REPORT NO.: RES40945

DOCUMENT OF THE WORLD BANK

RESTRUCTURING PAPER
ON A
PROPOSED PROJECT RESTRUCTURING
OF
PERNAMBUCO RURAL ECONOMIC INCLUSION
APPROVED ON MARCH 6, 2012
TO
STATE OF PERNAMBUCO

AGRICULTURE AND FOOD
LATIN AMERICA AND CARIBBEAN

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I. BASIC DATA

Product Information

<table>
<thead>
<tr>
<th>Project ID</th>
<th>Financing Instrument</th>
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<tr>
<td>P120139</td>
<td>Investment Project Financing</td>
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<th>Original EA Category</th>
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<td>31-Mar-2020</td>
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Organizations

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<th>Borrower</th>
<th>Responsible Agency</th>
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<tr>
<td>State of Pernambuco</td>
<td>SARA</td>
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Project Development Objective (PDO)

Original PDO

The objective of the Project is to promote rural business initiatives and expansion of rural access to water and other complementary infrastructure by supporting the Borrower’s Results Management Framework.

Summary Status of Financing

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<tr>
<th>Ln/Cr/Tf</th>
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<th>Signing</th>
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Policy Waiver(s)

Does this restructuring trigger the need for any policy waiver(s)?

No

I. SUMMARY OF PROJECT STATUS AND PROPOSED CHANGES
PROJECT STATUS

1. The Pernambuco Rural Economic Inclusion Project, Loan Agreement (8135-BR), locally known as ProRural, was signed on June 18, 2012, became effective on July 23, 2012 and is currently scheduled to close on March 31, 2020. The Project Development Objective (PDO) is to "promote rural business initiatives and expansion of rural access to water and other complimentary infrastructure by supporting the Borrower's Results Management Framework".

2. The project was restructured three times, in July 2016, March 2018 and January 2019. The first restructuring adjusted activities to include Partner Organizations to support implementation, modified the date for submission of annual operating plans, reallocated funds among categories, and increased the percentage of expenditures covered from 50% to 100%. The second reduced the original loan of US$100.0 million to US$80.0 million. The third, (i) cancelled an additional US$5 million of the Loan, (ii) reallocated US$9.8 million between components and disbursement categories, (iii) extended the closing date by 14 months to March 31, 2020. (iv) reduced counterpart funding to US$2.5 million; (v) adjusted a few targets in the Results Framework; and, (vi) included a Fiscal Diagnosis of the State to support a restructuring of the State’s fiscal framework.

Implementation Progress:

3. The Implementation Progress rating is currently Moderately Satisfactory. Disbursements are at US$63.6 million, 85% of the US$75.0 million Loan. There are still around US$ 7.9 million of loan amount in the designated account. The currently ongoing and proposed actions will reach a total of US$ 64 million of the loan. The remaining resources to reach the total loan amount, around US$ 11 million, will be subject to a follow-on restructuring - under preparation by the Borrower, to scale up the project support to the beneficiaries, full completion of the project investments and full measurement of results. The Borrower has financed around US$ 5.2 million as counterpart funds (109 percent above the agreed amount) of Project activities. To date, the project has financed 297 agreements with Rural Producer Organizations (RPO) for subproject investments in 135 municipalities, benefiting over 30,000 families.

4. Since the third restructuring was approved, back in January 2019, four missions to support Project implementation and supervision were carried out on April, June, August and November/December 2019, followed by a number of monitoring video conferences in between. These missions, especially the April and June 2019 ones, identified several managerial, technical and fiduciary issues that compromised the resolution of all pending issues identified by the technical audit back in 2018, as well as the completion of the investments in a timely manner to evaluate effects/results.

5. A Subproject Technical Audit was undertaken from March to July 2018, in response to several complaints from project beneficiaries. The Technical Audit was contracted to meet beneficiaries and stakeholders in 255 of the subprojects and identify technical, physical, managerial, operational and/or environmental deficiencies. The Report resulted in the immediate suspension of new approvals and focused resources on strengthening project management and supervision capacity, and on remediating identified deficiencies in the existing portfolio. Furthermore, an environmental audit found subprojects with non-compliance issues which are now being rectified, and an experienced environmental engineer was hired to oversee the activities and prevent them from recurring. Technical specialists and rural extension (ATER) services were contracted to work closely with RPOs in supporting productive and infrastructure subprojects and in correcting deficiencies defined by the Audit, concluding unfinished subprojects, ensuring subproject functionality and fostering improved subproject management. In addition to the technical audit, a dam safety audit assessment was carried out by the Bank team. The audit visited the sites and assessed the rehabilitation needed in two small dams financed by the Project. Activities to be implemented to rehabilitate the dams were agreed upon and are being contracted.
The following summarizes the status of component execution:

6. **Component 1 - Investments in Rural Economic Inclusion:** The project’s new management team is focused on correcting the existing portfolio of subprojects based on the findings of the Technical Audit as well as of the State General Controller (CGE) Audit and improving their management. Contracted, specialized technical and rural extension services are supporting the productive subprojects.

7. **Component 2 - Complementary Infrastructure in Rural Areas:** Water systems and sanitary kits implemented to date are generally in good quality, but some systems need corrective actions in order to improve their operation capacity and mitigate environmental concerns; and support to improve community management of the systems. Two small dams also need rehabilitation to properly operate. The water and sanitation team has been strengthened, and the component has improved its processing, monitoring and internal controls. This component also supported the initial discussions to implement an O&M framework based on Ceara’s SISAR system for rural water and sanitation systems involving local communities, to ensure their quality and sustainability.

