MILLENNIUM CHALLENGE CORPORATION
REDUCING POVERTY THROUGH GROWTH

FRANCES C. MCNAUGHT
VICE PRESIDENT, CONGRESSIONAL AND PUBLIC AFFAIRS

CONGRESSIONAL NOTIFICATION TRANSMITTAL SHEET

We wish to inform you of the signing of a Millennium Challenge Compact with the Government of El Salvador in accordance with Section 610(b)(1) of the Millennium Challenge Act. In addition to the enclosed Notification, we have included a detailed summary of the Compact along with the text of the Compact signed November 29, 2006.

The attached notification is being sent to Congress on November 30, 2006.

Sincerely,

Frances C. McNaught
Vice President
Congressional and Public Affairs

Enclosure:
As stated

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MILLENNIUM CHALLENGE CORPORATION
CONGRESSIONAL NOTIFICATION

November 30, 2006

PROGRAM:	Eligible Countries
APPROPRIATIONS CATEGORY:	FY 2006 and FY 2007 Program Funds
OBLIGATION AMOUNT:	$460,940,000

In accordance with section 610 (b)(1) of the Millennium Challenge Act of 2003 (the "Act, Pub. L. 108-199, Division D), this is to advise that the Millennium Challenge Corporation (MCC) has entered into a Compact with the Government of the Republic of El Salvador (GoES) pursuant to Section 609 of the Act, through which MCC will grant up to US$369,000,000 of FY 2006 Millennium Challenge Account ("MCA) funds and US$91,940,000 of FY 2007 MCA funds for a total amount of US$460,940,000. Of this amount, MCC intends to obligate pursuant to the authority of Section 605 of the Act up to US$451,722,000 when the Compact enters into force. The Compact will enter into force pursuant to Section 1.3 of the Compact subject to relevant conditions precedent set forth in Section 4.1 of the Compact. These funds will be disbursed in tranches over the course of the Compact's term upon satisfaction or waiver of relevant conditions precedent.

In order to accelerate implementation of the Compact, MCC has obligated US$9,218,000 of the total amount ("Compact Implementation Funding) at the time of signing of the Compact, pursuant to the authority of Section 609(g) of the Act.

The United States, acting through MCC, and the GoES executed the Compact on November 29, 2006.

A detailed summary of the compact follows along with a copy of the text of the Compact.

Executive Summary

I. Introduction

In 1992, El Salvador entered into the peace accord that ended a decade of civil conflict. The conflict cost over 70,000 lives and left nearly two-thirds of the country's population in poverty. During the war, human capital formation lagged, public investment was deferred, and deterioration of the natural resource base accelerated. The northern zone of El Salvador (the "Northern Zone) fared the worst; its mountainous territory served as a primary staging ground for the conflict, thereby increasing violence and instability in the

area and causing an exodus of large numbers of the region's inhabitants. Despite the significant national economic growth that followed the peace accord, progress has stagnated in recent years and the poverty rate in the Northern Zone (53 percent) remains higher than the national average (34 percent). Today, approximately 450,000 of the country's 2.33 million poor people reside in the Northern Zone.

Overcoming these obstacles and unifying the Northern Zone with the rest of the country have become national priorities. The Northern Zone serves as a primary source of water, energy, biodiversity and other key resources for El Salvador and neighboring countries in Central America. Halting, and indeed reversing, the deterioration of these resources, and ensuring more sustainable approaches to economic development, comprise strategic goals. The population of the Northern Zone requires a comprehensive development program to enable it to fully participate in El Salvador's growth, the benefits of regional integration, and the economic opportunities brought about by the recently signed Central America-Dominican Republic-United States Free Trade Agreement.

The five-year, $460.94 million Compact provides an historic opportunity to fulfill these goals and transform El Salvador's economic development.

II. Program Overview, Budget, and Impact

The program supported by the Compact (the "Program) is comprised of three strategic and interdependent projects: (1) human development; (2) productive development; and (3) connectivity.

Multi-Year Financial Plan Summary

Component	(USD millions)					
	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Human Development Project	5.62	23.18	24.04	21.02	21.22	95.07
Productive Development Project	13.55	18.28	20.76	22.01	12.87	87.47
Connectivity Project	16.44	82.79	111.58	18.80	3.95	233.56
Accountability	2.85	5.65	6.67	4.27	4.82	24.26
Program Administration	4.35	4.07	4.18	4.03	3.95	20.59
TOTAL ESTIMATED MCC CONTRIBUTION	$42.82	$133.97	$167.22	$70.12	$46.81	$460.94

The Program is projected to directly alleviate the poverty of over 150,000 Salvadorans and enhance the livelihoods and welfare of over 850,000 people in the target area. It is expected that as a result of the Program, incomes in the region will increase by 20 percent over the five-year term of the Program, and by 30 percent within ten years of the start of the Program.[1] Increased investment, trade, and productivity in the Northern Zone are expected to have spillover benefits for the country as a whole, as well as for the entire Central American region.

[1] Without the Program, income in the Northern Zone is expected to increase by only 2 percent over the period of the Program and by 4 percent within 10 years of the start of the Program.

