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ON A

PROPOSED LOAN

IN THE AMOUNT OF US\$ 70.0 MILLION

TO THE

REPUBLIC OF COLOMBIA

FOR A

WATER AND SANITATION SECTOR SUPPORT PROJECT

IN SUPPORT OF THE FIRST PHASE OF THE WATER AND SANITATION SECTOR
SUPPORT PROGRAM

FEBRUARY 15, 2005

FINANCE, PRIVATE SECTOR, AND INFRASTRUCTURE
COLOMBIA AND MEXICO COUNTRY MANAGEMENT UNIT
LATIN AMERICA AND THE CARIBBEAN REGION

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Annex 1: Country and Sector or Program Background

COLOMBIA: Water and Sanitation Sector Support Project

1. Country and Sector Context

Sector Background

Overview. Colombia, with a population of about 45 million inhabitants, has made impressive progress in expansion of water and sanitation services in urban areas in recent years. According to United Nations guidelines – which include private wells in the case of water supply and septic tanks and latrines in the case of sanitation – access to safe water and sanitation services has become virtually universal, especially in large urban areas of Colombia during the last decade. Using stricter definitions of household connections to water and sewerage, the current level of access in urban areas would be 97% for water and 90% for sewerage, which still compares impressively with higher income countries like Argentina (70%) and the rest of the region. Rural coverage (broadly defined) is much lower (53% for water and 57% for sanitation), with these levels shrinking to 52% and 15% respectively when the definition is restricted to household water and sewerage connections. Although there has been substantial progress over in the expansion of urban and rural coverage recent years, there remain significant discrepancies in the coverage ratios in large urban areas and in peri-urban and rural areas, where efforts must be more than doubled in sanitation expansion and increased by 25% in water to achieve universal access by 2020. However, the increase in coverage rates masks shortcomings in the quality of service. Although the overall performance indicators for the 59 largest utilities show reasonable levels of efficiency and service levels, in smaller municipalities water rationing and intermittent supplies are common in most water supply systems. Only slightly less than 50 percent of all drinking water outside the major urban centers is being properly treated and, as a result, the drinking water quality in many systems is substandard (one of the main reasons for this is that almost a third of the smaller municipalities, although equipped with water treatment plants, do not make the necessary purchases of chlorine for water disinfection due to their weak technical capacity as well as cash flow problems that restrict the availability of resources to purchase basic production inputs). Sufficient pressure in the water supply systems is often lacking, adding to the risk of bacterial contamination. Sewage collection systems do not have sufficient hydraulic capacity to handle wastewater flows, especially in poor neighborhoods, resulting in overflow problems and direct health and environmental impacts. The share of wastewater receiving any kind of treatment is about 10%, which is low for a middle income country such as Colombia. Regarding continuity of service, two thirds of households report access to a 24-hour water service in large urban areas. In smaller municipalities, lack of systematized information makes it difficult to assess general service quality, but widespread anecdotal evidence – as well as the sample utilities analyzed in detail under the preparation of this Project – show that the continuity of the services in the served areas under evaluation is far from being 24 hours.

Context of Decentralization. Colombia has had a highly decentralized framework for the provision of water and sanitation services since the 1986 the Decentralization Law, which transferred the responsibility for operating and managing the water and sewerage systems to the municipalities, and decentralization has been a major force in shaping the water and sanitation sector's structure. Colombia now comprises 1,091 municipalities and over 1,300 registered water and sanitation service providers in urban areas, including municipal departments, utilities (public, private and mixed) and other authorized organizations and some 12,000 community based organizations providing service in rural areas. The market is geographically concentrated with the 40 largest municipal utilities serving 70% of the urban population, equivalent to 55% of the national population. The extreme atomization of the remaining service providers has led to substantial loss of scale economies, and contributes to the weak management and precarious financial viability of the smaller operators.

Key Institutions. The Ministry of Environment, Housing and Regional Development (MAVDT) is now responsible for the water and sanitation sector policy at the national level. Within the MAVDT, the *Directorate for Potable Water and Basic Sanitation* (DAPSBA) oversees the sector, formulates sector policies, and plans sector development. The *Departamento Nacional de Planeación* (DNP) is responsible for designing and monitoring the policies, plans, programs, studies, and investment projects for the water and environment sectors, including supporting decentralization and institutional reform efforts. The *Water Regulatory Commission* (CRA) promotes competition among service providers, controls monopolies, defines tariff-setting methodologies based on standard formulas and on investment plans submitted by the operating companies, and sets quality-of-service and technical standards to be followed by utilities. The Superintendency of Public Enterprises (SSPD) is responsible for monitoring and supervising the adequacy and efficiency of utility operations, establishing uniform accounting systems, supervising the administration of subsidies, and monitoring the general administration of public service companies. Environmental regulation is handled by Autonomous Regional Corporations (CARs).

