

**MILLENNIUM CHALLENGE CORPORATION
CONGRESSIONAL NOTIFICATION**

July 12, 2005

PROGRAM:	Eligible Countries
APPROPRIATIONS CATEGORY:	FY 2004 Program Funds
OBLIGATION AMOUNT:	\$110,078,488

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 Cape Verde pursuant to Section 609 of the Act. The United States, acting through MCC, and the Government of the Republic of Cape Verde executed the Compact on July 4, 2005. The provisions of the Compact will enter into force pursuant to Section 1.3 of the Compact, including satisfaction of certain conditions set forth in Section 4.1.

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

**Summary of the Millennium Challenge Compact
with the Republic of Cape Verde**

I. Introduction

Since gaining its independence from Portugal in 1975, Cape Verde has achieved an annual growth rate of approximately 6%. In addition, a major asset of Cape Verde is its strong record in terms of democratic governance, stability, transparency, and lack of corruption. Cape Verde, however, relies heavily on large inflows of foreign assistance and remittances, which together represent roughly 25% of GDP. Recognizing that reliance on such flows is not sustainable, Cape Verde has created a long-term development strategy predicated on moving from aid-dependency to self-sustaining, private-sector led economic growth, focused around services. Meanwhile, Cape Verde continues to have high levels of poverty and unemployment, which are partly attributable to a lack of obvious economic growth opportunities and a scarcity of resources, particularly water. Only 10% of the land is arable and roughly 83% of rainfall is lost through evaporation and runoff. Agricultural productivity is low and approximately 85% of the country’s food is imported – 70% in the form of food aid.

Cape Verde conducted a comprehensive consultative process that identified key impediments to economic growth: severe water scarcity, lack of adequate infrastructure, weak institutional support for the private sector, and an insufficiently trained work force. To address these impediments, Cape Verde requested MCC support to:

- Increase agricultural productivity on the islands of Santo Antão, Fogo, and São Nicolau by (i) improving water management, (ii) improving agribusiness development services, and (iii) increasing access to credit and capacity of financial institutions;
- Integrate internal markets and reduce transportation costs by: (i) improving road infrastructure on the islands of Santiago and Santo Antão, and (ii) upgrading the Port of Praia; and

- Develop the private sector by improving the investment climate and reforming the financial sector.

This MCC-funded program in Cape Verde (the “*Cape Verde MCA Program*”) comprises a solid investment in a country that has relatively limited opportunities. The expected impact of the three projects in the program is an increase in annual income to \$10 million in Year 5 and over \$22 million in Year 10. This corresponds to approximately 1.2% and 2.2% of annual GDP respectively, assuming a real GDP growth rate of 4% per annum.

The product of a strong consultative process, the MCA Program will complement the efforts of various multinational and bilateral donors working in Cape Verde. This program conforms with MCC’s goal to be a major donor and have a large economic impact in Cape Verde.

II. Program Activities, Costs and Performance

The proposed program is summarized in the table below:

Program Costs (\$ millions)		
1. Watershed Management and Agricultural Support		10.8
(a) Water Management	6.8	
(b) Agribusiness Development	3.6	
(c) Credit	0.4	
2. Infrastructure		78.7
(a) Port	53.7	
(b) Roads and Bridges	25.0	
3. Private Sector Development		7.2
(a) Partnership to Mobilize Investment	5.0	
(b) Financial Sector Reform	2.2	
4. Monitoring and Evaluation		4.9
5. Program Administration and Control		8.4
(a) Program administration	5.8	
(b) Fiscal control and procurement management	1.0	
(c) Enhanced transparency initiative	1.1	
(d) Audits	0.5	
TOTAL		\$110

1. Watershed Management and Agriculture Support (\$10.8 million)

Cape Verde forms part of the semi-desert Sahelian ecology, with its erratic, low rainfall and degraded soils. MCC will fund investments that increase the capture, storage and distribution of rainfall water, thus enabling poor farmers to irrigate their fields and increase agricultural productivity. Increases in irrigated land and reliability of water supply will facilitate a shift from low-value, rain-fed agriculture to higher value-added crops that are grown more intensively (e.g., from two to three annual crop cycles). This project includes the following:

- Water Management and Soil Conservation (“*Water Management*”): Construction of reservoirs, dikes, terraces, check dams and other structures to capture water and recharge water tables.

