



Progress Report on Tranche Release

Program Number: 36609
Loan Number: 2058
November 2008

Nepal: Kathmandu Valley Water Services Sector Development Program

CURRENCY EQUIVALENTS

(as of 14 October 2008)

Currency Unit	–	Nepalese rupee/s (NRe/NRs)
NRe1.00	=	\$0.01295
\$1.00	=	NRs77.19

ABBREVIATIONS

ADB	–	Asian Development Bank
CPN-M	–	Communist Party of Nepal (Maoist)
FY	–	fiscal year
GDP	–	gross domestic product
IA	–	implementing agency
KUKL	–	Kathmandu Upatyaka Khanepani Limited
KVWSMB	–	Kathmandu Valley Water Supply Management Board
MWSDB	–	Melamchi Water Supply Development Board
MWSP	–	Melamchi Water Supply Project
NWSC	–	Nepal Water Supply Corporation
PBMC	–	performance-based management contract
PSP	–	private sector participation
SARD	–	South Asia Department
SDR	–	special drawing rights
VRS	–	voluntary retirement scheme
WSTFC	–	Water Supply Tariff Fixation Commission

NOTES

- (i) The fiscal year (FY) of the Government ends on 15 July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2008 ends on 15 July 2008.
- (ii) In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. On 18 December 2003, the Asian Development Bank (ADB) approved two loans to the Government of Nepal for the Kathmandu Valley Water Service Sector Development Program.¹ The first, Loan 2058-NEP (the Program), was a program loan for SDR3,473,000 (\$5 million equivalent); the second, Loan 2059-NEP, was a project loan for SDR6,945,000 (\$10 million equivalent). Both were financed from ADB's Special Funds resources. The Loan Agreements were signed on 8 April 2004 and became effective on 7 December 2004.

2. The Program was designed to assist in the institutional reform of Kathmandu Valley's water supply and wastewater sector. The reform includes (i) restructuring the Kathmandu Valley operations of the Nepal Water Supply Corporation (NWSC) by creating three new entities, i.e., Kathmandu Valley Water Supply Management Board (KVWSMB),² Kathmandu Upatyaka Khanepani Limited (KUKL),³ and Water Supply Tariff Fixation Commission (WSTFC),⁴ by financing the initial operation costs of these entities, and (ii) rightsizing the staff transferred to KUKL from NWSC by utilizing a voluntary retirement scheme (VRS) and providing related retirement assistance programs. The project loan is also linked to institutional reform and aims to improve Kathmandu Valley's water supply and wastewater services by introducing the private sector participation (PSP) modality for the management of KUKL via a performance-based management contract (PBMC).

3. These institutional reforms are required to deliver quality water services efficiently and responsively and to manage and sustain the water service system, which is being improved under ADB's ongoing Melamchi Water Supply Project (MWSP).⁵ The provision of efficient and affordable water services in Kathmandu Valley will, in turn, support the area's economic growth and contribute to the country's overall poverty reduction.

4. Under the Program, two tranches of \$2.5 million equivalent each have been linked to sequenced policy reform targets. The first tranche was released on 14 December 2005 upon compliance by the Government with the conditions for its release. The first tranche conditions involved: (i) passing of the WSTFC Act, which articulated principles for tariff adjustments to ensure financial sustainability of water services in urban areas; (ii) establishment of KVWSMB and WSTFC; (iii) transfer of the Program's implementation responsibilities from the Melamchi Water Supply Development Board (MWSDB) to KVWSMB; and (iv) executing the subsidiary loan agreement between the Government and KVWSMB. The second tranche's release was expected approximately 5 months after the first tranche's release. The Program loan, originally scheduled to close on 31 December 2005, has been extended to 31 March 2009.

II. BACKGROUND

5. The Program has been affected by a series of macroeconomic and political developments in the country. Extreme political instability, with frequent changes of governments⁶ as well as countrywide armed conflict, has caused a significant delay in the

¹ ADB. 2003. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Kingdom of Nepal for the Kathmandu Valley Water Services Sector Development Program*. Manila.