A. Human Development Project

This project is based on the foundations and ongoing work achieved in two existing Government of El Salvador ("GOES) programs – the Solidarity Network and the National Education Plan 2021. It is divided into two broad activities:

1. *Education and Training* will support both formal and non-formal technical training programs, secondary and post-secondary technical and vocational education with related infrastructure and equipment; over 27,000 people will benefit directly; and

2. *Community Development* will provide improved access to potable water systems for 90,000 people and improved sanitation services for over 50,000. Electricity coverage in the Northern Zone will increase from 70 percent to no less than 97 percent, benefiting 235,000 individuals. Through construction and improvement of community infrastructure (e.g., tertiary roads, improved drainage, small bridges) over 130,000 people will have greater access to markets, employment, and facilities supporting health and education.

B. Productive Development Project

This project includes provision of technical assistance, training, and financial services to farmers to help them shift from basic grains to higher value crops and to micro, small and medium businesses to make efficient, productivity improving investments. It is expected to lead to increases in net income for 55,000 beneficiaries, and is organized into three activities:

1. *Production and Business Services* will provide technical assistance to farmers and business development services to micro, small and medium enterprises, all on a cost-sharing basis;

2. *Investment Support* will provide investment capital on market terms to competitively selected applicants for commercially-viable activities by the private sector; and

3. *Financial Services* will provide credit guarantees and technical assistance to financial institutions to generate increased lending activity by banks and non-bank financial institutions to farmers and rural enterprises. In addition, crop insurance will help mitigate risks for small producers in the Northern Zone.

C. Connectivity Project

This project addresses the issue of the Northern Zone's physical isolation with two activities:

1. *The Northern Transnational Highway* includes the design, construction, and rehabilitation of a 289-kilometer two-lane secondary road, forming a transportation corridor from Guatemala to Honduras across the Northern Zone of El Salvador. More than 80 percent of the highway span involves rehabilitation; new roads are expected to comprise approximately 50 kilometers; and

2. *The Connecting Road Network* includes paving and improvement of 240 kilometers of unpaved roads that will enable increased access to markets, health, and education services, and integrate the Northern Zone with national and regional highway systems.

Increased connectivity is expected to lead to new economic opportunities for rural households, lower transportation costs, and decrease travel times to markets and social service delivery points for upwards of 600,000 beneficiaries.

III. Program Management

Through an act of its legislature, the GOES will create Fondo del Milenio ("FOMILENIO) to serve as the accountable entity for the Program. FOMILENIO will be governed by an independent board of directors (the "Board) which will make strategic decisions, provide oversight, and ultimately be responsible for the results of the Program. The Board will be comprised of seven voting members — four members designated by GOES, one private-sector member, and two representatives of nongovernmental organizations. The Board also will benefit from the participation of an advisory council, consisting of members of the National Development Commission and other stakeholders. An executive director will manage the day-to-day activities of FOMILENIO and will be supported by key officers, technical staff, and administrative personnel.

FOMILENIO will engage line ministries, other public agencies, a second-tier development bank, and contractors/consultants for direct execution of the Program activities. However, as the accountable entity, FOMILENIO will remain responsible for the successful implementation of the Program. The financial management unit within FOMILENIO and the Ministry of Finance will share the financial management responsibilities for the Program. FOMILENIO will utilize outside procurement and fiscal oversight agents. As a governmental entity, FOMILENIO will be subject to GOES audit requirements as well as audits required by the Compact.

IV. Other Highlights

A. Consultative Process

The National Development Commission has led a public dialogue on a new vision for El Salvador's development. As a result of this dialogue, the National Development Commission produced a shared national development strategy, known as the Plan of the Nation, setting forth a vision for development of each of the five regions of El Salvador, including the Northern Zone. In response to the Plan of the Nation, and based on local, regional, and national level consultations, GOES created a plan for developing the Northern Zone (the "Northern Zone Investment Plan).

To develop their proposal for Millennium Challenge Account ("MCA) assistance, GOES refined the Northern Zone Investment Plan based on input received in a series of consultations with various stakeholders and interested parties. Consultations included local mayors, private-sector representatives, academic experts, international donors, multilateral development organizations, sector specialists, and the general public. In total, GOES held more than 50 formal workshops and informal discussions with over 2,200 Salvadorans. GOES, through FOMILENIO, plans to continue engaging civil society, local government, and other key constituencies in oversight and guidance through Program implementation. It will do this via private sector and civil society representation on the Board, and through ongoing participation by the National Development Commission, local mayoral commission, government representatives, and other stakeholders on FOMILENIO's Advisory Council.

B. GOES Commitment and Contribution to the Program

GOES has demonstrated substantial commitment to the Compact development process since first becoming eligible for MCA assistance in November 2005. Under the guidance of a high-level oversight commission, and with the leadership of the executive director of the MCA-El Salvador team, GOES presented a comprehensive proposal just over five months after becoming eligible. The President and other high-level officials have been directly engaged in developing the Program, providing the political leadership necessary for its success. Recent progress on policy reform, and ongoing efforts by GOES to strengthen rule of law, administration of justice, and other relevant areas, contributed to El Salvador being re-selected as an MCA-eligible country in November of 2006.

