

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

H O N D U R A S

**SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM PHASE
II (SPS II)**

**Operation No. 1104/SF-HO
Approved on June 5, 2002**

HONDURAS

**SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM
PHASE II (SPS II)**

(HO-0175)

MEMORANDUM FOR PHASE II

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ABBREVIATIONS

CMU	Concession Monitoring Unit
COSEX	Comité Organizador de los Sextos Juegos [Organizing Committee of the Sixth Central American Games]
CR	Credit Regulations
DIAM	Dirección Ambiental Municipal [Municipal Environment Office]
DIEM	División de Investigación y Estadística Municipal [Municipal Research and Statistics Office]
DIMA Nueva	División Municipal del Ambiente [Municipal Environment Department]
DIMA	División Municipal de Aguas [Municipal Water Department]
DSRA	Debt service reserve account
FDS	Desechos Solidos [Solid Waste]
FHIS	Fondo Hondureño de Inversión Social [Honduras Social Investment Fund]
FSO	Fund for Special Operations
MDTF	Municipal Development Trust Fund
MIF	Multilateral Investment Fund
MR	Municipal Regulations
MSPS	Municipality of San Pedro Sula
OR	Operating Regulations
SEFIN	Ministry of Finance
SIAF	Sistema Integrado de Administración Financiera [Integrated Financial Administration System]
SIG	Sistema de Información Geográfica [Geographic Information System]
UTF	Urban Transportation Fund
UTTU	Urban Transportation Technical Unit



Honduras

TENTATIVE LENDING PROGRAM

2002

Project Number	Project Name	IDB Fin. US\$ Millions	Status
HO0175	San Pedro Sula Municipal Dev II	9.0	
*HO0211	San Pedro Sula Water and Sewerage Projec	13.7	
HO0116	Sustainable Strength of Roads Sector	7.6	
HO0217	Supplement Sewer System Puerto Cortés	5.0	
HO0210	Judicial System Modernization	30.0	
HO0192	Microenterprise Global Program	35.0	
HO0212	Poverty Reduction Sector Program	30.0	
HO0198	Environmental Management Bay Islands Phase II	12.0	
Total - A : 8 Projects		142.3	
HO0189	Strength Trade Negotiations Capacity	3.5	
HO0197	Poverty Reduction Program focusing on Indigenous peoples and Afro descendants	10.0	
HO0205	Sula Valley Citizenship Security	20.0	
HO0214	Statistics System Modernization	4.0	
HO0208	Disaster Risk Mgmt. and Insurance	5.0	
HO0174	Sanitation and Water Investment Complem.	14.0	
Total - B : 6 Projects		56.5	
TOTAL 2002 : 14 Projects		198.8	

2003

Project Number	Project Name	IDB Fin. US\$ Millions	Status
HO0139	Housing Program II	30.0	
HO0140	Health Sector Reform	30.0	
HO0181	Reform of the Hondurean Family Institute	3.0	
HO0191	Marginal Areas Improvement	15.0	
HO0194	Basic Education Second Stage	25.0	
HO0195	Coast Marines Enviromental Systems Management	20.0	
HO0199	Yojoa Lake Enviromental and Tourist Dev.	17.0	
HO0202	Secondary Education Program	15.0	
HO0215	Labor Market Program	10.0	
HO0216	Homeless Women and Children	10.0	
Total - A : 10 Projects		175.0	
HO0207	Roads Rehab and Sustainability Fase I	60.0	

Total - B : 1 Projects	60.0
TOTAL - 2003 : 11 Projects	235.0

Total Private Sector 2002 - 2003	13.7
Total Regular Program 2002 - 2003	420.1

*** Private Sector Project**



HONDURAS

IDB LOANS

APPROVED AS OF APRIL 30, 2002

	<i>US\$Thousand</i>	<i>Percent</i>
TOTAL APPROVED	2,183,857	
<i>DISBURSED</i>	1,786,244	81.8%
<i>UNDISBURSED BALANCE</i>	397,613	18.2%
<i>CANCELLATIONS</i>	163,146	7.5%
<i>PRINCIPAL COLLECTED</i>	605,059	27.7%
APPROVED BY FUND		
<i>ORDINARY CAPITAL</i>	490,674	22.5%
<i>FUND FOR SPECIAL OPERATIONS</i>	1,627,419	74.5%
<i>OTHER FUNDS</i>	65,764	3.0%
OUTSTANDING DEBT BALANCE	1,181,185	
<i>ORDINARY CAPITAL</i>	185,756	15.7%
<i>FUND FOR SPECIAL OPERATIONS</i>	994,995	84.2%
<i>OTHER FUNDS</i>	435	0.0%
APPROVED BY SECTOR		
<i>AGRICULTURE AND FISHERY</i>	289,341	13.2%
<i>INDUSTRY, TOURISM, SCIENCE -TECHNOLOGY</i>	70,036	3.2%
<i>ENERGY</i>	396,075	18.1%
<i>TRANSPORTATION AND COMMUNICATIONS</i>	380,675	17.4%
<i>EDUCATION</i>	71,293	3.3%
<i>HEALTH AND SANITATION</i>	241,281	11.0%
<i>ENVIRONMENT</i>	67,879	3.1%
<i>URBAN DEVELOPMENT</i>	142,144	6.5%
<i>SOCIAL INVESTMENT AND MICROENTERPRISE</i>	300,200	13.7%
<i>REFORM -PUBLIC SECTOR MODERNIZATION</i>	191,539	8.8%
<i>EXPORT FINANCING</i>	6,908	0.3%
<i>PREINVESTMENT AND OTHER</i>	26,486	1.2%

** Net of cancellations with monetary adjustments and export financing loan collections.*



HONDURAS

STATUS OF LOANS IN EXECUTION AS OF APRIL 30, 2002

(Amounts in US\$ thousands)

APPROVAL PERIOD	NUMBER OF PROJECTS	AMOUNT APPROVED	AMOUNT DISBURSED	% DISBURSED
Before 1996	6	67,300	52,583	78.13%
1996 - 1997	4	42,550	23,959	56.31%
1998 - 1999	8	252,416	114,073	45.19%
2000 - 2001	16	253,735	28,409	11.20%
TOTAL	34	\$616,001	\$219,024	35.56%

* Net of Cancellations . Excluding export financing loans.

**SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM
PHASE II (SPS II)**

(HO-0175)

EXECUTIVE SUMMARY

Borrower:	Republic of Honduras	
Executing agency:	Municipality of San Pedro Sula	
Amount and source:	IDB (FSO):	US\$ 9.00 million
	Local counterpart:	US\$ <u>2.25 million</u>
	Total:	US\$11.25 million
Financial terms and conditions:	Amortization period:	40 years
	Grace period:	10 years
	Disbursement period:	
	Minimum period:	3 years
	Maximum period:	3 years and 6 months
	Interest rate:	1% for the first 10 years, 2% thereafter
	Inspection and supervision:	1%
	Credit fee:	0.5% on undisbursed balances
Background:	<p>On 18 November 1998, the Bank's Board of Executive Directors approved the municipal development program for the cities of Tegucigalpa and San Pedro Sula in Honduras (1024/SF-HO). (The executive summary of the loan proposal corresponding to document PR-2350 is attached (Annex I)). The program's objective is to bring about sustainable improvement in urban services in Tegucigalpa and San Pedro Sula. The Bank conceived and analyzed the program as a single operation implemented in two phases. By approving Phase I of the program, the Board of Executive Directors approved for each Municipality the conditions under which Phase II would be presented to the Board.</p> <p>For the Municipality of San Pedro Sula (MSPS), it was agreed that the Phase II memorandum could be presented to the Board once the Municipality had implemented a plan, approved by the Bank, to restructure outstanding debt on municipal bonds issued in 1997 to</p>	

finance the construction of a sports complex (see PR-2350, paragraph 2.73). The MSPS has met this condition.

Since this is a two-phase program, each phase is covered by a separate loan (US\$27 million and US\$9 million, respectively). The total cost of the program (both phases) is US\$41.25 million, with Bank financing equal to US\$36 million.

Fulfillment of conditions for Phase II:

In 1994, the Central American and Caribbean Sports Organization selected San Pedro Sula as the site for the 1997 Sixth Central American Games, and the decision was made to build a sports complex for the occasion. One element of financing for the project and the event was a municipal bond issue by the MSPS. The repayment plan for this bond issue did not proceed as expected and contributed to serious over-indebtedness on the part of the MSPS, a risk identified during preparation of Phase I. Accordingly, the Bank identified and agreed with the MSPS concerning the need to restructure this debt, to make the debt service less burdensome and free up resources for the ordinary financial obligations of the MSPS. The MSPS and the Government of Honduras have refinanced the bonds thereby fulfilling the conditions for Phase II of the program (see paragraphs 1.4 through 1.12).

Program objectives:

The San Pedro Sula municipal development program was designed to bring about sustainable improvement in urban services in San Pedro Sula through two main elements: (i) restructuring the financial management; and (ii) modernization of the arrangements for providing services.

The financial restructuring is based on creating greater transparency, greater efficiency, and stricter discipline. The program supports implementation of a strategy to improve urban services, particularly potable water and sewerage, road transportation, solid waste management, and improvement of marginal neighborhoods. This entails greater involvement by private companies in the provision of services, as well as institutional reorganization and the strengthening of MSPS capacity to supervise these private service providers.

Results of Phase I:

To date, a total of US\$14.072 million has been disbursed under Phase I of the program, equal to 52% of all allocated resources. The present allocation of resources and disbursement flows suggest that the MSPS will have disbursed all available resources for this phase by the end of 2003.

To date, the MSPS has implemented a significant series of institutional reforms and improvements in municipal services.

Achievements during Phase I include:

- Strengthening of the financial position of the MSPS, and administrative restructuring,
- Concessioning of municipal water and sewerage services,
- Creation of the (Municipal) Concession Supervision Unit,
- Creation of the Urban Transportation Technical Unit and the Urban Transportation Fund,
- Development of a methodology for projects in marginal neighborhoods, and
- Rapid recovery from the damage caused by Hurricane Mitch in various sectors.

Objective of Phase II:

The objective of Phase II of the program is to continue with modernization of the administration and provision of services in the Municipality of San Pedro Sula. The activities proposed for Phase II will allow modernization efforts to be continued based on the achievements of Phase I and those achievements to be consolidated.

Description:

The program will support these objectives by financing: (i) technical assistance for activities to modernize the structure of the Municipality and to improve its financial management and capacity to supervise services; (ii) technical assistance to implement modernization plans for municipal services; and (iii) municipal investments in sectors where investments have not been transferred to private entities in accordance with modernization plans. Following the procedures of Phase I, access to investment funds will be conditional upon compliance with performance indicators and conditionalities, as presented in the eligibility matrix (Annex II).

Component 1. Road infrastructure and transportation (US\$2.28 million)

The focus of this component is to improve municipal administration of the municipal road system, and transparency and sustainability of its financing. Technical assistance will be provided to: (i) develop road maintenance and traffic management programs; (ii) establish appropriate policies and procedures to manage sector funds; and

(iii) plan investments. Investment funds will be used for construction and for all modes of transportation, with special attention to nonmotorized transportation. This last sort of investment is of particular benefit to low-income travelers.