² Originally, this entity was called the Water Authority.

³ Originally, this entity was called the Water Utility Operator.

⁴ Originally, this entity was called the National Water Supply Regulatory Board.

⁵ ADB. 2000. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Kingdom of Nepal for the Melamchi Water Supply Project*. Manila.

⁶ Since 2003, the Government has turned over several times, i.e., administrative powers were under control of the crown in May 2003; a broad-based coalition government was formed in June 2004; a royal takeover by King Gyanendra occurred in February 2005, dissolving Parliament; Parliament was restored and power was handed over to the seven-party alliance in April 2006; Communist Party of Nepal (Maoist) joined the interim government in April 2007 following the Comprehensive Peace Agreement signed in November 2006; Nepal declared a Federal

reform process. The unstable political and security situation inevitably affected the bidding climate for the performance-based management contract (PBMC) envisaged under the project loan as well as major decision-making related to the institutional reform. The bidding process for recruiting the private management contractor under the PBMC was stretched over 3.5 years and was eventually cancelled.

6. Following the Comprehensive Peace Agreement signed between the seven-party alliance and the Communist Party of Nepal (Maoist) (CPN-M) in November 2006, peace and democracy were expected, formally marking the end of the Maoists' decade-long insurgency. In April 2007, CPN-M joined the interim government and parliament. After having been deferred twice in 2007, historic Constituent Assembly election was held on 10 April 2008, overcoming significant security risks and political uncertainties. The elected Constituent Assembly passed the proposal for declaring Nepal a Federal Democratic Republic, abolishing the 240-year old monarchy, in its first session in May 2008 with immediate effect. A new cabinet was formed following several months of intensive power sharing negotiations among political parties.

7. Although the political environment remained difficult for reform and development activities, gross domestic product (GDP) growth rebounded to 5.6% in FY2008 from 2.6% in FY 2007 on the back of weather-assisted recovery in agriculture. Growth was also aided by continued expansion of the service sector. Overall macroeconomic stability was preserved in FY2008 despite the sharp increase in inflation and the increased pressure on public spending in the transitional period. Year-on-year inflation surged to 13.4% in mid-July 2008 from 5.1% a year ago, mainly due to the sharp increase in prices of fuel and food products. The budget deficit was contained at an estimated 3.4% of GDP (compared to 2% in FY2007) despite unforeseen additional expenditures for the elections and the peace process. Longer term growth and development prospects are hinged on the establishment of lasting peace and political stability as well as preserving macroeconomic stability and continuity of key economic reforms.

III. PROGRESS OF PROGRAM IMPLEMENTATION

8. Kathmandu Valley's water services have been suffering from (i) the absence of a clearly defined policy for the urban water sector, (ii) a lack of professional skills and corporate culture required for utility management and service delivery in NWSC, and (iii) a chronic drinking water shortage. The MWSP is expected to address the lack of adequate, long-term water sources in Kathmandu Valley. Institutional reforms were designed with the objective of building an appropriate institutional framework and operational environment that will facilitate the provision of efficient and affordable water services in Kathmandu Valley's urban areas.

9. The institutional reforms under the Program were designed to restructure the existing utility management system through (i) separation of asset management from ownership, (ii) establishment of independent and autonomous utility operators, (iii) engagement of private sector professional managers to manage the water services on behalf of the new utility operator, and (iv) introduction of a regulatory body for water tariffs. Despite the cancellation of the bidding process for the PBMC (see para. 5), the Government has made substantial progress in the remaining reform requirements, which is an unrivaled achievement in the region. KVWSMB was established as asset owner of the water system related to Kathmandu Valley operations, which will in turn be leased out to KUKL under an operating license. WSTFC was established as the sector's economic regulator, which will review and approve water tariff adjustments as well as provide water service oversight to protect customers. KUKL was established as the utility operator to operate the water system and provide customer services as per the operating

license issued by KVWSMB. The new institutional framework ensures a professional and commercially-driven operational environment for KUKL.

