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Report No: 46216-MK

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF
EURO 18.9 MILLION (AS OF 2/12/09)
(US$25 MILLION EQUIVALENT)

TO

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

FOR A

MUNICIPAL SERVICES IMPROVEMENT PROJECT

September 24, 2009

FORMER YUGOSLAV REPUBLIC OF MACEDONIA
Municipal Services Improvement Project

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

ECSSD

Date: February 12, 2009	Team Leader: C. Fallert Kessides
Country Director: Jane Armitage Sector Manager/Director: Wael Zakout	Sectors: Water supply (40%); Sub-national government administration (30%); Sanitation (10%); Solid waste management (10%); District heating and energy efficiency services (10%). Themes: Access to urban services and housing (P); Municipal governance/ institution building (S)
Project ID: P096481	Environmental screening category: Partial Assessment
Lending Instrument: Specific Investment Loan	

Project Financing Data

[X] Loan [ ] Credit [ ] Grant [ ] Guarantee [ ] Other:

For Loans/Credits/Others:
Total Bank financing: EUR 18.9 million (US$25.0m equivalent) as of 2/12/09:
Proposed terms: IBRD Flexible Loan Euro denominated Variable-Spread Loan (VSL) with a 13 year maturity including a 5 year grace, with level repayment of principal

Financing Plan (US$m)

Source	Local	Foreign	Total
Borrower	0.00	0.00	0.00
International Bank for Reconstruction and Development	10.2	14.8	25.00
Total:	10.2	14.8	25.00

Borrower:
Former Yugoslav Republic of Macedonia (FYR Macedonia)

Responsible Agency:
Ministry of Finance
St. Dame Gruev 14
Skopje
Tel: (389-2) 311-6012Fax: (389-2) 311-7280

Estimated disbursements (Bank FY/US$m)									
FY	2009	2010	2011	2012	2013	2014	2015		
Annual	0.12	2.00	2.48	6.20	8.60	4.60	1.00		
Cumulative	0.12	2.12	4.60	10.80	19.40	24.00	25.00		

Project implementation period: Start June 1, 2009 End: May 30, 2014
Expected effectiveness date: May 30, 2009
Expected closing date: November 30, 2014

Does the project depart from the CAS in content or other significant respects? ***Ref. PAD I.C.***	[ ]Yes [X] No
Does the project require any exceptions from Bank policies? ***Ref. PAD IV.G.***	[ ]Yes [X] No
Have these been approved by Bank management?	[ ]Yes [ ] No
Is approval for any policy exception sought from the Board?	[ ]Yes [ ] No
Does the project include any critical risks rated "substantial" or "high"? ***Ref. PAD III.E.***	[]Yes [X] No
Does the project meet the Regional criteria for readiness for implementation? ***Ref. PAD IV.G.***	[X]Yes [ ] No

Project development objective ***Ref. PAD II.C., Technical Annex 3***
To improve transparency , financial sustainability and delivery of targeted municipal services in the participating municipalities

Project description ***Ref. PAD II.D., Technical Annex 4***
Component A (Municipal Investments) would provide loans to municipalities for investments in (i) revenue-generating public services and (ii) other investment projects of high priority to municipalities and with cost saving potential.

Component B (Capacity Building and Institutional Strengthening) finances technical assistance grants for (i) sub-project preparation; (ii) local capacity building for municipalities and Communal Service Enterprises (CSEs) to improve performance in service provision; and (iii) national level Institutional strengthening.

Component C (Performance Based Investment Grants) provides investment grants to municipalities as an incentive and reward for implementation of reform initiatives aimed at performance improvements in service delivery.

Component D (Project Management, Monitoring and Evaluation) would support operation of a project management unit and assist with project implementation, monitoring and communications.

Which safeguard policies are triggered, if any? ***Ref. PAD IV.F., Technical Annex 10***
The interventions envisaged under the project trigger the Bank's Environmental Assessment Safeguard Policy OP 4.01 and Involuntary Resettlement Policy OP 4.12.

Significant, non-standard conditions, **if any**, for:
Ref. PAD III.F.
Board presentation: none

Loan/credit effectiveness: (i) Borrower adopts the Project Operating Manual, including models of a Sub-loan Agreement and a Grant Agreement, satisfactory to the Bank, (ii) Project Coordinating Committee with a composition, resources and terms of reference satisfactory to the Bank has been established by the Borrower.

Covenants applicable to project implementation:

- The Borrower shall ensure that all measures necessary for the carrying out of the EAMF, LARPF shall be taken in a timely manner.
- The Borrower shall ensure that sub-projects under Component A and C of the Project shall be selected, appraised, implemented and evaluated according to procedures acceptable to the Bank and each sub-loan and Grant will be provided to participating municipalities on terms and conditions satisfactory to the Bank as outlines in the POM and the Loan Agreement.
- Prior to commencement of works under Component A and C of the Project the Borrower shall (a) submit to the Bank for its approval (i) the proposed site for said works and, where required by the EAMF and/or LARPF, the related site-specific environmental management plan, land acquisition and/or resettlement plan and checklist, said site-specific plans and checklist to be in form and substance satisfactory to the Bank; and (ii) the proposed contract for said works to ensure that the provisions of said site-specific plans and checklist are adequately included in said contract; and (b) ensure that such works are carried out in accordance with the EAMF and/or LARPF.
- The Borrower shall ensure that no Loan proceeds are used to finance activities which are expected to generate significant adverse long lasting and irreversible environmental effects.

CURRENCY EQUIVALENTS

(Exchange Rate Effective 1/12/09)

Currency Unit	=	Macedonian Denar
MKD 45.8	=	US$1
US$	=	SDR 1

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

ADKOM	Association of Municipal Communal Enterprises
CPAR	Country Procurement Assessment Review
CQ	Selection based on Consultant's Qualification
CSE	Communal Service Enterprise
DA	Designated Account
EA	Environmental Assessment
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia Region
EIA	Environmental Impact Assessment
EAMF	Environmental Assessment and Management Framework
EMP	Environmental Management Plan
EU	European Union
FM	Financial Management
FMR	Financial Management Report
FYR	Former Yugoslav Republic
GDP	Gross Domestic Product
GPN	General Procurement Notice
GTZ	German Agency for Technical Cooperation
IBNET	International Benchmarking Network of Water and Sanitation Utilities
IDA	International Development Association
IFR	Interim Financial Report
KfW	Bank for Reconstruction (Germany)
LARPF	Land Acquisition and Resettlement Policy Framework
LED SP	Local Economic Development Strategic Planning
M&E	Monitoring and Evaluation
MEPP	Ministry of Environment and Physical Planning
MKD	Macedonian dinar
MLSG	Ministry of Local Self-Government
MOA	Ministry of Agriculture
MOF	Ministry of Finance
MTC	Ministry of Transport and Communications
NCB	National Competitive Bidding
NGO	Non Governmental Organization

OECD	Organization for Economic Cooperation and Development
OM	Operations Manual
PAD	Project Appraisal Document
PAS	Procurement Accredited Staff
PCC	Project Coordinating Committee
PDD	Public Debt Department (Ministry of Finance)
PDO	Project Development Objective
PFS	Project Financial Statement
PIT	Personal Income Tax
PMU	Project Management Unit
POM	Project Operational Manual
PP	Procurement Plan
PRO	Public Revenue Office
PSP	Private Sector Participation
QCBS	Quality and Cost Based Selection
QER	Quality Enhancement Review
SEE	South East Europe
SIA	Social Impact Assessment
SOE	Statement of Expenses
SSO	State Statistical Office
TA	Technical Assistance
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
VAT	Value-Added Tax
ZELS	Macedonian Association of Local Self-Governments

Vice President:	Shigeo Katsu, ECAVP
Country Director:	Jane Armitage, ECCU4
Country Manager	Markus Repnik, ECCMK
Sector Manager:	Wael Zakout, ECSSD
Task Team Leader:	Christine Kessides, ECSSD

FORMER YUGOSLAV REPUBLIC OF MACEDONIA
Municipal Services Improvement Project

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Board presentation: none

Loan/credit effectiveness: (i) Borrower adopts the Project Operating Manual, including models of a Sub-loan Agreement and a Grant Agreement, satisfactory to the Bank, (ii) Project Coordinating Committee with a composition, resources and terms of reference satisfactory to the Bank has been established by the Borrower.

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- The Borrower shall ensure that no Loan proceeds are used to finance activities which are expected to generate significant adverse long lasting and irreversible environmental effects.

I. STRATEGIC CONTEXT AND RATIONALE

A. Country and sector issues

1. Former Yugoslav Republic of Macedonia (FYR Macedonia) is a small, land-locked country with a multi-ethnic population of about two million people. The country has made impressive progress over the past few years, steadily recovering from the economic, political and social fallout from the 2001 ethnic conflict. Today, FYR Macedonia enjoys European Union (EU) candidate status and has applied for North Atlantic Treaty Organization (NATO) membership. The Ohrid Framework Agreement, which provided the basis for resolving the 2001 conflict, initiated an ambitious decentralization agenda that is shaping a new relationship among citizens, local authorities, and the national government. In 2005, FYR Macedonia began formally implementing the first phase of fiscal and political decentralization, and as of September 2008, 64 of the 84 municipalities had entered the second phase of decentralization.[1]

2. Economic performance was strong in the first quarter of 2008. The GDP grew by 5.2 percent compared to the same period of the previous year. However, despite its recent achievements, the economy reflects some thorny structural problems. Growth has been insufficient to significantly reduce poverty and unemployment. Accelerating economic growth to the level envisioned by the new government that came to power in July 2008 will require public service delivery to be more effective and efficient, and higher incentives for the private sector to increase investment. Given the new institutional realities brought by the unfolding decentralization process, better performing municipalities are crucial to deliver the ambitious agenda. Municipalities provide key public services and infrastructure for citizens and local businesses; municipal governments control over seven percent of public spending (a figure likely to increase as more municipalities enter phase two); and local authorities influence, shape, and maintain stable inter-ethnic relations at the level closest to citizens.

Sector issues

3. Against this backdrop, FYR Macedonia faces the duel challenge of increasing investment in municipal services while tackling shortcomings in municipal performance and local capacity. According to the 2008 Public Investment Program, approximately EUR 90 million is to be invested in water, waste water, and solid waste management services. The Program for Implementation of the Decentralization Process 2008-2010 has laid out priorities to strengthen municipalities. To take full advantage of these opportunities, including resources that accompany EU pre-accession, municipal governments will have to fulfill a greater role for which they are insufficiently prepared.

4. Local service delivery**.** Most local public services—water and sanitation, urban transit, street cleaning, and operating parks, marketplaces, cemeteries, and so on, are provided through municipal-owned enterprises—in most cases a single multipurpose entity, although a few municipalities have separate water utilities. The legal and regulatory framework remains weak and does not effectively promote independent, commercially oriented utilities. Communal service enterprises (CSEs) are legally independent from their municipal owners; however, in

[1] Municipalities which qualify for Phase Two of decentralization, by satisfying specific conditions of good financial performance, receive block grants for operating expenditures of social service institutions, including schools.

practice there is not an arms-length relationship. The two major issues are (a) ambiguous ownership of infrastructure assets, and (b) lack of CSE financial autonomy and the burden this imposes on the municipality. Broadly, CSEs operate based on an informal arrangement with municipalities, whereby the CSE uses infrastructure owned by the municipality or the state to provide services, with the tariffs being proposed by the CSE and approved by the municipality.

5. Municipal financial management. FYR Macedonia's intergovernmental fiscal relations are based on a model that assigns own sources of revenue to the local government, in combination with intergovernmental transfers intended to bridge the gap between revenue and expenditure assignments. Decentralization has been transforming local budgets. Under the decentralization launched in July 2005, municipalities can set the level of, collect, and retain locally raised revenues. Municipal budgets experienced a dramatic increase in all local government revenue sources—from a total of MKD 1.98 billion in 1999 to MKD 10.5 billion in 2007. However, total local government revenues remain very small in relation to GDP (estimated at 3.8 percent), because municipal budgets do not all as yet cover full operating (salary) costs for education and social institutions. At the same time, municipalities face newly assigned tasks and responsibilities that must be funded from local budgets—mainly operating budgets, which have increased almost threefold.

6. Government strategy for the communal services sector. Government recognizes the need to strengthen capacities and significantly enhance the performance of municipalities and CSEs. The Ministry of Finance has requested Bank assistance to develop a strategy and action plan for comprehensive CSE sector reform; for this purpose the Public Private Infrastructure Advisory Facility (PPIAF) funded a study that was discussed and delivered to Government in final draft in October 2008. The diagnostic and strategy report, which includes proposals for sectoral and institutional strategies and a preliminary action plan for reform, was presented to key stakeholders represented in a Steering Committee chaired by the Ministry of Finance. The Strategy is undergoing further government review.

B. Rationale for Bank involvement

7. Against this background, investments in municipal services and technical assistance (TA) to address shortcomings in municipal performance and local capacity are both required. Numerous donors, notably multilateral (the European Agency for Reconstruction -EAR and the United Nations Development Programme-UNDP) and bilateral (United States Agency for International Development-USAID; German Agency for Technical Cooperation-GTZ; and Swiss and Austrian aid agencies, among others), have invested in the decentralization process through technical assistance and training for municipalities, particularly in financial management, tax administration, budgeting, local economic development strategic planning, urban planning, and participatory governance. However, many accompanying investments (largely in water, sanitation, and local roads) were focused on smaller/rural municipalities.

8. The Bank has provided local-level assistance through the Community Development Project (CDP—a social fund) and two small community-based operations, all now completed. A US$5.5 million Global Environment Facility (GEF) project with technical assistance (TA) for energy efficiency and a small line of credit/guarantee facility for such projects through

commercial banks is also open to municipalities. The European Bank for Reconstruction and Development (EBRD) has completed a water and sanitation investment project with the CSEs of six medium-sized cities; and KfW (German Bank for Reconstruction and Development) is embarking on a similar project providing loans and grants to eight CSEs. Additionally, GTZ provided institutional support for accounting and performance measurement in a larger sample of CSEs. In terms of reforms, the EBRD project achieved separation of business lines and tariff increases in the participating CSEs, and the new KfW project is requiring other specific (mainly financial) performance conditions. In light of the enormous investment needs, the donors have welcomed the Bank becoming involved in the sector, including by promoting CSE policy and institutional reforms which are a bottleneck to sustainable services..

C. Higher level objectives to which the project contributes

9. The Country Partnership Strategy for FYR Macedonia (Report-No.: 38840) targets two pillars of World Bank assistance: (a) fostering economic growth, job creation, and increasing living standards for all; and (b) improving governance and transparency of public service delivery to support the market economy. The proposed project focuses on the second pillar, but addresses the first pillar by supporting sustainable local services that are essential to the local economy and improved living standards; and it also supports the government's overarching goal in the next few years, which is to meet conditions for EU membership.

II. PROJECT DESCRIPTION

A. Lending instrument

10. The lending instrument is a specific investment loan of US$25 million. The IBRD loan would be a Euro-denominated Variable-Spread Loan (VSL) with a 13-year maturity including a five-year grace, with level repayment of principal, at the choice of the Borrower.

11. The Borrower will be the FYR Macedonia, represented by the Ministry of Finance. The Ministry of Finance will on-lend the funds to participating municipalities through sub-loan and grant agreements on the same terms as the Bank loan, but the grace period shall be up to three years and the last repayment date of each sub-loan shall not exceed the last date of repayment of the Bank's Loan. The Ministry of Finance will assume the currency risk and sub-loans and grants will be in local currency.

12. Fiscal transfers are expected to be used as loan collateral for the municipalities, since the legal provision on fiscal finances will permit intercept of transfers. The first sub-loan agreement and grant agreement will be subject to Bank review and become the model for future agreements.

B. Project development objective and key indicators

13. The proposed project development objective is to improve transparency, financial sustainability and delivery of targeted municipal services in the participating municipalities. The project aims to achieve this objective through a focus on infrastructure and services under the responsibility of participating municipalities and their communal service enterprises, such

as water supply, sanitation, and solid waste management, but may also include support for other functions such as energy efficiency, urban transport, and other services under municipal provision.

14. The monitoring indicators are: (i) Increased transparency as evidenced by (a) X percent of participating municipalities/CSEs involved in performance measurements and benchmarking as recommended by the International Benchmarking Network of Water and Sanitation Utilities (IBNET), and (b) publication of benchmarks and project progress information on municipal websites and the project portal of the project management unit (PMU); (ii) Number of participating municipalities implementing institutional development reform initiatives as evidenced by (a) Number of municipalities that qualified for performance grants, and (b) Number of municipalities that have achieved some of the reform criteria for Component C but do not qualify for a performance grant; (iii) Improved financial performance as reflected by X percent of the participating municipalities achieving increased revenue earnings, and/or cost savings in delivery of services supported by the project; and (iv) X percent of participating municipalities achieving targeted improvements in delivery of select services.

Project components

15. The project would finance investments in basic local infrastructure and municipal services; provide TA to municipalities and CSEs; and support institutional reforms in municipalities through performance-based investment grants. The project would also provide institutional support to central agencies for policy and strategic analysis related to financial sustainability of communal services. In addition, the project would cover operational costs associated with project implementation, and support project management. The four components are described below; for detailed descriptions see Annex 4.

16. To become eligible for participation in MSIP, municipalities must have been approved by MOF for the second phase of decentralization,[2] as the first condition. To qualify for investment funding under Component A, a municipality must receive a "positive opinion" from MOF, allowing it borrow.[3] To promote basic transparency and accountability, participating municipalities must meet these additional conditions: (a) establish a stakeholder feedback mechanism, and (b) ensure that water/sanitation CSE participates in the IBNET-supported benchmarking program implemented by ADKOM. Sub-projects to be financed by sub-loans under Component A, or by grants under Component C, must meet sub-project eligibility conditions outlined in Annex 4. The sub-projects will be evaluated based on standard Bank economic, financial, technical, environmental, and social appraisal criteria. To qualify for Performance Based Investment Grants under Component C, municipalities must present evidence of having met at least four of seven reform objectives, listed as performance

[2] Municipalities are individually approved by MOF for the second phase of decentralization when they meet the following conditions: resolution of previous debt arrears; staff hired for financial management; good financial results for at least 24 months; and no new arrears to suppliers exceeding standard payment terms.
[3] See Annex 1 for borrowing preconditions for municipalities, which are based on the Public Debt Law and 2007 Ministry of Finance guidelines. The MOF issues its "positive opinion" based on review of specific project proposals from municipalities with specific borrowing terms.

criteria and outlined in Annex 4 (see eligibility for performance grants). Only municipalities that are receiving sub-loans are eligible to apply for the performance grants.

17. **Component A (Municipal Investments) – US$20.00 million.** This component would provide loans to municipalities that are eligible to borrow. Investments to be financed under this component would be mainly for revenue-generating public services and other investment projects of high priority to municipalities and with cost saving potential. Though subprojects are not limited to certain sectors, it is expected that revenue-earning investments would be primarily for services and infrastructure provided by CSEs, while cost-saving projects could either be under CSEs or under the direct provision of municipalities. Subprojects should therefore have to demonstrate either revenue earning or cost savings to qualify. It is expected that subprojects will be considered for funding on a rolling basis by the PMU based on operational manual procedures. However, there will be a time limit on submissions of subprojects, set at one year before the project closing date, to allow for full implementation of the subprojects. Municipalities and CSEs will be assisted with project preparation activities, including review of feasibility studies, preparation of detailed design and bidding documents as well as supervision of construction activities. The consultancy services for these preparatory activities will be provided to the municipalities and CSEs by the PMU and consultants it would hire (see Component B), and are not part of the sub-loans.