Component 2. Solid waste (US\$1.39 million)

During Phase II, funds will be invested in converting the existing MSPS garbage dump into a sanitary landfill and improving its environmental impact. Support will also be provided for: (i) hiring a private company to implement solid waste management and street sweeping; (ii) developing a regulatory framework; and (iii) establishing a sustainable financial mechanism to finance sector operations and investments. A social program will be implemented to retrain the community of trash pickers who make a living from an informal recycling system at the landfill, under unhealthful and dangerous conditions, as well as a social program for the street sweeping personnel. This Phase II activity contributes to social equity in the MSPS.

Component 3. Improving marginal neighborhoods (US\$2.10 million)

This component will provide technical assistance, financing, promotion, and development to expand resettlement and legalization activities and stimulation of the land market for low-income housing. Infrastructure investments will be made relative to developing housing for at least 2,000 beneficiaries, new resettlement models involving the private sector will be tested, and offices that coordinate the involuntary resettlement plan will be strengthened. Technical assistance will be used to develop a decentralized system for titling of local property and for systematization via a web page providing lot purchase and sale information.

Component 4. Administrative modernization (US\$1.61 million)

This component will allow the MSPS to continue to modernize its administration, including implementation of an integrated financial management system model (SIAF). The MSPS will also expand the use of telecommunications media as a tool for assisting the public and as a means of transparency ("electronic government"). The national government is expected to transfer the Sixth Central American Games Complex to the Municipality during Phase II. Technical assistance resources provided through the program will support outsourcing of the facility. Municipal public service reform will also be financed.

Component 5. Environmental management reforms (US\$1.03 million)

This component will support continued strengthening of the Municipal Environment Department (DIMA Nueva); the development of a plan to manage the Merendón, one of the region's most significant watersheds, development of a system of payments for environmental impacts, consolidation of the environmental management plan, and development of a plan for the MSPS to attain ISO 14001 certification.

Component 6. Urban development (US\$1.40 million)

This component will improve the procedures and instruments of the MSPS to plan and manage growth and urban development, and will address the deteriorating conditions in the center of the city and other municipal public assets. Public participation in planning will be strengthened, and the involvement of civil society and the private sector will be encouraged to protect the historic heritage and cultural identity of San Pedro Sula. A process will be implemented to relocate street vendors, and a reforestation program will be undertaken along protective dikes and in other urban areas.

Relationship of the project to the Bank's sector and country strategy:

The program supports certain key areas in the Bank's country strategy as reflected in the country paper (document GN-2070-1). Specifically, the program emphasizes private-sector involvement in providing services. Another key outcome of sector investments is improvement in infrastructure solutions and services aimed at low-income groups. Finally, the administrative reform actions are consistent with the Bank's objective for the country in terms of modernization of public authorities. The program is consistent with the Bank's subnational development strategy (document GN-2125-3) in terms of its focus on institutional reform for the MSPS, its contribution toward promoting credit discipline for the municipal sector, and its emphasis on improving public services to citizens and the private sector, as an aid to local economic development.

Environmental and social review:

Owing to the nature of the program, a specific environmental impact assessment (EIA) of the individual investment projects was not performed ex ante.

The Municipality will apply the Bank's rules set out in the loan contract for Phase I and the environmental standards and procedures that have been developed as part of strengthening the environmental management capacity of the Municipal Environment Department (DIMA Nueva) during Phase I.

Benefits and risks:

Benefits. The reforms advocated by the program will provide four major benefits: First, further improvement in terms of discipline and transparency in the financial management of the MSPS, which will increase the availability of future local resources. Second, efficiency and equity in providing services will be improved through rate rationalization and administrative efficiency. This will allow for expanded service coverage for the poor, and an improvement in the quality of the services they access most frequently. Third, improvement in managing urban development and the settlement process will provide access to the market dealing in small legal lots. Fourth, the program will improve the capacity of the MSPS to manage the urban development process.

Risks. The project carries an economic risk because one focus of the project is to have the people of San Pedro pay for public services. In 2002, the Honduran economy will once again post a growth rate of approximately 2% of GDP, reflecting an unfavorable international context characterized by a decline in the terms of trade and a possible increase in unemployment. To mitigate this risk, the program design ensures that the municipality analyzes the financial impact of each project and identifies the source of available income to cover repayment of the relevant new subloan. Additionally, the municipality will implement an effective collection system, particularly with regard to contributions for improvements, which has contributed to the financial strengthening of the MSPS in recent years.

In the marginal neighborhoods sector, interventions focusing on involuntary resettlement of the low-income population run the potential risk of encountering problems if social, legal, and organizational issues are not duly addressed. The experience gained by the MSPS during Phase I with regard to the Villa Vida Nueva project attests to these risks: irregular groups not covered by the initiative invaded the project area, under the pretext of presumed illegality of the sites. This invasion was overtly political in nature, and revealed weaknesses in the Honduran legal system, owing to which the project has yet to be reclaimed. Phase II of the program will be governed by a municipal resettlement policy that is consistent with Bank policy. Moreover, the program will address those risks by incorporating better planning processes for land use and legalization. Finally, other forms of resettlement will be tried in Phase II, to include public/private models and smaller-scale approaches, as well as strengthening of the offices coordinating the involuntary resettlement plan.

Poverty reduction and social classification:

This operation qualifies as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704) owing to the expansion of services for low-income citizens which will result from modernization activities and investments to improve the quality of life of those citizens in specific sectors (see paragraphs 2.4, 2.6, and 2.7).

This operation does not qualify as a poverty-targeted investment (PTI). Applying the Bank's criteria for PTI classification for Phase II, a clear qualification could not be established as in Phase I. In Phase I, resources were narrowly focused on sectors that qualify automatically (marginal neighborhoods) or in sectors where the expected improvements would intentionally have a greater impact on poorer segments of the population (water and sanitation). Phase II will not include new municipal investments in water, owing to the granting of concessions in the sector, and the proportion of resources allocated to the marginal neighborhood sector is comparatively low. However, Phase II will have a measurable impact on the quality of life of less privileged groups, and the project sets specific indicators to measure improvement in social equity (see Annex III).

Exceptions to Bank policies:

See procurement section.

Procurement of goods, construction, and consulting services:

Contracting for works, procurement of goods and related services, and contracting for consulting services will be handled in accordance with the Bank's policies and procedures. International competitive bidding will be required for works involving amounts equal to or above US\$1 million, and equal to or above US\$250,000 for procurement of goods and related services. International open calls for proposals will be required for consulting services involving amounts above US\$200,000. Contracting for construction and procurement of goods and related services costing less than these amounts will be tendered in accordance with Honduran law, provided that the law does not conflict with the Bank's policies.

It is recommended that MDTF administration be handled by the same private bank selected for Phase I of the program (see paragraph 3.21).

Special contractual conditions:

The borrower will submit evidence to the Bank that:

1. The MDTF is current and operational in accordance with the terms previously agreed among the borrower and the Bank.
2. The modifications agreed upon between the borrower and the Bank are in effect with respect to the contract to transfer resources signed by the borrower, the Central Bank of

Honduras (BCH), and the MDTF, in accordance with the terms previously agreed upon between the borrower and the Bank.

3. The program's Operating Regulations have been approved and are in force in accordance with the terms and conditions previously agreed among the borrower, the MSPS, and the Bank.

I. SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM

A. Background

- 1.1 On 18 November 1998, the Bank's Board of Executive Directors approved the municipal development program for the cities of Tegucigalpa and San Pedro Sula in Honduras (1024-SF/HO). (The executive summary of the loan proposal corresponding to document PR-2350 is attached as Annex I). The program's objective is to bring about sustainable improvement in urban services in San Pedro Sula. The Bank conceived and analyzed the program as a single operation implemented in two phases. When Phase I of the program was approved, the Board of Executive Directors approved for each municipality the conditions under which Phase II would be presented to the Board.
- 1.2 In the case of the Municipality of San Pedro Sula (MSPS), it was agreed that the memorandum for Phase II could be presented to the Board once the Municipality had implemented a plan, approved by the Bank, to restructure outstanding debt deriving from municipal bonds for up to US\$15 million issued in 1997 to finance the construction of a sports complex (see PR-2350, paragraph 2.73). MSPS has met this condition as analyzed in section B of this chapter.
- 1.3 The objectives of this memorandum are: (i) to demonstrate fulfillment the condition necessary for presentation of Phase II, (ii) to submit a brief summary of the results of Phase I of the program to date; and (iii) to submit the project for Phase II of the San Pedro Sula municipal development program to the Bank's Board of Executive Directors for approval.

B. Fulfillment of the condition for Phase II: restructuring the debt from the Sixth Central American Games

- 1.4 In 1994, the Central American and Caribbean Sports Organization selected the city of San Pedro Sula as the site for the 1997 Sixth Central American Games. The decision was made to build a sports complex with a stadium and other Olympic-quality facilities for the event. The President of the Republic created the Organizing Committee for the Sixth Central American Games (COSEX), which was established by Executive Order 03-95 of 7 March 1995, to coordinate construction and administration of the games. One element of financing for the project and the event was the issuance of municipal bonds by the MSPS.
- 1.5 With authorization from the Central Bank of the Republic of Honduras, in 1996 the MSPS issued 6-year municipal bonds in the amount of US\$15 million, at an 11% interest rate to be paid in quarterly installments, with repayment of the principal at the end of the term. Most bond purchasers were private companies involved in building the installations. An agreement with COSEX gave the MSPS the right to sell executive boxes in the stadium, with the understanding that the MSPS would use the resulting income to pay the interest and principal obligations associated with

- the bonds. This would prevent the MSPS from having to settle these obligations with funds from its ordinary municipal revenues.
- 1.6 The MSPS managed to sell only some of the boxes, and as a result had to cover the interest payments on the bonds from their date of issue mainly from its municipal budget resources. This situation led to serious over-indebtedness on the part of the MSPS, identified as a risk during the preparation of Phase I of the program. Accordingly, the Bank identified and agreed with the MSPS concerning the need to restructure this debt, to make interest service less burdensome and free up resources for the ordinary financial obligations of the MSPS.
 - 1.7 The MSPS and the Government of Honduras have refinanced the bonds in compliance with the conditions for processing and approval of Phase II of the program.
 - 1.8 On 14 December 1999, the MSPS and the Honduran Ministry of Finance (SEFIN) signed a loan agreement (Agreement 02088) in which the Secretariat granted the MSPS financing for up to L300 million (US\$20 million). The purpose of these funds was to pay the obligations associated with the bonds and in January 2002, the Bank received confirmation of fulfillment of the refinancing process. The total amount of the MSPS' obligation relating to the bonds is approximately L260 million (US\$16 million).
 - 1.9 The conditions of this loan are: amortization period of 15 years with a 5-year grace period, at a fixed annual interest rate of 4%. The MSPS will begin making payments of interest and principal in January 2005.
 - 1.10 This refinancing will improve the financial position of the MSPS according to projections prepared by the Financial Department of the MSPS and reviewed by the Bank. A comparative analysis of the net impact of the refinancing shows that expenditures decrease in the first three years (2000 to 2002), since the MSPS will not have to make semiannual payments to bond holders. Expenditures increase in 2005 when loan repayment begins. The annual service on this debt is US\$1.75 million. While the total payment in dollars increases over the 20-year period (an additional US\$12.58 million), the present value of the change is positive, totaling US\$3.16 million during the period, applying a discount rate (or opportunity cost) of 10%.
 - 1.11 The issue of ownership of the sports complex installations remains unsettled. COSEX owns the installations while the MSPS owns the land. The Honduran Congress is studying a bill that would formalize the transfer of all sports complex assets to the MSPS, along with all liabilities from other obligations acquired during and after construction. The Bank, through a nonreimbursable technical-cooperation operation (ATN/JF-5934-HO), is financing a study that will analyze the financial

impact of this transfer and the feasibility of various options for operating the complex, including private concession.