10. Establishment of KVWSMB and WSTFC were two of the first tranche's release conditions, which were complied with when the Water Supply Management Board Ordinance 2062 (2005) and the Water Supply Tariff Fixation Commission Ordinance 2062 (2005) were circulated in accordance with Article 72 of the Constitution of the Kingdom of Nepal (1990).⁷ Subsequent to Parliament's reinstatement in April 2006, the Water Supply Management Board Act 2063 (2006) and the Water Supply Tariff Fixation Commission Act 2063 (2006) were enacted, effectively replacing the previous two ordinances. Following the passing of these Acts, all members of KVWSMB's executive committee kept their positions, while three WSTFC members were newly selected.

11. KUKL's establishment under the Companies Act 2053 (1996) is a release condition of the second tranche, which was complied with when KUKL registered as a limited liability company with the Office of the Company Registrar on 24 December 2006. KUKL is owned by shareholders, including the Government (90,000 shares), Kathmandu Metropolis (90,000 shares), Lalitpur Sub-metropolis (30,000 shares), Federation of Nepal Chamber of Commerce and Industry (9,000 shares), Lalitpur Chamber of Commerce and Industry (4,500 shares), Bhaktapur Chamber of Commerce and Industry (4,500 shares), Nepal Chamber of Commerce (27,000 shares). KUKL is authorized to issue preference shares⁸ to KVWSMB against (i) the value of fixed and current assets to be transferred to KUKL,⁹ and (ii) the net value of short-term assets¹⁰ minus short-term liability¹¹ of NWSC transferred to KUKL. Following the Shareholders' Agreement and Articles of Association, seven members¹² of the KUKL board of directors were nominated, holding their first board meeting on 4 April 2007. As mandated, KUKL has undertaken the responsibility for operating and managing the water services system within Kathmandu Valley since 13 February 2008.

12. In parallel to restructuring NWSC and establishing the three new entities, the assets and liabilities of NWSC needed to be split inside and outside of Kathmandu Valley, and those inside needed to be transferred to KVWSMB. These include (i) fixed assets such as land, buildings, and all water supply and sewerage facilities, including the plant and machinery, pipelines, reservoirs, wells, and treatment plants; (ii) long-term debts; and (iii) assets and liabilities associated with the water services operation in Kathmandu Valley that will be transferred to KUKL. The assets transferred to KVWSMB are estimated to be about NRs3.898 billion, while liabilities are estimated at NRs4.547 billion. Out of the assets and liabilities taken over by KVWSMB, the assets transferred to KUKL are estimated to be about NRs503 million, while the liabilities are estimated at NRs657 million. The assets and liabilities associated with the water services outside of Kathmandu Valley were to remain with NWSC, which continues to be the utility operator. The assets and liabilities transfer proposal was first approved by the NWSC board on 25 July 2007, then by the Ministry of Finance on 10 September 2007, and finally by cabinet on 30 September 2007. NWSC and KVWSMB signed the assets and liabilities transfer document on 3 February 2008.

13. KVWSMB was to lease out its water services system assets to KUKL under the Asset Lease Agreement; at the same time, it was to issue an operating license to KUKL. KVWSMB is

⁷ These two ordinances expired in validity in October 2006.

⁸ The preference shares carry a 4% cumulative dividend.

⁹ These include headquarters and branch offices, office equipment, vehicles, and laboratory equipment.

¹⁰ These include cash balances, bank balances, staff advance payments, title to deposits, and advance payments.

¹¹ These include customer deposits for connections, advance tariff and tanker payments, and other customer advance payments.