18. **Component B (Capacity Building and Institutional Reform) – US$1.0 million.** This component would include consultancy services and technical assistance for the following:

- *Sub-project preparation support*: feasibility studies and required financial, environmental, and social assessments; preparation of final designs and bidding documents; and bidding procedures for investments funded under Component A.
- *Local capacity building*: finance technical assistance, training, and consulting services for municipalities and CSEs to improve service provision performance and meet project objectives. Capacity-building activities and institutional strengthening would help municipalities and CSEs meet criteria for Component C (performance grants). The TA would also support communications and public outreach activities.
- *National-level institutional strengthening*: support national agencies through a study of policy issues and strategy development related to the financial sustainability of municipal services, including possibilities to establish a revolving fund.

19. **Component C (Performance-Based Investment Grants) – US$3.0 million.** This component provides grants to municipalities as incentives and rewards for implementing reform initiatives to improve service delivery performance. Performance grants will be awarded according to simple and objective criteria based on enforcing current FYR Macedonia legal and regulatory requirements (see Annex 4 for proposed criteria). Performance criteria are formulated as a menu for municipalities to prioritize their own reform agenda. The performance grant can be awarded any time up to one year before the close of the project, whenever the measures are verifiably implemented. The grant award amount to an individual municipality will be 20 percent of the investment sub-loan. The grants can be used for new investment of the type funded under Component A, and in fact could be an extension of the original investment funded by the sub-loan. The municipality would need to present a sub-project proposal to the PMU that meets the same appraisal criteria as Component A

investments. The Performance Grants would be subject to separate Grant Agreements under terms and conditions and in a format specified in the POM.

20. **Component D (Project Management, Monitoring and Evaluation) – US$1.0 million.** This component would support project management unit (PMU) operation and assist with project implementation and monitoring. The component will finance PMU incremental operating costs incurred through its responsibility for overall project management; the PMU reports to the Ministry of Finance. Project management services will assist with project implementation in municipalities and CSEs, provide guidance and support to local project entities, and ensure that Bank fiduciary (procurement and financial management) and safeguard guidelines (environment, social/land acquisition or other) are observed. The PMU will be responsible for the quality and management of the procurement process, and appraisal of sub-projects that become eligible during project implementation. The PMU will establish a project portal website as a central forum for stakeholder dialogue and feedback; an independent consultant will be hired to monitor and verify municipalities' achievement of performance-based criteria to qualify for the 20 percent grant.

C. Lessons learned and reflected in the project design

21. The project was requested by Government following the 2006 sector study (*FYR Macedonia Issues in Urban and Municipal Development: A Policy Note*) prepared by the Bank in cooperation with the government and published in 2007. A main study finding on CSE performance was that communal services were relatively well developed, but showing signs of strain following the early years of transition, particularly after local governments assumed full responsibility for them. High losses, low collection rates, and low tariffs deprived the system of funding necessary for operation and maintenance, major repairs, rehabilitation, or new investments.

22. The Bank has considerable experience in the Balkans supporting preparation and implementation of municipal services in transition economies, particularly those shifting responsibilities to municipalities; and experience in many newly decentralized countries on how to transfer funds and responsibilities within a framework that encourages local accountability while promoting national oversight and policy developments. These experiences and lessons are incorporated in the project design, specifically adapted to the FYR Macedonia situation.

23. The project also benefited from collaboration and discussions with other agencies supporting the municipal services sector in FYR Macedonia. The EBRD implemented a water and sanitation project under similar on-lending arrangements. The KfW is beginning implementation of a project in eight municipalities after considerable preparation efforts, including developing performance contracts between participating municipalities and CSEs; the MSIP will benefit from these experiences. Both EBRD and KfW projects demonstrated that intensive technical support was needed to negotiate performance environments to ensure investment sustainability, including tariff adjustments, for individual municipalities/CSEs, because no national institutional framework existed. To address the broader policy context for CSEs, the Bank provided a PPIAF-funded study at Government request and will pursue dialogue on its reform recommendations in parallel to the MSIP. Several key study

recommendations that can be adopted at the municipality/CSE-level are reflected in the conditions for proposed performance grants. The MSIP is not proposing national-level policy reform conditionalities. However, some capacity-building TA under Component B will be available to assist national authorities to refine and implement national elements of the CSE reform strategy outlined in the PPIAF-funded report, such as elaborating a water and wastewater subsidy scheme—essential to the process of progressively implementing cost recovery tariffs.

24. Donor experience in the municipal sector, including that of the Bank, confirms that most municipalities require continued capacity-building assistance and that strong central-level coordination is required to ensure project implementation. The project design provides for a project management unit (PMU) in the MOF, an approach similar to that used for both the EBRD and KfW projects (which, however, worked mainly with the MOTC). The MOF was selected as the central ministry in the project design because of its key role in approving and overseeing municipal borrowing; however, other ministries, notably MOTC, Ministry of Environment and Physical Planning (MOEPP), and Ministry of Local Self-Government (MLSG), will be involved through a coordinating committee chaired by the MOF.

D. Alternatives considered and reasons for rejection

25. Initially, a "utilities" project was considered that focused only on investments in the water and sanitation sector. However, municipalities' demand covered a broader spectrum of services, some provided by CSEs, such as waste collection, and others stemming from other municipal responsibilities and priorities, such as energy efficiency. Moreover, since the relationship between municipalities and CSEs is itself an issue and in practice, CSEs have little financial autonomy, the selected project design places municipalities in a central position as sub-borrower to emphasize their overall accountability for providing communal services.

26. The Bank and the government also considered establishing a more general municipal development funding arrangement as a longer-term vehicle for selection, appraisal and implementation of sub-projects, and for channeling funding from MSIP and potentially, other sources and donors. Now, funds for municipal investment under separate donors and domestic agencies are subject to only informal coordination. But a sector-wide approach encourages consistent incentives and synergies, and ensures that implementation capacity is retained; government and donors recognize the value of this. These issues will gain importance as larger EU funding flows are forthcoming for municipal (and especially environmental) investments. However, the government needed more time to study this approach to ensure that all the regulatory requirements and agreements are in place among stakeholders. The option of on-lending investment funds to municipalities through commercial banks, through a secondary lending institution, was also discussed but considered premature for the start of the MSIP. The experience of the small GEF project component of this nature, and of the USAID development credit authority providing guarantees through a commercial bank, will be observed to determine the scope for greater reliance on commercial credit channels. The Bank has been sharing with the government international experiences on alternative municipal infrastructure financing structures; further study to define an arrangement for FYR Macedonia would be included in the proposed project under Component B.

III. IMPLEMENTATION

A. Partnership arrangements (if applicable)

27. Project preparation benefits from collaboration with multilateral and bilateral agencies active in FYR Macedonia, such as the EU, KfW, GTZ and USAID. Such collaboration will continue, and will support government efforts to streamline procedures for donor investments in municipal activities. The project will encourage CSEs to use the cost accounting software developed by GTZ, and to build on the model performance contracts promoted by KfW. The USAID has expressed willingness to support the project by directing its programmed technical assistance for municipal creditworthiness analysis, and energy efficiency technical evaluation, to the participating municipalities. At government request, the Bank will strengthen efforts to harmonize donor support to FYR Macedonia's municipal investments.

B. Institutional and implementation arrangements

28. **Project Management Unit.** A Project Management Unit (PMU) has been established in the Ministry of Finance and will be adequately staffed. An interim PMU director, financial management, and procurement specialists have already been active in project preparations. In addition, the PMU will operate with a roster of consultants for specific expertise.

29. The PMU will be responsible for project implementation, according to the requirements of the Borrower and the World Bank, and have full responsibility for project financial management, and monitoring and evaluation. The PMU will promote the project among municipalities, and will receive and evaluate proposals for sub-projects according to criteria agreed with the Bank and recorded in the Project Operational Manual (POM). The PMU will also request Bank review and final 'no objection' for sub-projects. The PMU will then be responsible for finalizing sub-loan and grant agreements between the MOF and the borrowing municipality, and for reviewing service agreements between the municipality and the CSE, where applicable. Due to the lack of capacity and knowledge of Bank procurement procedures at the municipal level, the PMU will take lead responsibility for quality assurance and management of the sub-project procurement process. Specifically, the PMU will carry out procurement under the sub-projects on behalf of municipalities, with their participation in all stages of the procurement process.

30. The PMU will liaise closely with the Bank on all fiduciary and safeguard issues and on adhering to the legal agreements.

31. The PMU director shall have overall management responsibility for daily project implementation, ensuring environmental and social requirements, and liaising with government entities and the World Bank. The director will ensure appropriate and timely reporting, monitoring and evaluation. The POM will specify project procedures for participating municipalities and the PMU, and refer to Bank project documents, including procurement guidelines and Loan Agreement, as part of the POM.

32. **Municipalities**. Municipalities as the sub-borrowers from MOF will have lead responsibility for preparing and supervising the sub-projects. Municipalities will be supported

by the PMU. Contracts will be signed by authorized municipal representatives and selected contractors. Details of procurement roles and procedures are outlined in Annex 8 and will be elaborated in the POM. Municipalities will prepare disbursement applications and forward them with the supporting documents to the PMU for final verification, recording in project financial management system, processing within the Treasury, and forwarding to the World Bank. The PMU will ensure process quality control, and will conduct periodic and random checks on participating municipalities. Considerable training and support will be provided to participating local governments during sub-project preparation and implementation.

33. **Project Coordinating Committee**: An inter-ministerial committee will be set up by the project effectiveness date because several central agencies have oversight of the municipal infrastructure sector (Ministries of Finance, Local Government, Transport and Communication, Environment and Physical Planning). The committee will comprise ministry representatives and provide a forum for information-sharing and advising the PMU on project management. The committee's main responsibilities are: to ensure good inter-agency communications about project objectives, rules, and implementation progress; to advise the PMU on sectoral or inter-ministerial issues that may affect project-funded activities, such as those pertaining to water and sanitation policies and investments; and to reinforce transparency in the selection of municipalities and sub-projects. The Ministry of Finance will chair the committee.

C. Monitoring and evaluation of outcomes/results

34. The PMU will be responsible for project monitoring and evaluation, reporting, and discussions with the Bank. The PMU will conduct pre- and post-evaluations of the project development objective (PDO) indicators to determine project impact on the performance of municipalities and CSEs. The PMU will collect significant indicators agreed in the project operational manual (POM) on municipalities' technical and financial situation before and during project implementation. For example, the POM would include well-tested and comparative indicators for water and sanitation based on the international benchmarking network methodology (IBNET). The monitoring and evaluation of project progress against plans will be reflected in the semi-annual progress reports prepared by the PMU and provided to the Bank; the reports will outline any corrective actions needed to sustain or improve progress. In discussions with government stakeholders, the Bank team will monitor the project continuously and evaluate progress and achievement of outcomes at least once annually, and intensively during the mid-term review.

35. Project monitoring would include: (a) performance indicators of participating utilities according to the international benchmarking network methodology (IBNET). Participation in IBNET-based benchmarking would be an eligibility condition for municipalities and CSEs to access Component A financing. The IBNET tools were tested in the country during 2008 by the National Association of Municipal Communal Enterprises (ADKOM), with Bank technical assistance. Preliminary results and experiences from Albania, and Bosnia and Herzegovina have shown their relevance for the municipal water sector in those countries; (b) the results of stakeholder workshops and surveys; and (c) progress in preparing and implementing sub-project investment programs. The PMU will conduct analyses of indicator data. The Bank

supervision team would monitor implementation progress and evaluate outcomes on a semi-annual and annual basis, using PMU-prepared report information.

36. The PMU will be responsible for monitoring project progress and outcomes. The PMU will prepare semi-annual progress reports required by the Bank as the basis for supervision. The progress report should: include financial management reports and updates of the procurement plans; narrate progress against plans, highlight issues, and propose solutions; include a section on monitoring indicators and evaluation of outcomes and results that could be discerned at the time of the report. For municipalities that participate in the Performance-based Investment Grant Component, an independent consultant will be hired to monitor and verify whether municipalities have met the performance-based criteria to qualify for the 20 percent grant.

D. Sustainability

37. The project is designed to assist the FYR Macedonia government to strengthen municipal services sector operations following decentralization to ensure sustainable services delivery to local people. The project aims to address local- and central-level sectoral issues. At the municipal level, the project promotes responsible local borrowing for investment, accountability to citizens and consumers by encouraging local voice and transparency, and creating more sustainable financial and supervisory relationships between local governments and CSEs. The project builds on the strong disciplinary role imposed by the central government in its oversight of municipal borrowing. Also, the project provides a flexible testing ground to improve local-government functioning by offering a selection of performance targets and financial incentives for practices and investments that improve services and rehabilitate infrastructure.

38. The project-funded infrastructure improvements are expected to be financially sustainable—mainly rehabilitation or replacement of existing facilities without expansion—and selected because they raise revenues or lower costs of services. In the present institutional circumstances of communal services, municipalities have ultimate financial responsibility for the CSEs and will be responsible for loan repayment.

E. Critical risks and possible controversial aspects

Description of risk	***Mitigation measures***	***Rating of residual risk***
Selection of project participants may be subject to political interference.	- Selection criteria for municipalities and for eligible sub-projects, and performance grant criteria, will be widely discussed with stakeholder agencies, publicized by the PMU, and included in Project OM. Selections will be reviewed by the Bank. - Legal framework for municipal borrowing is in place and has been widely publicized, and subject to concerted sector dialogue among donors.	Moderate
Inter-Agency coordination: Oversight of	- Project inter-ministerial advisory	Moderate

municipal sector is shared among ministries (MOF, MOLG, MOTC, MOEPP); MOF is taking the lead in hosting PMU but requires coordination with other ministries.	committee to be set up. All concerned ministries involved in preparation consultations.	
Open questions on agency responsibilities under new Water Law and resulting unclear policy leadership may impede decision making on sectoral reforms such as tariff increases	- Strong government interest in World Bank and other donor participation in water sector investment, and Bank dialogue on PPIAF-funded reform strategy for communal services enterprises.	Moderate
Municipalities and CSEs have uneven capabilities to do technical work for selection and preparation of sub-projects, and for oversight of works. This could contribute to delays in proposals and implementation of sub-projects.	TA provided under project as needed to help municipalities/CSEs with detailed sub-project preparation, procurement documents, and with implementation.	Low
PMU insufficiently staffed and lacking technical experience in safeguards and procurement**	- PMU and municipal staff involved in sub-projects will receive training on safeguards in accordance with the agreed Environmental Assessment and Management Framework (EAMF) and the Land Acquisition and Resettlement Policy Framework (LARPF) -Safeguards specialist will be hired	Moderate
Municipalities may not carry out reforms.	Municipalities can choose among menu of performance criteria to suit those most feasible for them. Criteria are specified for ex ante eligibility for TA and for investment loans; performance-based investment grants are awarded after respective reforms made.	Moderate
Take-up of investment loans may be low due to inadequate creditworthiness of municipalities, leading to low participation and slow disbursements	Numbers of municipalities receiving approvals to borrow will be carefully monitored during implementation. Favorable conditions of WB lending and lack of significant alternative grant financing for municipal investment portend adequate demand for WB loan.	Moderate
Municipal elections scheduled in Spring 2009 could delay start of implementation	Initial responses of municipalities indicate high interest in participation. PMU will do outreach with newly elected mayors.	Low
Overall Risk		**Moderate**

**Note: Procurement and Financial Management risks are detailed in Annex 7 and Annex 8

F. Loan conditions and covenants

Conditions

39. Conditions of Negotiations:

- Draft of Project Operating Manual, including Financial Manual.

- Draft of a model sub-loan agreement between MOF and municipality acceptable to the Bank

40. Condition of Board presentation: none

41. Effectiveness condition: (a) Borrower adopts the POM, including Financial Manual, satisfactory to the Bank, and (b) the Project Coordinating Committee (PCC) with a composition, resources and terms of reference satisfactory to the Bank is established by the Borrower.

Major Legal Covenants

42. The Borrower shall ensure that all measures necessary for carrying out the Environmental Assessment and Management Framework (EAMF), and Land Acquisition and Resettlement Policy Framework (LARPF) are taken in a timely manner.

43. The Borrower shall ensure that sub-projects under Component A and C of the Project shall be selected, appraised, implemented and evaluated according to procedures acceptable to the Bank and each sub-loan and Grant will be provided to participating municipalities on terms and conditions satisfactory to the Bank as outlines in the POM and the Loan Agreement.

44. Prior to commencement of works under Component A and C of the Project the Borrower shall (a) submit to the Bank for its approval (i) the proposed site for said works and, where required by the EAMF and/or LARPF, the related site-specific environmental management plan, land acquisition and/or resettlement plan and checklist, said site-specific plans and checklist to be in form and substance satisfactory to the Bank; and (ii) the proposed contract for said works to ensure that the provisions of said site-specific plans and checklist are adequately included in said contract; and (b) ensure that such works are carried out in accordance with the EAMF and/or LARPF.

45. The Borrower shall ensure that no Loan proceeds are used to finance activities that are expected to generate significant adverse, long-lasting, and irreversible environmental effects.

IV. APPRAISAL SUMMARY

A. Economic and financial analyses

46. Sub-projects are expected to be revenue-generating or cost-saving investments. Economic and financial analyses using net present value methodologies or cost effectiveness (least-cost) analysis will be used, depending on the size and nature of the investment. Several projects, such as those prepared to date, involve renovation and upgrading and focus on cost savings rather than revenue generation. Such projects do not always yield high financial rates of return as they do not generate additional demand or revenues; instead, they focus on increased efficiencies and improvements in service performance. They may also generate large, yet difficult-to-quantify benefits for health, the environment, comfort or safety.

47. At minimum, the following qualification procedures and financial principles will apply for selection of sub-projects:

(i) The sub-project is revenue earning or cost saving;

(ii) For the revenue-earning entities (CSEs), available financial statements are appraised to highlight strengths and weaknesses, calculate critical ratios (collection ratio, operating ratio, current ratio) and to propose solutions;

(iii) The investment is justified based on financial and economic net present value, or least-cost approach.

(iv) The sub-project has been publicly disclosed to citizen beneficiaries and approval obtained from elected local councils to determine priority and relevance, prior to the funding decision.

B. Technical

48. Technical analysis is expected to identify and compare potential alternatives, taking into account critical considerations such as environmental requirement, land availability, quality of material, and long-term operational costs. A description of each sub-project, including costs and phases, will be elaborated.

C. Fiduciary

49. **Financial Management.** The financial management arrangements are assessed to be acceptable. The implementing entity will maintain a financial management system acceptable to the Bank. The project financial statements and the Designated Account will be audited by independent auditors acceptable to the Bank and on terms of reference acceptable to the Bank. The project audit will be required to extend the scope with respect to loans and grants to include performance review at least on a sample basis to ensure that agreed outputs are delivered in an efficient manner. The annual audited project financial statements and audit report will be provided to the Bank within six months of the end of each fiscal year and at project closing. Audits will be conducted in accordance with International Standards on Auditing (ISA) as issued by the International Federation of Accountants (IFAC) and on terms of reference acceptable to the Bank. Any audits of municipalities performed by the State Audit Office (SAO) will be submitted to the World Bank.

50. Ministry of Finance (MOF) will be in charge of overall project implementation through a designated team within the Ministry. The project management unit (PMU) has been established and adequately staffed to begin project implementation; it includes a qualified and experienced professional who will be responsible for project financial management.

51. The loan includes sub-loans and grants to municipalities. Funds will flow first to municipalities and then to the suppliers for each payment, but overall financial management responsibilities will remain with the PMU. Accounting and reporting for the loans/grants will be done by the PMU. The overall financial management risk is rated ‘substantial’ before mitigation measures, and ‘moderate’ with adequate mitigation measures in place.