8. **Component 3 - Management, Supervision, Monitoring and Evaluation:** The project management team was restructured, and a new Director appointed. A firm was contracted to evaluate project results and impact. Procurement is prioritizing acquisitions related directly to achievement of the PDO and that can be concluded within the extended timeframe. The MIS was improved, and project databases were updated. A new monitoring model is generating better-quality information to support subproject evaluation and decision-making.

9. **Project Management:** The project management team was restructured and strengthened, with changes in team composition, roles and responsibilities. There is a strong focus on compliance as a management tool for demonstrating capacity through the correct and transparent execution of the project in accordance with the Legal Agreement, Operational Manual and the PAD. An integrated management model was introduced to provide more accurate, reliable and relevant information on the subproject approval and execution cycle, improving overall quality and efficiency. The PMU meets monthly with its regional counterparts to discuss the status of subproject agreements with beneficiary RPOs, as well as actions required to maintain pace and quality.

10. **Financial Management:** The prior FM performance was rated as Unsatisfactory. However, on December 2019 the state proved to have observed the agreed action plan with respective improvement in the financial management controls, and the new FM performance being rated as Moderately Satisfactory. There are no audits or audit issues outstanding. Even so, the overall Project FM Risk Rating remains High, as there have been significant changes in control risk factors (budgeting, accounting, internal controls, flow of funds, financial reporting and auditing).

11. **Procurement:** Overall, quality of procurement documents has improved, but some challenges remain. The first internal audit of the Project, done by the State General Controller (CGE), was concluded in October 2019, and it confirmed the findings of the March 2019 post review. Former PIU management staff were involved in allegedly potential fraud and corruption cases, both at the central and decentralized levels, duly reported to INT. Although there are no restrictions to open competition in the market or lack of suppliers, throughout the years, participation in the CDD procurement has been limited to a small group of suppliers due to the lack of adequate control and monitoring. This capture was so strong that even now, despite the PIU’s renewed efforts to expand advertising and to centralize the procurement for greater control, not much has improved: the same suppliers are still the only ones participating, and very few bids/quotes are received. Despite the efforts to expedite procurement, there are several processes that are still underway and several contracts whose execution periods would pass beyond the project current’s closing date. An extension of the Project closing date, however, could support the following improvements: (i) a clear
indication to market that new contracts would be given more time to be completed, possibly helping address the limitation in competition; and (ii) more contracts could be finalized and financed under the Project.

12. Safeguards: The project environmental team was strengthened by the addition of two environmental analysts. Environmental regularization is progressing, and compliance issues and environmental liabilities revealed by the Technical Audit are being rectified. The project environmental team has identified all needed corrections and is now conducting field visits to engage OPFs, confirm/adjust proposed activities and mobilize local teams to implement them. No significant environmental impacts have been observed to date. Based on observed progress, the rating for Environmental Safeguards compliance was upgraded by the May 2019 supervision mission to Moderately Satisfactory and environmental risk rated Moderate. Compliance with Social Safeguards is rated Satisfactory and social risk is rated Low. Agreed measures to improve and accelerate activities with Indigenous Peoples and Quilombola communities are being implemented. No project-supported activities have had adverse impacts related to Involuntary Resettlement. The project makes investments in community infrastructure and productive subprojects involving small civil engineering works, which does not require involuntary resettlement.

Rationale for Restructuring
13. The Borrower’s objective is to position the project for successful conclusion and achievement of its PDO. There will be no change in the PDO, or the project outcome and intermediate outcome indicators. The requested extension of closing date by three months will be sufficient to complete the ongoing project investments, by the proposed revised closing date of June 30, 2020. ProRural's Financing Plan through June 30, 2020 shows activities with signed contracts, procurement being processed or under execution totaling US$ 6.6 million. Activities to be financed in the proposed three months, adhering closely to the recommendations of the Technical Audit, are: technical assistance and rural extension to train the beneficiaries of existing subprojects (completed and under completion); the physical upgrading of subprojects (complete or under implementation); conclusion of incomplete subprojects (under implementation); complementary works for subprojects to ensure functionality (under implementation); and minor activities needed to fully comply with Bank’s safeguard policies. With the proposed extension of three months, the project would be on track to achieve its current PDO, whose progress is currently rated Moderately Unsatisfactory.

14. Considering the tangible improvement in Project Management and the actions already taken and continuing, to implement the findings of the Technical Audit and successfully conclude the project’s remaining activities - based on project information and evidence in the field - the Bank project team is confident that major implementation challenges are being addressed in a rigorous manner and will be overcome to increase impacts/results in the Borrower’s territory.

Proposed Changes
15. Extension of the Closing Date: A three-month extension of the closing date is proposed (from March 31, 2020 to June 30, 2020) to finalize the implementation of the comprehensive corrections recommended by the Audits; to guarantee adequate evaluation of project activities; as well as, to serve as a bridge for the definition and preparation of a follow up proposal to use the remaining project funds, estimated at around US$ 11M, and a further extension of closing date to implement such additional activities. The State Governor has already sent a follow-on restructuring proposal Letter to the Bank, as well as to the Guarantor, which is attached to this RP.

II. DETAILED CHANGES
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<th>Ln/Cr/Tf</th>
<th>Status</th>
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<th>Revised Closing(s)</th>
<th>Proposed Closing</th>
<th>Proposed Deadline for Withdrawal Applications</th>
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