- 1.12 Finally, for purposes of processing and submitting Phase II for the consideration and approval of the Bank's Board of Executive Directors, the project team, after analyzing the terms and conditions of the agreement signed between the Secretariat of State for Finance and the Municipality of San Pedro Sula, its impact on the finances of the MSPS, and the positive results in terms of the debt restructuring issue, in accordance with the financial projections that have been made, concluded that the condition indicated in the loan proposal (document PR-2350) has been met for purposes of financing Phase II of the Program.

C. The municipal development program of San Pedro Sula

- 1.13 The program was designed to bring about sustainable improvement in urban services in San Pedro Sula. The strategy for attaining this improvement has two main elements: (i) restructuring MSPS financial management; and (ii) modernizing the arrangements for providing services. The financial restructuring is based on creating greater transparency, greater efficiency, and stricter discipline. Along with the financial reform, the program is supporting implementation of a strategy to improve the conditions for delivering urban services, particularly in terms of drinking water and sewerage systems, roads and road transportation, solid waste management, and improvement of marginal neighborhoods. This entails greater involvement by private companies in providing services, as well as institutional reorganization and strengthening the capacity of the MSPS to supervise these private services.
- 1.14 To meet these objectives, the program is financing the following types of interventions: (i) technical assistance to improve the financial management of the MSPS and its capacity to manage or supervise services; (ii) implementation of action plans to restructure municipal services, using service, leasing, or concession contracts to transfer operational and, where possible, investment responsibilities to private companies; and (iii) municipal investments in services not transferred to the private sector under the restructuring plans.
- 1.15 The program was structured in two phases, each financed by an independent loan of US\$27 million and US\$9 million, respectively. The total cost of the program (both phases) is US\$41.25 million, of which the Bank is financing up to the equivalent of US\$36 million. The execution period for Phase I is four years, and will be 3 years for Phase II.
- 1.16 MSPS access to program resources is managed through an eligibility matrix that establishes three levels of conditions, relating to: (i) the overall performance of the MSPS, (ii) the performance of each of the sectors eligible for financing; and (iii) the specific projects (Annex II). Requests for financing for specific projects are

reviewed by the Municipal Development Trust Fund (MDTF), managed by a private bank (see paragraph 3.6 for a detailed explanation of the MDTF). The MDTF, after verifying compliance with the indicators referenced above, submits the specific project for the Bank's consideration. At the same time, the technical unit of the MDTF, which consists of a team of professionals with experience in municipal finance, supports and works with the MDTF to underwrite the municipal projects.

- 1.17 To monitor the performance of the MSPS, a periodic evaluation system (rating system) is implemented for monitoring and control, using the same loan eligibility matrix. This system is based on rating each condition in terms of the compliance achieved and in accordance with the following parameters resulting from the review, to be performed every six months during program administration missions.

Table I-1
Levels of Compliance with Program Indicators
San Pedro Sula municipal development program I and II

Level of Compliance (Rating)	Description
A	Full compliance.
B	Compliance nearly complete; represents significant progress.
C	Some noncompliance; delay in compliance but no structural obstacles.
D	Serious non-compliance. Significant problems exist.
P	Compliance pending; compliance postponed or dependent on compliance with a previous condition.
NA	Not applicable. Compliance no longer valid.

- 1.18 Based on the rating indicated in the above table, for purposes of the Bank's periodic review, a rating of A or B means that the MSPS is "complying acceptably" with the conditionalities established in the eligibility matrix. Corrective actions will be negotiated when these compliance levels are not being achieved.

D. Phase I of the program

- 1.19 To date, the MSPS has accomplished a significant number of institutional reforms and improvements in municipal services. Phase I activities include: (i) administrative reorganization of the MSPS; (ii) modernization of municipal finances; (iii) reform of environmental management; (iv) concessioning of DIMA [Municipal Water Department] water and sewerage services; (v) investments in the road network and restructuring of the management and financing of public transportation; (vi) investments in solid waste management and contracting out of collection and disposal services; and (vii) activities relating to improving marginal neighborhoods and creating a land market.

- 1.20 The financial resources approved for Phase I (US\$27 million) were allocated to six sectors, with emphasis on transportation, water and sanitation, and marginal neighborhoods. Table I-2 presents a summary of the original allocations, along with changes in the allocations explained in this section, and the status of execution to date.

Table I-2
Allocation of funds by component, Phase I
San Pedro Sula municipal development program
(in millions of US\$)

Sector	Original allocation	Emergency stage	Social contributions	Normal stage	Other reallocations	Current allocation	Executed as of March 2002	To be executed Phase I
Water and sanitation	8,000	1,604	2,800	3,596	(3,979)	4,021	3,582	0.439
Solid waste	1,800	--		1,790	(0.355)	1,435	0.090	1,345
Roadway transportation	6,000	1,987		2,402	1,610	6,000	1,641	4,359
Finance and organization	1,000	1,013		0.387		1,400	0.851	0.549
Marginal neighborhoods	8,500	4,741		3,355	(0.096)	8,000	3,828	4,172
Protection projects	-	1,295		--	2,657	3,952	2,264	1,688
Environment	0.250	0.360		0.090	0.163	0.613	0.386	0.227
Subtotal, Sectors	25,550	11,000	2,800	11,620	0.000	25,421	12,642	12,779
Revolving fund							1,350	(1,350)
Administrative costs	0.520			0.649		0.649	0.080	0.569
Financial costs	0.930			0.930		0.930		0.930
Total	27,000	11,000	2,800	13,199	0.000	27,000	14,072	12,928
						100%	52%	48%

1. Creation of the emergency stage

- 1.21 As a consequence of the damage caused by Hurricane Mitch in October 1998, which resulted in over 8,000 deaths, 10,000 missing persons, and economic losses in the US\$4 billion range, the Bank, in agreement with the Government of Honduras, decided to make one tranche of resources allocated to the program more flexible, and to divide Phase I into two stages: (i) the emergency stage; and (ii) the "normal" stage, in order to allow for a better and timely response by the MSPS to the needs resulting from Hurricane Mitch.
- 1.22 The following changes were included for subprojects in sectors originally covered by the program, and in areas where Hurricane Mitch caused damage or destruction: (i) inclusion of emergency contracting procedures; and (ii) approval of subprojects directly by the IDB project team, through COF/CHO, instead of waiting for MDTF contracting and operation. During the emergency stage, actions were introduced to restore, manage, and control urban protection dikes to prevent flooding along the main rivers that flow through the municipality.

- 1.23 The amount of resources allocated for the emergency stage was US\$9 million, and US\$18 million for the normal stage. The amount of resources allocated for the emergency stage was later increased by US\$2 million, for community construction work in marginal neighborhoods and to back infrastructure projects in marginal neighborhoods, as well as settlement studies for low-in populations, which the Bank approved on 12 December 1999.

2. Conditions of the subloans

- 1.24 The interest rate to be applied for subloans in Phase I is adjusted every six months to 85% of the weighted average of deposit rates in the local banking system. Maturities are set to reflect the economic life of project assets. Specifically, subloan maturity must never exceed the term of the IDB loan to avoid creating a negative mismatch between subloan repayment and IDB debt service.

3. Execution of Phase I

- 1.25 In late June 2001, the MSPS began the normal execution stage of Phase I of the program. As of March 2002, a total of US\$14.07 million had been disbursed, equivalent to 52% of all Phase I resources. The present disbursement flow, the fact that all resources available in Phase I (emergency and normal stages) have already been distributed and allocated, and the advanced status of bidding and contracting procedures indicate that the MSPS will disburse all available resources for that phase in some sectors by the end of 2002 and in all sectors by the end of 2003. Phase II resources will be used to complement the activities of Phase I. Phase II activities will be executed in parallel with Phase I, in an integrated manner.
- 1.26 In accordance with the latest performance review of Phase I in January 2002, the Bank updated the performance rating of the MSPS (using the rating scheme described in paragraph 1.17). Its performance has been highly satisfactory in administrative areas (finance and transparency) and in the various service sectors. The lowest ratings went to the transportation sector, owing to delays in sector compliance that have now been resolved (see paragraph 1.33), and to the land legalization sector, reflecting the difficulty that the MSPS encountered in setting up an institutional structure to coordinate the sector. Phase I is providing technical assistance to resolve this situation.

1.27 The following table presents a summary of MSPS performance:

Table I-3
Rating by area^{a/} Municipality of San Pedro Sula
Six-month review, May 2001

Sector	Grade May 2001	Grade January 2002
Finance	A-	B+
Transparency	A-	B+
Environment	A-	A
Highway administration and transportation	C	B-
Water and sewerage sanitation	A	A
Solid waste	B	B+
Marginal neighborhoods	B	B
Land legalization/land market	C-	C+

^{a/} The rating areas do not correspond precisely with the program components.

4. Sector activities of Phase I

1.28 This section presents a brief summary, by sector, of the original objectives of Phase I, and a description of the targets achieved.

a. Component 1. Water and sanitation

(i) Modernization strategy

1.29 The program's sector modernization strategy calls for significant private-sector involvement in providing water service, while existing infrastructure will continue to be owned by the MSPS. The contracted operator is required to invest in new infrastructure, and the concession contract will also include coverage levels and other indicators to be achieved. A supervisory body has also been created, and the functions of the Municipal Water Department (DIMA) have been changed.

(ii) Targets agreed and achieved

1.30 US\$8 million was originally allocated to this sector. Of the US\$4.02 million currently allocated, US\$3.6 million have been executed. During the emergency stage, the MSPS restored damaged portions of the water system and invested in repairs to wells, conduits, and pumping stations. At the same time, modernization of the DIMA went forward, concluding with a successful international competitive bidding process on 31 July 2000, awarding the concession for these services to an Italian-Honduran consortium. The operating firm *Aguas de San Pedro, S.A.* was founded and began operations in February 2001. To fulfill the conditions of the concession contract, *Aguas de San Pedro S.A.* is expected to invest approximately

US\$160 million over a 30-year period. This includes secondary treatment of 70% of the city's wastewater. One immediate benefit of this process was to obtain a 10% reduction in service rates in comparison with the rates under DIMA.

- 1.31 In February 2001, the loan contract was changed to include payment of social security benefits for DIMA staff, to be transferred to the new operator of the water and sanitation services in accordance with current Honduran law.
- 1.32 As a consequence of this first concession process for municipal services, the MSPS created the Unidad de Supervisión de Concesiones [Concession Monitoring Unit] (CMU), which is responsible for overseeing all services outsourced by contract, to ensure that operators are complying with the conditions of their contracts, and to promote other outsourcing in specific areas such as public parking, markets, and urban roadways, among others. US\$440,000 remains for strengthening the USC.

b. Component 2. Highway administration and urban transportation

(i) Modernization strategy

- 1.33 The strategy in this sector aims to consolidate financial and administrative autonomy to ensure the sustainability of the following basic sector functions: roadway maintenance, transportation operations, investment programming, and nonmotorized transportation planning.
- 1.34 A further aim is to promote investment in: roadway efficiency (traffic signals, signage, parking), infrastructure relating to the use of public transportation and nonmotorized transportation, road repair, and new infrastructure projects (through the concession modality). Of the US\$6 million allocated to this sector, US\$1.6 million have already been executed.