Legal Framework. The national Constitution of 1991 confirmed the right of municipalities to provide water and sanitation services, including the power to grant concessions or other forms of private sector participation. The Constitution provided the legal framework and established the grounds to introduce more aggressive reforms in the water sector by clearly separating service provision and policy making, and by allowing PSP in the infrastructure sector. Law 142, enacted in 1994, is one of the most complete examples of utilities legislation in the region and the water and sanitation sector, along with the provision of other utilities, is regulated through this framework law, although to date there has been no additional sector-specific law developed. Law 142 emphasizes efficiency of service provision through the introduction of competition and the promotion of PSP in the sector. Among the key elements of the law is the creation of the Superintendence for Public Services and the definition of the functions of the Regulatory Commissions, the *Comisión Reguladora del Agua* in the case of the Water and Sanitation Sector. Another key element of the Law is the promotion of cost recovery tariffs for the utilities, and establishes limits on the extent of cross-subsidization between customers. The law also establishes immediate liberalization of all utility services, including those traditionally regarded as natural monopolies, and explicitly exonerates service providers from any requirement to hold a concession from the conceding authority. As stated above, the water and sanitation sector does not have any sector legislation beyond Law 142/94, and this legal vacuum has made it even more difficult to establish general standards and performance criteria that could apply to the large number of decentralized utilities across the country. The Government is now contemplating the issuance of a new Water Law to enhance the policy environment as regards water resources management, particularly.

Sector Policy Framework. The Government's policy for the sector is very much focused on improving the institutional and financial capacity and sustainability of service providers, an important tenet of which has been the promotion of PSP. There has been significant experimentation with private participation, with more than half of the 26 largest utilities, equivalent to 13% of the urban market, operating with some degree of private sector involvement through various types of models, mainly mixed capital, concession and management contracts. The performance of all these utilities has improved. Colombia has pioneered the mixed enterprise model for private sector participation in the water sector, whereby the municipal government remains a significant (usually controlling) share of the utility; the private sector is represented on the Board and takes a leading role in operation of the company and investments are co-financed between the public and private sector to varying degrees. In spite of a favorable Government policy, private sector participation in the water sector is still not widespread and is far lower than has been expected, in part as a result of security problems which deter foreign operators and investors and in part as a result of the inherent complexities of carrying out PSP processes, which require strong political commitment at the local level, Government technical assistance and financial support in order to be successful.

Sector Issues. The main outstanding sector issues in the country are the following:

- **Poor Utility Performance.** The main reason for poor utility performance, particularly in small municipalities (less than 50,000 inhabitants), is inadequate management capacity, often a result of political intervention in management, political nomination of managers, and their frequent replacement for reasons not related to performance. Poor utility performance is reflected in the low quality of service provided and in inadequate commercial systems, low billing and collection, and inadequate maintenance. Coverage rates do not reflect the real quality of service; a better performance indicator is the effective water service coverage, which takes into account continuity of service and water quality, in addition to physical coverage. The effective water service coverage in Colombia, which reflects coverage of 24 hours per day with water quality that complies with drinking water standards, is shown in Table 1. These data indicate that (i) utility performance in the country, on average, is less than satisfactory; (ii) utility performance in medium and small municipalities is deficient; and (iii) there are great disparities between major cities and the rest of the country, with larger utilities presenting reasonable operational indicators of efficiency and smaller utilities presenting very weak operational and financial indicators).

Major Cities	Medium Cities	Small Municipalities	National Average
82%	46%	27%	< 50% ??

Source: ACODAL, Estado del Sector de Agua y Saneamiento en Colombia, 1998

- **Large Regional and Urban - Rural Disparities in Service Coverage.** Whereas access to water and sanitation in urban centers has become practically universal, in the rural areas there is still a long way to go, with 53.1% coverage for water and 57.9% for sanitation, and 52% and 15.2% respectively when the definition is restricted to household water and sewerage connections (though networked service is not always appropriate in rural areas). The Atlantic Coast (Caribbean region), Orinoquia and Amazonia regions present the lowest coverage rates for both services.
- **High Investment Needs.** Total investment required for investments in the services in the next five years (2004-2008) is estimated at US\$ 2.1 billion or approximately US\$ 420 million per year. These figures include investment in wastewater treatment and maintenance of existing assets, as well as investments needed to reach the Millennium Development Goals for the sector. Consequently, there is a need for maximizing the efficiency and impact of Government's support to the sector, in addition to increasing cash generation from utilities and attracting private sector investment.
- **Limited Subsidies to the Poor.** Cross subsidies are part of the design of the tariff structure in Colombia and have proven to be an effective mechanism for income redistribution in large urban areas. However, as the number of municipalities in which the entire population classified in the lower income strata has grown, the cross subsidy mechanism has become less effective. Given the unfavorable structure of demand and the fact that the sector is still far from reaching the legally established tariff parameters, the cross-subsidy scheme presents a large deficit of US\$161 million per year, equivalent to 20% of sector turnover. Therefore, the current cross-subsidy scheme has proven an insufficient tool to expand service delivery in many peri-urban areas or provide sufficient financing in municipalities with predominantly poor populations, where the underlying imbalance between contributors and beneficiaries is greater. A specific mechanism, Solidarity Funds, was proposed to allow a better service to low-income groups while helping utilities achieve financial sustainability by providing an additional direct subsidy to the service provider.

