

Report No: AB1168

MEXICO

WATER SUPPLY AND SANITATION TECHNICAL ASSISTANCE LOAN
PROJECT INFORMATION DOCUMENT (PID)

CONCEPT STAGE

Project Name	Water Supply and Sanitation Technical Assistance Loan
Region	Latin America and the Caribbean
Sector	Water and Sanitation
Project ID	P0 91695
Borrower(s)	Government of Mexico
Implementing Agency	CNA /
Environment Category	<input type="checkbox"/> A <input type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> FI <input checked="" type="checkbox"/> TBD (to be confirmed)
Safeguard Classification	<input type="checkbox"/> S ₁ <input type="checkbox"/> S ₂ <input type="checkbox"/> S ₃ <input type="checkbox"/> S _F <input checked="" type="checkbox"/> TBD (to be confirmed)
Date PID Prepared	September 2004
Estimated Date of Appraisal Authorization	March 2005
Estimated Date of Board Approval	May 2005

1. Key Development Issues and Rationale for Bank Involvement

Mexico's Water Supply and Sanitation Sector (WSS) has been influenced by recent developments in the economic, social and political context in the country. Particularly in recent years, attention has shifted from macroeconomic reforms concentrated in the search for economic stability to changes in the institutional set up where greater attention is put toward social and environmental reforms. The Government of President Fox regards the water sector as a matter of national security, and the lack of adequate water supply as one of the main factors contributing to structural poverty in Mexico. Although between 1990 and 2001, important progress has been made as regards to service coverage (water supply and sewerage coverage levels are 89% and 77%, respectively), Mexico still faces significant challenges in meeting its sector development needs. Major issues affecting the sector are: (i) institutional and political constraints(excessive politicization, weak institutional and regulatory arrangements at the sub-national level, inadequate pricing and inadequately focused sector programs); (ii) inappropriate financing policies and mechanisms; and (iii) significant financing needs for the investments required to improve the quality of the services, expansions in coverage and wastewater treatment nationwide.

The above issues have been acknowledged by the Government and policy reforms to address them are contemplated in the Government's plans for the sector. The new legal framework, resulting from the recent modifications to the National Water Law, represents a new scenario that will impact the development of the sector in the immediate years. The Law now mandates the

decentralization of *Comision Nacional del Agua*¹ (CNA), the development of the national Water Financial System (*Sistema Financiero del Agua*) and promotes improvements in service provision. This new legal framework constitutes a unique opportunity for moving the reform process forward, for which the water supply and sanitation sector would require further assistance. Although the sector financing needs are large, at this moment it would seem premature to develop a large investment or adjustment operation, since the institutional framework is undergoing times of change and thus a certain dose of uncertainty. This was indicated by the senior management of CNA and *Secretaría de Hacienda y Crédito Público*² (SHCP), by requesting a technical assistance loan (TAL) at this point, with the expectation that it would set the stage for a substantial financing operation subsequently. This TAL would support the implementation of the reform agenda whilst establishing a firm sector dialogue with the Government and paving the way for a potential investment or adjustment operation in the future.

The proposed TAL would support the implementation of reforms mandated by the water Law by: i) improving the institutional and regulatory framework for the water supply and sanitation sector; ii) supporting the development of replicable models for an efficient and sustainable provision of water supply and sanitation services (“success cases”); iii) structuring and implementing the Water Financial System; iv) designing a national information system aimed at improving the decision-making and regulation in the sector; and v) contributing to the existing efforts to promote the training at managerial and operational levels of the personnel of the sector. As stated above, the development of this project will allow to consolidate the sector reform process and hence to create the conditions for improving the quality of the services and expanding the access, especially to the poor.