¹² Four members were nominated by shareholders, and three independent directors were recruited based on their specified professional and technical qualifications and experience.

responsible for monitoring whether KUKL complies with the provisions of this lease agreement and operating license. Under the Asset Lease Agreement, KUKL has exclusive use of leased assets for the purpose of providing water services over 30 years and is responsible for maintaining the leased assets in good working condition; preparing capital investment, asset management, and 5-year investment plans; and implementing the investment plan as approved by KVWSMB. This lease agreement requires KUKL to pay lease fees to KVWSMB, which is computed as the sum of (i) 4% of the gross revenues invoiced for the water supply and wastewater services by KUKL, and (ii) 6% of the current cost valuation of the leased assets.¹³ Under the operating license, KUKL is authorized to act as a water service provider in Kathmandu Valley over 30 years. The license also provides the service standards to be met by KUKL so that KUKL will operate the services in a manner designed to achieve the following service goals: (i) regularity and continuity of water supply, (ii) protection of public health and security, (iii) efficiency in operations, (iv) equity and universality of supply and service, and (v) responsiveness to customers' needs. KUKL is required to submit a proposal to WSTFC for any tariff revision required, considering inflation and the reasonable cost of providing services, and is authorized to levy and collect tariffs for the provision of water services to consumers as approved by WSTFC. The operating license also requires KUKL to pay license fees to KVWSMB as prescribed in the terms of license¹⁴ and regulatory fees to WSTFC.¹⁵ The Asset Lease Agreement was signed by KVWSMB and KUKL on 12 February 2008, and the operating license was issued to KUKL by KVWSMB on 12 February 2008.

14. KUKL was to contract out the utility operation's management to a management contractor through an international competitive bidding procedure. However, following the proposed major change in the project's implementation arrangements to revise the modality of KUKL's management support from a PBMC to a capacity building and public-private partnership support team, the PBMC conditions have been waived.¹⁶

15. The responsibilities and functions related with respect to the ownership and operation of Kathmandu Valley were designed to be transferred from NWSC to KVWSMB and KUKL, with the responsibilities of the Program's implementation. Initially, the entire Program's Implementing Agency (IA) was MWSDDB, until the two new institutions were established and made functional. Upon establishment, KVWSMB was to become the IA for portion of the Program that concerns KVWSMB's functioning to hold assets for water services, determine policies, and monitor licenses for Kathmandu Valley's water services. This transfer of IA responsibilities to KVWSMB was effectively made when KVWSMB and ADB entered into an assumption agreement on 1 December 2005. Likewise, KUKL, upon establishment, was to become the IA for the portion of the Program that concerns KUKL's functioning to operate Kathmandu Valley water services under a license granted by KVWSMB and right-sizing of staff within Kathmandu Valley. Now that the existing NWSC staff within Kathmandu Valley operations were transferred to KVWSMB then seconded to KUKL for the first year of transfer during which the right-sizing exercise will be implemented through VRS, accordingly, the employer—KVWSMB—is legally authorized and liable for VRS implementation, and it is not necessary for KUKL to enter into the Assumption Agreement. Therefore, this condition has also been waived.¹⁷

¹³ However, it is 0% in the first 2 years, 2% in the third year, and 4% in the fourth year. Furthermore, the amount is capped at 50% of the gross revenues invoiced for services provided by KUKL.

¹⁴ According to the terms of license, KUKL shall pay to KVWSMB an initial license fee of an amount equal to NRs1.25 million per month multiplied by the number of full months remaining in the fiscal year. The license fee payable in each subsequent year shall be calculated by adjusting the initial license fee of NRs10 million to allow for the cumulative level of inflation.

¹⁵ The regulatory fee shall not exceed 1% of KUKL's gross revenue.

¹⁶ Waiver of these two conditions for the second tranche release was sought in the Board paper on major change in scope and implementation arrangements for the projects approved by the Board on 7 February 2008.

¹⁷ Waiver of this condition for the second tranche release was sought in the same Board paper as described in footnote 16.