(ii) Targets agreed and achieved

- 1.35 During the emergency stage, paved and unpaved urban streets were repaired, with improvement works undertaken for some access roads to marginal neighborhoods and on the main public transportation routes.
- 1.36 With regard to sector modernization, the MSPS agreed to set up the Unidad Técnica de Transporte Urbano [Urban Transportation Technical Unit] (UTTU), attached to the MSPS, and the Fondo de Transporte Urbano [Urban Transportation Fund] (UTF). (Minutes No. 74 (18 January 2001), MSPS).
- 1.37 The UTTU, which is attached to the Municipality, is responsible for: (i) roadway infrastructure maintenance; (ii) transit administration and parking control; and (iii) planning for nonmotorized transportation. The UTF will administer income from the sector in a transparent manner (such as private vehicle registration fees), to ensure the financial sustainability of these basic sector functions and to facilitate

public roadway investments. The resources of the urban road and transportation sector of Phase I and Phase II will be part of the UTF. The management and use of UTF resources and the technical and financial criteria for project approval in the sector will be part of the UTTU Operating Regulations.

- 1.38 Finalization of the urban roadways concession is planned during the normal stage, with private investment expected to total about US\$45 million. The concessionaire, which will be regulated by the Concession Monitoring Unit, will receive a portion—to be defined—of the tolls collected at the main entrances to the city, as its sole source of payment, without provision of a municipal guarantee. Prior to granting the concession, the MSPS is completing transportation reorganization and negotiations, and is implementing measures to improve the control of revenues from toll booths.
- 1.39 The MSPS has also initiated studies to identify and create a roadway efficiency program for the central area of the city ("Preferred Corridors") to streamline traffic of all types, with particularly attention to nonmotorized transportation.

c. Component 3. Solid waste

(i) Modernization strategy

- 1.40 The strategy is to modernize solid waste collection and disposal services by contracting a private company, expanding the coverage of service, and providing the service more efficiently and on a sustainable financial basis. The CMU will monitor companies' compliance with the contractual conditions. US\$1.4 million has been allocated to this sector, US\$90,000 of which has been executed.

(ii) Targets agreed and achieved

- 1.41 During the emergency stage, nonreimbursable technical-cooperation resources were available (ATN/JF-5776-HO) for consulting support for the process of concessioning waste collection and disposal services. Using the same resources, the MSPS has begun all the requisite complementary activities, such as technical studies, designs of construction projects to be financed under Phases I and II, drafting of municipal standards, and preparation of the environmental impact assessment.
- 1.42 In 2001, the MSPS conducted an international competitive bidding process under a service contract. The MSPS will be responsible for certain basic investments relative to conducting the environmental audit study for the dump, paving the access road, purchasing equipment, and building a perimeter fence for the dump. Under the service contract, the operator will be responsible for managing contracts financed in Phase II to convert the dump into a sanitary landfill. The MSPS expects to award the contract during 2002.

d. Component 4. Improvement of marginal neighborhoods

(i) Modernization strategy

- 1.43 The strategy is to undertake actions to regularize land ownership and titling, improve infrastructure, promote the division of land into lots and land use policies, and to consider involuntary resettlement plans for the population living in high-risk areas.

(ii) Targets agreed and achieved

- 1.44 In Phase I, US\$8.5 million (later reduced to US\$8 million) were allocated, and US\$3.8 million of that amount has been executed.
- 1.45 During the emergency stage, the MSPS made official and implemented a method for selecting and prioritizing projects with marginal communities, and began the community development projects resulting from the use of this approach. An action plan was also developed concerning the involuntary resettlement of squatters located along the dikes built to protect against flooding.
- 1.46 The MSPS has undertaken actions to: (i) repair streets in the marginal neighborhoods hardest hit by Hurricane Mitch, (ii) design and carry out a health campaign for the population in at-risk areas; (iii) build and repair rainwater drainage systems; (iv) repair and equip affected health centers and schools; and (v) provide technical assistance to develop marginal neighborhoods improvement projects.
- 1.47 The aim in expanding the emergency stage was to finance infrastructure projects for the Villa Vida Nueva settlement, an ambitious housing project backed by a private foundation and intended to house 4,500 families, including hurricane victims and residents of the city's at-risk areas. Owing to problems that occurred with the Vida Nueva project, which was encroached, the Bank decided to reorient the resources originally available for the project towards community works in other marginal neighborhoods, and to finance technical assistance and infrastructure works to develop a smaller-scale settlement called "Colonia 14 de Febrero", which will house 345 families, to be voluntarily resettled from areas of the city that are subject to flooding.
- 1.48 During the normal stage, municipal initiatives concerning land legalization and titling must be based on updated cadastral information, linking municipal information to the Land Registry.¹ In Phase I, support was provided for

¹ Land titling in Honduras is a process handled by the Land Registry, which is attached to the Supreme Court. The objective of the MSPS has been to improve the quality of information from the local level, in order to speed up the procedures at the Registry, and eventually to negotiate the delegation of some of the Registry's functions to the municipal level.

modernization and updating the land register and for conducting pilot programs for land legalization efforts in marginal neighborhoods. This involves topographical mapping, georeferenced data systematization, and registration process improvement. The MSPS has contracted consulting services to systematize the experience gained through the projects.

- 1.49 The remaining resources in this sector are being used during the normal stage for: (i) community development construction projects, prioritized and selected by applying a participatory investment-targeting method; (ii) legalization of lots and access to serviced sites; and (iii) technical assistance operations for the institutional strengthening of the MSPS's Human Development Office.

e. Component 5. Finance and organization

(i) Modernization strategy

- 1.50 The main objectives in this sector are to: (i) begin an overall reorganization of the MSPS; (ii) improve its financial position; (iii) increase the effectiveness of its financial management; and (iv) enhance the transparency of municipal administration.

(ii) Targets agreed and achieved

- 1.51 The Municipality's financial position has recovered in a very satisfactory way. The MSPS renegotiated the bond issue debt for the Sixth Central American Games, and the final settlement was made in January 2002. In 2001, tax revenues in real terms (in dollars) were up by 15%, from US\$9.1 to US\$10.5 million, and current collections increased by 27%, from US\$19.9 million in 2000 to US\$25.2 million in 2001. The reason for this increase is the significant rise in capitation taxes and taxes on industry, and business and services (32.7% and 13.5%, respectively), and a 136% increase in the collection of back taxes as a result of the amnesty program authorized by the Congress on penalties, fees, and interest.
- 1.52 The 2001 the budget performance reflected a short-term imbalance of US\$10.6 million, owing to the rapid termination of some public works using internally generated resources of the MSPS in the final year of the previous administration. In fiscal 2002, this imbalance has been offset through savings in operating expenses and through a restructuring of banking and commercial obligations, which have been deferred in the medium term. With regard to financial indicators, an estimate was made, adjusted to December 2001 (debt service/current revenue at 35%; debt service/current saving at 75%); the first indicator is being met (21%), but noncompliance with the second indicator is significant. The MSPS has negotiated a temporary adjustment in the indicator, and expects significant improvement in compliance with the indicators by the end of 2002.
- 1.53 The audited financial statements for 2000 have been reviewed by the Bank and have been published on the MSPS website and in three newspapers. The MSPS

audit was unqualified, with the sole exception of the lack of an adequate system at the DIMA to control its assets and installations, and their depreciation. The MSPS is addressing those issues now. Its management is expected to improve substantially owing to the design and implementation of a comprehensive financial management system during the remainder of Phase I and during Phase II. Of the US\$1.4 million allocated to this sector, US\$550,000 remains to be executed.

f. Component 6. Environment

(i) Modernization strategy

- 1.54 The strategy is to separate the provision of services from environmental regulatory functions by creating and reinforcing a Municipal Environmental Unit responsible for regulatory and policy-making functions. Financing for the unit will come from the general budget of the MSPS and partly from environmental levies or fees.

(ii) Targets agreed and achieved

- 1.55 The MSPS has made significant progress in this sector by creating and strengthening the Municipal Environment Office (DIAM), which has been set up as a regulatory and policy-making body in the context of municipal environmental management. The MSPS has also signed an agreement with the Secretariat of Natural Resources and the Environment (SERNA), a government agency responsible for environmental impact review, to start decentralizing and/or delegating certain licensing, auditing, and environmental control functions, with the broad participation of the DIAM. Progress has been made on the first phase of the municipal environmental management study, which will support the establishment of the environmental indicators baseline, acquisition of the equipment needed, implementation of a geographical information system (SIG), and preparation for certification of the Municipality's environmental management procedures pursuant to ISO 14001. The MSPS has decided to merge the DIAM with the portion of DIMA that has not been privatized (see paragraph 1.30), creating the Municipal Environment Department (DIMA Nueva), which includes management of the municipality's water resources among its environmental responsibilities. US\$380,000 of the US\$610,000 final allocation to this sector have been executed.

g. Improving dikes

- 1.56 During execution of the emergency stage and at the express request of the MSPS, an investment subcategory entitled Flood Protection Works was created to address the urgent repair of dikes within the confines of the city. An initial amount of US\$1.29 million was allocated to this investment subcategory through a transfer of funds from the subcategories of urban transportation and marginal neighborhoods, an amount now increased to US\$3.95 million. The studies and designs for the rehabilitation of these works were backed by nonreimbursable technical-

cooperation ATN/SI-6511-HO financed by the Spanish Fund for Consultants. In some parts of the municipality, adequate maintenance of the restored works will depend on involuntary resettlement of the squatters living along the dikes. The bidding process for the last group of works initially identified with the US\$1.69 million available is now underway. During Phase II, additional rehabilitation works and planning for the use of the dikes will continue as part of component 6.

E. Sustainability of institutional reforms

- 1.57 The institutional reforms backed by Phase I of the program were very significant. The changes made with the new organizational structure—the outcome of the reengineering process undertaken in the Municipality—have been adopted officially through agreements of the municipal council, which indicates that these reforms are likely to be relatively sustainable. Moreover, the recently elected mayor served as an alderman in the previous council and has been involved in a number of program-related activities and decisions since the preparation stage for Phase I. In modernizing public services, the Municipality is also having the National Congress of Honduras ratify its outsourcing contracts, which lends strong support to the sustainability of these arrangements. Finally, the efforts of the MSPS to improve dissemination of municipal information via the Internet, among other means, have created an expectation of transparency and access to municipal information on the parts of its citizens.

F. Lessons learned from Phase I

- 1.58 A key element for the success of Phase I is that the project team has remained active. This facilitated program supervision and allowed changes and adjustments to be made expeditiously. The Bank's team has been able to maintain the cooperative working relationship it established with the MSPS during the initial preparation of the program, in addition to the close cooperation between Bank headquarters and COF/CHO.
- 1.59 Phase I showed the value of using various sources of resources available to the Bank for a single project. In this instance, nonreimbursable funds deriving from a wide variety of sources were used to support the design and implementation processes, and for training procedures, responses to contingencies, and the overcoming of omissions in project design. Additionally, the Multilateral Investment Fund (MIF) was involved in financing the process that led to the concession of water and sewerage services (ATN/MT-6467-HO and ATN/MT-6462-HO). The MIF is also supporting the concessioning process for the urban roads of the city's second peripheral ring road (ATN/MT-5916-HO and ATC/MT-5917-HO).
- 1.60 Phase I pointed out the need for and the benefits of coordinating the Bank's various actions on "common ground". Various conditions in Bank projects, investment

activities in marginal neighborhoods of the FHIS and this project, for example, created conflicts in approaches, which the new administration is working to resolve.