- Agribusiness Development Services (“*Agribusiness Development*”): Applied technical and field research; training for farmers and extension agents; improvements in agricultural extension centers and farm demonstration sites; building capacity in export requirements; packing sheds; and centers for inspection and certification.
- Access to Credit (“*Credit*”): Provision of credit for drip irrigation, working capital, and agribusiness investment in the three watershed areas and technical assistance to increase capacity of financial institutions in the provision of financial services.

Improved watershed management will reduce or in some cases reverse erosion, thus preserving the value of land and water. Increased economic vitality in rural areas will create opportunities and reduce migration to urban centers. Continued growth in the tourism industry should provide a strong demand pull for the agricultural production by the project.

2. Infrastructure (\$78.7 million)

Cape Verde consists of ten separate islands, which inhibits the development of a common national market, increases the costs of production, and hinders the flow of resources between the more prosperous islands and the more rural, poorer islands. Economic activities such as tourism, manufacturing, and agricultural production are severely constrained by inadequate roads, ports, and inter-island transportation services. The following projects will be supported:

- Upgrade and Expansion of the Port of Praia (“*Port*”): Due to the complexity and scope of the port expansion plan, this project is intended to be done in two phases. Phase I involves improving quayside and off-terminal container handling facilities; providing for a second access road and breakwater; and initiating certain preparatory activities – geotechnical studies, cargo/passenger market studies, feasibility studies, and environmental impact assessments – that are needed for long-term expansion. Phase II will include extending the quay and creating space for a new two-berth specialized terminal container storage area.
- Roads and Bridges (“*Roads and Bridges*”): This project is designed to achieve basic connectivity and improve mobility on two targeted island networks. This will be done by: (i) rehabilitating two heavily traveled east-west axes on Santiago; (ii) reconstructing three rural roads linking isolated agricultural and fishing communities to the main network; and (iii) ensuring all-weather and reliable access to two major towns by constructing a series of bridges in Santo Antão.

Improvements to the Port of Praia, which handles half of the island nation’s cargo and facilitates the movement of people to and from the population center of Cape Verde, are intended to maximize the existing operational capacity and productivity, given the existing constraints, followed by longer-term investments to create new infrastructure and facilities to alleviate the Port’s inherent berth, space, and geometry problems. The prime objective of the road investments is to ensure a continuous network linking the population with social services, employment opportunities, local markets, and ports and airports.

3. Private Sector Development (\$7.2 million)

The primary goal of Cape Verde’s long-term economic transformation strategy is to become less dependent on remittances and donor aid by developing a competitive, private-sector driven economy

through a focus on priority sectors such as tourism, financial services, transportation services, and fisheries. Successfully implementing the economic transformation strategy will require cross-cutting investments to strengthen human capital; promote financial sector reform; upgrade capacity within the private sector and the policy-making apparatus; and improve infrastructure. In addition, financial institution competition is weak and depositors have few options to hold savings. Accordingly, this project includes the following:

- **Partnership to Mobilize Investment (“Partnership to Mobilize Investment”)**: The International Finance Corporation (“IFC”) and the Government of Cape Verde will finance an analysis of the priority sectors to identify the constraints to private sector investments and the design of potential interventions to eliminate those constraints. Based on this analysis, MCC will fund the selected interventions such as policy reforms and/or projects (including physical infrastructure and other tangible assets) to address vocational training and education, human resource development, infrastructure, access to financial services, and entrepreneurship development. MCC will fund these interventions based on specific investment criteria, including meeting an economic rate of return (“ERR”) hurdle rate of 10%, having clearly identified target outcomes, and being consistent with MCC’s Environmental Guidelines.
- **Financial Sector Reform (“Financial Sector Reform”)** MCC funding will support microfinance institutions by providing technical assistance that will allow them to take advantage of expanded deposit-taking powers and to ease the transition to a new regulatory environment. In addition, technical assistance will be provided to help the Ministry of Finance and Planning design new auction procedures for the government securities market and the necessary supporting infrastructure, e.g., a registry of security ownership.