However, as these funds are supposed to be financed with municipal resources, fiscal constraints at the local level have inhibited their rollout. As of 2002, only 54% of municipalities had established such funds, and of those only 5% were allocating resources to these funds. The current cross-subsidy mechanism also ails from poor effectiveness (90% of the resources leak away to households above the poverty line) due to deficiencies in the stratification system. The Government has commissioned a detailed study of the current cross-subsidy mechanism and stratification system to define the reforms needed to solve the structural problems mentioned above

- Low Wastewater Treatment Coverage. Only about 10% of the wastewater generated in the country undergoes any kind of treatment and only half of installed wastewater treatment capacity is operational. This is a result of deficient maintenance that leaves plants inoperative, and also to the fact that some plants are located in municipalities that still lack the necessary sewerage infrastructure for wastewater collection. The remaining 90% is discharged without any treatment, contaminating a significant part of the natural water resources. Contributions from the central government for water quality control are normally assigned as a result of difficult negotiations between regional and central authorities and there is no clear mechanism for financing municipal wastewater treatment plants.
- Weaknesses in the Regulatory System. The regulatory and supervising agencies (CRA and SSPD) have regulation and monitoring oversight responsibility for over 1,300 service providers in the country. This situation makes the regulatory activity costly and inefficient. Large utilities serving over 6 million inhabitants like Bogotá are regulated in the same way as those serving 2,000 inhabitants. The result has largely been one of paralysis, with the large fringe of smaller utilities lacking the capacity or inclination to engage in regulatory processes, and the central agencies themselves lacking the manpower to interact meaningfully with such a large number of service providers. In addition, many of the smaller utilities are in such a precarious condition, that it is questionable whether regulation is even an appropriate intervention, as opposed to technical assistance or outright liquidation. Current regulation is based on tariff setting formulas that were designed to provide incentives for efficient services, but have not been fully successful in promoting efficiency. Tariff levels are, in most cases, still too low due to political considerations that override sector incentives, and although significant progress has been made in setting tariffs to cost-recovery levels, the process is far from complete and in practice, the application of the tariff increases was uneven. The largest utilities have made substantial progress, now charging reference tariffs within about 10% of the cost recovery benchmark, and making substantial progress towards the rebalancing of the cross-subsidy system. However, in the smaller utilities, there has been greater reluctance to embrace the goal of financial sustainability. This is due to politicization of the Boards of the municipal utilities, which are often presided by the local mayor, and which have the ultimate power to set tariffs even if obliged to do so within the regulatory framework laid down by the CRA. Furthermore, a number of new legal measures taken in 2003 to increase the subsidy limit for Stratum 1 households from 50% to 70% of the tariff, and subsequently outlaw any future real increases in the tariffs of Strata 1 and 2 households, have effectively undermined the process of rebalancing of the cross-subsidy framework, making the goal of cost recovery ever more distant. The existing regulatory and legal frameworks do not provide sufficient comfort to potential private investors and constitute an obstacle to the efforts of consolidating the reform initiated in 1994.
- Limited Coordination Among Central Government Agencies. There are many institutions in the sector, some with overlapping functions in certain areas. Under such circumstances, coordination efforts are a must. Utilities frequently complain about the large amount of information requested by the government, and about the costs associated with generating it. As is described in the next

section, the establishment of the *Ventanilla Única Program*, key component of the Government's strategy for the sector, aims at addressing this issue.

- Lack of a national rural water policy and no explicit rural investment programs. In contrast to other infrastructure sectors, there is no explicit central policy scheme to promote rural access to water and sanitation, beyond the fiscal transfers and the general legal framework. Although Government Programs such as the Microempresas Comunitarias have proven useful tools to improve management and operation of rural utilities, the poor performance of rural utilities in raising coverage suggests that such a well defined targeted rural water policy might be necessary to address the significant efforts needed to keep up the pace in increasing coverage expansion rates and to reduce the discrepancies in coverage ratios between urban and rural areas.

Despite the need for improvements, the water and sanitation sector in Colombia is relatively advanced as compared to many of its Latin American neighbors. In particular, the sector is characterized by:

- An Adequate Sector Policy Framework. The Government of Colombia has been a pioneer in adopting good sector policies in the water sector. The decentralization policy was enacted long ago, and promotion of PSP is a key sector policy. These are advanced policies, which provide opportunities for improvements in sector performance. The Government has also steadily provided financing to the sector and continues to do so.
- Satisfactory Service in the Large Cities. The water and sewerage services in five of Colombia's largest cities (Bogotá, Medellín, Cartagena, Barranquilla, Bucaramanga), which serve a population of about 12 million inhabitants, are good, though efficiency improvements are still needed. The exception is Cali, which is currently undergoing a crisis in the water and sewerage services.
- Successful Performance of Utilities with PSP. Private sector participation is not uncommon among the largest utilities, and takes place within the framework of a distinctive mixed enterprise model. There has been significant experimentation with private participation, with more than half of the 26 largest utilities, equivalent to 13% of the urban market, operating with some degree of private sector involvement (Figure 2.6). Colombia has pioneered the mixed enterprise model for private sector participation in the water sector, whereby: the municipal government remains a significant (usually controlling) share of the utility; the private sector is represented on the Board and takes a leading role in operation of the company; and investments are co-financed between the public and private sector to varying degrees. The experience with the privatized utilities (Cartagena, Barranquilla, Santa Marta, Tunja, Monteria, Palmira, Girardot, Riohacha and more) is encouraging. The performance of all of them has greatly improved, customer satisfaction is high and they provide good examples for resolving the water sector problems. Consequently, PSP is emerging as a methodology that tends to be adopted by mayors who are interested in improving the water sector performance.