16. The proceeds from the program loan of \$5 million equivalent were to be on-lent to KVWSMB and KUKL. The Ministry of Finance has passed down \$0.2 million equivalent of the program loan's proceeds to KVWSMB in an equal mix of loan and grant by executing the subsidiary loan agreement with KVWSMB on 8 December 2005. The subsidiary loan agreement between the Government and KUKL is no longer required due to the change in implementation arrangements for VRS as explained in para. 15. Therefore, this condition has been waived (see footnote 17). Instead, the existing subsidiary loan agreement between the Government and KVWSMB will be amended to increase the on-lent program loan's proceeds to \$5 million equivalent.¹⁸

IV. STATUS OF TRANCHE RELEASE CONDITIONS

17. The status of compliance with second tranche conditions under the Program is summarized in the table below, which is more detailed in the attached policy matrix in Appendix 1.

Status of Compliance of Second Tranche Release Conditions

Conditions	Status
A. Institutional Reforms	
1. The WUO (renamed KUKL) shall have been formed and incorporated as a limited liability company in accordance with the provisions of the Companies Act 2053, as amended or superseded from time to time.	Complied with
2. The Borrower shall have conclusively determined, allocated and transferred, to the satisfaction of the Bank, the proper portion of the existing debts of the NWSC to the WA (renamed KVWSMB).	Complied with
B. Water Utility Operator	
3. The WA shall have approved the leasing of the assets of the water supply and wastewater systems in the Kathmandu Valley under an operating license to the WUO.	Complied with
4. The WA shall have leased the assets of the water supply and wastewater systems in the Kathmandu Valley under an operating license to the WUO.	Complied with
5. The WUO shall have signed the Management Contract.	Waived
6. The Management Contractor shall have commenced implementation of the Management Contract and shall have become fully functional.	Waived
C. Program Agreement	
7. The WUO shall have entered into the WUO Assumption Agreement with the Bank and shall have assumed all the rights and obligations of the MWSDB, to the extent that they are applicable to the WUO, under the Program Agreement.	Waived
D. WUO Subsidiary Loan Agreement	
8. The WUO shall have entered into the WUO Subsidiary Loan Agreement with the Borrower, upon the terms and conditions satisfactory to the Bank.	Waived

KUKL = Kathmandu Upatyaka Khanepani Limited, KVWSMB = Kathmandu Valley Water Supply Management Board, MWSDB = Melamchi Water Supply Development Board, NWSC = Nepal Water Supply Corporation, WA = water authority (renamed as KVWSMB), WUO = water utility operator (renamed as KUKL).

¹⁸ The other terms and conditions of the existing subsidiary loan agreement—equal blend of grant and sub-loan, interest rate for sub-loan, sub-loan tenure—will be retained.

V. CONCLUSION

18. The Government has made substantive progress in meeting the Program's objectives and in complying with loan covenants. The most notable achievements were establishment of the three new entities in the urban water services sector to realize separation of asset management from ownership under the new regulatory system. Such institutional reforms were not easy to accomplish, given the political instability in recent years and fierce resistance from existing utility operators' unions. Despite the difficulties, all the conditions for the second tranche release, except for the four waived conditions, have been fully complied with.

VI. THE PRESIDENT'S DECISION

19. In view of the progress made in the implementation of the Kathmandu Valley Water Services Sector Development Program as evidenced by the full compliance of the four remaining tranche release conditions, the President is satisfied with the overall implementation of the Kathmandu Valley Water Services Sector Development Program and that the necessary conditions for the release of the second tranche of the Kathmandu Valley Water Services Sector Development Program have now been fulfilled. In accordance with the established procedure, the President will authorize the release of the second tranche in the amount of SDR1,737,000 (\$2.5 million equivalent). The authorization shall be effective not less than 10 working days after the circulation of this progress report to the Board.