52. The PMU will submit a full set of interim un-audited financial reports (IFRs) to the Bank in the agreed format after the end of each calendar quarter throughout the life of the project. The reports will include consolidated financial information, including all loans/grants to

municipalities, and an additional sheet of details on loans/grants to municipalities. The reporting is based on Treasury reporting, however software can be used for project accounting and reporting if it is acceptable to the implementing entity and the World Bank to provide financial transparency and reliable project data. It was agreed that locally developed software (Edusoft), used for an ongoing project within the MOF, will be used for project accounting and reporting and the cost will include acquiring an additional usage license for the new project. The software was tested and assessed as acceptable to the World Bank for providing reliable accounting information.

53. Appropriate procedures, policies and controls for project implementation have been designed and instituted. Existing MOF controls and procedures have been reviewed and the assessment is that additional controls and procedures are needed to create a sound system of internal controls for project implementation. Procedures relating to on-lending to municipalities (loans, grants) need to be defined and described in detail in a Project Operations Manual (POM) by negotiation. The POM needs to describe procedures for eligibility, rules for evaluation and selection, flow of funds for loans and grants, monitoring of expenditures, and reporting mechanisms. As part of the POM, a draft Financial Manual has been prepared that describes all procedures and controls for accounting, reporting, lines of responsibility, authorized signatories, flows of documentation and funds, and external audit. The Financial Manual as part of the POM, acceptable to the Bank, needs to be adopted by the Borrower by the date of loan effectiveness.

54. The National Bank of the Republic of Macedonia (NBRM), where the Designated Account will be opened, is maintaining the Single Treasury Account and appropriate reporting is done from this system. A mirror Denar account for the foreign currency Designated Account will exist within the Treasury, and will serve as a transit account with zero balance. Separate Denar accounts will be opened within the Treasury for each municipality that is the beneficiary of a loan/grant. The funds will flow to municipalities' accounts from the Designated Account (passing through the mirror Denar account) for each specific payment, and municipalities will be obliged to transfer the funds immediately to the respective supplier.

55. **Procurement.** The first Country Procurement Assessment Report (2002) rated public procurement 'high risk' (based on an earlier classification of low, average, high) that may negatively affect implementing agencies' ability to carry out procurement under Bank-financed projects. However, since that assessment, the government has made considerable progress in setting up a modern procurement function. That process is still underway and significant challenges remain to improve (a) public procurement legislation, supplementary regulations, rules, and procedures, and standard bidding documents; (b) procurement capacity building; and (c) control of public procurement, complaints mechanism, and interaction among institutions. The August 2007 Country Fiduciary Assessment (CFA) stated that procurement risk was 'significant,' but since then substantial progress was made in public procurement legislation. Parliament adopted the new public procurement law in December 2007; it is fully compliant with the new European Community Public Procurement Directives, and became effective on January 1, 2008. Another update of the CFA is underway.

56. Municipalities do not yet have experience and capacity to handle Bank project procurement, therefore, the PMU established in the MOF will handle procurement, with the

participation of the municipalities. An assessment of PMU capacity to implement project procurement actions was carried out in October 2008. The PMU procurement staff has gained experience in procurement of goods and selection of consultants under Bank-financed projects, but lacks experience in procuring works in accordance with Bank procurement guidelines. This could create significant risk for implementing project procurement.

57. To mitigate the risks for project procurement, the following measures will be adopted: (a) project procurement will be carried out in accordance with the Bank Procurement and Consultant Guidelines and using standard bidding documents and requests for proposals agreed with the Bank; (b) an additional procurement officer with experience in Bank works procurement and other staff will be hired as needed; (c) the procurement staff, municipal representatives, evaluation committee members, and other technical staff involved in procurement will be adequately trained in Bank procurement guidelines and procedures; (d) an international procurement advisor will be hired at the beginning of project implementation to provide advice and on-the-job training of PMU staff; (e) the POM will specify procurement procedures and responsibilities according to Bank procurement guidelines; (f) the procurement methods thresholds will be in accordance with the ECA Region Reference Thresholds for Procurement Methods; (g) all contracts will be subject to prior or post review as specified in the procurement plan agreed with the Bank; (h) the procurement plan for the first year of project implementation will be prepared and agreed upon at negotiations, and updated as needed. Details are in Annex 8.

D. Social

58. During project preparation, a Poverty and Social Impact Analysis (PSIA) was conducted, representative for FYR Macedonia, to help design the government-requested CSE reform study (strategy and action plan) and to inform project design. The results are summarized in Annex 11.

59. A key finding of the study is the need to strengthen social accountability between municipalities and CSE service providers and the consumers/citizens. Existing CSE operations lack autonomy and efficiency because their roles are not separated from the roles of municipalities, and because consumer/citizen voice is weak. Service providers are not accountable to consumers and political considerations frequently drive decisionmaking rather than sound business principles, consumer responsiveness, or economic efficiency. The study highlights the importance of raising public awareness and encouraging consumers to influence service providers; and the study provides sector-specific recommendations including reforming current institutional structures through an incremental approach to structural change as municipalities and CSEs become ready. The study also provides an action plan to improve service delivery to customers and reduce direct and indirect negative impacts on citizens as national or local taxpayers. Drawing on the PSIA, the PPIAF-funded study includes analysis and proposals for an improved subsidy arrangement to address concerns about the affordability of tariff increases.

60. The PMU will verify that municipalities have undertaken public disclosure and consultations with beneficiaries/citizens on proposed sub-projects, and require municipalities to institute a stakeholder feedback mechanism as a condition for project participation.

E. Environment

61. The project is classified as Category B due to the anticipated nature of the sub-projects. Because the project is demand-driven (Component A – Municipal Investments, and Component C – Performance Based Investment Grants), the complete list of sub-projects to be financed during the project life span is unknown ex-ante. However, activities under components A and C are not expected to generate significant adverse environmental effects. Furthermore, any sub-projects expected to generate significant adverse, long-lasting, and irreversible environmental effects—sub-projects that would qualify for a Category A rating according to OP 4.01—will be ineligible for financing under the project.

62. In accordance with the Bank's Operational Policy 4.01, an Environmental Assessment and Management Framework (EAMF) report was prepared for the project in August 2008 and the draft disclosed in country on October 28, 2008. The final report incorporated comments received during public discussion, and was submitted to the Bank in November 2008. The EAMF report presents an overview of the FYR Macedonia legal framework regarding environment and local self–government; procedures for environmental assessment of project development required under national legislation; procedures for environmental assessment for project development under World Bank procedures, and analysis of potential environmental impacts caused by sub-projects during implementation of project activities. Potential negative environmental impacts for each type of project activities and environmental mitigation and monitoring activities are listed, in order to neutralize impacts. The final EAMF report was published by the World Bank Infoshop in December 2008, and made publicly available in the country and on the Ministry of Finance website.

63. The requirements triggered by Bank safeguard policy OP/BP 4.01 (Environmental Assessment) relate to Components A and C, which would provide loans/grants to eligible municipalities. Investments to be financed will include water supply, sanitation and solid waste (services provided by CSEs), and may include energy efficiency, urban transport, or other municipal services. The EAMF report lists generic issues that would be considered when preparing site-specific EA/EIA and EMPs for each type of sub-project activity financed under the project.

64. Contracts for project civil works will be screened for environmental impacts by the environmental entity responsible in FYR Macedonia. All studies and bidding documents related to civil engineering works will include measures to minimize and/or mitigate potential environmental damage. For each sub-project, in accordance with national legislation, separate site-specific EA/EIAs will be prepared if required, as will EMPs. In addition, even when EA/EIA studies are not required by national legislation, the Borrower will observe requirements set in the EAMF report and prepare EMPs for this project. Those EAs/EIAs/EMPs will be publicly disclosed, reviewed, and endorsed by the responsible environmental entity in FYR Macedonia, and the World Bank. The Project Operational Manual provides details of procedures to produce and review the EA/EIA/EMPs. Monitoring compliance according to EAMF report findings and requirements of EMPs, including progress monitoring on EMP implementation, will be undertaken by the PMU and reported to the World Bank twice per year in semi-annual progress reports.

F. Safeguard policies

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment (OP/BP 4.01)	[x]	[ ]
Natural Habitats (OP/BP 4.04)	[ ]	[x]
Pest Management (OP 4.09)	[ ]	[x]
Physical Cultural Resources (OP/BP 4.11)	[ ]	[x]
Involuntary Resettlement (OP/BP 4.12)	[x]	[ ]
Indigenous Peoples (OP/BP 4.10)	[ ]	[x]
Forests (OP/BP 4.36)	[ ]	[x]
Safety of Dams (OP/BP 4.37)	[ ]	[x]
Projects in Disputed Areas (OP/BP 7.60)*	[ ]	[x]
Projects on International Waterways (OP/BP 7.50)	[ ]	[x]

65. In addition to the environmental safeguard above, the project may trigger the involuntary resettlement safeguard policy. Some sub-projects may require temporary access to land, and possibly land acquisition. The PMU will check potential for this trigger in all investments and determine: (a) whether land acquisition or access to land will be required; (b) if private land acquisition can be avoided; and (c) if resettlement is required, that it is done according to agreed procedures. Chance finds might be discovered during civil works, and these should be reported to the authorities and dealt with accordingly.

66. Although resettlement is not anticipated, a land acquisition and resettlement policy framework (LARPF) has been developed for the project, to be used for sub-projects to be appraised during implementation in case any of these require land acquisition or resettlement. For appraised sub-projects, all land acquisition and resettlement issues will be clarified, and a land acquisition and resettlement action plan (LARAP) developed. The LARPF was disclosed on October 28, 2008. Any subsequent LARAPs must be reviewed by the Bank and publicly disclosed. The POM will include the environmental and land acquisition frameworks and instructions handling chance finds. The POM will also include the Bank OPs 4.01 and 4.12 requirements dealing with these safeguards, and these will also be provided to participating municipalities and consultants/contractors.

G. Policy Exceptions and Readiness

67. The Project complies with all applicable Bank policies and no exceptions are required.

68. Three sub-projects, representing about 10 percent of Component A funding allocation, are expected to be fully appraised by effectiveness and implementation will begin within the first year of the MSIP.

* *By supporting the proposed project, the Bank does not intend to prejudice the final determination of the parties' claims on the disputed areas*

Annex 1: Country and Sector Background

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project

Background

1. Former Yugoslav Republic of Macedonia (FYR Macedonia) is a small, land-locked country with a multi-ethnic population of about two million people. As one of the smallest and poorest of the six republics emerging from the breakup of Yugoslavia, the country entered the transition process with a per capita income only one-third of that in Slovenia and one-half of that in Croatia. FYR Macedonia inherited an economy narrowly based in low value-added sectors such as agriculture, textiles, and iron and steel production. Although the country has mostly been spared from direct violence seen elsewhere in the region, it experienced an inter-ethnic conflict in 2001 that ended six months later with an internationally mediated peace agreement called the Framework Agreement for Peace, also known as the Ohrid Agreement.

2. FYR Macedonia has made impressive progress over the past few years, steadily recovering from the economic, political, and social fallout of 2001. Today, the country enjoys EU candidate status and has applied for NATO membership. Successive governments in FYR Macedonia have been pursuing economic reforms and successfully preserved macro-economic stability. The Ohrid Framework Agreement, which provided the basis for resolving the 2001 ethnic conflict, has initiated an ambitious decentralization agenda that is shaping a new relationship among citizens, local authorities, and the national government. In 2005, FYR Macedonia began formally implementing the first phase of fiscal and political decentralization, and since April 2008, 64 municipalities have entered the second phase of decentralization, assuming full responsibility for operating primary and secondary education, and cultural and social services, such as kindergartens and elderly care. Municipalities that have entered the second phase receive formula-based block grants. In addition to funds for maintenance of facilities provided to first-phase municipalities, the second-phase formula also covers expenditures for employee wages and salaries.

3. Economic performance was strong during the first quarter of 2008. The GDP grew by 5.2 percent compared to the same period of the previous year, due to good performance in trade, construction, mining, and manufacturing. On the demand side, consumption and investment were supported by wage and credit growth. However, the foreign trade deficit widened considerably, reaching 6.7 percent of annual GDP in the first quarter of 2008 alone, as a result of higher energy prices and stronger imports of investment goods. Though moderating recently, annual inflation remains high at around 10 percent. The Central Bank continued to tighten monetary policy to curb credit growth, and steadily increased its interest rates until June of this year when it introduced additional reserve requirements for banks with annual credit growth above 40 percent.

4. Despite recent achievements, the economy reflects some thorny structural problems. Growth has been insufficient to significantly reduce poverty, which has not declined since 2002, or unemployment, which stood at 34.9 percent in 2007. Since then the reported unemployment rate has declined, but remains the highest in South Eastern Europe, excluding Kosovo. Many old public enterprises have closed, few new establishments have opened to provide sufficient job growth, and the domestic private sector remains small. Economic growth is moderate and the latest available data shows a high poverty rate of 29.4 percent in 2007, which is a decrease by 0.4 percentage points

compared to 2006. One-fifth of the population lives below the absolute poverty line, and some seven percent of people have expenditures so low that they are unable to acquire even a minimum caloric intake. However, stagnation in national poverty levels masks some internal changes in and out of poverty: urban poverty in secondary towns and rural poverty have risen, while the urban poverty in Skopje has decreased. This may indicate some dysfunction in the country's urban economies because, in most countries, poverty incidence is much lower in urban areas as cities offer deeper labor markets and easier access to services and formal safety nets than rural areas.

5. Although FYR Macedonia achieved EU-candidate status in December 2005, it has not yet received a date for official negotiations. In its November 2007 Annual Report, the EU acknowledged the progress of FYR Macedonia government in continuing to implement the Ohrid Framework Agreement, pursuing judiciary reform and intensifying the fight against corruption. However, the EU also raised critical issues regarding recent political developments, and inefficiencies in the public administration as areas that still need to be addressed.

6. The government that took office in July 2008, laid out five main goals: (a) increase economic growth by more than six percent and decrease unemployment; (b) integrate with the EU and NATO and solve the name issue with Greece, based on preserving national identity; (c) fight corruption; (d) stabilize inter-ethnic relations; and (e) prioritize education as the best long-term investment..

7. Accelerating economic growth to the level envisioned by the new government will require strengthening the effectiveness and efficiency of public service delivery and providing incentives for increased investments by the private sector. Given the new institutional realities brought by the unfolding decentralization process, better-performing municipalities will be crucial to deliver such an ambitious agenda. Municipalities provide key public services and infrastructure to citizens and local business. Over seven percent of public spending is under the control of municipal governments; and local authorities are responsible for shaping and maintaining stable inter-ethnic relations at the level closest to citizens.

Sector issues

8. Against this backdrop, FYR Macedonia faces the challenge of increasing investments in municipal services while tackling shortcomings in municipal performance and local capacity. According to the 2008 Public Investment Program, approximately EUR 90 million is to be invested in water, waste water, and solid waste management services. In addition, the "Program for Implementation of the Decentralization Process 2008-2010" has laid out priorities to strengthen municipalities. It envisions: (a) enabling all municipalities to enter the second phase of fiscal decentralization; (b) establishing a functional and objective financial monitoring system; (c) establishing minimum standards for calculating the costs of services; and (d) raising the level of grants and developing an effective fiscal equalization system.

9. To take full advantage of these opportunities, including the resources that will come with EU pre-accession, municipal governments will have to fulfill a greater role for which they are insufficiently prepared. Municipalities and central government must work together to sustain growth, equity, and continue to integrate in the external economy, which will require upgrading local service delivery and municipal financial management.

10. **Local service delivery.** Local infrastructure services, particularly water and sanitation, solid waste management, and public transport, are among the most important responsibilities of local government, as these services contribute directly and indirectly to economic growth, household welfare, and environmental sustainability. Most such communal services in FYR Macedonia were relatively well-developed at the time of transition, but have suffered in the last decade and a half from delayed maintenance, rigid price control, and poor financial management, leading to a vicious cycle of deteriorating assets and lack of funding for new investments.

11. Most local public services, including water supply and sanitation, urban transit, street cleaning, and operation of parks, marketplaces, cemeteries, and so on, are provided through municipally-owned enterprises—in most cases a single multipurpose entity, although a few municipalities have separate water utilities. Communal service enterprises (CSEs) are legally independent from their municipal owners; however, in practice there is not an arm's-length relationship. Broadly, CSEs operate based on an informal arrangement with municipalities; the CSE uses infrastructure owned by the municipality or the state to provide services and proposes tariffs, which are then approved by the municipality. The municipality in the current structure is owner, policy-maker, and regulator, as well as a large user of CSE services through its own institutions. In current practice, the average customer has very little power.

12. Although the legal framework for communal services is comprehensive, it is contradictory in several respects. First, it is defined by a plethora of laws administered by separate ministries, and municipal regulations must be compatible with all these laws. Overall, the legal and regulatory framework remains weak and ineffective to promote independent, commercially oriented utilities. There are two major issues in the legal and institutional framework relevant to CSE reforms: (a) ownership of infrastructure assets is ambiguous, and (b) CSEs lack financial autonomy, which is a burden on the municipality.

13. Although a legal distinction exists between the finances of CSEs and those of the municipality, practices are not entirely consistent with this principle. Multipurpose CSEs engage in extensive cross-subsidies, for example, the commercial orientation of tariff-based services such as water is eroded by cross-subsidies to fund public services such as park maintenance, which should be funded by general taxes. Combining operations of such diverse services in a single enterprise can be an efficient solution, especially for small municipalities, provided strict accounting separations are maintained between revenue-earning and non revenue-earning activities. However, strict accounting separation is not common practice in FYR Macedonia, nor are financial reports widely available. Antiquated accounting rules contribute to many CSEs carrying persistent arrears on their books, mainly due to non-payment by other public entities, whereas good commercial practice would be to clear these arrears. Also, many CSEs have accumulated debts, especially short-term, to finance their own operations; few acquire long term loans for investment. In general, CSE financial reporting is incomplete and obscure, which burdens municipalities, as owners and guarantors, in potential contingent liabilities. In this incentive environment, CSEs suffer from over-employment and political influence in the staffing structure is common.

14. Numerous and persistent financial problems in many CSEs are mutually reinforcing and linked with the institutional framework issues. High water losses (average of 40-50 percent) and low collection rates (about 50 percent of billings) reflect a combination of managerial and technical inadequacies. The tariff regime has been inflexible—since 2005, when the national government

lifted a decade-long moratorium on water tariff increases, only thirteen municipalities have raised tariffs for key services, and tariffs still need considerable adjustment to rationalize the exceptionally wide divergence of tariffs across the country, unrelated to variations in the underlying cost structure. The water tariff calculation methodology introduced by the Ministry of Transport and Communication (MTC) is not widely used, and no national water regulator exists. The growing backlog of maintenance and investment requirements is only one obvious result of CSEs' weak financial situation—aging vehicles and equipment also need to be replaced. Available MTC investment funds are adequate only for routine capital repairs and minor system expansions.

15. CSE financing is about to change. In the past, central government transfers were the main source of financing for CSE investment but under Phase II of the decentralization program, capital requirements are to be met predominantly from loans and a mix of central and local government subsidies (some funded via foreign grants, primarily from the EU) and retained earnings. Recurrent expenses are expected to be funded internally, through cost recovery. The expected increase in borrowing for investment will increase the importance of revenue from tariffs, which will have to cover debt service charges and recurrent expenses. The Bank is continuing a dialogue on these issues as outlined in the PPIAF-funded reform strategy discussed below.