Government Strategy

In recent years, the Government has implemented a modernization and reform program for the water and sanitation sector to address the issues described above. Current strategy and policy for the sector is outlined in the 2002-2006 National Development Plan (NDP), and aims to consolidate the reform undertaken and to create the financial, institutional and monitoring conditions to ensure investment in sector needs and the modernization of utilities to improve efficiency levels and performance. Government's strategy is based in the following actions:

- (i) incorporating the private sector into the management and operation of public water utilities where technically, financially and institutionally feasible;
- (ii) increasing financial support to publicly run utilities to address the high structural sector investment needs through a national investment program based on direct subsidies from the Government for capital expenditure, to extend assets to the poor in both urban and rural areas, with the goal of achieving sector self-sustainability in the medium term;
- (iii) implementing, as a prior condition for accessing financial support, institutional strengthening and technical assistance programs to promote utility modernization and efficient management;
- (iv) rationalizing the institutional framework at the national level to improve coordination in the sector and fight sector fragmentation, ensuring access to finance from utilities; and
- (v) strengthening the regulatory framework for the sector and enforcing mechanisms to ensure the application of tariff regulation and the use of Law 715 transfers.

Incorporating the Private Sector. The benefits of PSP in the delivery of water supply and sanitation services in Colombia are well documented and PSP remains the core of the Government's approach in larger urban agglomerations. There has been significant private participation in the sector, mostly under the concession or mixed enterprise models. The successful experiments in Barranquilla and Cartagena in the early 1990s prompted widespread experimentation, and there are currently around 100 private operators serving 15% of the urban population. Private participation is also occurring through outsourcing activities in the three main cities (Bogotá, Medellín and Cali), where public enterprises remain in charge of providing the services. In Bogotá for instance, the public utility has used BOT contracts for the construction of water and sewage treatment plants, and recently awarded management contracts for the operation and billing of services in five zones of the distribution network. As part of the policy to encourage this type of reform, the Government designed a Program for Utility Modernization (*Programa de Modernización Empresarial - PME*), aimed at facilitating the incorporation of the private sector in the management and operation of the water and sanitation services in the utilities of participating territorial entities and at providing financial support to these utilities, while ensuring provision of services to the poor. A World Bank study⁷ shows that since the operator took over in Cartagena, 95% of new connections were in households classified as Strata 1 and 2 (i.e. the poorest). In Barranquilla, the corresponding figure was 86%; in Tunja 79%; and in another private utility, Santa Marta, over 50%. The implementation of this Program is being supported by the Bank through the ongoing loan Water Sector Reform Assistance Project (CO-7077) which supports key PSP transactions, targeting improvement of efficiency and expansion of water and sanitation services in medium-size cities or regional associations of municipalities (with populations of up to about 300,000 inhabitants) and small municipalities (with populations of up to about 12,000 inhabitants).

Increasing Financial Support through a National Investment Program. Achieving the financial self-sustainability of the sector is a core objective of Government's strategy. The National Development Plan 2002-2006 focuses on promoting the concept that financing of sector utilities will be mainly based on income generated by collection of bills as well as by incorporating private investors, where feasible (approximately half of the expected subprojects would incorporate the introduction of private management). Municipalities can subsidize the tariff of low-income customers or subsidize part of the investments using the revenue transfers of Law 715 and existing public funds allocated to the sector. As part of the efforts to increase the available financing sources for the sector, Law 788 of 2002 additionally established a tax rebate scheme as an incentive to investment by regional utilities. Only when the aforementioned resources are proved insufficient, given affordability constraints, to cover investment

⁷ Colombia: Expanding Services to Low-Income Areas comparing private and public water utilities, (Sotomayor, 2001)

needs and effectively provide services, can the Government make available to individual municipal utilities, under strict eligibility conditions, additional resources from the national budget to finance specific investments and help solve structural problems, at all instances working with the utility towards the goal of eventually achieving financial self-sustainability.