4. Program Monitoring and Evaluation (\$4.9 million)

A monitoring and evaluation plan (“M&E Plan”) is being developed for the Cape Verde MCA Program to measure progress toward achieving the program objectives. A series of indicators will be used to track implementation, improve program management, and evaluate the impact of the Program on increasing economic growth and reducing poverty. Indicators will be disaggregated by gender, income level and age, to the extent practicable.

The key indicators and expected results for each Project are listed below:

Watershed Management and Agriculture Support Project: Increase agricultural productivity in the intervention areas		
	Baseline	Year 5
Increase in profits and wages for farmers and agribusinesses (million dollars)	0	1.5
Productivity of horticulture crops (tons per hectare)	9	24
Area irrigated with drip irrigation (cumulative hectares)	9	121
Aquifer level	To be determined by the National Water Institute before implementation begins	> Baseline

Infrastructure Project: Increase integration of internal markets and reduce transportation costs		
	Baseline	Year 5
Port:		
Volume of goods shipped between Praia and other islands (tons)	137,995	220,741
Tons of general cargo handled per hour	20	35
Containers handled per hour	8.66	11
Roads and Bridges:		
Savings on transport costs from asphalt roads and bridge improvements (million dollars)	0	1.9
Percentage of beneficiary population who take at least 5 trips per month	52%	65%
Kilometers of roads rehabilitated (cumulative)	0	63

Private Sector Development Project: Develop Private Sector		
	Baseline	Year 5
Partnership to Mobilize Investment:		
GDP contribution from priority sectors - tourism, financial services, transport, fisheries (escudos)	0	To be determined after specific activities have been identified
Increase of public and private investment in priority sectors (escudos)	0	To be determined after specific activities have been identified
Financial Sector Reform:		
Volume of deposits in micro-finance institutions as percentage of total deposits	0%	3%
Percentage of government securities held outside of financial institutions and government agencies	0%	8%

5. Program Administration and Control (\$8.4 million)

MCA-Cape Verde will be an independent entity, responsible for management and oversight of the implementation of the program, the legal form of the entity to be agreed upon by the MCC and GOCV. It will be overseen by a Steering Committee composed of (i) voting representatives from government, the private sector, and non-governmental organizations (“NGOs”) that will make key strategic decisions, provide oversight to management, and monitor progress and (ii) non-voting observers including an MCC representative and representatives from the private sector or NGOs. A Stakeholders’ Committee comprised of representatives from central and municipal government as well as the private sector and

civil society will provide feedback and recommendations to the Steering Committee in an advisory capacity.

The Government of Cape Verde has very strong financial management and procurement practices and will take the lead on these issues. Procurement and contract management will be carried out under the broad oversight and authority of the Steering Committee, through a Procurement Review Commission using World Bank guidelines. Cape Verde's Ministry of Finance and Planning will serve as the fiscal agent and as an independent control mechanism, and will be the sole signatory to the permitted bank account. While the Ministry of Finance and Planning will not charge a fee for services rendered, MCC will help build its institutional capacity by covering the cost of additional equipment and software necessary to provide these fiscal agent services as well as to improve program management and the reporting capacity for the monitoring and evaluation of the program. This support will help improve the government's existing financial management system.

As another element of capacity building, MCC will work with Cape Verde to establish a transparent e-procurement system for all levels of government. Extending this system government-wide will allow suppliers, government officials, and the public to have access to the rules governing procurement; insight into the procurement transactions themselves; and a transparent record of competition and results of solicitations. In addition, the Government of Cape Verde has undertaken a process to enact and implement unified procurement legislation that will consolidate existing procurement rules into a single transparent system. Funding for technical assistance to support this effort will help draft appropriate legislation and regulations as well as to train individuals involved in the procurement system at all levels of government. The combination of unified procurement procedures and the establishment of completely electronic procurement transactions and documentation will result in one of the most transparent and efficient procurement systems in the developing world.

III. Other Highlights

1. Consultative Process

Cape Verde has a strong history of consultation, and the ideas in the MCC proposal build on previous priority-setting efforts and development strategies that have been evolving since 1996, including the "Grand Options" Plan, the National Development Strategy, the Economic Transformation Strategy, the Agricultural Development Strategy, and the Growth and Poverty Reduction Strategy Paper. An extensive series of consultations was held regarding the MCC proposal, which has led to widespread support in the relevant communities including the opposition political party's support. Cape Verde was the first MCC-eligible country to post its Proposal on the Internet (www.virtualcapeverde.net).