16. **Municipal financial management.** FYR Macedonia's intergovernmental fiscal relations are based on a model that assigns own revenue sources to the local government, in combination with intergovernmental transfers intended to bridge the gap between revenue and expenditure assignments. The July 2005 decentralization process has been transforming local budgets because municipalities now have authority to collect and retain locally raised revenues and to set rates, within a specified range, for property tax and various charges and fees. Municipal budgets experienced a dramatic increase in all local government revenue sources—from a total of MKD 1.98 billion in 1999 to MKD 10.5 billion in 2007. Locally raised 2008 tax revenues were projected to increase by about 70 percent over their 2003-04 levels, although this would represent a decline in percent of the total because transfers (including for maintenance of schools and social services) will almost triple for municipalities in the second phase of decentralization. However, total local government revenues remain tiny in relation to GDP (estimated at 3.8 percent), because municipal budgets do not yet cover all operating (salary) costs of education and social institutions.

17. At the same time, municipalities face newly assigned tasks and responsibilities that must be funded from the local budget and have the greatest impact on operating budgets, which have increased almost threefold since the start of decentralization. Funding most local investments from own revenues poses an additional challenge, particularly for smaller and poorer municipalities. Some municipalities inherited large debts from the previous administrations (prior to decentralization) and will be unable to assume new borrowings for at least several years.. The national government has established a firm and correct position against bailouts, and a new fiscal law permits local borrowing only if good financial performance has been demonstrated. Ultimately, municipalities' healthy balance sheets will depend on their ability to mobilize own-source revenues and reform CSE financial management.

18. The basic preconditions for municipal borrowing shall be in accordance with provisions of the Law on Financing Local Governments. Moreover, Article 50 of the Law stipulates that a municipality is eligible to borrow if it has not had arrears on its books for two years and if it has continuously submitted positive financial reports for at least 24 month, except in cases when the

government agrees to remove this restriction for capital investments. Ensuring that the rules for municipal borrowing are clear and fairly applied is increasingly important given the subnational investment needs indicated in the national development plan and upcoming requirements of EU accession.

19. Municipalities have limited incentives for undertaking multi-year investment planning, and little experience with it. Despite expectations of increased autonomy, municipalities continue to rely heavily on central investment grants, including capital grants and transfer windows to finance municipal investment projects, especially for road and water-related investments. However, MTC acceptance of proposals is largely based on technical criteria and whether preparatory documents and permits are ready, a selection process that ignores sound investment analysis. Proposals for local infrastructure investment, including for CSEs, are submitted by the municipality. The magnitude of MTC funds for investment is difficult for individual municipalities to foresee; funds fall well below requests and municipal allocations appear to lack strategic prioritization. As a result, municipalities and enterprises rarely prepare multi-year investment and financing plans or financial and economic analysis of proposals and alternatives, resulting frequently in unfinished projects. In general, it is unclear how productive public investments are in FYR Macedonia, as noted in the Bank's 2008 Public Expenditure and Institutional Review (PEIR). The Public Investment Program is characterized by lack of project prioritization, weak monitoring, and almost non-existent linkages among sector strategies. As a result, project execution is frequently delayed and completion rates range from 70-80 percent of budgeted amounts. In the case of national regional and local road investments, the recently approved Regional and Local Roads Program Support Project (P107840) financed by the Bank is helping to improve project planning, evaluation and prioritization.

Government strategy for the communal services sector

20. The government recognizes the need to strengthen the capacity and performance of municipalities and CSEs. The Ministry of Finance has requested Bank assistance to develop a strategy and action plan for comprehensive CSE sector reform; for this purpose the Public Private Infrastructure Advisory Facility (PPIAF) funded the preparation of a study to the government in October 2008. The draft diagnostic and strategy study, which included proposals for sectoral and institutional strategies and a preliminary action plan for reform, including of water tariff and subsidy policies, was presented to key stakeholders represented in a Steering Committee chaired by the Ministry of Finance, that included representatives from the Ministries of Labor and Social Policy, Transport and Communications, Local Self-Government, and Environment and Physical Planning, and two representative bodies—the Association of Municipal Communal Enterprises (ADKOM) and the national Association of Local Self Governments (ZELS).

21. The main study recommendations are to introduce: (a) formal Customer Charters that specify the legal responsibilities and obligations of municipalities and CSEs to the citizens/customers; (b) cost centre accounting to discern the financial viability of each service provided by CSEs as part of improved financial management and greater transparency (particularly financial flows between municipalities and CSEs); (c) a strengthened national system of municipal tariff regulation, to provide more consistent and predictable cost-recovery for CSE services; (d) benchmarking CSE performance to encourage competitive emulation of best performers and provide a framework for public service delivery monitoring; (e) public awareness-raising to strengthen accountability; and (f)

a water-and-waste poverty scheme to target subsidies for welfare recipient households. The proposed project aims to support municipal- and CSE-level implementation of several of these measures.

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

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project

Project	Amount in USD	FY	Sector Issues Addressed	IEG Rating for Bank Projects
Bank Financed				
Macedonia Community Development Project (LIL) (Completed)	5 million	FY03	Create culture-based industries in areas adjacent to cultural heritage sites, while improving management of cultural assets	Implementation Completion Report (ICR) rated DO satisfactory.
Macedonia Regional and Local Roads Project	105 million	FY08	Improve regional and local roads network, including institutional set-up for managing and maintaining them	Latest IP and DO ratings are Satisfactory
Macedonia Real Estate & Cadastre Registration	14 million	FY06	Contribute to development of efficient land and real estate markets	Latest IP and DO ratings are both Satisfactory
Macedonia Trade & Transport Facilitation in Southeast Europe	20 million	FY08	Increase competitiveness through improved regional transport infrastructure	Latest IP and DO ratings are Satisfactory.
Macedonia Railways Reform	19.4 million	FY06	Improve financial viability, productivity and effectiveness of railway operations	Latest IP and DO ratings are Satisfactory
Macedonia Energy Community of Southeast Europe	25 million	FY07	Support integration into the Regional Power Market	Latest IP and DO ratings are Satisfactory
Other Development Agencies				
USAID: Macedonia Local Government Activity	6 million	FY07	Support Macedonian municipalities by improving financial management capacities and strengthening creditworthiness	
Austrian Development Cooperation	2.5 million 3 million	FY05 FY08	Invest in water supply and waste water systems (2008 program TBD)	
Swiss Development Cooperation	3.3 million 1.5 million	FY07	Improve citizen participation in local governance. Support institutional strengthening for ZELS Improve water supply in one municipality	
EBRD: Municipal Environment Action Program	16 million	FY03	Water supply improvement and sub national finance in 5 municipalities	
KfW: Water and Sewerage Programme	20 million	FY08	Ensure sustainable and affordable supply of drinking water for selected municipalities.	

Annex 3: Results Framework and Monitoring

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project

Results Framework

PDO	Project Outcome Indicators	Use of Project Outcome Information
To improve transparency , financial sustainability and delivery of targeted municipal services in the participating municipalities	Increased transparency as evidenced by : • X percentage of participating municipalities/CSEs involved in performance measurements and benchmarking as per IBNET practices. • publication of benchmarks and project progress information on municipal websites and PMU project portal. Number of participating municipalities implementing institutional development reform initiatives as evidenced by: • Number of municipalities that qualified for performance grants • Number of municipalities that have achieved some of the reform criteria[4] but do not qualify for a performance grant. Improved financial performance as reflected by X% of the participating municipalities achieving increased revenue earnings, and/or cost savings in delivery of services supported by the project. X% of participating municipalities achieving targeted improvements in delivery of select services	Monitor financial and implementation performance of sub-projects through the PMU's M&E information system. Evaluate the commitment of participating municipalities and CSEs to reform Measure progress towards PDO in relation to the respective sub-projects of participating municipalities, so as to derive lessons learned and make corrective actions as necessary. To measure the contribution of the project to improved municipal services
Intermediate Outcomes	**Intermediate Outcome Indicators**	**Use of Intermediate Outcome Monitoring**
Component A (Municipal Investments) : Implementation of municipal investments in specific services under the responsibility of municipalities (and CSEs)	Number of applications for sub-loans as a percentage of eligible municipalities.[5] X% of approved sub-projects successfully implemented.	Monitor effective demand for subloans by municipalities and adequacy of capacity. Analyze reasons for rejection and acceptance. Track project progress at mid-term and upon project completion. Determine corrective actions to improve implementation during duration of project.

[4] From among the performance criteria listed for Component C.

Component B (Capacity building and institutional strengthening): Increased capacity of participating municipalities and CSEs in delivering services.	Number of sub-projects proposals approved for funding. Percentage of CSEs participating in IBNET benchmarking exercise and training. Continued and sustained dialogue on institutional reform as evidenced by submission and review of studies to concerned ministries, such as • Development of a Strategy for Financial Intermediation for Municipal Investments Completion of TA contracts to clients' satisfaction.	Ascertain the improvement in the capacity of the municipalities and CSEs in preparing a project proposal. Evidence of commitment by the central agencies to reform the municipal sector and the delivery of services. Feedback from TA clients (municipalities, CSEs, and central agencies) helps determine progress in capacity improvement.
Component C (Performance Grants): New municipal performance grant incentive in place and applied to allocate funds to reforming participant municipalities.	Number of municipal applications to participate in the Performance Grant incentive. Number of municipalities receiving: • A 20% performance grant for achieving at least 4 of the 7 listed performance criteria. • Number of municipalities achieving 1-3 of the 7 listed performance criteria.	Determine interest in and commitment to reform by the municipalities and CSEs and whether such grants incentivize reform efforts. M&E system will track criteria for receiving performance grants, number of municipalities that are eligible.

[5] The total number of eligible municipalities listed at project effectiveness will be taken as the basis for calculating and monitoring this indicator.

Arrangements for results monitoring

		Target Values[6]					Data Collection and Reporting		
Project Outcome Indicators	**Baseline**	**YR1**	**YR2**	**YR3**	**YR4**	**YR5**	**Frequency and Reports**	**Data Collection Instruments**	**Responsibility for Data Collection**
1. Increased accountability and transparency as evidenced by :							Semi-annual report	PMU M&E report. IBNET benchmarking reports, IBNET workshop attendance list	PMU through consultants
• X% of participating municipalities/CSEs involved in performance measurements and benchmarking as per IBNET practices.	0%	20%	30%	50%	80%	100%			
• publication of benchmarks and project progress information on municipal websites and PMU project portal	No information on benchmarks collected/published	collection of data	Website updated quarterly	Website updated quarterly	Website updated quarterly	Website updated quarterly	Semi-annual progress report		PMU, with supervision consultants
2. Number of participating municipalities implementing institutional development reform initiatives as evidenced by:	1-4 participating municipalities[7]	1-4	2-4	3-4	3-5	4-5	Mid-term review	Project database, referenced by feasibility studies for respective sub-projects	PMU, independent monitoring consultant
• Number of municipalities that qualified for performance grants	1-4 participating municipalities	1-4	2-4	3-4	3-5	3-6			
• Number of municipalities that have introduced some decree of reform initiatives but do not qualify for a performance grant.	0%	0%	10%	15%	20%	25%	Mid-term review	Supervision missions and PMU monitoring and evaluation	PMU
3. Improved financial performance as reflected by X% of participating municipalities achieving increased revenue earnings, and/or cost savings in delivery of services supported by the project.	0%	0%	10%	20%	30%	40%		Supervision missions and PMU monitoring and evaluation	
4. X% of participating municipalities achieving targeted improvements in									

[6] Target numbers are cumulative.
[7] Tentative baseline number of potentially participating municipalities initiating or having already instituted municipal reform agendas. This number will be finalized when the number of participating municipalities is known.

delivery of selected services.									
Intermediate Outcome Indicators									
Component A 1.Number of applications for sub-loans 2. X% approved sub-projects successfully implemented.	 3 0%	 3 0%	 5 10%	 7 25%	 9 50%	 10 80%	Semi-Annual Project reports, mid-term review	Project database, Supervision missions and PMU monitoring and evaluation	PMU and supervision consultants
Component B 1.X% of sub-projects proposals approved for funding. 2, Percentage of participating CSEs taking part in IBNET benchmarking and training 3. Continued and sustained dialogue on institutional reform as evidenced by submission and review of studies to concerned ministries, such as • Development of a Strategy for Financial Intermediation for Municipal Investments 4. Completion of TA contracts to clients' satisfaction.	 0% 0% No strategy No TA available	 10% 20% Procurement of consultants. Satisfactory	 20% 30% Commencement of study. Satisfactory	 30% 50% Submission of inception report. Satisfactory	 50% 80% Draft Strategy submitted to concerned central agency/ministry and discussion Satisfactory	 80% 100% Final report submitted to concerned ministry for review. Satisfactory	Semi-Annual Project reports, mid-term review	Project database, supervision missions and PMU monitoring and evaluation, IBNET reports	PMU and supervision consultants

Annex 4: Detailed Project Description

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

1. The proposed project development objective is to improve transparency, financial sustainability, and delivery of targeted municipal services in participating municipalities. The project aims to achieve this objective through a focus on infrastructure and services under the responsibility of participating municipalities and their communal service enterprises (CSEs), such as water supply, sanitation, and solid waste management, and may include support for energy efficiency, urban transport, and other services under municipal provision.

2. The project would finance investments in basic local infrastructure and municipal services; provide technical assistance (TA) to municipalities and CSEs; and support institutional reforms in municipalities through performance grants. The project would provide institutional support to central agencies for policy and strategic analysis related to financial sustainability of communal services. The project would cover operational costs associated with project implementation, and support project management. The four components are described below.

3. **Component A: Municipal Investments – US$20 million** (Bank financing: US$20 million). This component would provide loans to municipalities that are eligible to borrow. Investments to be financed under this component would be mainly for revenue-generating public services and other investment projects of high priority to municipalities and with cost saving potential. Though subprojects are not limited to certain sectors, it is expected that revenue-earning investments would be primarily for services and infrastructure provided by CSEs, while cost-saving projects could either be under CSEs or under the direct provision of municipalities. To qualify, subprojects should therefore have to demonstrate either revenue earning or cost savings. It is expected that subprojects will be considered for funding on a rolling basis by the PMU based on operational manual procedures. However, to allow for full implementation of the subprojects there will be a time limit on submissions of subprojects, set at one year before the project closing date. Municipalities and CSEs will be assisted with project preparation activities, including review of feasibility studies, preparation of detailed design and bidding documents as well as supervision of construction activities. The consultancy services for these preparatory activities will be provided to the municipalities and CSEs by the PMU and consultants it would hire (see Component B), and are not part of the sub-loans.

4. Sub-projects may include the following:

(i) *Water and sanitation services:* finance for civil works, equipment, and consulting services to rehabilitate water and sanitation services, including for source and consumption metering, leak detection and repair, network rehabilitation and optimization, pressure zoning, and equipment for operations; and urgent rehabilitation and repair of selected sewers, sewer maintenance equipment, and pipe replacement.

(ii) *Solid waste management:* finance for collection infrastructure and support equipment, such as collection bins, support vehicles, and other related equipment and consulting services; and to a limited extent, civil works and equipment to upgrade existing disposal sites to meet minimum sanitary standards.

(iii) *Other revenue-generating or cost-saving investments:* finance for civil works, equipment and related consulting services for upgrading and/or expanding of other services or facilities under the responsibility of municipalities, such as public lighting, storm water drainage systems, urban transport systems, green markets, or insulation of public buildings to lower energy consumption or otherwise enhance efficiency.

5. **Component B: Capacity Building and Institutional Reform–US$1.0 million** (Bank financing: US$1.0 million)**.** This component would include consultancy services and technical assistance for:

(iv) *Sub-project preparation:* feasibility studies and required financial, environmental and social assessments; support preparation of final designs and bidding documents; and provide support for bidding procedures for the kinds of investments funded under Component A. This TA component would be offered only to approved or prospective participants of the MSIP for subprojects proposed for MSIP funding, up until the midterm review. At that time, if there are greater requests for TA to prepare feasibility studies of major subprojects such as large scale environmental investments for later funding outside of the MSIP, such as through EU structural funds, such support will be provided as far as resources permit.

(v) *Local capacity building:* finance technical assistance, training and consulting services for municipalities and CSEs to improve performance in service provision and meet the objectives of the Project. Capacity-building activities and institutional strengthening would be related in particular to helping the municipalities and CSEs meet criteria for Component C (performance grants). The TA would also support communications and public outreach, i.e. communication strategies and programs in participating municipalities to raise public awareness and stimulate informed public debate about the need to strengthen sustainability of communal service delivery and the rational for reforms. The communications strategy would aim to assure a high level of transparency, access to information and feedback mechanisms to stakeholders. The strategy would include a Communications Assessment in participating municipalities to determine required support, for example to establish and maintain stakeholder feedback mechanisms such as municipal websites and/or citizen relations center.

(vi) *National level institutional strengthening:* support to national agencies through study of policy issues and strategy development related to the financial sustainability of municipal services. Priority topics would include preparation of a framework for future municipal investment borrowing through an independent intermediary, with a view to participation of commercial banks and streamlining donor financing and approaches to on-lending, including possibilities to establish a revolving fund.

6. TA under Component B would be limited to prospective participants of Component A, i.e. municipalities and CSEs that receive sub-loans or would be expected to receive them after further preparatory work In general, technical assistance grants to municipalities would be allocated on a "first come, first served" basis as far as permitted within the total allocation to this component. This amount will be reviewed at midterm in light of demands and available resources.

7. **Component C: Performance-based Investment Grants – US$3 million** (Bank financing: US$3 million). This component provides grants to municipalities as an incentive and reward for implementation of reform initiatives aimed at performance improvements in service delivery.

Performance grants will be awarded according to simple and objective criteria based on the enforcement of legal and regulatory requirements currently in place in FYR Macedonia (see below for agreed criteria). Performance criteria are formulated as a menu for municipalities to prioritize their own reform agenda. The performance grant can be awarded anytime up to one year before the close of the Project, whenever the measures are verifiably implemented. The awarded grant amount to an individual municipality will be 20 percent of the investment subloan. The grants can be used for new investment including extension of the original investment funded by the subloan. The municipality would need to present to the PMU a subproject proposal meeting all the same appraisal criteria as for Component A investments. The Performance Grants would be subject to separate Grant Agreements under terms and conditions and in a format specified in the POM.

8. **Component D: Project Management, Monitoring and Evaluation – US$1 million** (Bank financing: US$1 million). This component would support operation of a project management unit (PMU) and assist with project implementation and monitoring. The component will finance staff and incremental operating costs incurred by the PMU, which would be responsible for overall project management and reports to the Ministry of Finance. The project management services will assist with project implementation in municipalities and CSEs, provide guidance and support to local project entities, and ensure that the Bank fiduciary (procurement and financial management) and safeguard (environment, social/land acquisition or other) guidelines are observed. Due to the lack of capacity and knowledge of Bank procurement procedures at the municipal level, the PMU will take the lead responsibility for quality assurance and the management of the procurement process. The PMU will liaise closely with the Bank on all fiduciary and safeguard issues and on adhering to the legal agreements. The PMU would also be responsible for appraisal of sub-projects that become eligible during the course of project implementation. In addition, the PMU will establish a project portal website as central forum for stakeholder dialogue and feedback. Under this component an independent consultant will be hired to monitor and verify whether the municipalities have met the performance based criteria to qualify for the 20 percent grant.

Financing

9. Overall project size is US$25.0 million. All project expenditures will be funded by the Bank. However, the municipal governments will fund most project preparation costs, detailed project design, and supervision. The Ministry of Finance will provide the PMU with in-kind facilities support. Sufficient municipal government ownership is signaled by their willingness to borrow for Component A and, if they choose to participate in Component C, their implementation of challenging reforms. Fund allocation among components will be reviewed at midterm in light of demands and needs to meet the project development objective.