Consistent with the objectives outlined above, Law 812 of 2003, which adopted the NDP, established the 2002-2006 medium-term national financial commitments to the sector. The Government will provide capital investment grant resources to be utilized based on the outcomes of the recently conducted participatory public consultation process known as the *Audiencias Públicas* (August 2003). As part of this process, departmental and regional investment needs were examined and evaluated by a technical committee based on poverty- and technically-weighted criteria, resulting in fund allocation at a departmental level. Approximately US\$ 135 million has been allocated for investment in the water and sanitation sector under the umbrella of the *Audiencias Públicas*. Implementation arrangements for accessing these funds, particularly the direct oversight by the MAVDT and the development of a harmonized and publicly disseminated set of procedures, along with the use of financial intermediaries for fiduciary management, has been designed to mitigate the risk of political capture of the public consultation process to ensure the efficient use of grant transfers. The Government has designed a mechanism to centralize all publicly funded⁸ investments in the sector, including the allocations deriving from the *Audiencias Públicas*, through a Program called *Ventanilla Única* (to be financed under the proposed APL), managed by the Directorate for Water and Sanitation (*Dirección General de Agua Potable y Saneamiento Básico*) within the MAVDT. This Program will channel and manage all funds assigned by the Government to the sector.

Implementing Institutional Strengthening and Technical Assistance Programs. The Government is currently implementing a policy effort to improve the institutional development and financial and technical performance of publicly-run utilities in small- and medium-size localities (both urban and rural) where PSP is not likely to be adopted in the short-term. The Government has designed two different Programs, *Fortalecimiento Institucional* and *Microempresa Comunitaria*, which aim to bring utilities to reasonable levels of management, operational efficiency and financial viability and pave the way for private sector participation by improving the productivity of utilities and strengthening of management and administrative systems.

For the purposes of the Program, municipal water enterprises would be categorized into three categories based on their level of institutional development and financial performance (see Annex 9 for details) and participation in the Government's Program would be contingent upon institutional strengthening efforts (concurrent or ex-ante) based on the existing capacity of the utility.

Rationalizing the Institutional Framework and Improving Sector Coordination. Coordination at the national level has been fostered through the strengthening of the MAVDT, consolidating DAPSBA as the key coordinating institution for sector development and the creation of an umbrella Program for managing national financial support to the sector, the *Ventanilla Única*. The *Ventanilla Única* (described below) establishes a uniform approach to analyzing and financing sector investments by various involved agencies, to coordinate sector investments in a more rational way across the different institutions involved in sector investment, regulation, and management. The Program design aims to improve DAPSBA (and more generally, the MAVDT) from a technical and managerial perspective, enhance its sector and environmental monitoring capacity, and better articulate its role as an inter-agency coordinator.

Supporting the Public Sector Reform Agenda. The Program supports the Government's public sector reform agenda aimed at rationalizing and streamlining the activities of public sector institutions thus

⁸ Refers to publicly provided grant resources and not credit funds provided through, for example, FINDETER.

maximizing their efficiency and allowing them to focus in their core policy responsibilities. In particular, and in respect to the water and sanitation sector, the Project institutional arrangements have been based on the evolving structure of the institutions involved in sector administration and will support public sector reform by the following:

- A harmonization and standardization of eligibility rules and procedures for the channeling of central government subsidies to the sector through the *Ventanilla Única* approach, which will reduce the number of instances and institutions participating in the funding process and improve the efficiency of the entire process.
- The elimination of the use of Project Implementation Units (PIUs) within the MAVDT, which often become unnecessarily large and semiautonomous structures that prevent the necessary capacity from being built within the Ministry itself and results in a loss of institutional memory when the Project has been completed.
- The use of FONADE as a project management agent will help to reduce the moral hazard inherent in transfer of funds to local governments by putting in place a solid governance structure, and will bring a higher level of transparency and accountability to the operation, providing comfort to the Bank, Government, MAVDT and local governments alike.

Small-scale providers. Small-scale service providers (both public and private) play an important role in Colombia with more than 1,700 local entities providing service in small municipalities and over 4,600 in rural areas. The Project will support the Government's strategy for these specific types of providers, which is based in three different programs:

- ***Microempresas Comunitarias*** (community based micro-enterprises): Targeted at municipalities and rural areas of less than 5,000 inhabitants, this program aims to establish community based micro-enterprises (local or regional) that can effectively respond to consumer demands, recuperate investment costs and operate with reasonable levels of efficiency. The main objectives of the program are: (i) to achieve community ownership; (ii) to reduce political interference in service provision; (iii) to take advantage of economies of scale for procurement of goods and services, amongst others; and (iv) to support a social handling of public services and the development of microenterprises.
- ***Fortalecimiento Institucional:*** Targeted at urban and rural areas of less than 12,000 inhabitants with poor management capacity, this program aims to implement a business-like approach in those service providers through a combined strategy of providing technical assistance and training. During project implementation, the MAVDT will provide technical assistance to small public operators to assist them in obtaining the knowledge and experience required for managing a water utility. The MAVDT has prepared a package of technical assistance for the small entrepreneurs which provides information, training and software for financial and commercial (billing and collection) management, operational performance in aspects such as unaccounted for water reduction, metering, service coverage, labor efficiency etc.
- ***Operator-Constructor model:*** Targeted at small municipalities with populations of up to about 12,000 inhabitants, which decide to incorporate a private operator through a simplified process. The differentiation with PSP processes in larger municipalities is made specifically to reflect the conditions in small municipalities (from the private sector's standpoint, the business is different in the two size ranges of municipalities, and the required type of operator is different in both) and is possibly the most significant innovation of the Colombian approach to PSP. Through competitive

bidding, small- and medium-size construction companies, possibly in association with small consulting firms, will compete for the construction and/or rehabilitation of the water supply and sewerage systems in a small municipality and the winning bidder commits to operate the systems for a period of 10-15 years from the date of signing the contract. The winning bidder will receive training in management of water utilities as well as written material and management software. Certification of small operators will also be undertaken by MAVDT two years after the initiation of the activity of each operator. In this manner, the Program will help to convert the constructors to operators.