2. Economic Analysis

A summary of the estimated economic rates of return is included in the table below:

Project	ERR (per annum)
Watershed Management and Agriculture Support	10%
Roads and Bridges	14%
Port	23%
Financial Sector Reform	11%

These ERRs were arrived at through the following methodologies. The Watershed Management and Agriculture Support Project considers the increase in income that results from the horticulture and fruit production made possible by the investments in watershed management. The ERR of the Roads and Bridges project measures the reduction in vehicle operating costs from improving existing roads and laying new ones, as well as the increased earnings resulting from new bridges connecting areas previously cut-off during rainy periods. For the Port project ERR, improvements to the port infrastructure are assumed to prevent a slowdown in growth in the tourism sector that would otherwise result from congestion and higher transportation costs at the port; additionally, benefits from the concession paid by the private operator, and tax collections, are included. The Partnership to Mobilize Investment project will require among the investment criteria that the intervention meet an ERR hurdle rate of at least 10%. Finally, the ERR of the Financial Sector Reform project is based on published econometric estimates of the impact of an improved financial sector on GDP growth. These estimates are conservative, as there are several potential positive externalities that have not been included in the calculations.

3. Government Commitment and Effectiveness

The Government of Cape Verde has exhibited a high degree of commitment to and ownership of this program, culminating in the fact that the MCA-Cape Verde Steering Committee's will have four cabinet members and the Chief Advisor to the Prime Minister. As part of the program, the Government of Cape Verde is taking such concrete steps as establishing a Road Maintenance Fund to ensure sustainable maintenance financing; committing to privatize the operations of the country's ports by the first half of 2006; and funding \$500,000 for the design/evaluation phase of the Partnership to Mobilize Investment project.

4. Sustainability

Watershed Management and Agriculture Support Project

The Ministry of Agriculture, Environment and Fisheries, the National Water Institute, and municipalities will receive technical assistance to build their capacity to improve soil and water management, through appropriate water pricing. The Government of Cape Verde has committed to establishing a water fee policy that reflects the economic cost (*i.e.*, scarcity) of the resource, in consultation with the local communities. This commitment is a major policy breakthrough that no other donor has been able to achieve. In the first year of implementation, training and technical assistance centering on best practices will facilitate the establishment of realistic fee protocols and lead to actual collection and more rational water usage. The water user fees will be established as the farmers participating in the program realize the benefits of improved access to water and new technologies, allowing for higher value-added crops and resulting in higher incomes. As part of a national strategy, higher value crops will primarily meet growing tourism demand and related domestic markets.

Services will be demand-driven and designed to meet specific needs of the targeted beneficiaries in the watersheds. As farmers in the watershed areas increase their commercial activities, their ability to pay for services will increase. This will enable the Ministry of Agriculture, Environment and Fisheries to maintain the training and extension services provided to agricultural producers. The Ministry will implement a “fee for services” policy, charging fees for training, quality inspections and certifications. Through the life of the Compact, farmers who adopt drip irrigation will receive both the training and credit necessary for successful adoption and sustained use of the new technology.

Infrastructure Project

Port: The introduction of private sector participation in operations is a critical element to the sustainability of the Port activities. The Government has agreed to pursue privatization and commence the process to bring in private sector operators. Improved operating margins resulting from more efficient operations and the privatization of port operations, together with the institutional reorganization supported by the World Bank, will also improve the long-term sustainability for port services.

Roads and Bridges: The creation and ongoing funding of a Road Maintenance Fund is designed to address long-term maintenance and, hence, sustainability of the roads sector. It will finance maintenance with the proceeds of a fuel levy (and potentially other charges on heavy vehicles) the Government has agreed to introduce. In the first year, the amount committed to be collected will be approximately \$3.75 million. This amount will increase annually in subsequent years.