Pursuant to Section 609(b)(2) of MCC's legislation applicable to a lower middle income country receiving Compact funds, GOES will make an appropriate contribution, relative to its national budget and taking into account prevailing economic conditions, towards meeting the objectives of the Compact. The GOES contribution will be in addition to the government's spending allocated towards such objectives in the country's budget for the year immediately preceding the establishment of the Compact. GOES expects to make a qualifying contribution to the Northern Zone Investment Plan of approximately $327 million over the five-year term of the Compact. In addition, GOES invested over $1.7

million in proposal preparation and has committed another approximately $9 million to fund up-front feasibility, design and environmental impact studies related to the Connectivity Project.

C. Sustainability

MCC is requiring assurances from GOES that it will provide the staffing, equipment and other recurrent costs of new (and, in some cases, existing) facilities and infrastructure investments necessary for the sustainability of the Program. The education and training activity will include strong private-sector involvement and will engender local and civil society ownership. As part of the technical assistance activity, an assessment will be made of alternative revenue sources needed to cover recurring costs. These elements will support more sustainable impact of this activity.

Selection criteria for the water and sanitation and community infrastructure activities under the Human Development Project will stipulate a minimum level of community contribution to investment in and maintenance of new infrastructure. Municipalities and/or community-level entities will be responsible for system operation and maintenance. System designs will reflect lowest cost alternatives in order to reflect users' ability to pay tariffs for operation and maintenance costs. For the rural electrification and water and sanitation activities, user fees that correspond with system operation and maintenance needs will be applied.

The Productive Development Project will provide support to encourage alliances, joint ventures, and other collaborations between more established enterprises and smaller/disadvantaged organizations and individuals. In addition to technical assistance provided to micro, small, and medium sized enterprises, support will be provided to financial institutions to enable them to better serve new clients. These activities are expected to accelerate start-up of productive activities, and improve prospects for success and sustainability.

Sustainability of MCC investments in transportation infrastructure is contingent upon proper and effective road maintenance. El Salvador possesses substantial road maintenance capabilities in the Fondo de Conservacion Vial. Disbursement of MCC funding for the Connectivity Project will depend on the satisfaction of conditions related to road maintenance of all roads within the Connectivity Project for the life of such roads.

D. Environment and Social Impacts

Environmental and social sustainability of the Program will be enhanced through oversight, ongoing public consultation and institutional capacity building. A strategic environmental assessment funded by the World Bank will be performed in the Northern Zone to address the project components and the need to strengthen land use plans. To address the lack of institutional capacity for effective monitoring and oversight, GOES will commit to increasing environmental staff in the implementing and regulatory entities and creating an inter-departmental task force, focused on the Northern Zone investments,

in the Ministry of Environment and Natural Resources. GOES will also strengthen the environmental management system to help in the enforcement of land use plans and participation of Salvadoran communities in the sustainable management of natural resources. MCC is providing funding for training in environmental management to further improve the institutional capacity.

The Connectivity Project is classified as Category A under MCC's Environmental Guidelines. An environmental impact assessment, environmental management plans, resettlement action plans, and HIV/AIDS awareness plans will be undertaken and funded by GOES. GOES and MCC also have conducted multiple consultations with non-governmental organizations in El Salvador and in the U.S. to review concerns and ensure they are adequately addressed in advance of implementation.

As part of the Human Development Project, classified as Category B under MCC's Environmental Guidelines, the education and training activity will require a gender assessment to address issues of access and meaningful participation. The community development activity will require selection criteria for provision of community services that take into account environmental sensitivity and social impact considerations and site-specific environmental analysis as needed.

The Productive Development Project, classified as Category D under MCC's Environmental Guidelines, will adhere to guidelines contained in an operations manual that defines environmental and social/gender requirements. Specifically, potentially adverse environmental impacts may result from new or expanded activities supported by the Project. To address these and other potential impacts, technical assistance will involve the dissemination of environmental sustainability principles, and selection criteria for eligible proposals will include environmental sensitivity and social impact considerations.

E. Donor, Multilateral, and Interagency Coordination

The Program was developed in collaboration with a wide variety of donors and multilateral finance institutions. Several Program components will build upon activities pioneered by other donors (such as the Inter-American Development Bank's rural roads program, and the U.S. Agency for International Development's water and sanitation and rural productivity projects). MCC worked with the European Union and the Japanese International Cooperation Agency as it reviewed proposed transportation infrastructure activities. MCC also worked closely with the World Bank to ensure proper coordination on the strategic environmental assessment, and on matters related to land tenure, land administration, and protected areas management.

To further advance understanding of the proposed Program, MCC held numerous meetings with representatives from various U.S. Government agencies. MCC looked primarily to USAID and the U.S. Department of State for information on the development context in El Salvador. For insight into the integrity of GOES financial management systems, MCC received detailed reviews and recommendations from