US$ million	World Bank	As share of Total %
Component A (Investment Loans)	20.0	80
Component B (Capacity Building and Institutional Development)	1.0	4
- *Project Preparation*	*0.6*	
- *Performance Capacity Building*	*0.3*	
- *Support to National Policy and Strategy*	*0.1*	
Component C (Performance Grant Investments)	3.0	12
Component D (Project Management, Monitoring and Evaluation)	1.0	4
- *Project Management*	*0.9*	

- *Monitoring of Performance Grants*	*0.1*	
TOTAL	**25.0**	**100**

Eligibility criteria

10. **Municipalities.** The first eligibility condition for municipalities to participate in MSIP is MOF approval for second-phase decentralization.[8] Second, to qualify for investment funding under Component A, municipalities must have received a positive opinion from MOF to allow borrowing.[9] Finally, to promote basic transparency and accountability, municipalities will be expected to meet the following additional conditions:

- Establish a stakeholder feedback mechanism (e.g., municipal website, citizen relations center, or feedback drop box);
- The municipal-owned water/sanitation CSE participates in the IBNET-supported benchmarking program implemented by ADKOM (participates in at least one training event and registers to contribute data to the database).
- **Sub-projects.** Sub-projects to be financed by sub-loans under Component A, or by grants under Component C, would need to meet standard Bank technical, financial, economic, social and environmental criteria outlined in the POM and elaborated in Annex 9 and 10.

11. **Performance grants.** To receive performance-based investment grants under Component C, municipalities must provide evidence of having met the performance criteria. Only municipalities that are receiving sub-loans will be eligible to apply for performance grants. Municipalities can choose from a menu of seven performance criteria in line with their own reform agenda. Municipalities that meet *at least four of the seven criteria* become eligible for performance grants under project Component C, and would be awarded an amount equivalent to 20 percent of the overall sub-loan amount. The requirements to be met under each of the following performance criteria are explained in detail below. They can be classified as:

- **Performance measure that the Municipality undertakes itself:** Municipal local revenues have increased by a minimum percentage rate over a three year period, with 2007 as the base year.
- **Performance measures that the Municipality and CSE undertake together:** (a) Municipality and CSE have signed a service level agreement on water/wastewater services that defines the rights and obligations of each party; (b) Municipality and CSE have published audit results; (c) Municipal council has approved a time-bound program to raise CSE tariffs towards cost recovery and has passed the first increase within the previous two years.
- **Performance measures that the CSE undertakes itself** (although with general support of the municipal council, which approves its budget): (a) CSE has introduced separate

[8] Municipalities are individually approved by MOF for the second phase of decentralization when they meet the following conditions: resolution of debt arrears; hired staff for financial management; show good financial results for at least 24 months; and no new arrears to suppliers that exceed ordinary terms of payments.
[9] See Annex 1 for preconditions for municipalities to borrow, based on the Public Debt Law and 2007 Ministry of Finance guidelines. The MOF issues its "positive opinion" after reviewing a municipality project proposal with specific borrowing terms.

cost accounting centers for its activities; (b) CSE has introduced a non-revenue water reduction program and started implementation; (c) CSE prepares an asset inventory.

12. Municipalities and CSEs can adopt any of the above measures in any order. The performance grant would be awarded when the measures are completed as certified by a private monitoring group hired by the PMU, until the final year of the MSIP. To the greatest extent possible, documentation will be based on a template developed and included in the Grant Agreement attached to the POM..

Detailed description of performance criteria

13. **Criterion 1: Increased local revenues.** Local revenues include taxes and fees collected by the municipality as defined in the Law on Financing of the Units of Local Self Government (2004), including tax on income, property, inheritance and gift, transfer of real-estate and rights, business signage fees, road usage and vehicle registration, use of public lighting, construction permit fees, entrepreneurial and property income, administrative fees, and fees for services. The data source would be the municipalities' end-of-year financial report submitted to the Ministry of Finance. The minimum total percentage increase required during 2008-10, taking December 31, 2007 as the base, would vary by municipal category:

(i) More than 50,000 inhabitants: increase of at least 10 percent in per capita local revenues (average 2006: MKD 2,079 per capita or 57 percent of total revenue).
(ii) Between 20,000 and 50,000 inhabitants: increase of at least 7.0 percent in per capita local revenues (average 2006: MKD 982 per capita or 40 percent of total revenue).
(iii) Below 20,000 inhabitants: increase of at least 5.0 percent in per capita local revenues (average 2006: MKD 863 per capita or 26 percent of total revenue).

14. **Criterion 2: Service-level agreement.** The municipality will sign a legal agreement with its CSE that specifies roles, rights, responsibilities, and obligations for each party regarding the services provided by the CSE on behalf of the municipality. The agreement will be made publicly available at the CSE, the municipality, and by mail to CSE customers, and will specify minimum customer rights and CSE responsibilities. The agreement will specify: (a) the CSE service area covered; (b) minimum service quality measures; (c) CSE planning, budgeting, reporting, and auditing requirements; (d) financial and technical performance targets; (e) governance structure; (f) municipality tariff calculation methodology and annual review procedure; (g) customer complaint and appeals procedures, and public monitoring and accountability mechanisms. The PMU will assist by providing sample contracts.

15. **Criterion 3: Published Audits**. Municipality and CSE will publish internal and external audit results on their webpage or other publicly accessible medium.

16. **Criterion 4: CSE tariff adjustment program.** The municipal council, which is legally responsible for approving tariff proposals formulated by the CSE, will have: (a) approved a time-bound program to increase CSE tariffs towards cost recovery, defined as costs of operation, maintenance, and debt service; and (b) passed the first tariff increase within the previous two years from the time of grant application.

17. **Criterion 5: Separate cost center accounting.** The CSE will have established separate cost accounts for each service provided or activity undertaken, to enable the calculation of unit costs for each product or service. The CSE would apply cost accounting software comparable to the software that was implemented with the GTZ support in ten municipalities.

18. **Criterion 6: Implement a non-revenue water reduction program.** The CSE would need to (a) present a feasible non-revenue water reduction program to reduce non-revenue water within the next three years; and (b) provide evidence of a working source meter, the first step of implementing a non-revenue water program. Other minimum requirements include a detailed network screening plan, and a customer connection survey that detects all existing and working connections.

19. **Criterion 7: CSE asset inventory.** The CSE would need to present a completed inventory of assets owned and/or used by the CSE. The inventory must be suitable to serve as the basis to assess the physical condition of the water supply system as well as the current and replacement value of assets (although meeting this condition does not require full asset valuation).

Identified sub-projects

20. In a preliminary screening, four potentially eligible sub-projects were identified and are in advanced preparation. Draft feasibility studies of the sub-projects were submitted to the PMU and are being carefully reviewed. Three of the sub-projects, representing about 10 percent of the Component A funding allocation, are expected to be fully appraised by effectiveness and will start implementation within the first year of the MSIP. The sub-projects are described briefly below. A forth possible sub-project identified in Valandovo is currently being pre-appraised.

21. **Kočani – Water network rehabilitation**. The Municipality of Kočani has some 39,000 inhabitants and is the administrative, economic, cultural, and educational center of the Kočani valley. The municipality proposes to borrow approximately US$660,000 (in equivalent MKD) to replace asbestos pipes with High Density Polyethylene (HDPE) pipes in the middle pressure zone of the municipal water supply network. Approximately five km of pipes would be replaced, or about 20 percent of total pipe network length. This sub-project is a part of Kočani's municipal water master plan, which calls for phased pipe network rehabilitation as funds become available. Anticipated key benefits include higher efficiency, lower demand due to reduced physical water loss (the middle pressure zone is the leakiest part of the network), improved water quality due to replacement of asbestos pipes, and reduced infiltration of pollutants through leaks.

22. **Veles – Street lighting.** Veles, in the center of Macedonia, has ca. 55,000 inhabitants, and is predominantly industrial. Veles proposes to borrow about US$577,000 (in equivalent MKD) to replace 3,626 mercury vapor street lamps with 3,510 higher efficiency sodium lamps. The investment will significantly reduce electricity consumption, and maintenance costs are expected to decline because the more expensive sodium lamps last three years versus one year for the mercury vapor street lamps.

23. **Veles – School insulation**. Veles' second proposal is to borrow about US$426,000 (in equivalent MKD) to replace single-glazed and broken windows with double-glazed windows at two primary and one secondary school, and install Styrofoam wall insulation at one of the primary schools and the secondary school. The proposed investment will lead to significant energy cost

savings for heating during the winter months, and improve the classroom learning environment through improved temperature regulation and better sound insulation. Roof insulation has also been proposed.

Annex 5: Project Costs

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project

Project Cost By Component and/or Activity	Local US $million	Foreign US $million	Total US $million
Component A: Municipal Investment	**8.0**	**12.0**	**20.0**
IBRD	8.0	12.0	20.0
Component B: Capacity Building and Institutional Strengthening	**0.6**	**0.4**	**1.0**
IBRD	0.6	0.4	1.0
Component C: Performance Grants	**1.2**	**1.8**	**3.0**
IBRD	1.2	1.8	3.0
Component D: Project Management and Operational Cost	**0.4**	**0.6**	**1.0**
IBRD	0.4	0.6	1.0
Total Baseline Cost	**10.2**	**14.8**	**25.0**
Total Financing Required			

All contracts to be financed under the project will include taxes.

Annex 6: Implementation Arrangements

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project

1. **Project Management Unit.** A PMU has been established in the Ministry of Finance (MOF) because the project is relevant to fiscal decentralization and the MOF has a key role in approving and overseeing municipal borrowing. The PMU will be adequately staffed. An interim PMU director, financial management and procurement specialists are already on board, and additional required expertise will be supplied by a roster of consultants. The cost of consultants for monitoring and evaluation will be included in PMU funding.

2. The PMU will be fully responsible for all aspects of project implementation according to Borrower and World Bank requirements: project financial management, project monitoring and evaluation; increasing awareness about the project among the municipalities; receiving proposals for sub-projects and providing assistance to refine them; and evaluating sub-project proposals in accordance with the Project Operational Manual (POM) and Bank agreements. The PMU will forward sub-projects proposals to the Bank for its final 'no objection.' During the first year, the Bank is expected to review all proposals; after that, if the Bank assesses PMU capacity as adequate to evaluate sub-project proposals, the responsibility for final approval may be delegated to the PMU. Following Bank agreement to sub-project proposals, the PMU will be responsible for finalizing sub-loan and grant agreements with municipalities, and reviewing service agreements between municipalities and CSEs, where applicable. Due to the lack of municipal-level capacity and knowledge of Bank procurement procedures, the PMU will take lead responsibility for quality assurance and procurement process management. The PMU and the Bank will liaise closely to ensure adherence to all fiduciary, safeguard, and legal agreement issues.

3. The PMU director shall have overall management responsibility for daily project implementation, ensuring environmental and social requirements are met, and liaising with government stakeholders and the World Bank. The director can access required additional skills for project implementation, and must ensure timely reporting, monitoring, and evaluation. The POM will specify project procedures for participating municipalities and the PMU, and include Bank project documents, such as procurement guidelines and the Loan Agreement.

4. The POM will specify project objective, description, and financing; and include the following:
   - (i) Project implementation activities/ responsibilities, including fiduciary (procurement and financial management procedures) and safeguards (environment and land acquisition/resettlement); and reporting requirements for participating municipalities and the PMU;
   - (ii) Sub-project preparation activities and responsibilities, including procedures and formats for sub-project proposals, appraisal, and approval activities;
   - (iii) Application of Borrower laws to environment and land acquisition/resettlement;
   - (iv) Application of Bank fiduciary procedures;
   - (v) Bank safeguard requirements, including Environmental Assessment and Management Framework, and Land Acquisition and Resettlement Policy Framework;
   - (vi) Terms of reference and responsibilities of PMU staff; and
   - (vii) Formats for semi-annual project progress reports.

4. **Municipalities.** Municipalities as sub-borrowers from MOF will have lead responsibility for preparing and supervising sub-projects, with PMU support. Municipal technical teams will be responsible for preparing sub-projects—identification, technical documentation, and final execution of contractual obligations with contractors. The PMU and its specialists will support municipalities in preparing sub-project technical designs and feasibility studies, and executing contracts signed by authorized municipal representatives and selected contractors. Procurement roles and procedures are detailed in Annex 8 and will be elaborated in the POM. Municipal financial officials will prepare disbursement applications in accordance with the authorization to pay of the supervising consultant. Disbursement applications and required supporting documents will be forwarded to the PMU for final verification, recorded in the project financial management system, processed by Treasury, and forwarded to the World Bank for the transfer of funds in accordance with the legal agreement and disbursement letter. The PMU will ensure process quality control, and undertake periodic and random checks on participating municipalities. Considerable training and support will be provided to participating local governments during sub-project preparation and implementation.

5. **Project Coordinating Committee**: An inter-ministerial committee will be set up by project effectiveness including representatives from the central agencies that have oversight of the municipal infrastructure sector (Ministries of Finance, Local Government, Transport and Communication, Environment and Physical Planning). The committee will provide a forum for information sharing and advice to the PMU on project management. The committee's main responsibilities are: to ensure good communications among government stakeholders on project objectives, rules and implementation progress; to advise the PMU on sectoral or inter-ministerial issues that may affect project-funded activities, such as water and sanitation policies and investments; and to reinforce transparency in the selection of municipalities and sub-projects. The committee will be chaired by the Ministry of Finance and will also include the national professional associations, ZELS and ADKOM. The committee will meet quarterly and will receive summaries of the project progress reports prepared by the PMU.

Table 1: Sub-project Implementation Roles and Responsibilities

Function	Municipality	CSE	PMU	MOF	PCC
Propose sub-projects	Local Council approves	Proposes to municipality			
Prepare sub-projects (designs, technical specifications, bidding documents)	With technical support from project-funded consultants as needed	With technical support from project-funded consultants as needed			
Appraise sub-projects			With no-objection review by WB		
Select sub-loan terms and funding approval			Recommendation to MOF PDD, and finalizes sub-loan and performance grant agreements with municipalities	PDD issues positive opinion on borrowing by municipality and terms of sub-loan (grace and repayment periods)	
Procurement	Participates in procurement activities under PMU responsibility; Municipal representative signs contracts with suppliers		Carries out procurement for sub-projects on behalf of municipalities at all stages, with their participation. Manages and assures quality of all stages of procurement, with post review by WB on at least 20 percent of contracts		
Financial management	Submits disbursement requests to PMU; Makes payment to suppliers upon receipt of funds from MOF		PMU verifies completion and documentation, and forwards to Treasury for payment; Oversees all FM procedures Manages the Project Designated Account and makes payments from DA to the Denar accounts of participating municipalities		
Supervise works (contract implementation and acceptance of deliverables)	For sub-projects of direct municipal responsibility. Also confirms CSE supervision of works	For sub-projects concerning CSE services and activities	Makes periodic and random checks on completion of works		
Environmental and social safeguards	Responsible to apply EAMF/LARPF to sub-project	Responsible to apply EAMF/ LARPF to sub-project	Certifies that WB and national safeguard policies observed according to EAMF/LARPF, with WB review		
Monitoring & Evaluation	Reports to PMU	Reports to municipality	Reports to Bank and PCC		
Inter-ministerial coordination			Quarterly reporting to PCC for information sharing and transparency		Quarterly meetings to review reports

Annex 7: Financial Management and Disbursement Arrangements

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project

Risk Analysis

1. The overall financial management risk for the project is substantial before mitigation measures, and with adequate mitigation measures agreed, the financial management residual risk is rated moderate. Table below summarizes the financial management assessment and risk ratings of this project:

Table 1: Risks

Risk	***Risk Rating***	***Risk Mitigation Measures***	***Risk Rating after mitigation Measures***
1. Inherent Risk			
Country level. Perceived corruption in the country is high. Capacity of State Audit Institution is low. Nevertheless, CFA 2006 described that the Government has well functioning Treasury operations and exercise good control over spending of budget entities. The NBRM efficiently administers the Treasury Single Account (TSA) on behalf of the Government	S	Risk as described on the left allows that reporting is based on the Treasury and Designated account opened in the NBRM. Corruption risk will be mitigated by instituting additional procedures and strengthening system of internal controls. The internal controls to be applied in practice are described in Financial Manual. Quarterly IFRs will be submitted to the Bank, and the Bank's FMS will perform on site supervision. Risk imposed by low capacity of SAO will be mitigated by using private auditor acceptable to the Bank for the project audit.	M
Entity level. The MoF has prior experience in implementing Bank projects and good track record. Nevertheless, it was assessed that internal controls and procedures within the ministry need strengthening.	S	Financial Manual will be prepared for the project, clearly describing procedures and controls to be applied during project implementation. Application in practice of agreed controls and procedures will be verified by the Bank's supervision.	M
Project level. The project is characterized by rather complex design and implementation arrangements, mainly with respect to loans/grants to municipalities, which imposes risk on the flow of funds and accounting and reporting for those.	H	The risk will be mitigated by developing sound financial management system for the project, which clearly describes procedures and controls to be applied, including flow of funds and documentation and authorizations and approvals needed, including loans and grants to municipalities. This is described in Project Operations Manual and Financial Manual as integral part of it. Application in practice of agreed controls and procedures will be verified by the Bank's supervision.	S
Overall Inherent Risk	***S***		***M***
2. Control Risk			
1. *Budgeting and Planning.* Capacity for budgeting and planning is adequate, and there is substantial experience in this respect. However, additional risk is imposed by the fact	S	The PMU will gather necessary information from the municipalities on the estimated forecasts of expenditures in order to allow for more accurate planning. Capacity within the municipalities to provide reliable forecasts will need to be appropriately monitored and supervised. Reasonableness of	M

that plans and budgets will include loans and grants to municipalities, thus making it more difficult to estimate actual expenditures on the municipalities' level.		estimates will be verified by the PMU once again.	
2. *Accounting.* The PMU will need to account for transactions under loans and grants for municipalities.	S	Treasury accounting will be supplemented by using Edusoft software for accounting and reporting for the project. The software is assessed to provide reliable accounting information.	M
3. *Internal controls* need to be clearly defined in order to ensure that project funds are used for intended purposes. The importance of this is emphasized by the fact that appropriate procedures need to be instituted for loans/grants to municipalities and the role of municipalities in the process.	S	Internal controls and procedures to be applied during project implementation are described in Financial Manual, and Project Operations Manual as a whole. It needs to clearly define flow of documentation and funds, accounting, reporting, disbursement, roles and responsibilities for all types of processes under the project, including mechanism of loans and grants to municipalities. Application of controls in practice will be verified during Bank's supervision.	M
4. *Funds flow.* Flow of funds is described in details in later sections of the report. It incorporates certain complexity and risk due to involvement of more entities (ministry and municipalities).	H	Flow of funds, including related procedures such as authorizations and approvals of payments are clearly described in details in the FM Manual. The loans will flow through municipalities to suppliers under close supervision and control checks by the PMU (see flow of funds section). Application of the procedures in practice will be verified during Bank's supervision.	S
5. *Financial reporting.* Financial reports will provide consolidated information, including loans and grants to municipalities. The PMU needs to obtain necessary data from municipalities.	S	Financial reporting will be based on the Treasury reports and supplemented by Edusoft software. Financial reports will include an additional report which will provide details regarding loans and grants to municipalities.	M
6. *Auditing.* Low capacity of SAO.	S	Private audit firm acceptable to the Bank will perform audit of the project. SAO audits of municipalities will be requested as additional assurance.	M
7. Staffing.	M	Qualified and experienced professional has been appointed to be in charge of financial management aspects of the implementation. No additional mitigation measures needed.	M
Overall Control Risk	**S**		**M**
Overall FM Risk	**S**		**M**

Country Issues

2. The latest diagnostic work in public financial management area in FYR Macedonia confirms that improvement is required in the management of public expenditures, especially for the improvement in internal control in the budget users and strengthening of internal and external audit. Mitigating measures shall include the Bank's supervision and the use of private auditor for the audit of the project accounts. No reliance will be placed either on the internal audit or the external audit conducted by the FYR Macedonia State Audit Office (SAO).

