursed	151	0
Disbursements	0	0
Principal repayments	27	70
Interest payments	15	3
IDA		
Total debt outstanding and disbursed	838	1,353
Disbursements	38	151
Total debt service	8	18
IFC (fiscal year)		
Total disbursed and outstanding portfolio of which IFC own account	42	3
of which IFC own account	27	3
Disbursements for IFC own account	9	0
Portfolio sales, prepayments and repayments for IFC own account	26	10
MIGA		
Gross exposure	16	0
New guarantees	0	0

Note: Figures in italics are for years other than those specified. 2006 data are preliminary. .. indicates data are not available. - indicates observation is not applicable.

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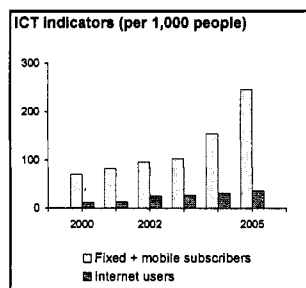
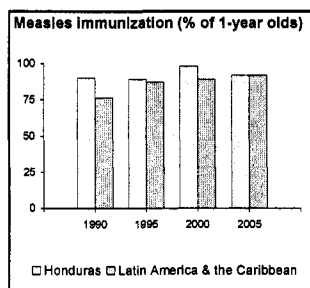
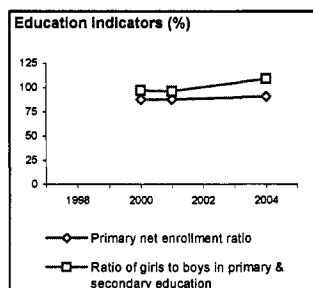
Development Economics, Development Data Group (DECDG).

Millennium Development Goals

Honduras

With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Honduras			
	1990	1995	2000	2005
Goal 1: halve the rates for \$1 a day poverty and malnutrition				
Poverty headcount ratio at \$1 a day (PPP, % of population)	37.8	25.0	20.7	14.9
Poverty headcount ratio at national poverty line (% of population)	..	47.0	48.0	..
Share of income or consumption to the poorest quintile (%)	2.8	3.4	3.0	3.4
Prevalence of malnutrition (% of children under 5)	18.0	25.4	16.6	..
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	89	..	88	91
Primary completion rate (% of relevant age group)	65	71	..	79
Secondary school enrollment (gross, %)	33	..	..	65
Youth literacy rate (% of people ages 15-24)	80	..	..	89
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	106	..	97	109
Women employed in the nonagricultural sector (% of nonagricultural employment)	48	45	48	47
Proportion of seats held by women in national parliament (%)	10	8	9	23
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	59	49	43	40
Infant mortality rate (per 1,000 live births)	44	37	33	31
Measles immunization (proportion of one-year olds immunized, %)	90	89	98	92
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	110	..
Births attended by skilled health staff (% of total)	45	55	56	..
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	1.5
Contraceptive prevalence (% of women ages 15-49)	47	50	62	..
Incidence of tuberculosis (per 100,000 people)	115	101	89	78
Tuberculosis cases detected under DOTS (%)	..	..	101	82
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	84	..	..	87
Access to improved sanitation facilities (% of population)	50	..	..	69
Forest area (% of total land area)	66.0	..	48.5	41.5
Nationally protected areas (% of total land area)	..	..	..	21.0
CO2 emissions (metric tons per capita)	0.5	0.7	0.8	0.9
GDP per unit of energy use (constant 2000 PPP \$ per kg of oil equivalent)	5.0	4.9	5.3	4.8
Goal 8: develop a global partnership for development				
Fixed line and mobile phone subscribers (per 1,000 people)	18	29	71	246
Internet users (per 1,000 people)	0	0	12	36
Personal computers (per 1,000 people)	..	3	11	16
Youth unemployment (% of total labor force ages 15-24)	7.4	5.2	7.2	7.0



Note: Figures in italics are for years other than those specified. .. indicates data are not available.

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