The Mexican authorities have expressed their interest in Bank’s active involvement in the sector at this critical time of the reform agenda, as a useful way to provide impartial technical advice based on international good practice. During the last missions, the authorities committed to set the team that will collaborate with the Bank in preparing the TAL. From both its lending in Latin America and other regions, the Bank has wide experience in water and sanitation sector reform processes, regulatory and institutional issues, improvement of the performance of utilities and access of the poor to the services, all of which are important for the proposed project. The Mexican Government and the Bank have agreed to developing an Infrastructure Public Expenditure Review in selected sectors, including water and would expect further assistance to implement reforms recommended by that study, among which will be the Water Financial System. Benefits to the country will thus arise in the form of both the Bank’s comparative advantage in the sector, as well as in the financing provided for technical assistance. Also, the Bank has a comparative advantage in its ability to facilitate working across institutions that do not have a history of close cooperation, as is the case with the relevant water sector institutions in Mexico.

The importance of Bank’s involvement in the water sector in Mexico is directly related to the Strategy proposed in the CAS in the context of the Government’s poverty reduction efforts. Moreover, this project would support three of the four pillars stated in the CAS: “to reduce poverty and inequality”, to “strengthen institutions” and to “promote environmental sustainability in Mexico”. These efforts would match those of other members of the donor community currently active in the sector in the country. The Inter-American Development Bank has recently approved

¹ Entity responsible for the administration of water resources at the national level and design and implementation of investment programs for the water and sanitation sector

² Ministry of Finance

a US\$ 10 million loan (Water Supply and Sanitation Institutional Development Demonstration Loan ME-0253) to provide assistance to five utilities in medium and small-size municipalities on a demonstration basis. The proposed TA loan would complement the IDB project by addressing the crucial issues of reforming the system of federal and state funding for water supply and sanitation and establishing a national information system, and the full spectrum of modes of service provision including various forms of PSP. The proposed TAL would assist in developing innovative approaches in the water sector, such as the experience of Tlanepantla de Baz³ and others. The project team also proposes to work closely with the Water Cluster and the teams working in the following projects: Irrigation & Drainage; Decentralized Infrastructure; Environmental SAL II; PROMMA II; Water Rights; Water Policy Development SAL; the various water sector AAA activities, as well as with CNA, to ensure coordination both on the CNA side and on the Bank's side to make the most efficient use of the technical support and management of associated fiduciary responsibilities.

The proposed TAL will build on the main lessons from the Mexico Public Expenditure Review and ICR of the Second Water Supply and Sanitation Project: i) the need for adequate attention to regulatory, and sector reform issues; ii) the need for sustainable and efficient allocation of public funds, that provide the incentives for local governments to either increase cash generation, or borrow to improve services; iii) the need for credible monitoring systems, reinforcing the need for measurable goals, through established mechanisms, i.e., appropriate information systems, and project management reviews, integrated monitoring, and information systems; and iv) the need for effective conditionality, timely action to restructure, and adjust operations, and maintain a sustained dialogue with the client. In accordance with this experience, the proposed TAL will assist the GOM to develop the tools and instruments to induce local authorities to improve financial sustainability and efficiency of service provision in their jurisdiction.

As a result of the new legal framework, the Mexican authorities have expressed a sense of urgency in addressing the performance problems in the sector, both from a resource management angle and from a redistributive/poverty reduction perspective. Given this sense of priority from the Mexican authorities, the need for further financing of technical assistance and the effective dialogue the Bank is having in sector policy, there is a unique opportunity for Bank's involvement to support the Government in implementing and consolidating the envisaged reforms as a the first stage of a broader strategy that would include Investment or Adjustment Lending in the future. In this respect, the proposed operation, although limited to technical assistance, is both timely and sound and its impact will be maximized through complementing available funding from the Federal Government and from other donors, to develop a financially sustainable sector for the long term.

2. Proposed Objectives

This project will assist the Government of Mexico to develop the tools and instruments to induce local authorities to improve financial sustainability and efficiency of water supply and sanitation service provision in their jurisdiction. This will imply a shift toward "performance based" allocation of public (federal and state) transfers and concessional lending (via the Development Banks) and a key criteria for performance will be improvements in cost recovery and poverty targeting. To this end, this project will: i) design and implement the water financial system; ii) improve the technical and commercial performance of selected water utilities and regulatory

³ Using its newly established Municipal Fund, IFC and the World Bank have supported the Municipality of Tlanepantla de Baz in issuing a US\$ 8.8m equivalent local currency bond without a sovereign guarantee by providing a Partial Risk Guarantee in partnership with a private bank.

capacity in participating states through capacity building and improved information systems; and iii) develop and demonstrate replicable models of successful and sustainable provision of water and sanitation services, including modernization of publicly run utilities and PSP transactions in cases where deemed appropriate.