- 1.61 The inclusion of both San Pedro Sula and Tegucigalpa is one aspect of this program that should be repeated in other Bank projects. It allowed for a fruitful exchange of ideas and experiences between the two Municipalities, whose efforts have progressed differently and whose successes are reflected in different sectors and activities. A number of exchanges of information and team interactions took place during Phase I of the program.
- 1.62 Within the MSPS, one of the most notable aspects is the maturing of what had been a health and population statistics unit into what is now the Municipal Research and Statistics Office (DIEM). The DIEM provides high-quality data and studies to the MSPS and to other public and private entities in the Sula Valley. Owing in part to the demand for studies and other sorts of statistical and cartographic information that the program required of the DIEM, its work has increased in volume, quality, and diversity. The DIEM is now a significant technical resource for the development of the project, the MSPS and the region.

II. PHASE II OF THE SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM

A. Objective

- 2.1 The activities proposed for Phase II are in keeping with the program's original objective, i.e., modernization of municipal management and provision of services. These activities will enable modernization efforts to continue, building on the accomplishments of Phase I. Phase II will include investments and administrative modernization and sector reform activities in the same sectors that were financed in Phase I of the loan. In the water and sanitation sector, the activities undertaken in Phase I make new investments unnecessary in one sector (water and sanitation). Phase II includes additional activities to improve urban planning and municipal growth management so that the achievements of Phase I will be sustainable.

B. Description

- 2.2 The components of Phase II and the main actions will be:

1. Component 1. Highway transportation and infrastructure (US\$2.28 million)

- 2.3 The focus of this component will continue to be improvement in the basic municipal administration of urban transportation and the transparency and sustainability of its financing. To strengthen the Urban Transportation technical Unit (UTTU) and the Urban Transportation Fund (UTF), technical assistance will be provided to: (i) develop road maintenance and traffic management programs; (ii) establish adequate policies and procedures to manage sector funds; and (iii) plan investments.

- 2.4 The funds of this component will be used for investments in roadway efficiency projects (signage, traffic lights, improvements in the layout of problem intersections) identified in the preferred corridor study (ATN/PT-6711-HO), which will expand the initial capitalization of the UTF. Implementation of this program will have a positive impact on the quality of traffic for all modes of transportation, with particular attention to nonmotorized transportation. Priority sidewalk and bicycle path networks will be built, an investment of special benefit to low-income individuals.

2. Component 2. Solid waste (US\$1.39 million)

- 2.5 To consolidate the contracting of a private company to handle solid waste management services, the MSPS will use program resources to finance investments in the existing dump, to convert it into a sanitary landfill. Plans call for investment in the design and execution of priority works at the sanitary landfill, including

rainwater control systems, drainage, leachate treatment, elimination of gases, and hazardous waste management.

- 2.6 Through technical assistance activities, Phase II will support the establishment of a solid waste fund (or account) similar to the UTF, to improve the financial sustainability of operations and investments in the sector. Other activities will be social programs to retrain the community of hundreds of trash pickers who now make a living based on an informal recycling system at the landfill, under unhealthful and dangerous conditions, and a social program for the street sweeping personnel. This Phase II activity contributes to social equity in the MSPS.

3. Component 3. Improvement of marginal neighborhoods (US\$2.10 million)

- 2.7 This component focuses on strengthening and continuing resettlement and legalization activities and stimulation of the land market for low-income housing under approaches already approved by the Bank. In keeping with municipal policy, infrastructure and housing development projects will be undertaken for at least 2,000 beneficiaries, new resettlement models will be tested, including public-private models on a smaller scale, and offices that will coordinate the involuntary resettlement plan will be strengthened. With technical assistance resources, the MSPS will also implement a decentralized system for titling of local property and for systematization of lot purchase and sale information.

4. Component 4. Administrative modernization (US\$1.61 million)

- 2.8 The objective of this component is to enable the MSPS to continue to modernize its management systems, including implementation of an integrated financial management system (making San Pedro Sula the first municipality in Honduras to have a SIAF system compatible with the new national regulation on public-sector management systems). The MSPS will also expand the use of telecommunications media as a tool for assisting the public and as a means for transparency ("electronic government").
- 2.9 The MSPS will consolidate its progress in outsourcing municipal services, to include strengthening the Concession Monitoring Unit established in January 2001, and will implement a process for identifying new outsourcing processes for municipal services in areas such as managing the intercity transportation terminal, municipal markets, parks, tax collection, and services provided by the DIEM.
- 2.10 In Phase II, the national government can transfer the Sixth Central American Games complex to the MSPS. The MSPS may then concession the facility, or enter into a contract for the facility's operation. The program will support this process to ensure that the financial impact of the transaction is as positive as possible for the MSPS.

- 2.11 Reforms will also be financed in the municipal public service, to include restructuring operations at the departmental level, streamlining of professional positions, and a salary system that is results-oriented and takes the quality of service into consideration. Vocational training and development of municipal employees will also be supported, along with a related action plan.

5. Component 5. Environmental management reforms (US\$1.03 million)

- 2.12 The MSPS made great strides in its environmental management capacity during Phase I. Phase II will continue to support these efforts in order to achieve model results for the region. This component will support continued strengthening and training for the Municipal Environment Department (DIMA Nueva); the development of a plan to reorganize and manage the Merendón, the most extensive green space in the municipality and one of the region's most significant watersheds; development of a payment system for environmental services and impacts; consolidation of the environmental management plan; and development of a plan for the MSPS to attain ISO 14001 certification.

6. Component 6. Urban development (US\$1.40 million)

- 2.13 This component will improve the procedures and instruments to plan and manage the municipality's growth and development, particularly the updating and implementation of the urban development plan and a strategic development plan. The objectives are: to establish better physical and strategic planning procedures, to strengthen public participation in planning, and to increase the involvement of civil society and the private sector in protecting the historic heritage and cultural identity of San Pedro Sula.
- 2.14 In the context of best urban planning practices and for historic heritage projects, technical assistance and investment will be provided to: implement the urban development plan; strengthen municipal planning capacity; design a program to restore and renovate the city center and protect its historic heritage; and carry out reforestation activities for flood protection dikes and other urban areas. The MSPS will implement a strategy to improve the placement of street vendors around the central park and to encourage public-private coinvestment in improving the city center.

C. Cost

- 2.15 The total cost of Phase II will be equal to US\$11.25 million, distributed by investment category and source of financing as follows:

**Table II-1. Program Costs
(in millions of equivalent US\$)**

Category	IDB	MSPS	Total	Safeguards
Subloans	8,440	1,360	9,800	
1. Highway administration and urban transportation	1,960	0.316	2,276	
2. Solid waste	1,200	0.194	1,394	<2.50
3. Marginal neighborhoods	1,808	0.291	2,099	
4. Administrative modernization	1,388	0.224	1,612	
5. Environment	0.884	0.143	1,027	>1.0
6. Urban development	1,200	0.194	1,394	>1.0
Administrative Costs	0.265	0.750	1,015	
1. MDTF	0.265		0.265	
2. External audits		0.075	0.075	
3. Operating expenses of the PCU		0.675	0.675	
Financial costs	0.295	0.140	0.435	
Interest	0.205	0.059	0.264	
Credit fee		0.081	0.081	
Inspection	0.090		0.090	
Total	9,000	2,250	11,250	
%	80%	20%	100%	

- 2.16 The preceding table reflects the amounts allocated for each sector, which may vary subject only to the restrictions indicated for the highway administration and urban transportation sector (mandatory ceiling), environment (mandatory minimum); and administrative modernization (mandatory minimum).

III. EXECUTION OF PHASE II

A. Borrower, financial agent, and executing agency

- 3.1 The borrower will be the Republic of Honduras. Resources are transferred to the MSPS through the Municipal Development Trust Fund [Fideicomiso de Desarrollo Municipal] (MDTF), operated by a private bank. The Republic of Honduras is ultimately responsible for payment of the loan to the Bank should the MSPS fail to comply. However, to minimize the likelihood that the Government of Honduras will have to use its own resources to amortize the IDB loan, a series of credit enhancement mechanisms and guarantees have been implemented for each subloan.
- 3.2 The MSPS will execute the investments and technical assistance financed by the program. To coordinate activities, the MSPS will keep active the MSPS/IDB coordinating unit that managed Phase I of the program, made up of the team contracted by the MSPS with its own resources. The MSPS will prepare projects for submission to the MDTF to be financed by subloans and will provide a counterpart contribution of 20% of the cost of each project. Each subloan will be covered by a contract that complies with all program conditions, including those regarding the provision of guarantees and the maintenance of special accounts, in accordance with the Credit Regulations.

B. Administration of Phase II

1. The Municipal Development Trust Fund (MDTF)

- 3.3 The same MDTF mechanism will be used as the financial agent of the project, and the Phase I Credit Regulations will continue to apply. A summary of these aspects of the program is presented in the loan proposal for Phase I (document PR-2350, paragraphs 3.3-3.20). The Credit Regulations summarize the functions and activities of the MDTF and the program's financing policies (available in the technical files of the program in EN2).
- 3.4 The borrower will submit evidence to the Bank that (i) the MDTF is in force and operational in accordance with the terms previously agreed among the borrower and the Bank; (ii) the modifications agreed upon between the borrower and the Bank are in effect with respect to the contract to transfer resources signed by the borrower, the Central Bank of Honduras (BCH), and the MDTF, in accordance with the terms previously agreed upon between the borrower and the Bank, and (iii) the program's Operating Regulations have been approved and are in force in accordance with the terms and conditions previously agreed among the borrower, the MSPS, and the Bank.

2. Responsibilities of the MDTF

- 3.5 The MDTF will function as a line of credit that grants loans to the MSPS in accordance with the Credit Regulations. To perform its functions, the MDTF will be assisted by a specialized firm that will serve as the technical unit of the program. The following table summarizes the various functions involved in any MDTF transaction.

Table III-1

Function	Responsible Party	Comments
Project preparation and submission to the MDTF	MSPS	Activities financed using own funds or technical assistance sponsored by the program
Project appraisal and recommendation	MDTF Technical Unit	Based on the eligibility matrix in the Credit Regulations
Project approval decision	IDB Country Office in Honduras	
Signing of loan contract	MSPS and MDTF	
Disbursements	MDTF	Disbursement to the MDTF will be authorized by the IDB and made via the Central Bank
Loan collection	MDTF	
Portfolio monitoring	MDTF	Long-term portfolio management requires a technical analysis of the alternatives.
Monitoring of the MDTF	IDB Country Office in Honduras	Adequate management of funds and reflows from subloans. External auditors will conduct an in-depth review twice a year.

- 3.6 It is the responsibility of the MDTF to: (i) assess specific projects, applying the technical criteria previously agreed with the Bank, and make recommendations to COF/CHO regarding approval; (ii) authorize disbursements for approved projects; (iii) monitor the portfolio and arrangements for problem debts and conduct a performance evaluation by comparison with a set of relevant indicators; and (iv) keep the program's accounts, prepare financial reports, and submit semiannual progress reports to the Bank and to the Government of Honduras. The remuneration of the MDTF will include: (i) the tasks to be carried out by the technical unit (project evaluation and structuring of subloans); and (ii) fund management tasks (disbursements and repayments) and monitoring of the portfolio (including resolution of overdue debts).
- 3.7 The contract with the government for Phase I stipulates that during at least the 18 months of Phase I execution, the Bank's Country Office in Honduras will approve specific projects, and after that period the role of the MDTF and the use of

ex ante IDB approval will be evaluated. The results of that review will apply to Phase II.