Strengths

3. Control of spending of budget entities from the side of the Government, as well as the well-functioning treasury system, represent principal strengths of the project financial management

arrangements. The MoF, and in particular the financial management officer for the project, have substantive prior experience in implementing World Bank supported projects.

Weaknesses

4. Principal weakness noted relates to the level of complexity of the project linked primarily to on-lending operations to municipalities in the form of loans and grants. This poses risks in monitoring and controlling this process, as well as for flow of funds. Additional safeguards and appropriate mechanism need to be designed in order to ensure appropriate controls and monitoring of the process.

Implementing Entity

5. MoF through the PMU which is to be mandated with a specific assignment of coordinating and managing the project, will act as the overall implementing agency for the project. The project management unit (PMU) has been assigned with project roles and responsibilities. The MoF and some staff of the PMU have substantial prior experience in implementing World Bank supported projects.

Planning and Budgeting

6. The MoF has adequate capacity for planning and budgeting in terms of human resources, availability of quality information and IT system. Staff has experience in budget preparation. The PMU will prepare single budget for all project components, including loans and grants to municipalities, for which the PMU will need to communicate with respective municipalities. This process and lines of communication between the PMU and the municipalities should be closely monitored, as planning and budgeting will involve more risk due to the need to estimate actual expenditures on the municipalities' level.

Accounting

7. Staffing: The PMU has appointed staff to core functions. The financial officer within the unit assigned to project financial management is a qualified specialist with substantial experience in implementing World Bank supported projects. Detailed Terms of Reference for financial management staff are included in the Financial Manual portion of the Project Operations Manual.

8. Information Systems: For accounting and reporting, the MOF uses the Treasury system, which was assessed in FYR Macedonia diagnostic work as sound with reliable reporting and ex-ante controls. The Bank and the PMU agreed that due to the complex project design, and the need for reliable, transparent, and timely information, Edusoft software would be used for project accounting and reporting and will supplement Treasury reports. Edusoft software was reviewed, tested, and is acceptable to the Bank for reliable accounting information. Edusoft can generate IFRs automatically and accounting data will be backed up regularly.

9. Accounting Policies and Procedures: Accounting books and records will be maintained on a cash basis with additional information on signed contracts. Project financial statements will be presented in Euros. The PMU will do accounting and reporting for the loans/grants; policies and procedures for project implementation are described in the draft Financial Manual.

Internal Controls

10. A robust system of internal controls and procedures will be instituted for the project. The controls and procedures to be applied are described in the draft Financial Manual. Key internal controls to be applied for the project include:

- appropriate authorizations and approvals;
- segregation of duties;
- different persons being responsible for different phases of transaction;
- reconciliations between records and actual balances, as well as with third parties should be performed on regular basis;
- complete original documentation should exist to support project transactions.

11. Adequate procedures and controls need to be instituted and applied to loans and grant lines to municipalities. Procedures will be designed to ensure use of funds for intended purposes and will be described in the Project Operations Manual. Key internal controls and procedures include:

- Description of eligibility criteria for beneficiaries
- Description of eligibility criteria for projects
- Procedures and responsibilities for municipality evaluation and selection
- Procedures, processes, and reporting for monitoring grants implementation
- Procurement processes for the grants
- Flow of funds

12. The MOF publishes tenders and municipalities are contract signatories. Municipalities receive an invoice and forward it to the PMU with supporting documentation to prove that goods/services have been received and align with the contract. A PMU engineer will perform on-site visits to check that delivery quality and quantity aligns with contracts. Independent consultants may also be contracted to verify that delivered goods, services, or works are acceptable, prior to payments.

13. The invoice is then reviewed by the PMU finance officer who registers and checks the invoice. After putting his/her initials the invoice is reviewed by the project procurement staff. All relevant documentation shall be attached to the invoice enabling the Project Director to immediately evidence that the necessary checks have been performed. Payment orders and the invoice with all designated approvals and signatories are submitted for payment. In the cases of loans, the funds are transferred to municipalities, which are obliged to transfer the funds to suppliers in the shortest possible time. Any future request for payment by municipalities needs to be supported by appropriate documentation that the previous payments have been executed.

14. Commercial Bank Statements of the Designated Account are received daily by the PMU, and Treasury reports on a regular basis. Municipalities submit statements of their accounts to the PMU on regular basis and frequency is defined by the on-lending agreement. Based on the Bank Statements/Treasury reports the PMU Financial Specialist will record executed payments and perform due reconciliation of the bank balances.

Reporting and Monitoring

15. Project management-oriented interim un-audited financial reports (IFRs) will be used for project monitoring and supervision. The IFR format will be agreed during negotiations and attached to the Minutes of Negotiation. MOF will produce a full set of IFRs for each calendar quarter

throughout the life of the project; the IFRs are due 45 days after each quarter ends. Accounting and reporting for loans/grants will be done by the PMU, and presented within the IFRs.

16. The IFRs will comprise the following reports presented in the agreed format:
- Statement of Sources and Uses of Funds
- Uses of Funds by Activity
- Designated Account statement
- Unit of Output by Activity
- Breakdown of Loans and Grants to Municipalities
- Narratives to the Reports

External Audit

17. The SAO audits MOF as a government entity. However, SAO capacity for conducting efficient financial audits is still quite limited, so project financial statements will be audited in accordance with terms of reference acceptable to the Bank by a private sector auditing company acceptable to the Bank, and the audit report will be submitted to the Bank no later than six months after the end of the period audited. The project audit will be required to extend the scope with respect to loans and grants to include performance review at least on a sample basis to ensure that agreed outputs are delivered efficiently. The annual cost of project audits will be covered by project funds. Any audits of municipalities performed by the SAO will be submitted to the World Bank.

Funds Flow and Disbursement Arrangements

18. The project will use transaction-based disbursement. At project effectiveness, a Designated Account will be opened in the National Bank of the Republic of Macedonia (NBRM), to which funds will be transferred. A mirror Denar account will be opened within the Treasury Single Account as an operating account for withdrawals from the foreign currency account, and is in essence a transit zero balance account. The Designated Account will be managed and operated by the the PMU within the MOF. Beneficiary municipalities will open Denar accounts within the Treasury Single Account, to which funds will flow from the Designated Account, and from which funds will flow to suppliers.

19. The funds are initially transferred from the Designated Account (passing through the mirror Denar account) to accounts owned by municipalities who are beneficiaries of loans/grants. The municipalities are obliged to transfer the funds to suppliers within five working days. Any future request for payment by municipalities needs to be supported by appropriate documentation that the previous payments have been executed. The Ceiling for this Designated Account will be defined in the disbursement letter for the project. Documentation requirements for replenishment would follow standard Bank procedures as described in Disbursement Handbook. The MOF, via the Treasury system, will execute any counterpart funding.

Supervision Plan

20. During project implementation, the Bank will supervise project financial management arrangements in two main ways: (a) review project interim un-audited financial reports for each calendar quarter, project annual audited financial statements, and auditor management letter; and (b) perform on-site supervisions, review project financial management and disbursement arrangements to ensure compliance with Bank minimum requirements. Supervision will be performed by the Bank-accredited Financial Management Specialist.

21. **Allocation of activities.** Loan proceeds will be allocated as follows:

Table 2: Allocation of Loan Proceeds

Category	Amount of the Loan Allocated (US$)	Percentage of Expenditures to be financed
(1) Sub-loans under Part A of the Project	19,937,500	100
(2) Goods, works, consultants' services and Training for the Project	1,872,381	100
(3) Grants under Part C of the Project	3,000,000	100
(4) Operating Costs	127,619	100
(5) Front-end Fee	62,500	Amount payable pursuant to Section 2.03 of the Loan Agreement in accordance with Section 2.07 (b) of the General Conditions
TOTAL AMOUNT	25,000,000	

Annex 8: Procurement Arrangements

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

A. General

1. Procurement for the Municipal Services Improvement Project will be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004 and revised in October 2006 (Procurement Guidelines); and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004 and revised in October 2006 (Consultant Guidelines), and the provisions stipulated in the Financing Agreement (FA). The various procurement actions under different expenditure categories are described in general below. For each contract to be financed under the FA, the various procurement or consultant selection methods, the need for pre-qualification, estimated costs, prior review requirements, and time frame have been agreed between the Borrower and the Bank in the Procurement Plan (PP). The PP will be updated at least annually or as required to reflect the actual project implementation needs and improvements in institutional capacity. A General Procurement Notice (GPN) will be published in March 2009 in UNDB on-line and in its printed version as well as in dgMarket online. Specific Procurement Notices (SPN) will be published for all ICB procurement and Consulting contracts as per Guidelines as the corresponding bidding documents and RFPs become ready and available.

B. Assessment of the Agency's capacity to implement procurement

2. The first Country Procurement Assessment Report (2002) rated public procurement "high risk" (based on earlier classification of low, average, high) that may negatively affect the ability of implementing agencies to carry out procurement under WB-financed projects. Since the assessment, however, the government has made considerable progress in setting up a modern procurement function. That process is still underway but significant challenges remain to further improve (a) the public procurement legislation, supplementary regulations, rules, and procedures, and standard bidding documents; (b) procurement capacity building; and (c) the control of public procurement, complaints mechanism and interaction between institutions. The Country Fiduciary Assessment (CFA) prepared in August 2007 therefore also assessed procurement risk as "significant". After the preparation of the CFA in 2007 significant progress has been made with respect to the public procurement legislation. The new public procurement law, fully compliant with the new EC Public Procurement Directives, was adopted by parliament in December 2007 and became effective on January 1, 2008. Another update of the CFA is underway.

3. An assessment of the capacity of the implementing agency, Project Management Unit (PMU) at the MOF, to implement project procurement was conducted by a Bank procurement specialist during October 13 to October 17, 2008. The main findings are as follows:

- Municipalities, as sub-borrowers of the MOF, lack experience and capacity to handle procurement under Bank projects and therefore project procurement will be carried out by the PMU established in the MOF, with municipalities' participation. The PMU will be in charge of the overall project implementation including procurement, financial management, monitoring, and evaluation. The PMU should establish close cooperation and good interaction with the municipalities and CSEs during all the phases of sub-project execution.

Workshops will be organized for the technical and administrative staff of the municipalities and CSEs (under Component B) to strengthen technical and procurement capacity

- The PMU staff includes an interim director, financial management specialist; and procurement specialist. In addition, the PMU will operate with consultants with specific expertise. The PMU procurement specialist was hired on a competitive basis under MK DTF, has procurement experience under other Bank projects: MK DTF, PDPL1 and PDPL2; attended the 2007 Regional Procurement Workshop in Sarajevo; and has experience in procurement of goods and selection of consultants in accordance with Bank procurement and consultant guidelines, but lacks experience in procurement of works. Therefore, the procurement specialist will attend training on procurement of works and other training, as needed; and will receive on-the-job training from an international procurement advisor hired under the project.

- An additional procurement officer with experience in Bank works procurement and other staff will also be hired, as needed.

- An international procurement advisor will be hired when project implementation begins for procurement advisory and on-the-job training of the PMU procurement and other staff.

- Procurement staff, municipality and CSE representatives involved in sub-project implementation, members of the evaluation committees, and technical staff involved in project procurement will be trained in Bank procurement guidelines and procedures.

- POM will detail procurement procedures and responsibilities referring to Bank procurement guidelines and procedures;

- There is a potential risk of low-quality technical sub-project documentation due to the lack of technical capacity within the municipalities to develop sub-projects. Consulting services and technical assistance will be provided under project Component B, as needed.

- There is potential risk to daily implementation monitoring and supervision due to limited technical staff and capacity within municipalities and CSEs. Consulting services and technical assistance will be provided under project Component B, as needed.

- The Project will be subject to supervision by the Bank as specified in part F below.

C. Procurement risk assessment

4. The risks associated with procurement and the mitigation measures are summarized in the table below. Overall procurement risk after mitigation measures are implemented is rated **“moderate.”**

Table 1: Summary Risk Assessment

Description of risk	*Rating[a] of risk*	*Mitigation measures*	*Rating[a] of residual risk*
Municipalities lack experience and capacity to handle procurement under Bank projects.	H	Project procurement will be handled by the PMU with municipalities' participation. Municipalities' representatives, members of evaluation committees, and other technical staff involved in project procurement will be trained in Bank procurement guidelines and procedures.	M
When the project is fully underway, the PMU may be insufficiently staffed and may have insufficient experience and capacity to ensure solid and speedy procurement processes.	H	One procurement officer with procurement experience gained under other WB projects has been hired on SSS basis. Additional PMU procurement staff, with adequate qualifications and experience in works procurement will be hired, as needed. International procurement advisor will be hired when project implementation starts, for on-the-job training of PMU procurement staff, who will also receive training on Bank procurement, as needed.	M
Insufficient technical capacity within the municipalities and CSEs to develop the sub-projects and poorly prepared technical documentation, designs, specifications, etc., may delay procurement and cause cost overruns;	H	Adequate consulting services and technical assistance would be provided under project Component B, as needed;	M
Insufficient technical capacity within the municipalities and CSEs may cause contract supervision delays related to implementation and poor quality of goods, works and services.	H	Adequate consulting services and technical assistance would be provided under project Component B, as needed;	M
Average	H		M

H: High; M: Moderate and L: Low.

D. Procurement implementation and arrangements

5. The PMU will carry out procurement for the sub-projects funded by sub-loans and performance investment grants on behalf of the municipalities and with their participation in all stages of the procurement process. Municipalities will be in charge of preparing sub-project designs, technical specifications, and other necessary documentation, and will supervise contract implementation and acceptance of deliverables. The sub-project contracts will be signed between municipalities and awarded contractors, suppliers, and consultants. Municipalities will receive adequate consulting services and technical assistance under project Component B for sub-project and performance investment grant preparation and implementation including: feasibility studies; financial, environmental, and social assessments; preparation of detailed designs; and contract supervision, as needed. The PMU will establish and maintain cooperation with municipalities during all phases of the sub-project and/or grant execution. The roles and responsibilities of each party during the project implementation will be clearly defined in sub-loan agreements or grant agreements signed by the MOF and municipalities.

6. Project procurement will include:

7. **Procurement of Works**: Project works procured would include reconstruction or construction of water supply and sewerage networks, rehabilitation of buildings (replace windows, thermo insulation, etc.), among others related to municipal investments and performance investment grants:

- ***International Competitive Bidding (ICB):*** Works estimated to cost at the amount of more than US$ 1,000,000 equivalent, will be procured through International Competitive Bidding. The procurement will be done using World Bank Standard Bidding Documents. All documents will be agreed with the Bank.
- ***National Competitive Bidding (NCB):*** Works estimated to cost at the amount of less than US$1,000,000 equivalent, will be procured through National Competitive Bidding (NCB). The procurement will be done using World Bank Standard Bidding Documents, or regional documents for NCB. All documents will be agreed with the Bank.
- ***Shopping:*** Shopping procedures may be used for works contracts at the amount of less than US$100,000. The procurement will be done using ECA regional documents for shopping. All documents will be agreed with the Bank.
- ***Direct Contracting (DC):*** DC may be used, subject to the Bank's prior approval, for procurement of works which meet requirements for direct contracting referred to in paragraph 3.6 of the Procurement Guidelines.

8. All ICB contracts, the first two NCB contracts, the first two shopping contracts, and all direct contracts will be subject to Bank prior review. All other contracts will be subject to post review.

9. Domestic preference in accordance with clause 2.55 and Appendix 2 of the guidelines will not apply.

10. **Procurement of Goods.** Procurement of goods and services other than consulting services and goods (Supply and Installation) would include: bulbs for street lights, metering equipment for water network, IT and office equipment for the PMU, etc., and other goods and services related to the municipal investments and performance investment grants:

- ***International Competitive Bidding (ICB):*** Goods estimated to cost at the amount of more than US$200,000 equivalent, will be procured through International Competitive Bidding. Goods estimated to cost at the amount of more than US$100,000 equivalent, may be also procured through ICB. The procurement will be done using World Bank Standard Bidding Documents for Goods or Goods Supply and Installation (one stage). All documents will be agreed with the Bank.
- ***National Competitive Bidding (NCB):*** Goods estimated to cost at the amount of less than US$200,000 equivalent, may be procured through NCB. The procurement will be done using World Bank Standard Bidding Documents for Goods or Goods (Supply and Installation) (one stage). All documents will be agreed with the Bank.
- ***Shopping:*** Goods at the amount of US$100,000 equivalent or less will be procured through shopping. The procurement will be done using ECA regional documents for shopping. All documents will be agreed with the Bank.

- ***Direct Contracting (DC):*** DC may be used, subject to the Bank's prior approval, for procurement of goods which meet requirements for direct contracting referred to in paragraph 3.6 of the Procurement Guidelines.

11. All ICB, all Goods (Supply and Installation) contracts, the first two NCB and the first two shopping contracts will be subject to prior review. All other contracts will be subject to post review.

12. Domestic preference in accordance with clause 2.55 and Appendix 2 of the guidelines will not apply.

13. **Selection of Consultants:** Consultants' services contracts procured under this project will include: detailed design, supervision, financial audit, feasibility and environmental studies, strengthening capacity of the Municipalities and CSEs, other TA, etc. The following selection methods will be used:

(i) **Quality and Cost Based Selection (QCBS)**.
(ii) **Least Cost Selection (LCS).**
(iii) **Selection under a Fixed Budget (FBS*)*** may be used for assignments in accordance with paragraph 3.5 of the Consultants Guidelines.
(iv) **Selection Based on Consultants' Qualifications (CQ)** procedures will be used for very small consulting assignments at the amount of less than US$ 100,000 equivalent.
(v) **Individual Consultants** (local and international) will be hired in accordance with the provisions of Section V of the Consultants' Guidelines.
(vi) **Single Source Selection (SSS)** may be used, subject to the Bank's prior approval, for selection of consultants for some very specialized and low value contracts which meet requirements for SSS of the Consultants' Guidelines.
(vii) **Sole Source Selection** would be used, subject to the Bank's prior approval, for hiring of the current staff of the PMU and other individual consultants who meet requirements of paragraph 5.4 of the Consultants' Guidelines.

14. The selections will be made using Bank Standard Request for Proposal (RFP) and other regional sample documents agreed with the Bank. Consultant shortlists for services estimated to cost less than US$100,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines. Requests for Proposals (RFPs), short lists, terms and conditions of contracts, and evaluation reports and recommendations for awarding contracts of more than US$100,000 equivalent—first two contracts with firms for less than US$100,000 equivalent, the first two individual contracts and all individual contracts of more than US$50,000 equivalent, and all SSS contracts will be subject to Bank prior review. All other contracts will be subject to post review.

15. **Operating Costs**: This refers to incremental operating costs incurred by the PMU related to project implementation, management and monitoring, including dissemination of project-related information and publications, office rent and utilities, office and equipment insurance, maintenance, and repair, vehicle insurance, maintenance, and repair, local travel, communication, translation, and interpretation, bank charges, and other miscellaneous costs directly related to the project, all based on periodic budgets and procured using implementing agency administrative procedures acceptable to the Bank. Operating costs will not include salaries of civil servants.

16. **Training Costs:** The project will finance training (workshops, etc.) of the municipalities and CSEs for project introduction, and sub-projects' implementation and completion, and other training, as needed. The training will be carried out according to training plans, which the PMU will revise semi-annually or as needed and submit to the Bank for approval prior to implementation. Expenses will be covered under the training category and disbursed based on SOE.