3. Preliminary Description

The proposed Project will provide funding for specific studies and activities covering different areas where technical assistance is needed. The total project cost is estimated at US\$ 30 million (Bank's contribution, US\$ 15 million; Borrower's contribution US\$ 15 million). The criteria, conditions and mechanisms by which the technical assistance will be provided to the *Organismos Operadores*⁴ (OO) will be defined during project preparation, in a consistent manner with other existing programs of the Federal Government. In fact, one of the key expected outcomes of the proposed project would be to provide an objective basis, uniform approach and harmonized procedures for CNA and SHCP to allocate funds (both grant and loan) to the water and sanitation sector through the improved transparency and efficiency that will be brought about by the new financial system and information system to be implemented under the Project.

1. Institutional Development (US\$ 9 million)

- i) Structuring and implementation of the water sector financial system
- ii) Improving the institutional and regulatory framework for the sector
- iii) Design of the national information system
- iv) Training for sector officials at the state level

2. Utilities Management (US\$ 21 million)

- v) Development of replicable models for provision of efficient and sustainable services
- vi) Training in managerial and operational issues for staff of the water utilities

Other Bank assistance options considered were the following:

Limiting Assistance to AAA. The breadth of issues which demand urgent attention and sustained support required to work with key actors to put in place sound policies and programs exceed what several pieces of AAA can hope to provide. The Mexican authorities have expressed a willingness and desire to borrow for this purpose, despite the budget ceilings and lack of "additionality" that characterize Bank lending to Mexico.

Sectoral Adjustment Lending. In the current context that is characterized by poorly focused programs and the recent modifications to the National Water Law, there is a high degree of uncertainty concerning the implementation of the reforms mandated by the law, which are intended to further the decentralization process. Thus, an adjustment operation would not be opportune at this juncture, given that an important period of time could elapse before the Federal Government implements the reforms mandated under new legal framework.

Sectoral Investment Lending. In the future, with support from SHCP, loans to states that are committed to reforming their WSS sector may be a viable option for Bank support, since much of the water supply and sanitation agenda will be carried out at the sub-national level.

Technical Assistance Loan (TAL). After considering the formal request of the Mexican Government to prepare a Technical Assistance Loan and reviewing the different options, the team recommendation is to consider the preparation of a TAL as a first step in a more comprehensive assistance strategy. Once the implementation of the decentralization process is underway, the preparation of an adjustment or investment lending or any other operation could be considered, in

⁴ Service Providers

accordance with progress on improved policy formulation and program design and the recommendations of the studies and activities to be executed under the TAL.

4. Safeguard Policies that Might Apply

Applicable?	Safeguard Policy
[TBD]	Environmental Assessment (OP/BP 4.01) The Program does not foresee significant environmental impacts that could negatively affect the natural environment in the Project area.
[]	Natural Habitats (OP/BP 4.04) Not expected, to be confirmed during preparation
[]	Pest Management (OP 4.09)
[]	Involuntary Resettlement (OP/BP 4.12) No involuntary resettlement is expected. However, because the exact locations of the constructed treatment facilities have not yet been determined, this issue will be revisited during preparation.
[]	Indigenous Peoples (OD 4.20) To be determined only if project scope is expanded to include investments in the hinterlands.
[]	Forests (OP/BP 4.36)
[]	Safety of Dams (OP/BP 4.37)
[]	Cultural Property (draft OP 4.11 - OPN 11.03)
[]	Projects in Disputed Areas (OP/BP/GP 7.60)
[]	Projects on International Waterways (OP/BP/GP 7.50)

5. Tentative Financing

Source:	(\$m)
BORROWER/RECIPIENT	15
IBRD	15
Total	30

6. Contact Point

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