- 3.8 Recovery of the subloans will be handled by the MDTF for five years, from the beginning of the program, by means of a special account. The contract with the government for Phase I requires that, in the third year of Phase I execution, the Secretariat of Finance hire a consultant to design a strategy for MDTF portfolio management after the fifth year. This decision will also apply to Phase II. The strategy will analyze various options, to include: (i) proceeding with the sale of all or part of the MDTF portfolio on the secondary market; (ii) transferring responsibility for managing the MDTF portfolio to a commercial bank, contracted through a competitive bidding process; and (iii) having the Secretariat of Finance assume the portfolio. In selecting the best alternative, such important factors as the level of macroeconomic stability and the status of the local financial markets are expected to be taken into consideration.

3. Conditions of the municipal subloans

- 3.9 The financial conditions of the subloans are presented in the program's Credit Regulations.
- 3.10 The main financial conditions of the subloans are the interest rates, the amortization period, and the grace periods. **The interest rate** of the Phase II subloans will be variable, and will be adjusted automatically every six months to 85% of the weighted average deposit rate, excluding demand deposits, certified by the Central Bank of Honduras, unless an agreement to the contrary is reached between the borrower and the Bank concerning the interest rate.
- 3.11 **The due dates** will be set up to reflect the economic life of the project assets, in accordance with a scheme based on international standards to be included in the Operating Regulations. Specifically, the due date for the subloan may never exceed the IDB loan period. The **grace period** will be equal to the disbursement period plus one year.

4. Management of funds and guarantees

- 3.12 The MDTF recommends project approval to the Bank's Country Office in Honduras, which will make the final decision. When a project is approved, the mayor, duly authorized by the municipal council, and the MDTF will sign a subloan contract. The agreement will be a document that contains a detailed budget, a disbursement schedule, a supervision protocol, and a detailed description of the loan payment plan and the respective guarantees.
- 3.13 The MDTF may finance three types of projects: (i) Type I: income-producing projects, (ii) Type II: sector projects that produce income; and (iii) Type III: other projects. The subloan agreements provide different arrangements for each type.

Additionally, the operating costs of the MDTF and other administrative costs may also be financed. The borrower will have the right to recover the financial costs of the loan from the MSPS.

a. Source of repayment

- 3.14 The MSPS will set up special accounts with local commercial banks to isolate the main source of amortization for the subloans, and to make that source available for payments to the MDTF. For Type I loans, the primary source of amortization will be income from project revenues; for Type II loans, the primary source of amortization will be the specific revenues of the sector; and the main sources for amortization of Type III loans will be, in this order: (i) intergovernmental transfers; (ii) business taxes; and (iii) property tax. For each project, the arrangement is part of the subloan agreement. Commercial banks that control one or more special accounts must sign a contract with the MDTF that requires the banks to make automatic transfers from the special accounts to the MDTF.

b. Reserve accounts

- 3.15 The program has a system of reserves to ensure the availability of resources to pay the debt service.
- 3.16 **Debt service account.** This account is used to accumulate the total half-yearly payment to the MDTF for debt service on the subloans. At the beginning of each month, the MSPS will be responsible for depositing an amount equivalent to one-sixth of its next projected semiannual payment to the MDTF into the debt service account. These deposits may come from the special accounts (see paragraph 3.14) or from other municipal sources. Any deficit between the balance in the account and the amount needed for the semiannual payment will be paid at the beginning of the sixth month, to ensure an adequate balance for payment to the MDTF at the end of the half. The debt service account balance will be invested in low-risk and highly liquid instruments so as to maintain their value over time. The interest derived from the account will be credited to the MSPS.
- 3.17 **Reserve account for debt service.** This account will be a permanent reserve at the MDTF equivalent to the semiannual payment that the borrower owes the Bank for this loan. The reserve must be constituted by the available resources derived from repayment of the subloans to the MDTF. As soon as the borrower sends the last payment of the loan to the Bank, the reserve must be incorporated with the other balances at the MDTF. The balance of the reserve account for debt service will be invested in invested in low-risk and highly liquid instruments so as to maintain their value over time, and the interest will be credited to the MSPS.

c. Additional guarantees

- 3.18 The risk of default will be reduced further by means of a two-tier guarantee: (i) the MDTF will have a senior right of intercept on the special accounts at commercial banks; and (ii) the MSPS will provide a full guarantee pursuant to which any municipal income will be used to cover outstanding MDTF obligations. Finally, the MSPS will be subject to limits on its borrowing during the repayment period of the initial subloans. The MSPS must demonstrate its compliance to the Bank through a ratio relating its cash flow to its overall debt service obligations. Additionally, any additional borrowing must be consistent with a financial management scheme to which the Bank has given its nonobjection.

C. Procurement of goods, works, and consulting services

- 3.19 **Management of funds.** Disbursement of Bank resources will be handled through a two-level process. The Ministry of Finance will maintain a special account for the project at the Central bank. Transfers from that account to the MDTF are automatic. Disbursements from the MDTF to the MSPS will follow the procedures established in the Credit Regulations approved in Phase I, which include the following steps: (i) approval of the specific project and signature of the subloan agreement; (ii) keeping of an account by the MSPS at a commercial bank; and (iii) authorization of the disbursement and transfer of funds by the MDTF to the MSPS project account.
- 3.20 **Contracting.** All contracting will be handled in accordance with the Bank's policies and procedures. The threshold amounts above which international competitive bidding is required are US\$1 million for works, and US\$250,000 for procurement of goods and related services. For amounts below those indicated, Honduran law will apply, provided that the law does not conflict with the Bank's policies. An international open call for proposals is required for contracting for consulting service in amounts greater than US\$200,000.
- 3.21 **Services of the MDTF administrator:** In Phase I, administration of the MDTF was handled by a private bank, which was selected through an international competitive bidding process. The contract was signed in April 2000, but administration of the normal stage of Phase I only began in July 2001. The borrower will submit evidence to the Bank that Municipal Development Trust Fund (MDTF) has been established and is operational, in accordance with the terms previously agreed between the borrower and the Bank. With regard to hiring the trustee of the MDTF, the borrower may contract the services of the commercial bank now acting as trustee of the MDTF for loan 1024/SF-HO without conducting a competitive procedure. If the borrower has not reached an agreement with that commercial bank concerning the terms for managing the program's funds within 60 days from the entry into effect of the loan contract, the borrower must proceed with hiring another commercial bank in accordance with the procedures established in

the loan contract. The project team believes that the trustee of the MDTF will be able to continue management the MDTF for Phase II of the program. This recommendation is based on the following considerations: (i) this is the second phase of the same program; (ii) the bidding for Phase I was transparent and the selected firm was evaluated as the most appropriate choice, after a long and difficult process owing to a lack of interest on the part of the firms, which required that the bidding be repeated twice after adjustments were made in the terms of reference; and (iii) in Phase II, the MDTF will be maintained under the same conditions as those established for Phase I.

D. Disbursement schedule and supervision

1. Disbursement of funds

- 3.22 Phase II will be implemented over a 3-year period, with a 3.5-year disbursement period. The MSPS will use funds from both phases simultaneously.

**Table III-2. SPS II Program
Tentative Disbursement Schedule
(in thousands of US\$)**

Source	Year 1	Year 2	Year 3	Subtotal
Local	450	900	900	2,250
IDB/FSO	1,800	3,600	3,600	9,000
Total	2,250	4,500	4,500	11,250
%	20%	40%	40%	100%

2. External auditing

- 3.23 Phase II of the program will require that the MSPS have annual external audits conducted by an independent auditing firm, in accordance with terms of reference accepted by the Bank, and publish the results on its website. The audit must cover the program and the consolidated finances of the MSPS. The MSPS must submit the annual audit no later than 120 days after the end of the year.
- 3.24 The contract between the borrower and the MDTF stipulates that semiannual audits will be submitted of the use of resources transferred to the MDTF from the loan and the balances in the fund, within the same time periods as the MSPS. In Phase II, the borrower will also be required to submit an annual operational audit of compliance with all contractual obligations.

3. Supervision, control and monitoring

- 3.25 In addition to the monitoring contracted for each works project, for activities in excess of US\$1 million the MDTF will conduct on-site inspections every three

months during construction, to ensure that the disbursement and construction programs are proceeding as agreed. The MSPS will submit to the MDTF: (i) a preinspection report prior to each inspection, and (ii) a final report within two months of the last disbursement for an activity.

4. Supervision and evaluation of Phase II

- 3.26 Phase I of the program was continuously supervised at three levels, and this practice will continue in Phase II.
- 3.27 **Six-monthly program evaluation.** The Country Office will perform the six-monthly evaluation of Phase II through the usual program performance review system (PPMR), using a combination of performance indicators already established in Phase I and incorporating new indicators for the program's new component and new activities. A preliminary evaluation framework is presented in Annex III.
- 3.28 **Semiannual review of the eligibility matrix.** Every six months during execution, the Bank will conduct an administration mission to evaluate the performance of the MSPS based on the eligibility matrix. As mentioned above, the matrix establishes three levels of conditions relating to: (i) the overall performance of the Municipality; (ii) sector performance; and (iii) the eligibility of specific projects. The MDTF will be responsible for providing relevant financial and progress reports. When problems are identified in sector performance, the Bank and the MSPS will agree on specific actions and will set deadlines for resolving issues.
- 3.29 A preliminary eligibility matrix is presented in Annex II, based on the one for Phase I. The matrix identifies the performance evaluation areas for Phase II. The results of a consulting mission to assess the impact of the system of indicators and the eligibility matrix in Phase I will serve to refine the indicators for Phase II. The final matrix will be a part of the program's Operating Regulations. (The Levels of Compliance table is presented in paragraph 1.17.)
- 3.30 **Supervision by the MDTF.** The municipios' access to program investment resources will be governed by the same eligibility matrix referenced in the preceding paragraph. The MDTF will verify compliance with the indicators and agreements regarding compliance before submitting a specific municipal project for the Bank's consideration.
- 3.31 **Supervision of the MDTF.** In phase II, as part of the semiannual evaluation, a performance indicator matrix will be applied to the MDTF. The areas for evaluation include: its productivity in reviewing projects and preparing subloans, the quality of the work, the financial management of the fund, and compliance with its contractual obligations.
- 3.32 **Reports.** The government and the MSPS will submit an initial report, in accordance with the requirements and standards of the Bank. Semiannually, the MSPS and the

- borrower will submit reports to the Bank on the progress and results of the program in their respective areas of responsibility, using as a framework the performance indicators and work plans defined in the Operating Regulations. The semiannual report of the MSPS must include the unaudited financial statements.
- 3.33 **Periodic program evaluation.** The borrower and the MSPS will jointly conduct two evaluations of the program – a midterm evaluation (second year), and another at the end of the program. They will submit corresponding reports to the Bank. The evaluations will use the performance indicators and sector baselines set forth in the Operating Regulations; their purpose will be to measure the results and impact of the program. The midterm evaluation will have an additional focus, an analysis of the effectiveness and efficiency of the program’s execution structure. To evaluate the program’s impact on the citizens, both evaluations will include a survey of the users and beneficiaries of the sector activities.
- 3.34 **Operating Regulations.** The Bank will agree on the Operating Regulations (OR) of the program as a condition precedent to the first disbursement. The OR will be presented in two parts: the Credit Regulations (CR), which will govern the operations of the MDTF, and the Municipal Regulations (MR), for those aspects of the program carried out by the municipality, i.e. the preparation and execution of investment and technical assistance projects. The CR will include, among other things, the roles of the various parties involved in program execution, the terms of reference of the MDTF; activities eligible for financing and the conditions of eligibility; guidelines for project presentation and the technical, financial, social, and environmental criteria of the subloans; procedures for disbursement of subloans, the control of funds and recovery of investments; and the terms and conditions of the reserve account for debt service. The MR will include, among other things, the roles of the various parties involved in program execution, the control procedures for program funds; procedures for contracting and supervising technical assistance and works; programming the investments and technical assistance activities of the program, and criteria for periodic updating; the maintenance plan for works; procedures for setting up and maintaining the special accounts; the municipal work plan in general and the detailed plans for the sectors covered by the program; profiles of key positions by sector; performance indicators by sector, the baseline and benchmarks, and criteria for calculating and presenting them; and guidelines for preparing and presenting periodic reports and the formats of those reports.
- 3.35 **Launch workshop.** At the start of program execution, a joint mission of GDM-EN2 and the Bank’s Country Office in Honduras will hold an initial workshop for Phase II with all local participants, to review the Operating Regulations, the Credit Regulations, and the program eligibility matrix and to agree on the work plans and schedule for each component.

**SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM (HO-0115)
TEGUCIGALPA MUNICIPAL DEVELOPMENT PROGRAM (HO-0135)**

EXECUTIVE SUMMARY

Borrower	Republic of Honduras		
Executing Agency	Ministry of Finance through Private Trust		
Amount and Source		FIRST PHASE (covered by the attached resolution)	SECOND PHASES (to be presented to the Board at a later stage)
<i>San Pedro Sula Account</i>	IDB Financing (FSO)	US\$27 million	US\$09 million
	<u>Local Counterpart</u>	<u>US\$03 million</u>	<u>US\$01 million</u>
	Total	US\$30 million	US\$10 million
<i>Tegucigalpa Account</i>	IDB Financing (FSO)	US\$36 million	US\$15 million
	<u>Local Counterpart</u>	<u>US\$04 million</u>	<u>US\$10 million</u>
	Total	US\$40 million	US\$25 million
<i>Total</i>	IDB Financing (FSO)	US\$63 million	
	<u>Local Counterpart</u>	<u>US\$07 million</u>	
	Total	US\$70 million	
Terms and conditions	Amortization period	40 years with 10 year grace	
	Disbursement period	5 year	
	Interest rate	1% for the first ten years	
		2% thereafter	
	Inspection and supervision	1.0%	
Credit fee	0.5%		
Objectives	<p>The proposed Program aims at a sustainable improvement in urban services in Tegucigalpa and San Pedro Sula. The strategy for achieving this improvement has two principal elements: an overhaul of the municipalities' financial management, and the modernization of the arrangements for service provision. The <u>financial overhaul</u> will rely on instituting greater transparency (better information made widely available in formats consistent with accepted standards), greater efficiency (in the management of both expenditure control and revenue collection), and more rigorous discipline (access to credit will be automatically controlled through the independent and timely monitoring of financial benchmarks). Alongside this financial reform, the municipalities will implement a strategy for improving the arrangements for <u>delivering urban services</u>, most notably potable water and sewage, roads and public transport, solid waste management, and management</p>		

of marginal neighborhoods. This will involve wider use of private sector firms in actual service delivery, together with a radical reorganization and strengthening of the municipalities' capacity to supervise the performance of private providers.

Description

The Program will support these objectives by financing: (1) technical assistance to improve the municipalities' financial management and service supervisory capacity; (2) the implementation of action plans for restructuring the above services, using service, leasing or concession contracts to transfer operational and, where possible, investment responsibilities to private firms; and (3) eligible municipal investments for responsibilities not transferred to private parties under the restructuring plans. Access to investment funding will be linked to compliance with performance benchmarks and transaction-oriented conditionalities, as spelled out in the eligibility matrices presented in Annex III-1.

Under the San Pedro Sula component, the Program will: (1) foster an overall reorganization of the Municipality; (2) help modernize municipal finance by developing an income enhancement strategy, establishing reliable financial information systems, and fostering transparent management practices (US\$1 million); (3) transform the Municipality's environmental management unit into a regulatory unit (US\$250,000); (4) help corporatize the municipal water agency and finance short-term investments in support of the privatization (US\$9 million); (5) support the decentralization of public transport to the municipal level, help establish a semi-autonomous urban transport agency with dedicated sources of funding, and finance key public transport and road investments (US\$7 million); (6) help contract out solid waste management services and finance the rehabilitation and expansion of the existing landfill (US\$2 million); and (7) help the Municipality implement a comprehensive strategy to u-grade existing marginal neighborhoods and rationalize future urban growth (US\$9.5 million).

Under the Tegucigalpa component, the Program will: (1) help modernize municipal finance by developing an income enhancement strategy, establishing reliable financial information systems, and fostering transparent management practices (US\$1 million); (2) transform the Municipality's environmental management unit into a regulatory unit (US\$250,000); (3) support the decentralization of public transport to the municipal level, help strengthen the key functions of the urban transport sector (planning, programming and contracting), establish a financing mechanism to ensure road maintenance, and finance key public transport and road investments (US\$17 million);

(4) help contract out solid waste management services, help create micro-enterprises for service provision in marginal neighborhoods, and finance the rehabilitation of the existing landfill and development of a new landfill site (US\$1 million); and (5) help the Municipality implement a comprehensive strategy to legalize land ownership, upgrade existing marginal neighborhoods, and rationalize future urban growth (US\$18 million).

Program Phasing. Bank support to each of the two cities will be divided into two phases in order to account for a series of limitations that the municipalities presently have in their capacity to implement the proposed Program. The first phases will be financed through the loan outlined in the attached resolution. Each of the second phases would be financed through separate loans (one for each city), to be presented to the Board through a memorandum referencing the present document and presenting evidence that pre-agreed trigger conditions have been met.

The presentation of the San Pedro Sula Second Phase (US\$9 million) to the Board would be triggered by the Municipality's implementation of a Bank-approved plan to restructure the outstanding debt on a municipal bond issued two years ago to finance a sports stadium. This is expected to happen within the next eighteen months.

The presentation of the Tegucigalpa Second Phase (US\$15 million) to the Board would be triggered by the signature of a Bank-approved agreement (between by the Municipality and the Central Government) to transfer the responsibility for potable water and sewage services from the Central Government to the Municipality. This is expected to happen within the next twelve months.

Execution arrangements. Resources will be passed on to the two municipalities through a trust fund (hereafter referred to as the Municipal Development Trust Fund, MDTF), which will have two distinct accounts, one for each city. The MDTF will be managed by a private, competitively selected local commercial bank.

The MDTF will grant subloans based on the eligibility matrix agreed upon for each city. Subloans will carry a variable rate (eighty-five percent of the average passive rate in the local banking system) and a maturity reflecting the economic life of project asset (with a one-year grace). Each subloan will come with a cascade of guarantees aimed at ensuring that the sovereign guarantee does not need to be called.

Re flows from subloans will be used by the Government to repay the IDB debt. Any excess would be used to finance municipal projects under conditions similar to that of the Program.

Relationship of Project in Bank's country and sector strategy	The proposed Program is part of a new generation of Bank operations aimed at wholesaling Bank resources to municipalities. It should be seen as a first step which beneficiary municipalities are taking on the way to strengthening their financial management in order to access financial markets. This step is consistent with the strong decentralization movement that has been taking place in Honduras since the beginning of the decade.
Environmental and Social Review	Due to the nature of the Program, no project-specific Environmental Impact Assessment (EIA) was carried out ex-ante. However, institutional mechanisms will be established as part of the Program to ensure streamlined but effective review of environmental and social impacts.
Benefits	The reforms sponsored by the Program will yield two major benefits. <u>First</u> , they will bring about discipline and transparency in the financial management of the municipalities, which should result in enhanced resource allocation. <u>Second</u> , they will improve the efficiency and equity of service delivery, through increased pricing and management efficiencies. This will enable expanded service coverage for the poor.
Risks	<u>Implementation capacity</u> . Both operations are complex: they entail full-fledged reforms of most service sectors under municipal responsibility. In this respect, they are the municipal equivalent of a structural adjustment operation. The capacity of the municipal administrations to implement the proposed reforms will be key in ensuring the sustainability of the proposed Program. In both municipalities, there are encouraging signs: a clear political will on the part of the municipal executive, a high level of technical competence on the part of higher management, and a strong consensus that reforms are necessary. It is the Project Team's opinion that both municipalities are well prepared to initiate the reform process. <u>Political risks</u> . Working with municipalities entails a different set of risks involving intergovernmental relations. <u>Short-term risks</u> are present mainly in Tegucigalpa, where the municipal and central governments are from different parties. The proposed financing mechanisms has been designed to shield the Program from short-term political risks: appraisal of specific projects will be delegated to a technically competent, politically neutral third party (the Trustee), while the Bank's Country Office in Honduras will make final project approval decisions, initially at least. <u>Long-term risks</u> are inherent to long-term sub-sovereign lending, especially where the municipal finance market is too incipient

to impose discipline. For the next fifteen years, the way the municipalities are managed will be one of the most important factors influencing their capacity to repay the various loans they will secure from the MDTF. While the Bank is ultimately covered by the Sovereign's guarantee, a series of features have been included in the proposed Program to reduce the uncertainty of future municipal management. First, whenever possible, the proposed service reforms will be institutionalized through long-term contractual arrangements (service contracts, concessions), making reforms more irreversible. Second, for each specific subloan granted by the MDTF, a series of self-standing guarantees will be established to mitigate risks of municipal default.

**Special
contractual
conditions**

As a condition prior to first disbursement, the Borrower will submit evidence to the Bank that:

- (1) The MDTF has been legally established and the Credit Guidelines governing its operations have entered into effect in a form substantially equal to that of the draft guidelines agreed with the Bank; in particular, the Credit Guidelines will incorporate the eligibility matrices presented in Annex III-1;
- (2) An agreement between the Central Bank and the Ministry of Finance has entered into effect specifying the procedures which the Central Bank will follow to debit and credit the MDTF accounts; and
- (3) The MDTF Trustee has been recruited according to the terms of reference agreed upon with the Bank (see paragraph 3.1).

Other contractual conditions. The loan will provide for the reimbursement of expenditures incurred by the municipalities to finance activities eligible under the Program in accordance with Bank procedures, for an amount up to US\$500,000 per municipality.

Emergency measures. The loan contract will also allow the following temporary exceptions to the Program's execution arrangements in order to address the emergency conditions recently brought on by the Tropical Storm Mitch.

- (1) Until the end of the sixth month after the loan contract has entered into effect or until the MDTF becomes operational, whichever comes first, the two municipalities will be authorized to commit and spend Program resources up to an amount of US\$12 million for Tegucigalpa and US\$9 million for San Pedro Sula without

meeting the special contractual conditions (1) to (3) above. Instead, the following conditions will apply:

- Resources may only be used to finance studies and works for elements of infrastructure (a) in sectors covered by the Program and (b) which have been destroyed or damaged by the storm.
 - Specific activities must be authorized ex-ante by the Bank's Country Office in Honduras.
 - The Municipality must commit to repay the activity to be financed under the terms outlined in paragraph 3.12.
- (2) During the first six months the loan contract is in effect, streamlined procurement procedures will apply (see below).