Advance Contracting and Retroactive Financing:

17. The Borrower may wish to proceed with procurement before signing the loan agreement (LA) and may be reimbursed retroactively. Consulting services provided by PMU staff, goods (IT equipment, furniture, software, vehicles) and the operating costs necessary for PMU functioning during January 01, 2009 to the date of Loan Agreement for a total amount–not to exceed the equivalent of US$ 120,000 may be procured in accordance with the provisions of the Consultant Guidelines, Para 1.12. and Procurement Guidelines, Para 1.9. The Borrower may wish to proceed with procurement before signing the LA and may be reimbursed retroactively if all selection and procurement procedures, including advertising, have been in accordance with Bank Consultant Guidelines and Procurement Guidelines. The Bank shall review the process used by the Borrower.

18. **Filing and records keeping:** PMU will be in charge of project filing and record keeping. Municipalities will also keep all documentation related to the sub-projects and grants. The reporting formats will be agreed and included in the POM.

E. Procurement Plan

19. The PMU, at appraisal, developed an initial detailed Procurement Plan (PP) for project implementation, which provides information on procurement packages, methods, and Bank review method. The Borrower and the Bank project team will agree on this plan at negotiations, and the plan will be available in the implementing agency's project database and the Bank external website. The PP will be updated annually or as required, in agreement with the Bank project team, to reflect actual project implementation needs, and improvements in implementing agency institutional capacity. An initial PP was submitted to the Bank by the PMU and is appended to this Annex. The PP will be finalized before negotiations.

F. Frequency of Procurement Supervision

20. The Bank team will carry out prior review supervision, and post reviews on at least 20 percent of the contracts subject to post review. It is expected that a country supervision mission will be conducted every six months during which post reviews will be carried out. At a minimum, one post review report, which will include physical inspection by the Bank technical expert of sample contracts, including those subject to prior review, will be prepared each year. Not less than 10 percent of the contracts will be physically inspected.

G. Additional Provisions for National Competitive Bidding:

21. To ensure economy, efficiency, transparency, and broad consistency with the provisions of Section I of the Guidelines, the following criteria shall be followed in procurement under National Competitive Bidding procedures:

(a) Generalities

Bidding shall be conducted using "Open Procedures." Furthermore, restricted procedure shall not be used without the express consent of the Bank and is subject to the following conditions:

- The contracting authority shall invite all the candidates that meet the selection criteria
- No maximum number of selected candidates shall apply.

(b) Registration

- Bidding shall not be restricted to pre-registered firms
- If registration is required, bidders (i) shall be allowed a reasonable time to complete the registration process, and (ii) shall not be denied registration for reasons unrelated to their capability and resources to successfully perform the contract, which shall be verified through post-qualification; and
- Foreign bidders not from the territory of FYR Macedonia shall not be precluded from bidding. If a registration process is required, a foreign bidder declared the lowest evaluated bidder shall be given a reasonable opportunity to register.

(c) Advertising, time for submission of bids

- Invitations to bid shall be advertised in at least one widely circulated national daily newspaper. Invitations could be also advertised on the websites of the Public Procurement Bureau and respective ministry.
- Time allowed for the preparation and submission of bids shall not be less than thirty (30) days from the time of the invitation to bid or the date of availability of bidding documents, whichever is later.

(d) Pre-qualification

- When pre-qualification shall be required for large or complex works, invitations to pre-qualify for bidding shall be advertised in at least one widely circulated national daily newspaper. Invitations could be also published on the web sites of the Public Procurement Bureau and respective ministry.
- Time allowed for preparation and submission of bids shall not be less than thirty (30) days from the time of the invitation to bid or the date of availability of bidding documents, whichever is later.
- Minimum experience, and technical and financial requirements, shall be explicitly stated in the pre-qualification documents.

(e) Participation by Publicly-owned enterprises

- Publicly-owned enterprises shall be eligible to participate in bidding only if they can establish that they are legally and financially autonomous, operate under commercial law and are not a dependent agency of the contracting authority. Furthermore, they will be subject to the same bid and performance security requirements as other bidders.

(f) Bidding Documents

Procuring entities shall use the appropriate standard bidding documents acceptable to the Bank for procurement of goods and works.

(g) Bid Opening, Bid Evaluation and Contract Award

- Bids shall be submitted in a single envelope containing bidder qualification information, technical and price bids, which shall be opened simultaneously at the public bid opening;
- No bids shall be rejected at the bid opening except for late bids and bids shall not be evaluated as part of bid opening process.
- Bidders' economic, financial and technical capacity cannot be guaranteed by another entity, except joint venture and observing those criteria set up in the bidding documents.
- Bids shall be evaluated strictly according to quantifiable criteria declared in the bidding documents; evaluation criteria other than price shall be quantified in monetary terms.
- Bids not substantially responsive shall be rejected.
- Extensions of bid validity will be allowed once only for not more than 30 days. No further extensions shall be requested without the prior Bank approval.
- Contracts shall be awarded to the qualified bidder having submitted the lowest-evaluated and substantially responsive bid. No negotiation shall take place.

(h) Rejection of all bids

All bids shall not be rejected and a new procurement process started without prior Bank concurrence.

(i) Price Adjustment

Civil works contracts of long duration (more than 18 months) shall contain an appropriate price adjustment clause.

(j) Securities

- Bid security and performance security should follow the generally accepted practice used in the local market.
- Alternative methods such as bid securing declaration may be acceptable, in which case the Borrower may require bidders to sign a declaration accepting that if they withdraw or modify their bids during the period of validity or they are awarded the contract and they fail to sign the contract or to submit a performance security before the deadline defined in the bidding documents, the bidder will be suspended for bidding in any contract with the implementing unit.
- No advance payment shall be made to contractors without suitable advance payment security. These securities shall be included in the bidding documents in a text and format acceptable to the Bank.

(k) Right to inspect and audit

Each contract financed from Loan proceeds shall provide that suppliers, contractors, and sub-contractors shall permit the Bank, at its request, to inspect their accounts and records relating to contract procurement and performance and to have said accounts and records audited by Bank-appointed auditors. The deliberate and material violation by suppliers, contractors, or sub-contractors of such provision may amount to obstructive practice.

(l) Fraud & Corruption

The Bank shall declare a firm or individual ineligible, indefinitely or for a stated period, to be awarded a Bank-financed contract, if the Bank determines that the firm or individual has, directly or through an agent, engaged in corrupt, fraudulent, collusive, coercive or obstructive practices in competing for, or in executing, a contract financed by the World Bank Group.

PROCUREMENT PLAN							
#	**Component**	**Type**	**Contract Cost Estimate/ Budget (USD)**	**No. of Contracts**	**Procurement Method**	**Post/ Prior Review**	**Expected Contract Completion**
	A: MUNICIPAL INVESTMENTS						
1.	VELES – Street Lighting	Goods	687,600	1	ICB	Prior	24 Nov. 09
2.	VELES – School Insulation 3 Schools	Works	481,320	3	NCB/SH	Prior	01 Dec. 09
3.	KOCANI – Pipe Replacement (5km)	Works	550,080	1	NCB	Prior	25 Feb. 10
4.	VALANDOVO – Pipe Replacement (6km)	Works	618,840	1	NCB	Prior	05 Mar. 10
	Total pilot municipalities		*2,337,839*				
	Other municipalities		17,662,161				
	Total A		**20,000,000**				
	B: CAPACITY BUILDING AND INSTITUTIONAL STRENGTHENING						
5.	B.1.: TA support to Municipalities and Communal Services Enterprises for Sub-Project preparation (Detailed project design, Project supervision)	Consultant	540,000	Multiple	TBD		
6	B.2.: Strengthening Capacity of Municipalities and CSEs to Improve Performance in Services	Consultant	300,000	Multiple	TBD		
7	B.3.: Development of Strategy for Involvement of Financial Intermediaries in Municipal Investments	Consultant	100,000	Multiple	TBD		
8	B.4.i.: Project Introduction Workshop for Municipalities and CSA's - (Multiply Workshops)	Training	20,000				
9	B.5.ii.: Workshop for Strengthening the Capacity of Municipalities and CSEs for MSIP Sub-Project Implementation (Multiply Workshops)	Training	40,000				
	Total B:		**1,000,000**				
	C: PERFORMANCE GRANTS						
10	Performance grants for municipalities (20% of sub-project cost)	Goods/ Works	3,000,000	Multiple	TBD	Prior/Post	
	Total C:		**3,000,000**				
	D: PROJECT MANAGEMENT AND OPERATING COST						
	D.1/1: Project Management Unit (PMU)						

11	D.1/1.i. - Project Director	Consultant	107,266	1	TBD	Prior	
12	D.1/1.ii. - Financial Management Specialist	Consultant	80,862	1	SSS	Prior	
13	D.1/1.iii. - Financial Management Assistant	Consultant	52,808	1	IC	Prior	
14	D.1/1.iv. - Procurement Specialist	Consultant	80,862	1	SSS	Prior	
15	D.1/1.vi. - Procurement Specialist (Works)	Consultant	52,808	1	IC	Prior	
16	D.1/1.vii. - Construction Engineer	Consultant	86,225	1	IC	Prior	
17	D.1/1.viii. - Office manager	Consultant	45,164	1	IC	Prior	
	Total D1/1		**505,994**				
	D.1/2.: Part-time personnel (multiply)						
18	D.1/2.i - Specialists	Consultant		Multiple	IC	Post/Prior	
19	D1/.2.ii -Independent Specialist for Monitoring of Performance Grants Compliance	Consultant	100,000	1	IC	Prior	
20	D.1/2.iii - Safeguards Specialist	Consultant	50,000	1	IC	Prior	
	D.1/2.iv- International Procurement Advisor	Consultant	25,991	1	IC	Prior	
	Total D1/2		**175,991**				
	Total D1		**681,985**				
	D.2: Project Financial Audit (Multiple)						
21	Project Financial Audit	Consultant	110,016	4	LCS	Post	
	Total D2:		**110,016**				
	D.3: Other costs						
22	Furniture	Goods	6,120		SH	Post	
23	IT equipment	Goods	8,939		SH	Prior	
24	Vehicle	Goods	20,628		SH	Prior	
25	Software	Goods	3,438		SH	Prior	
26	Operating costs (telephone charges. office supply, materials, representation, travel etc.)	Operating costs	127,619				
27	Training for PIU staff	Training	41,255				
	Total D3:		**207,999**				
	Total D:		**1,000,000**				
	Grand Total		**25,000,000**				

Note: International Competitive Bidding **(ICB),** National Competitive Bidding (NCB), Quality and Cost Based Selection(QCBS), Individual Consultant(IC), Least Cost Selection (LCS), Shopping (SH), Consultant Qualifications (CQ)

Annex 9: Economic and Financial Analysis

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

1. MSIP was designed as a demand-driven project, therefore sub-projects to be proposed by municipalities under Component A (Municipal Investments) or Component C (Performance-based Investment Grants) have neither been identified nor appraised entirely at this stage. The project investment financing is intended for implementing small-scale infrastructure sub-projects to enhance municipal and CSE services and local community access to such public services. A financial and economic analysis carried out for a sample of four proposed investment projects—Kočani-water network rehabilitation; Valandovo-water supply system rehabilitation; Veles-street lighting and school insulation—applied the methodology for MSIP regarding subsequent sub-project selection and appraisal during implementation.

2. Investments under MSIP are likely to be small, less than US$1.0 million. Given the challenges in the infrastructure sector in the FYR Macedonia, sub-projects are likely to be for improvements in public service delivery and efficiency rather than expansion. Such investments rarely yield a high rate of return, particularly in low tariff environments, but the economic, environmental, and social benefits are usually quite high and these investments are necessary to improve services and reduce costs. For these reasons, future sub-projects are likely to be assessed on a least-cost basis.

3. At a minimum, the following qualification procedures and financial principles will apply to selection of sub-projects:

(i) Sub-projects will be revenue-generating or cost-saving;

(ii) Revenue-generating entities' (CSEs') available financial statements should be appraised to highlight strengths and weaknesses, calculate critical ratios (collection, operating, and current ratios) and to propose solutions.

(iii) Proposed sub-projects must represent a technically feasible, least-cost approach to address a specific problem or need. Costs of project alternatives, including doing nothing, should be evaluated.

(iv) Investments must be justified based on financial and economic net present value criteria, or least-cost analysis and social impact.

(v) The sub-project should be publicly disclosed to beneficiary citizens and approved by the elected local council to determine priority and relevance.

4. During pre-appraisal, draft feasibility studies of four proposed sub-projects were reviewed using a discount rate of 10 percent and a 30-year project lifespan. Costs and benefits were represented by the cash flow arising from the project. For economic analysis, taxes and inflation were excluded. Non-quantifiable social benefits represent a high proportion of project benefits.

5. For the water renovation projects financial net present values are low and depending on the assumptions, could be negative. However, both financial and economic rates of return were sufficient to cover the assumed five percent costs of project funds. Low net present values could

be attributed to the renovation nature of the sub-projects, where no additional connections and consumption are likely. Nevertheless the analysis points out the need for increased efficiency measures to reduce non-revenue water and improve collections to increase net present values. Once these actions are taken, local government can raise tariffs and consumers will be more likely to accept such decisions. Actions on efficiency improvements and tariff reform are needed to improve the financial situation of the utilities.

Annex 10: Safeguard Policy Issues

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

A. Environmental Safeguards

1. The Environmental Assessment and Management Framework (EAMF) for the Municipal Services Improvement Project was prepared by the Ministry of Finance. The report is prepared under the terms described in the World Bank OP/BP 4.01 and relevant legislation. The project team will follow the guidance of OP 17.50 on Disclosure Policy. The EAMF report was disclosed in October 28, 2008, prior to appraisal.

2. The project is classified as Category B on the basis of the expected types of subprojects. An environmental analysis which was carried out as a part of the project preparation activities to identify potential direct and indirect environmental impacts associated with the project, found that potential adverse environmental impacts of the project are in most cases minor or negligible. In cases where the negative impacts were identified, adequate mitigation measures have been proposed. There are no significant, long lasting and irreversible negative impacts associated with the project execution and implementation. Sub-projects which would qualify for Category A rating according to OP 4.01 will be ineligible for financing under the project.

3. The EAMF gives an overview of the legal framework of environmental and local-self government sectors in FYR Macedonia; procedures for environmental assessment for the project development required under national legislation; procedures for environmental assessment for project development under World Bank procedures, and analysis of potential environmental impacts caused by sub-projects during implementation of project activities. The EAMF lists potential negative environmental impacts for each type of project activity and provides environmental mitigation and monitoring activities to mitigate and neutralise impacts. The EAMF report contains separate Environmental Mitigation Plans and Environmental Monitoring Plans (EMPs) developed for each type of sub-project.

Legal Framework

4. FYR Macedonia has developed its own legal and institutional framework for Environmental Assessment (EA). This framework is generally in compliance with the existing Bank EA rules and procedures and European Union (EU) Environmental Impact Assessment Directives.

5. Environmental impact assessments for projects in FYR Macedonia are carried out in accordance with Articles 76-94 of the Law on Environment (OG of RM 53/2005). The types of projects that require separate EIA are determined in accordance with the Article 77 of the Law on Environment and the “Decree for determining projects and criteria on the basis of which the screening for an environmental impact assessment shall be carried out” (OG of RM 74/2005). The Law on Environment and relevant bylaws define procedures for conducting EIA and its goals, objectives, and principles. National legislation stipulates procedures for submitting project documentation and reviewing procedures. The EIA procedure precedes final decisionmaking about activities that may adversely affect the environment. Programs and projects can be executed only after receiving a positive opinion and approval of the EIA Study from the Ministry

of Environment and Physical Planning. The Department on Environment is the national authority responsible for EIA, presently within the Administration for Environment (AE), a body under the organizational responsibility of the Ministry of Environment and Physical Planning (MoEPP).

6. The 2002 adoption of the EU Aquis created a common obligation of all sectors of the state administration to carry out activities set in the National program in accordance with EU Aquis requirements. Due to these requirements, legislation adopted after 2002 complies with EU requirements. The following self-government and environment laws are most relevant to this project and safeguard policy issues: The Law on Local Self Government (OG RM 5/02); The Law on Environment (OG RM 53/05, 81/05, 24/07); The Law on Waters (OG RM 87/08); The Law on Waste Management (OG RM 68/04, 71/04); The Law on Forests (OG RM 47/97, 7/00, 89/04); The Law on Spatial and Urban Planning (OG RM 4/96, 8/96, 70/96, 7/97, 28/97, 53/01, 45/02, 52/05); The Law on the Implementation of the State Spatial Plan (OG RM 39/2004); The Law on Investment Project Development (OG RM 15/90, 11/91, 11/94, 18/99, 25/99); The Law on Noise in Environment (OG RM 79/2007); The Law on Agricultural Land (OG RM 25/98, 18/99, 02/04); The Law on Construction (OG RM 51/05); The Law on Construction of Investment Buildings (OG RM 15/90, 11/91, 11/94; 18/99 and 25/99); The Law on Protection and Rescue (OG RM 36/04, 49/04); The Law on Storage and Protection from Flammable Liquids and Gases (OG RM 15/76); The Law on Drinking Water Supply and Municipal Wastewaters (OG RM 68/04). The comprehensive list of relevant laws, policies, governmental decisions, instructions and standards is presented in the EAMF report.

Potential Environmental Impacts

7. The project would finance investments in basic local infrastructure and municipal services; provide Technical Assistance (TA) to municipalities and CSEs; and support institutional reforms in municipalities through performance-based investment grants. The project would also provide TA to central agencies for institutional strengthening and support of policy reforms. In addition, the project would cover operational costs associated with project implementation and support project management. The potential environmental impacts of project components are described below. For a detailed project description see Annex 4.

8. Component A (Municipal Investments) would provide loans to municipalities that are eligible to borrow. Investments to be financed under this component would be mainly for (a) revenue-generating services and (b) other investment projects of high priority to municipalities that have cost-saving potential. This component will provide funding in water supply, sanitation, and solid waste (services provided by CSEs), and may include energy efficiency, urban transport, and other services under municipal provision. Due to the demand-driven nature of this Component, the list of sub-projects to be financed throughout the project life is not known ex-ante. However, activities to be financed under Component A, if properly executed, are not expected to generate significant, long-lasting, or irreversible negative environmental impacts. The project team developed a list of generic issues that would be considered in preparation of site-specific EA/EIA and EMPs for each type of sub-project activity financed under this Component; details are provided in the EAMF. The following is a sample description of potential environmental impacts for projects involving improvement of water supply or waste water network.

Project activity - Replacement of water supply pipes and/or Replacement of sewerage pipes	
Potential environmental issue and impact	**Mitigation Measures**
– Damage to soil structure due to vehicles traffic and storage of construction materials in the immediate vicinity of construction works – Soil pollution due to leaks of lubricants – Temporary uncontrolled surface run-off due to construction of drainage channels – Soil pollution by components of combustion gases emitted by construction vehicles (esp. heavy metals) – Soil contamination due to construction materials/ construction wastes disposals – Soil erosion caused by re-canalization of waterways – Noise from construction activities, vibrations and other physical factors – Air pollution (dust from construction activities and pollutants from construction machinery and vehicles) – Construction debris and other non-hazardous waste – Hazardous waste (if observed and found on site during demolition and reconstruction works) – Loss or deterioration of protected environmental sites (natural heritage) and protected cultural heritage – Safety risks for workers, safety risks for the public, health hazards	• Proper measures to minimise erosion on sites; resurfacing of affected areas • Technical measures to minimise erosion effects, observing legal requirements • Plan construction works to minimize land affected and ensure soil pollution prevention • Minimize construction site size/ to minimize land affected/ to ensure soil pollution prevention • Apply good engineering practices • Design procedures for temporary on-site storage of waste; fence and protect the storage area • Ensure removal and disposal of waste by licensed contractor at approved location • Categorize hazardous waste according to local legislation • Separate hazardous waste from other waste on site • Design and implement safe removal of hazardous waste and dispose of it according to local legislation • Soil investigation where appropriate change in alignment if necessary • Careful planning and design; change in alignment if necessary • Adopt appropriate safety measures, use safety equipment, observe legal requirements • Ideally, fence area to restrict damage of surrounding lands • Clean up the work area after works are completed

9. Component B (Capacity Building and Institutional Reform) would include consultancy services and technical assistance for (a) sub-project preparation, including feasibility studies and required financial, environmental and social assessments; preparation of final designs and bidding documents; and support for bidding procedures for investments funded under Component A; (b) local capacity building for municipalities and CSEs to improve performance in service provision and meet project reform objectives; and (c) national-level institutional strengthening to support national agencies through policy issues studies and strategy development related to the financial sustainability of municipal services. Activities under this Component will be environmentally neutral with respect to the physical environment, but will have positive impacts through raising the awareness and capacity of local authorities to prepare, supervise, and implement sub-projects in an environmentally sound manner.