The Ventanilla Única Program (to be supported by the APL)

Program Objectives. The *Ventanilla Única Program* was defined by the Government to channel capital grant resources from the national budget to support solving structural deficits by financing investment subprojects. The Program aims to support an inter-agency arrangement to analyze subproject viability and provide the green light for accessing complementary grant resources. Traditionally, the management of national resources for water and sanitation projects had been handled through up to seventeen different institutions, including DNP, FNR (*Fondo Nacional de Regalias*), INCODER, the CARs, and FINDETER (the latter for management of loan resources). The existence of such an atomization of the sector resulted in delays and lack of information about financing sources as well as a lower quality in the process of project design, approval and implementation, putting at risk the financial sustainability in the medium to long term.

The Program provides harmonized selection and fund allocation criterion to coordinate resources from different financing entities and to monitor subproject implementation and supervision, for improved efficiency in fund allocation and better subprojects quality control. The Program's specific objectives are: (i) to achieve financial, social and environmental sustainability for the water and sanitation sector; (ii) to define social and economic impact goals that will allow monitoring of targets and strengthen the monitoring capacity of the implementation of Government's sector policy in urban and rural areas; (iii) improve inter-institution coordination in sector financing; and (iv) to ensure equality and efficiency in fund allocation. The resources to be made available for financing of subprojects through the *Ventanilla Única* will come from National Government's transfers from the national budget to the MAVDT and to other sector institutions (*Audiencias Públicas*, FONADE, FNR, etc.).

The proposed APL will support the financing of this Program (with Phase I supporting the investments identified in the National Development Plan for 2002-2006). The adaptive nature of the Program will support a learning environment for the application of an efficient financing policy for sector investments, whereby municipal governments decide whether or not to participate in the Program based on a clear understanding of the rules of engagement. This will include willingness by local governments to require users to meet their financial obligations and assume responsibility for sustaining and making effective use of their improved services. The programmatic approach will allow for the gradual application of the new policies throughout the country by providing investment incentives to municipalities that are willing to reform, and by coupling the transition with adequate institution building at all levels.

The *Ventanilla Única* approach aims at solving these problems and also to provide the Government with a tool to track the investment made in the sector and monitor the achievement of sector goals and targets, to measure the impact of national policy in the sector. The *Ventanilla Única* represents the following advances:

- The consolidation of a single framework for presentation of projects, to achieve more efficiency and agility in handling of financing requests, rather than having multiple windows or "doors to knock on" with different eligibility and presentation requirements.

- Harmonization of criteria for eligibility, viability and resource allocation nationwide.
- More efficiency, efficacy and equality in fund allocation, given a transparent and accurate knowledge of total national budget funds allocated to the sector.
- Better alignment of financing programs with other type of programs managed by DAPSBA such as the Institutional Strengthening Programs for the improvement of utility management and efficiency gains, as well as with modernization and PSP programs.

Guidelines for financing of subprojects under the Program. A detailed description of the functioning of the *Ventanilla Única* is articulated in the *Documento de Ventanilla Única* which will be approved by the Government by Decree prior to Effectiveness and which will form an integral part of the Operational Manual. As part of Project Preparation, and largely based on the *Documento de Ventanilla Única*, a Program Operational Manual for the proposed APL is under preparation and its finalization, satisfactory to the Bank, is a condition of loan Effectiveness. The Operational Manual covers all aspects and guidelines for Program implementation, including subproject appraisal methodology and procedures to mainstream social and environmental safeguard policies for the entire Program, as well as instructions for document flows, standards for progress reports, and procurement and disbursement procedures. The Operational Manual also provides detailed guidelines for the internal benchmarking system supported by the project, which will provide key information on improvements on performance indicators.

The Government's strategy is to initiate the Program in the areas identified as priorities during the participatory *Audiencias Públicas* process and to expand in a programmatic manner according to different priorities. The Program will finance subprojects identified in the *Audiencias* provided that: (i) the municipal utility complies with regulatory and sector national rules and legislation; (ii) the municipal utility makes available detailed viability and subproject design studies to ensure that subprojects meet appropriate design standards (to reduce overdimensioning); (iii) the subproject analysis determines that there is technical and economic rationality and viability; (iv) subproject complies with technical national norm – RAS – and other technical environmental regulations from MAVDT and national legislation; (v) the utility is contributing to financing the subproject with proceeds from tariffs, local contributions, transfers from law 715 and available loan financing and (vi) the utility is complying with efficiency standards or committing to reform and improvements through the signature of a tri-partite *Convenio de Apoyo Financiero* with the MAVDT and the regional or municipal authority and enrolling into one of the TA programs for institutional strengthening.