Private Sector Development Project

The Private Sector Development Project is oriented toward local capacity building. Technical assistance by its nature is provided to enhance institutional sustainability of the recipient institutions. MCC’s support for the Partnership to Mobilize Investment project is designed to complement the Government of Cape Verde’s efforts to strengthen economic policy-making capabilities of Cape Verdean officials. In the case of the Financial Sector Reform project, the technical support directed to the microfinance institutions will assist them to reduce their reliance on donor funds for growth, while allowing them to offer new financial products. Technical support provided to the Ministry of Finance and Planning to help develop the primary market for Government securities will lay the groundwork for developing new financial institutions and products.

5. Environment and Social

Watershed Management and Agriculture Support Project

Screening Category: B

Overall, this project is expected to be environmentally beneficial. The development of watershed management plans to include re-forestation, soil stabilization, livestock management, and water management will improve the overall quality of the environment and reduce runoff and soil erosion. Possible negative impacts could come from unsustainable water usage leading to depletion of reservoirs due to inadequate water pricing. Conditions to disbursements will be designed to ensure sustainable management of the watersheds.

Roads and Bridges

Screening Category: B

This project is assessed a “Category B” with potentially adverse environmental impacts that are site-specific and largely mitigable. The improvements are all planned on existing alignments and do not

directly affect protected areas or identified sensitive natural habitats. An Environmental Impact Study was completed for the World Bank, for which MCC contracted the U.S. Army Corps of Engineers to perform a technical review. In accordance with World Bank guidelines, contractors will be required to carry out an HIV/AIDS Awareness Program developed by the Cape Verde Committee to Fight HIV/AIDS. The Compact will also require adherence to road-specific environmental management plans.

Port

Screening Category: A

The environmental impacts of most of the short-term upgrade activities should be mainly positive; the development and implementation of an Environmental Management and Monitoring Plan should reduce the environmental impacts of the current port operations. However, there are potentially significant negative impacts from the new access road and breakwater at the Port of Praia, and the longer term upgrade activities including the quay extension, dredging, and reclamation. An Environmental Impact Assessment (“*EIA*”) of the Port Master Plan was conducted in 2004. MCC Disbursements under this project will be conditioned upon the development of an environmental management and monitoring plan and a full EIA – to include gathering of environmental baseline data and public consultation – before disbursements for major civil works. The Compact budget includes funds to put in place an environmental management and monitoring plan, as well as completing the EIA.

Partnership to Mobilize Investment

While it is not possible in advance to assess the potential environmental impacts of possible follow-on investments under this project, the Compact requires that projects funded will have to adhere to MCC environmental guidelines, which require screening and appropriate analysis in advance of any funding decision.

6. Donor Coordination

Donor coordination has been particularly strong in Cape Verde, and includes parallel financing and policy reform harmonization. MCC is working on projects that leverage off many donors, particularly the World Bank, IFC, and other U.S. Government agencies. While all of the projects benefit from the expertise of other donors, some particular highlights include:

- The proposed MCC investment in transportation infrastructure benefits from the project-preparation activities funded by the World Bank. MCC was able to leverage off the World Bank’s institutional-sustainability and capacity strengthening efforts for the road sector and its support for the privatization of port operations.
- The Partnership to Mobilize Investment project will use the expertise of the IFC to identify specific obstacles to investment at the sectoral level. This project will leverage existing support from the U.S. Trade and Development Agency in transportation services, and may also involve investment by other multilateral and bilateral donors. It is also designed to help investors to take advantage of opportunities under AGOA.
- The Financial Sector Reform project complements the efforts of the World Bank to strengthen the capacity of the Bank of Cape Verde to improve bank supervision, including for microfinance institutions.

7. Summary.

The Cape Verde MCA Program will:

- Increase access to water and agribusiness development services for 70,000 people in farm households on the islands of Santo Antão, Fogo, and São Nicolau.
- Institute an appropriate water fee policy, a major breakthrough that no other donor has been able to achieve.
- Reduce transportation costs and improve access to markets, schools, and health facilities to over 60,000 people on the islands of Santiago and Santo Antão.
- Increase efficiency of container handling by 130% in the Port of Praia.
- Improve business climate nation-wide and increase investment in priority sectors.
- Establish a completely electronic procurement transaction and documentation system, resulting in one of the most transparent and efficient procurement systems in the developing world.

The Cape Verde MCA Program will assist Cape Verde in achieving its overall development goal of transforming its economy from one of aid-dependency to one of competitive, private sector-led growth.