10. Component C (Performance-Based Investment Grants) would provide grants to municipalities as incentives for implementing reforms that improve service delivery performance beyond those required to qualify for investment loans. Performance grants will be awarded based on simple and objective criteria aligned with existing legal requirements in FYR Macedonia that have not yet been fully implemented. Investments financed by these grants will be the same as those under Component A and will be subject to the same environmental screening, development of EMPs, and other safeguards procedures determined for loans under Component A.

11. Component D (Project Management, Monitoring and Evaluation) would support operation of a project management unit and assist with project implementation and monitoring, including selecting new sub-projects. No environmental issues are associated with this Component.

Capacity Building and Environmental Impact Monitoring

12. The new legal framework is quite significant because it provides for establishing an integral management system for natural resources; introduces the concept of sustainable development, pollution prevention and control; and supports public disclosure and participation in decisionmaking. However, conflicts still exist between new environmental legislation and existing laws that do not call for EIA in the permitting process. As a result, Borrower environmental institutions are experiencing some challenges in implementing this emerging legal framework, and their national- and local-level enforcement capacity is still relatively weak.

13. The PMU within the Ministry of Finance has final responsibility for timely preparation of site-specific EA and/or EIA as outlined in the EAMF report, required by national legislation, and aligned with Bank procedures. In performing this task, the PMU will liaise with authorities in participating municipalities, the Ministry of Environment and Physical Planning, and any national bodies and authorities required by national legislation.

14. Generic environmental management and monitoring plans (EMPs) were developed as a part of EAMF report and as a condition for the Project Appraisal. The EMPs were prepared as two tables for each type of sub-project, and they list major issues, mitigation measures, monitoring requirements, and organization(s) responsible for carrying out these measures. The project will be implemented in line with the EMPs as a legal requirement for EMP funding and implementation; no further specific environmental covenants or conditional ties are needed. A detailed procedure for environmental safeguard screening and a sample environmental screening document are provided in the Project Operation Manual.

15. The PMU will carry out environmental monitoring in line with the EAMF report and environmental section of the Project Operation Manual (POM) and report to the Bank every six months, but no less than 30 days prior to the Bank supervision mission. The Bank supervision team will conduct regular environmental safeguard supervision missions, at least once per year; and for this purpose, the supervision team will include an environmental safeguard specialist to oversee implementation of site-specific EMPs.

B. Involuntary Resettlement

16. The project may trigger the involuntary resettlement safeguard policy because some sub-projects may require temporary access to land, or land acquisition, but sub-projects are unlikely to require resettlement. The PMU will check potential for this trigger in all investments and determine (a) whether land acquisition or access to land is required; (b) whether private land acquisition can be avoided; and (c) if resettlement is required, that it is carried out in accordance with agreed procedures. Chance finds might be discovered during civil works, and these should be reported to the appropriate authorities and dealt with according to established procedures.

Although resettlement is unlikely, a land acquisition and resettlement policy framework (LARPF) was developed for the project to be used for sub-projects to be appraised during implementation. For appraised sub-projects, all land acquisition and resettlement issues will be clarified, and a land acquisition and resettlement action plan (LARAP) developed. The LARPF was disclosed on October 28, 2008. Any subsequent LARAPs will have to be reviewed by the

Bank and publicly disclosed. The POM will include environmental and land acquisition frameworks and instructions for handling chance finds; Bank OPs 4.01 and 4.12 requirements for these safeguards, and FYR Macedonia laws and regulations, all of which will be provided to participating municipalities and consultants/contractors.

Annex 11: Poverty and social impact analysis to design CSE Reform and assist in project design

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

1. A nationally representative stakeholder survey was conducted in ten municipalities in early 2008 to inform the designs of the government-requested CSE reform strategy, and the MSIP. The survey instrument consisted of consumer satisfaction surveys (750 households; 200 businesses), 22 key-informant interviews, and 18 focus groups with public utility service providers, representatives of municipalities, and consumers. A key finding is a need to strengthen social accountability between service providers and consumers/citizens. The study provides sector-specific recommendations, suggests an incremental three-phase approach to reform, and provides an action plan for central government, municipalities, and CSEs. The project would assist participating municipalities to implement parts of the CSE reform strategy.

Key Findings

2. **Lack of Social Accountability**. The study identified a need to strengthen social accountability between service providers (municipalities, CSEs) and consumers/citizens. The CSE operation lacks autonomy and efficiency; the roles of CSEs and municipalities are not separated; and consumer/citizen 'voice' is weak. Service providers have little accountability to consumers and decisionmaking is often driven by political considerations rather than principles of sound business management, consumer-responsiveness, or economic efficiency.

3. **Institutional issues**. Respondents referred to municipalities' political influence on CSE operation, primarily in regard to tariff setting and CSE staffing. Municipalities are reluctant to increase the extremely low tariffs, which are unrelated to the underlying cost structure (recurrent and capital costs). Due to high unemployment rates, consumers and providers perceive CSE services as a social welfare mechanism, and tariff increases are socially and politically unpopular. Municipalities cross-subsidize loss-making services from profit-making CSE services. Political affiliation influences CSE staffing, which is considered excessive or inappropriate in terms of skills mix. Communal service regulation and institutions are comprehensive, but implementation and enforcement are hampered by the ambiguous ownership of infrastructure assets, weak human resources capacity, lack of political will, and lack of CSE financial autonomy (and the associated financial burden on municipalities).

4. **Provider awareness.** The study identified CSE management and employees as a potential target audience for raising awareness. Public disclosure of regular benchmarking of CSE performance and efficiency could improve CSE employee performance in enterprise operations, increase their efficiency, raise payment collection, and decrease costs and losses.

5. **Consumer Awareness**. Consumers are unaware of how CSEs operate due to the opaque flows of funds between municipalities and CSEs. Billing for water and solid waste collection, local property taxes, and fees for public lightning, are not separated or itemized. Although municipalities contract CSEs to provide services, consumers may confuse CSEs with local government as client and local tax authority.

6. **Consumer Satisfaction**. According to the survey, 64 percent of households are satisfied and 11 percent are very satisfied with **water** supply in their homes. The unsatisfied 23 percent referred to particles in the water, bad taste and lack of adequate or consistent pressure. Businesses expressed general satisfaction with the water supply system within the company premises; only 8.0 percent were dissatisfied. Focus groups and interviews revealed the following perceived **water supply and sanitation problem**: large water losses; lack of appropriate technical equipment; asbestos pipes in need of replacement; malfunctioning water meters that hamper accurate measurement and consumption-based billing; insufficient citizen awareness, especially among non-paying consumers; lack of sewage network access; household reluctance to connect to existing sewerage systems; obsolete sewerage network, leading to blockages and safety problems; and lack of purifying plants for wastewater treatment. Consumers expressed concern with the performance of CSEs in **solid waste management**. Only 48 percent of households and 64 percent of businesses were satisfied with waste collection from public areas, and 73 percent of households and businesses were satisfied with regular waste collection services. According to focus groups and interviews, consumers are dissatisfied as public areas are dirty and there are not enough garbage bins. They perceive the reasons to be lack of solid waste collection from public areas; lack of sanitary landfills; existence of illegal landfills; lack of technical equipment capacity of the CSE for waste collection; and low level of public awareness. Consumer satisfaction was lowest with **municipal services**, such as poor quality of roads, and the limited extent of green surfaces and parks.

7. **Tariffs**. It is not surprising that consumers are broadly satisfied with the current tariffs, which, however, are well below cost-recovery levels. The challenge for municipalities will be to achieve cost-recovery, both by reducing costs through increased efficiency and by raising revenues through necessary tariff increases and improved bill collection, while attaining higher service standards as required by European Union Directives.

8. **Willingness and Ability to Pay**. In the aggregate, minimum levels of water, wastewater, and solid waste management services appear affordable for consumers, including poor households. However, a disaggregated analysis (by income quintiles and geographical locations) illustrates that non-payment of utility bills correlates more highly with inability to pay than it does with unwillingness to pay. Only 11 percent of survey respondents did not pay their CSE bills because they were dissatisfied (for solid waste management, this figure was 21 percent). Some 55 percent of respondents earn less than MKD 20,000 per month, so increased tariffs for essential services such as water, sewerage, and solid waste removal, would be a considerable burden. Specifically, 15 percent of surveyed households could afford a 20 percent tariff increase for water supply and wastewater, while a 50 percent tariff increase would be supported by only 1.6 percent of households. For sanitation, affordability is a concern and 36 percent of poor households lack access to sewerage disposal. For solid waste, affordability is an issue for all households in the lowest three quintiles when paying maximum tariffs; in the case of average tariffs, the first and second lowest quintiles (16.4 percent of population) would be unable to afford the service. In sum, affordability is a pressing issue in municipalities with a high proportion of poor households and a relatively high cost of water and solid waste removal.

9. Existing subsidy mechanisms are implicit and untargeted, evidenced as cross-subsidies, low collection rates (about 50 percent), or underpriced services (water prices cover only 30-50 percent of costs). Poor households have continued access to water without being disconnected,

even though they do not pay due to de facto cross-subsidies from consumers that pay, or from municipalities' non-transparent subsidies that allow many CSEs to operate despite inadequate tariffs and revenue collection systems. Poor households receive non-earmarked social assistance through the Ministry of Labor and Social Policy, but benefits are insufficient for monthly household expenses, including utility services. According to the survey, 95 percent of households favor subsidizing poor households for water and sewage services, but stressed that subsidies should come from the national budget via the Ministry of Labor and Social Policy rather than via explicit or implicit cross-subsidies within CSEs—not from other consumers. Some 95 percent of respondents supported the idea of providing welfare recipients with $10m^3$ of free water each month.

10. The targeting of general social assistance is poor (about 60 percent of social financial aid does not reach the poor), and the system is inefficient. Hence, the study discussed several subsidy options for water and sanitation, including the following: (a) retain existing cross-subsidies—CSEs absorb water supply costs for poor, non-paying households (reported abuses would need to be addressed); (b) provide 'water for work' for welfare recipients to settle water bills; or (c) the Ministry of Labor and Social Affairs subsidizes welfare recipients who face 'water and waste poverty'. The study recommends improving 'targeted earmarked schemes', such as a voucher system or option 'c' (a water and waste welfare scheme). The Bank is continuing the dialogue with government on possible subsidy reforms to ensure that poor households can afford minimum service levels of water, wastewater, and solid waste management.

11. **Public-Private Partnerships**. The study found an extremely low level of support for public-private partnerships (PPP). In the water sector, only 30 percent of households consider PPP as a viable option for service delivery; businesses found PPP more acceptable (service and management contracts). Both consumer groups saw potential for PPP in the solid waste sector.

12. **Implications for the Project**. The stakeholder survey and the CSE reform strategy findings indicate a need for flexible and incremental reform of existing institutional structures. Structural changes should be introduced when municipalities and CSEs are ready to improve service delivery to customers and reduce the direct or indirect negative impacts on citizens as national or local taxpayers. Therefore the project aims to support reform objectives by: (a) increasing CSE efficiency to improve service delivery quality and lower costs; (b) increasing transparency and customer responsiveness in service delivery among CSEs and municipalities; and (c) promoting greater self-financing of CSE services or more transparent subsidies. Performance grant conditions outlined for the Project (see Annex 4) include some of the first-priority reforms recommended by the CSE reform strategy, including signing service-level agreements ("customer charters" in the CSE reform report), publishing audits, and separating CSEs cost center accounting. Component B of the Project provides for technical assistance to central agencies to further develop policy and institutional reforms; these could include outlining a national water policy and strategy, and preparing a viable subsidy scheme for vulnerable consumers.

Annex 12: Project Preparation and Supervision

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

	Planned	Actual
PCN review	07/03/2007	07/03/2007
Initial PID to PIC		07/09/2007
Initial ISDS to PIC		07/11/2007
Appraisal	12/15/2008	12/23/2008
Negotiations	02/11/2009	
Board/RVP approval	03/24/2009	
Planned date of effectiveness	05/30/2009	
Planned date of mid-term review	11/30/2011	
Planned closing date	11/30/2014	

Key institutions responsible for preparation of the project: Ministry of Finance and Municipalities

Bank staff and consultants who worked on the project included:

Name	Title	Unit
Christine Kessides	Lead Economist and Team Leader	ECSSD
Aleksandar Crnomarkovic	Financial Management Specialist	ECSPS
Bekim Imeri	Social Scientist	ECSSD
Bjorn Philipp	Junior Professional Officer	ECSSD
Nicolai Soubbotin	Counsel	LEGEM
Maha Armaly	Sr. Urban Financial Specialist	ECSSD
Nikola Ille	Sr. Rural Development Specialist	ECSSD
Plamen Stoyanov Kirov	Procurement Specialist	ECSPS
Richard W. Pollard	Sr. Water & Sanitation Specialist	ECSSD
Sabine W. Beddies	Sr. Social Scientist	SDV
Zarko Bogoev	Operations Officer	ECSSD
Yarissa Lyngdoh Sommer	Consultant	ECSSD
Lisa Fonick Haworth	Sr. Program Assistant	ECSSD
Ahmed Eiweida	Peer Reviewer, Sr. Urban Mgmt Specialist	MNSSD
Caroline Mascarell	Peer Reviewer, Sr. Social Protection Specialist	ECSHD
Aniruddha Dasgupta	Peer Reviewer, Adviser	MDW
Patricia Annez	Peer Reviewer, Urban Advisor	FEU

Bank funds expended to date on project preparation:

1. Bank resources: $284,089
2. Trust funds: $20,966
3. Total: $305,055

Estimated Approval and Supervision costs:

Remaining costs to approval: $20,000
Estimated annual supervision cost: $85,000

Annex 13: Documents in the Project File

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

1. Project Concept Note, June 22, 2007
2. Aide-Memoire, Project Identification Mission, May 28-June 4, 2007
3. Aide-Memoire, Project Preparation Mission, September 18-28, 2007
4. Aide-Memoire, Project Preparation Mission, December, 2007
5. Aide-Memoire and Letter to Government, Project Preparation Mission, May 11-16, 2008
6. Aide-Memoire from Project Preparation Mission, September 24-October 3, 2008
7. Republic of Macedonia: Strategy and Action Plan for Reform of Communal Services Enterprises with focus on Water, Sewerage, and Solid Waste Management : Diagnostic and Strategy Report –Economic Consulting Associates, in association with MCIC, Bar E.C.E., and IGE Consulting, October 2008, and component papers:
   - (i) Strategy and Action Plan for Communal Services Enterprises: Survey Report (Quantitative and qualitative finds) October 2008
   - (ii) Strategy and Action Plan for Communal Services Enterprises: Financial Issues and Institutional Aspects of Decentralisation in the Communal Sector Working Paper, October 2008
   - (iii) Working Paper – Legal and Institutional Framework for Communal Activities in Macedonia, February 2008
   - (iv) Affordability, Willingness to Pay and Support Mechanisms in Water, Sewerage and Solid Waste Management in Macedonia, by Lilit Melikyan ,September 2008

Annex 14: Statement of Loans and Credits

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

			Original Amount in US$ Millions						Difference between expected and actual disbursements	
Project ID	FY	Purpose	IBRD	IDA	SF	GEF	Cancel.	Undisb.	Orig.	Frm. Rev'd
P107840	2008	REGIONAL AND LOCAL RDS PROG SUPPORT PROJ	105.20	0.00	0.00	0.00	0.00	105.20	1.00	0.00
P101296	2008	PDPL 3	25.00	0.00	0.00	0.00	0.00	24.94	0.00	0.00
P101216	2007	AGR STRENGTHENING AND ACCESSION PROJECT	20.00	0.00	0.00	0.00	0.00	12.77	-2.57	0.00
P091723	2007	TTFSE 2	20.00	0.00	0.00	0.00	0.00	23.09	9.19	0.00
P082337	2006	ECSEE APL #3 (FYR MACEDONIA)	25.00	0.00	0.00	0.00	0.00	14.68	-3.20	0.00
P083499	2006	RAILWAYS REFORM	19.38	0.00	0.00	0.00	0.00	12.50	8.54	0.00
P089859	2006	LEG/JUD IMPLMNT & INST SPPRT	12.41	0.00	0.00	0.00	0.00	13.07	4.45	0.00
P079552	2005	BUSINESS ENV REFORM & INST STRENGTH	11.30	0.00	0.00	0.00	0.00	12.54	7.08	0.00
P083126	2005	REG & REAL ESTATE (CRL)	14.00	0.00	0.00	0.00	0.00	5.50	0.61	0.00
P086670	2004	HLT SEC MGT	10.00	0.00	0.00	0.00	0.00	5.87	5.12	0.00
P074358	2004	SOC PROT	9.80	0.00	0.00	0.00	0.00	3.66	3.43	2.56
P066157	2004	EDUC MOD	5.00	0.00	0.00	0.00	0.00	3.11	3.11	2.16
		Total:	277.09	0.00	0.00	0.00	0.00	236.93	36.76	4.72

FORMER YUGOSLAV REPUBLIC OF MACEDONIA
STATEMENT OF IFC's
Held and Disbursed Portfolio (In Millions of US Dollars)

		Committed				Disbursed			
		IFC				IFC			
FY Approval	Company	Loan	Equity	Quasi	Partic.	Loan	Equity	Quasi	Partic.
2001	Komercijalna	0.68	0.00	0.00	0.00	0.68	0.00	0.00	0.00
1998	Macedonia Telcom	0.00	11.31	0.00	0.00	0.00	11.31	0.00	0.00
2003	ProCredit MCD	0.00	1.13	0.00	0.00	0.00	1.13	0.00	0.00
1999	SEAF Macedonia	0.00	0.53	0.00	0.00	0.00	0.00	0.00	0.00
1998	Stopanska Banka	0.00	5.08	0.00	0.00	0.00	5.08	0.00	0.00
2000	Stopanska Banka	0.00	2.93	0.00	0.00	0.00	2.93	0.00	0.00
2001	Stopanska Banka	0.00	0.55	0.00	0.00	0.00	0.47	0.00	0.00
2003	Stopanska Banka	0.00	1.97	0.00	0.00	0.00	1.78	0.00	0.00
2002	Teteks	3.15	0.00	0.00	0.00	3.01	0.00	0.00	0.00
	Total portfolio:	3.83	23.50	0.00	0.00	3.69	22.70	0.00	0.00

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

Annex 15: Country at a Glance

FORMER YUGOSLAV REPUBLIC OF MACEDONIA: Municipal Services Improvement Project

Annex 16: Maps

FORMER YUGOSLAV REPUBLIC OF MACEDONIA:
Municipal Services Improvement Project