The Program will follow a strategy of promoting PSP but not discouraging the public utility from trying to become more efficient. PSP in the provision of the services, albeit the main strategy supported by the Government, may be considered unfeasible in some municipalities given the small size, high investment needs, low level of institutional development or political and public opinion opposition. The institutional strengthening component will support these municipalities across the country in achieving higher efficiency targets within an agreed timeframe.

Program Components. The key investment elements of the Program are: (i) expansion of water supply and sewerage infrastructure and networks; (ii) investments in appropriate wastewater treatment and disposal/discharge of municipal wastewaters; and (iii) institutional strengthening for improvement of utility performance and Program Management. A detailed description of the Project's components is provided in Annex 4.

The types of subprojects to be financed under the Program will be:

- (i) Subprojects for expansion of water and sewerage networks and adequate treatment of source water along with enhanced operation and management of municipal water and sewerage utilities (both publicly and privately operated);

- (ii) Subprojects for the construction of municipal wastewater treatment and discharge infrastructure; and
- (iii) “Modernization” and Institutional Strengthening programs.

In subsequent phases, the proposed APL Program aims at expanding and consolidating the results of the first phase through: (i) further asset expansion; (ii) further development of wastewater treatment levels; (iii) improvement of sector management through the establishment of financially viable regional water and sewerage companies with significant participation of the private sector; and (iv) increasing overall sector monitoring capacity through the consolidation of the national benchmarking information system.

Subproject Analysis: Eligibility, Viability and Prioritization Criteria. The candidates to participate in the Program will be municipalities and/or other territorial entities through their utilities at a regional or municipal level (utilities with PSP in the provision of the services may also be eligible for participating in the Program under specific arrangements). The utility, in order to be eligible for accessing the funds, will have to comply with the eligibility criteria outlined in the *Documento de Ventanilla Única* and in the Program’s Operational Manual, namely regulatory (and, in particular, tariff levels) and legal issues (permits, municipal agreements, proof of ownership and/or land usage permission etc.) and other legal, documental and presentational requirements.

The subproject analysis will contain a detailed study and assessment of the subproject viability in the following areas:

Institutional – assessing utility preparedness in terms of its ability to contribute to capital cost, management and operation capacity and financial viability. In this context, an assessment of water supply and sewerage operations is also included to ensure that they meet reasonable efficiency standards. Recommendations for management and efficiency improvements will be drawn from this analysis and incorporated in the Convenio de Apoyo Financiero to be subscribed between the MAVDT, FONADE, and the municipality or regional authority.

Financial – assessing the financial soundness of the subproject and institution, both in terms of project implementation and financial sustainability, taking into account all sources of financing (municipal resources, direct Government transfers, tariff revenues and Program’s funds) and evaluating that funds will be sufficient to cover O&M costs and depreciation.

Technical – engineering and design studies complying with the technical norm as established in the national norm for the water and Sanitation Sector (RAS 2000) and in the OM, including a least-cost and alternative investment analysis for each subproject considered, justifying the proposed subproject design and how it best suits the services needs.

Economic – assessing the economic soundness of the subproject on the basis of a cost-benefit analysis (or least cost analysis in the case of small investments).

Environmental and Social – assessing that environmental licenses, environmental assessments and action plans and other environmental and social safeguards are in place as required by national Law in Colombia and the Program’s Operation Manual agreed upon with the Bank.

Depending on the above assessments, the corresponding subproject will be deemed viable, conditionally viable (depending on the utility’s willingness to undertake the reform measures and other recommendations arising from the assessment of the project’s viability) or not viable (where a given subproject, according to the professional criteria of the evaluator, is not viable and no adjustments can be

made to it that would make it viable). The professionally based appraisal mechanism under technical and transparent criteria should diminish the risk of 'white elephants' and over dimensioned projects.

The Government has adopted the prioritization criteria outlined in the technical norms for the water and sanitation sector (RAS 2000), which ranks investments in the sector in terms of their urgency and sensitivity. Priority would be given to investments in potable water supply infrastructure and service; investments in sewerage would only be financed in the case of 80% coverage of an existing water supply system; and investments in wastewater treatment and discharge would be contingent upon existing sewerage systems covering at least 80% of the population.