POLICY MATRIX FOR RELEASE OF TRANCHES

Conditions	Status/Remarks	First Tranche	Second Tranche
A. Institutional Reforms			
The Act shall have been enacted and the provisions pertaining to WSTFC shall have articulated principles and a schedule for further tariff adjustments to ensure financial sustainability of the water supply and wastewater services in Nepal's urban areas, particularly those in Kathmandu Valley.	WSTFC Ordinance 2062 (2005) was promulgated by the King on 18 April 2005. This ordinance expired in validity on 13 October 2006. After Parliament's reinstatement by the King, WSTFC Act 2063 (2006) was promulgated by the House of Representatives on 1 December 2006, and published in the <i>Nepali Gazette</i> to be effective from 14 December 2006.	√	
KVWSMB and WSTFC shall have been established.	WSMB Ordinance 2062 (2005) was promulgated by the King on 18 April 2005. This ordinance expired in validity on 13 October 2006. After Parliament's reinstatement by the King, WSMB Act 2063 (2006) was promulgated by the House of Representatives on 7 November 2006, and published in the <i>Nepali Gazette</i> to be effective from 13 October 2006. This act has a provision for KVWSMB establishment in Kathmandu Valley's municipal areas.	√	
KUKL shall have been formed and incorporated as a limited liability company in accordance with the provisions of the Companies Act 2053, as amended or superseded from time to time.	The Shareholders' Agreement and the memorandum and Articles of Association were signed by all KUKL shareholders on 29 November 2006. Then, KUKL was registered with a certificate of registration issued by the company's Registrar's Office on 24 December 2006 in accordance with Companies Act 2063 (2006).		√
The Borrower shall have conclusively determined, allocated, and transferred—to the satisfaction of ADB—the proper portion of the existing debts of NWSC to KVWSMB.	The assets and liabilities transfer plan from the NWSC to the KVWSMB was approved by the NWSC board on 25 July 2007, by the Ministry of Finance on 10 September 2007, and by cabinet on 30 September 2007. The assets and liabilities transfer document was signed between NWSC and KVWSMB on 3 February 2008.		√
B. Water Utility Operator			
KVWSMB shall have approved the leasing of the water supply and wastewater system assets in Kathmandu Valley under an operating license to KUKL.	The Asset Lease Agreement and operating license were approved by KVWSMB on 10 December 2007.		√
KVWSMB shall have leased the water supply and wastewater system assets in Kathmandu Valley under an operating license to KUKL.	The Asset Lease Agreement was signed between KVWSMB and KUKL on 12 February 2008. The operating license was issued by KVWSMB to KUKL on 12 February 2008.		√

Conditions	Status/Remarks	First Tranche	Second Tranche
KUKL shall have signed the management contract.	Waived.		√
The management contractor shall have commenced the management contract's implementation, and it shall have become fully functional.	Waived.		√
C. Program Agreement			
KVWSMB shall have entered into the Assumption Agreement with ADB and shall have assumed all the rights and obligations of MWSDB, to the extent that they are applicable to KVWSMB, under the Program Agreement.	The Assumption Agreement was signed between KVWSMB and ADB on 1 December 2005, through which KVWSMB took over rights and obligations from MWSDB for NWSC restructuring and establishing KVWSMB to hold assets for water supply and wastewater services, determining policies and awards, and monitoring licenses and contracts for water supply and wastewater service operations in Kathmandu Valley.	√	
KUKL shall have entered into the Assumption Agreement with ADB and shall have assumed all the rights and obligations of MWSDB, to the extent that they are applicable to KUKL, under the Program Agreement.	Waived.		√
D. Subsidiary Loan Agreement			
KVWSMB shall have entered into the subsidiary loan agreement with the Borrower, upon the terms of conditions satisfactory to ADB.	KVWSMB and the Ministry of Finance signed the subsidiary loan agreement on 8 December 2005. Out of the proceeds of the program loan, SDR139,000 was passed down to KVWSMB in 50% grant and 50% loan. The agreement will be amended to increase the amount of on-lent program loan proceeds to SDR3,473,000.	√	
KUKL shall have entered into the subsidiary loan agreement with the Borrower, upon the terms and conditions satisfactory to ADB.	Waived.		√

ADB = Asian Development Bank, KUKL = Kathmandu Upatyaka Khanepani Limited, KVWSMB = Kathmandu Valley Water Supply Management Board, MWSDB = Melamchi Water Supply Development Board, NWSC = Nepal Water Supply Corporation, WSTFC = Water Supply Tariff Fixation Commission