**Poverty
Targeting and
Social Sector
Classification**

The economic evaluation carried out suggest that the proposed Program is a Poverty Targeted Investment (PTI) since about 55% of the Tegucigalpa and 45% of the San Pedro Sula beneficiaries are below the Bank's poverty threshold. In absolute value, Program benefits are likely to accrue in vast majority to the poor. In Tegucigalpa, the water component and the marginal neighborhood component are the two most poverty-targeted components. They will mobilize 66% of Tegucigalpa resources and 80% of their benefits will accrue to households under the poverty threshold. In San Pedro Sula, the marginal neighborhood component is the most poverty-targeted component. Its amount represents 50% of San Pedro Sula resources and its benefits will accrue almost entirely to the poor. The water component (30% of San Pedro Sula resources) will also benefit the poor in a significant fashion: it will result in a strong redistribution of welfare from richer neighborhoods presently consuming too much under-priced water to marginal areas currently not receiving service.

Consequently, it is proposed to apply paragraph 2.93 of the FSO Eighth Replenishment document (AB-1704) and have IDB financing account for up to 90% of total Program amount.

**Exception to
Bank policies**

None

Procurement

All contracting will follow the Bank's policies. International public bidding will be used for procurement of works in excess of US\$1,000,000 and for acquisition of goods and services in excess of US\$350,000. National procurement regulations will apply under these thresholds.

However, during the first six months the loan contract is in effect, streamlined procurement procedures will apply, as per the Bank's draft policy on procurement procedures for emergency projects recently submitted to the Board.

SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM—PHASE II

ELIGIBILITY MATRIX

This eligibility matrix summarizes the conditions that must be met for disbursement of funds to be authorized. It also serves as a frame of reference for Phase II six-monthly reviews. There are four levels of conditions: (a) conditions precedent to the first disbursement; (b) general performance conditions for the MSPS; (c) sector eligibility conditions; and (d) project eligibility conditions.

Parts B, C, and D of this eligibility matrix are preliminary, and are based on the Phase I eligibility matrix. Bank approval of the final eligibility matrix will be a condition precedent to the first disbursement of Phase II, as part of the program’s Operating Regulations.

Condition Level	Areas of Evaluation
A. Conditions Precedent to the First Disbursement of Phase II	<p>The borrower will submit evidence to the Bank that:</p> <ol style="list-style-type: none"> 1. The Municipal Development Trust Fund (MDTF) is in force and operational in accordance with the terms previously agreed among the borrower, the executing agency, and the Bank. 2. The changes agreed between the borrower and the Bank with regard to the contract for the transfer of resources signed by the borrower, the Central Bank of Honduras (BCH), and the MDTF are in force, in accordance with the terms previously agreed between the borrower and the Bank. 3. The program's Operating Regulations have been approved and are in force. The Operating Regulations will include, among other aspects, the eligibility matrix for financing resources, in accordance with the terms and conditions previously agreed between the borrower and the Bank.
B. Ongoing general performance conditions	<ol style="list-style-type: none"> 1. Compliance with financial indicators Indicators relating to: <ol style="list-style-type: none"> (a) Revenue management. (b) Revenue collection and recovery of delinquent payments. (c) Debt control. (d) Cash flow management.
	<ol style="list-style-type: none"> 2. Compliance with cost control targets Indicators relating to: <ol style="list-style-type: none"> (a) Control of staff costs. (b) Management of accounts payable.

Condition Level	Areas of Evaluation
	<p>(c) Infrastructure investment costs must always be financed with own resources or long-term external resources. (d) Additional long-term debt must have a lesser claim than the Bank's position with regard to MSPS flows, or must receive the Bank's nonobjection.</p>
	<p>3. Compliance with social equity requirements Indicators relating to: (a) Establishment of a monitoring system for beneficiaries of investments and municipal services by household income level; (b) Periodic dissemination of information.</p>
	<p>4. Compliance with transparency requirements Indicators relating to: (a) Periodic dissemination of financial statements, audited by certified external auditors; (b) Period dissemination of the list of contracts awarded; (c) Maintenance of the Internet site; (d) Internet dissemination of the following updated information (and the frequency of updates): 1. financial indicators 2. environmental data 3. performance indicators for each sector 4. social equity indicators.</p>
C. Sector eligibility conditions	
Urban Transportation Sector	<p>General eligibility conditions for investments in physical works Indicators relating to: 1. Urban street concessions; 2. Establishment of an adequate institutional framework for the sector, including a regulatory body, a technical unit, and a sector fund; 3. Approval of the operating regulations, the work plan, and the performance indicators for the sector; 4. Establishment of the financing policy and scheme for the sector and entities in it; 5. Programming of sector resources.</p>
Solid Waste Sector	<p>Indicators relating to: 1. Implementation of the service contract for solid waste management; 2. Establishment of an adequate institutional framework for the sector, including a regulatory body and a sector fund or account; 3. Approval of the operating regulations and performance indicators for the sector; 4. Establishment of the financing policy and plan for the sector, including the rate structure;</p>

Condition Level	Areas of Evaluation
	5. Programming of sector resources. 6. Implementation of the environmental impact control and mitigation program; 7. Implementation of the social action plan for trash pickers.
Marginal Neighborhoods Sector ¹	
General performance for the component	Indicators relating to: 1. Establishment the implementation plan for the component; 2. Establishment the financing policy and plan for the sector; 3. Programming and execution of resources for the component; 4. Operating Regulations and performance indicators for each subcomponent.
Group A	Indicators relating to: 1. Establishment of the implementation plan for the subcomponent; 2. Approval of the operating regulations, work plan, and performance indicators for the sector; 3. Project identification/selection system and contracting plan; 4. Programming of component resources; 5. Establishment of the project financing and repayment policy and plan, taking into account equity, gender issues, and mobilization of own resources for the beneficiary community.

¹ Allocation of resources in the marginal neighborhoods component:

	Subcomponent	Estimated cost
A	Improvement of housing and minimum basic services	US\$1,550,000
B	Legalization	US\$ 500,000
C	Technical assistance	US\$ 210,000

Condition Level	Areas of Evaluation
Group B-Legalization	Indicators relating to: <ol style="list-style-type: none"> 1. Establishment of the implementation plan for the component; 2. The program for contracting external services for the overall regularization package, to include: (i) legal analysis; (ii) topographical survey; (iii) social/economic analysis; (iv) a study of the willingness/ability to pay; and (v) title preparation; 3. The program to decentralize the property registry; 4. Protection of the rights of women in common-law marriages; 5. Identification of pilot projects, and contracting plan; 6. Training plan for entities involved in the process.
Group B-Purchase/Sale	Indicators relating to: <ol style="list-style-type: none"> 1. Development of the implementation plan for the component; 2. Establishment of a process for developing legalized land; 3. Establishment of financial arrangements for the purchase of lots in shantytowns; 4. Establishing the purchase/sale information system.
Urban Development Sector	<ol style="list-style-type: none"> 1. Operating Regulations, work plan, and performance indicators for the sector. (Where applicable, implementation of the plan with the Bank's focus on cultural heritage protection); 2. Implementation scheme for updating the plan and the other activities of the component and for interdepartmental coordination within the MSPS; 3. Mechanism for citizen participation, social equity enhancement, and private-sector involvement; 4. Establishment of an adequate institutional framework for the activities; 5. Establishment of the financing policy and plan for the sector and the entities in it; 6. Programming and execution of component resources.
D. Project eligibility conditions	
Subproject criteria	<ol style="list-style-type: none"> 1. Technical criteria: Each request for financing will require a technical study and a cost study based on acceptable standards. The Municipality must obtain the right of way and property titles to build the project; 2. Financial criteria: Each request for financing will require a detailed financial and economic analysis. Where applicable, rates will be set to cover long-term marginal costs. The investment plan for Phase II must indicate resource allocation that contributes to social equity in the municipio. 3. Environmental criteria: The conditions established under the Environment Act regarding environmental impact assessment must be met. Specifically, each request must include an environmental study based on acceptable standards. Each privatization project will also be required to include a diagnostic assessment of the environmental liability and a study of how the liability will be shared between the Municipality and the private operator. Financing will not be provided for projects in risk area IV;

Condition Level	Areas of Evaluation
Sector specific project criteria	<p>4. Social criteria: Where applicable, the acceptability of the project will be need to determined by survey.</p> <p>1. Solid waste sector</p> <ul style="list-style-type: none"> ▪ No financing will be provided for goods or equipment to be used to collect or transport solid waste. <p>2. Marginal neighborhoods</p> <ul style="list-style-type: none"> ▪ The economic analysis will be based on an assessment of the project benefits expected to accrue to the poor, using the urban poverty map developed by the DIEM. For Phase II, the Municipality and the Bank will agree on a maximum cost per family unit or beneficiary. ▪ 60% of beneficiaries must express their consent prior to the start of the project. ▪ Except in the case municipal land or public areas, the official owners of the land must indicate their approval or nonobjection prior to the start of improvement works. ▪ The beneficiaries will pay 20% of the project costs before construction work may begin.

SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM-PHASE II PHASE II PERFORMANCE INDICATORS

This matrix presents the evaluation indicators for the San Pedro Sula Municipal Development Program, Phase II. The matrix is preliminary, and is based on the performance indicators of Phase I. The Bank will prepare the final performance indicators prior to the first disbursement.

OBJECTIVE	INDICATOR
1. Urban services improved and provided efficiently and in a sustainable manner	1.1 Increase in service coverage. 1.2 Perception of quality service. 1.3 Increase in the number of titled landowners in marginal neighborhoods by the end of the project.
2. Transportation and Highway Infrastructure component implemented	2.1 Sector institutional arrangements (UTTU and UTF) established and operating in accordance with the work plan. 2.2 Compliance with sector performance indicators. 2.3 Level of the sector's financial self-sustainability.
3. Solid Waste component implemented	3.1 Sector institutional arrangements (service contract) established and operating in accordance with the work plan. 3.2 Compliance with sector performance indicators. 3.3 Level of the sector's financial self-sustainability.
4. Marginal Neighborhoods project implemented	4.1 Number of actions relating to housing improvement, sites, and site legalization carried out by 2005 (estimate: 2,000). 4.2 Sector institutional arrangements (Office of Human Development and inter-departmental coordination mechanism) established and operating in accordance with the work plan. 4.3 Compliance with sector performance indicators. 4.4 Sector activity financing strategy developed and implemented.
5. Municipal Financial Management reorganized, with greater efficiency, transparency, and discipline	5.1 Compliance with financial indicators. 5.2 Compliance with control indicators. 5.3 Compliance with transparency indicators. (Indicators are presented in the eligibility matrix.)
6. Administrative Modernization implemented	6.1 SAFIM implemented in accordance with sector work plan. 6.2 Electronic Government program implemented. 6.3 Service outsourcing strategy developed and implemented. 6.4 Municipal public service strategy developed and implemented.
7. Phase II impact on Social Equity maximized	7.1 Compliance with social equity indicators (Indicators are presented in the eligibility matrix.)
8. Environmental Management component implemented	8.1 Sector institutional arrangements (DIAM) established and operating in accordance with the work plan. 8.2 Compliance with sector performance indicators. 8.3 Payment for service strategy formulated, approved, and implemented.

OBJECTIVE	INDICATOR
9. Urban Development component implemented	9.1 Urban development plan updated and approved. 9.2 Sector institutional arrangements for implementation of the component established and operating in accordance with the work plan. 9.3 Compliance with sector performance indicators. 9.4 Reforestation and dike protection activities completed by end of project. 9.5 Sector activity financing strategy developed and implemented. 9.6 Level of the sector's financial self-sustainability.
10. Satisfactory performance of the MDTF	10.1 Productivity (number of requests for subloans processed). 10.2 Quality (timeliness of responses and perception of the MSPS). 10.3 Compliance with contractual indicators.