Tripartite Financial Support Agreement and Institutional Strengthening Program Enrollment. For municipalities that have not undertaken a modernization process to include a private operator in the operation of the systems, project participation would be contingent upon enrollment in one of the two programs for institutional strengthening developed by the MAVDT. Most Colombian water and sanitation utilities have ample opportunity to improve their productivity and thereby reduce the cost of management and operations. These programs have been designed as enhancement programs establishing time-bound targets for efficiency improvements in utility management and operations. The municipal or regional authority, the MAVDT and FONADE will sign a tripartite funding agreement outlining a time framework and milestones to reach pre-determined performance targets and improvements. The territorial entity would agree with the local utility on execution and performance improvement arrangements and in the case of publicly-managed utilities, would enter into a side agreement ("*carta de compromiso*") which would be signed at the same time as the *Convenio de Apoyo Financiero*. Targets may include a review of tariff and subsidy policies, adequate staff training, incorporation of the demand-driven approach to water and sewerage expansion, unaccounted-for water reduction, overall improvement of productivity and efficiency, upgrading of administrative and management systems, updating the utility's medium term vision, and/or eventually incorporating PSP in the provision of the services.

The tripartite funding agreement between MAVDT, the territorial entity (including local municipality/ies) and FONADE will define their mutual obligations for the duration of the Project. A draft model for this tripartite funding agreement has been reviewed by the Bank before Appraisal. These agreements will include monitorable annual or semi-annual targets for institutional performance, bill collection performance, and operational efficiency improvements. These performance targets will be used to track and evaluate progress made towards these objectives.

National Benchmarking System. Efforts for improving efficiency and productivity will benefit from the introduction of a nation-wide benchmarking system, which would allow national utilities to compare their performance with other utilities in Colombia and other countries. A system for benchmarking utilities exists within the *Superintendencia de Servicios Publicos*, but lacks reliable and transparent information. The proposed APL will support the population of the database for benchmarking and monitoring of utility performance and such a system will assure the transparency and accountability required for proper benchmarking of operator performance and will allow comparisons between private and publicly run utilities. Sector competition and benchmarking of public and private operator performance will enhance incentives or operational improvements.

The MAVDT's Organizational Structure and Process for Approval of Subprojects. Subprojects will be submitted for appraisal by regional or municipal authorities to DAPSBA. The flow of decision-making and subproject approval under the Program lays within the following bodies in the MAVDT:

DAPSBA's Management. Overall responsibility within the MAVDT for the implementation of the *Ventanilla Única* Program.

Technical Committee. This committee is composed by the Director of DAPSBA, the coordinator of institutional strengthening programs for municipalities and utilities, the coordinator for solid waste management, the coordinator for water resources management, and the coordinator for investment control, monitoring, and evaluation. The technical committee will approve the financing of subprojects that have been appraised and deemed viable, based on the background information presented to justify the subproject, recommend a financing plan for the subproject based on available resources and determine conditions and modifications to the subproject design precedent to accessing the funds and other conditions and agreements to be included in the Funding Agreement. This assessment and recommendations is then taken to the Interinstitutional Committee for final approval.

Interinstitutional Committee. This committee will be chaired by the Viceminister of Environment and includes DAPSBA's Director, and a Coordinator from the Technical Committee (*con voz y sin voto*) as well as the President, Director or main decision agent of other sector institutions that will contribute funds for the financing of the subproject (FNR, FONADE, etc.). This committee will prioritize the financing of subprojects and will make the final decision on allocating Program funds.

Project Supervision and Monitoring. During Project supervision, the Bank will appraise the subprojects proposed for financing under the Program on an annual basis. All procedures for subproject preparation and the criteria for subproject appraisal have been defined *ex-ante* and included in the Program's Operational Manual, which the Bank has reviewed and found to be satisfactory. Detailed engineering and technical designs for the sample subprojects in the first year of the Project, including environmental and social assessments, financial models, and tariff schedules agreed-upon with municipal officials, have been completed prior to loan Appraisal. During Project supervision, the Bank will conduct an annual appraisal of subsequent work program to ensure compliance with the guiding principles for subproject evaluation and eligibility.

In addition, during the implementation of the Program, MAVDT will contract an independent Project Management Entity (*Interventoria*) for supervising subproject construction and implementation (including procurement) under the overall supervision of MAVDT. Fund disbursements will be made from MAVDT in line with subproject status reports to be submitted by the Project Management firm.

Institutional and Implementation Arrangements. Territorial entities (usually municipalities), through their local utilities, will be responsible for the implementation of the subprojects with the support from DAPSBA. Similar to the successful approach used in the PME under the Water Sector Reform CO-7077, it is proposed that MAVDT will receive Project funds and channel these funds to municipalities participating in the Program. MAVDT, as the key technical implementing agency, would manage and supervise subproject implementation, reporting, procurement, and disbursements, in cooperation with the respective authorities and water utilities, supported by DNP's Department for Water and Sewerage.

Municipal authorities will be responsible for investing and managing the services. As such, they will ultimately be responsible for all aspects of local utility management, including tariff setting, billing and collection. As indicated above, the MAVDT will ensure that (a) subprojects are economically and financially sound based on an agreed-upon methodology for financial and economic assessment; (b) the municipalities and/or utilities are technically, financially, and institutionally capable of managing subproject implementation; (c) that financial arrangements, including any tariff changes which might be applicable, are agreed-upon prior to subproject appraisal and codified in the tripartite Financial Support Agreement between MAVDT, the corresponding municipality, and FONADE; and (d) that all safeguard approaches are followed as defined in the Operational Manual.