

Document
of the EurAsEC
Anti-Crisis Fund
00007

Eurasian Development Bank
Manager of the EurAsEC Anti-Crisis Fund Resources

EVALUATION REPORT

On the Preliminary Application

of the Republic of Armenia

for Investment Loan

Financed with Resources of the EurAsEC Anti-Crisis Fund for the project
"Construction of North-South Road Corridor (Phase 4)"

in the amount of US\$ 100 million

March 2013

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Republic of Armenia
Fiscal year: January 1 – December 31

National Currency Exchange Rate
as of 01/03/2013

Currency	AMD
1 RUR	13.4044
1 KZT	2.7202
1 US\$	409.0002
1 EUR	537,5484

Acronyms and Abbreviations

ACF, Fund	the Anti-Crisis Fund of the Eurasian Economic Community
ADB	the Asian Development Bank
CIS	the Commonwealth of Independent States
EDB, Resources Manager	the Eurasian Development Bank
EurAsEC	the Eurasian Economic Community
FS	Feasibility Study
GDP	Gross Domestic Product
GNI	Gross National Income per capita
IDB	International Development Banks
IFO	International Financial Organizations
RA	the Republic of Armenia
WB	The World Bank Group

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1. BASELINE INDICATIVE PARAMETERS OF LOAN RECOMMENDED BY RESOURCES MANAGER

Borrower	Republic of Armenia
Responsible Agency	Ministry of Transport and Communications of the Republic of Armenia
Amount and financial conditions	<ul style="list-style-type: none"> • Amount of ACF loan: US\$ 100 mln (will be specified upon completion of the detailed FS of the project). The project will be co-financed with the Asian Development Bank. • Interest rate: 1.65% • Risk premium: will be determined upon completion of project preparation. • Front-end fee: 0.2% of loan amount. • Loan maturity, including grace period: 20 years. • Grace period for principal repayment: 5 years. • Co-financing contribution by the borrower: US\$ 25 mln (20,0% of the total project cost) in the form of tax exemptions and payments for land acquisition. • Grant-element of the ACF loan: 32.58%.
Type of operation	Investment Loan
Sector	Transport (motor roads)
Main performance indicators	<ul style="list-style-type: none"> • Increase in throughput capacity and road safety in RA. • Conditions for smooth movement of trucks and passenger cars. • Improved access to markets and reduction of logistical costs. • Increased transit traffic across the territory of RA, including toward destinations in EurAsEC countries. • Good traffic conditions offered to residents of adjacent communities.
Main objective	Construction of a motor road to enable enlargement of transit capacity of RA, as well as to provide trucking services for motor transportation of export goods with adequate road safety systems in place.
Project Company	Ministry of Transport and Communications of RA which has set up a project implementation unit "North-South".
Key risks and their techniques	<p>The project is a subject to project, environmental, social, legal, and fiduciary risks.</p> <p>To mitigate the risks, the Manager proposes to clarify the prospects of using regulatory documents of the EDB and the ADB on compliance control and safety with the Asian Development Bank during the FS preparation, engaging independent technical expertise, procurement policy application, and impact on the environment and social setting, and clear the monitoring mechanism for the area where the Project is implemented.</p>

2. RESOURCES MANAGER'S EVALUATION REPORT ON PRELIMINARY APPLICATION

This Appraisal has been prepared following evaluation of the preliminary application of the Republic of Armenia (hereinafter the Applicant) for an ACF investment loan in the amount of US\$ 100 mln, which was received by EDB on 19 December 2012 (the letter # 1215-186-1170), (hereinafter the Application). The principal declared objective pursued in applying for this Loan is to finance the project "Construction of North-South Road Corridor (Phase 4)"(hereinafter the Project).

Section 3 of this document contains rationale for the Appraisal by the ACF Resources Manager (hereinafter the Manager) of the preliminary application.

Having considered the Application, the Manager offers the following recommendations and conclusions for consideration of the ACF Council:

The Application conforms to the mission of the Fund, its funding objectives, lending policy and conditionality, as defined by the Treaty on the Establishment of the Fund, the Fund Statute, and Regulation on the use of ACF resources for providing investment loans, and decisions of the Fund Council.

The Application is executed in full compliance with the requirements of the Fund. The level of the Application preparation in terms of the required data for assessment purposes and supporting documentation to enable a preliminary completeness approval is deemed satisfactory.

The Project is consistent with the ACF mission. The Project is an integral part of the Transport Infrastructure Development Strategy of Armenia. Its implementation will promote sustainability of the economic development and consolidation of the balance of payments of the Republic of Armenia. Availability of well-developed transport infrastructure is an indispensable precondition for enabling steady economic growth. The Project has a substantial integrative capacity, and when implemented, it will facilitate transit of goods from India and Iran via Armenia to the Russian Federation. In addition, the proposed construction of the "North-South" road corridor will improve traffic links between Armenia and ACF member states in Central Asia (See para 3.3 'Rationale' for details).

The Republic of Armenia has complied with all the commitments set out in the Treaty on the Establishment of the Fund, the Fund Statute, and decisions of the Fund Council. The obligation to make an initial cash contribution has been fulfilled. According to the information available to the Manager, the Republic of Armenia has no outstanding debts either to other Fund member states, or to any international financial institutions. By the date of the Fund Council approval of the Loan, the relevant supporting letters will have been received. Up till now the Republic of Armenia has never been granted ACF loans, and the requested amount is within the access limit to Fund resources of the Republic of Armenia .

To ensure proper quality of the Project documentation and efficient use of the Loan the Manager will cooperate with the Asian Development Bank, which has allocated US\$ 1 million as technical assistance to the Government of RA for the preparation of the Feasibility Study on the Project, including on construction of roads to be funded by ACF.

However, in line with commonly accepted EDB investment project preparation practice, the Manager will need an extra budget for evaluation of the FS, development of loan agreements and carrying out procurement activities for the Project in an amount of up to US\$ 200,000. In case the Fund Council approves the Loan, the ACF resources spent on the preparatory work should be incorporated into the principal of the Loan (as front-end fee).

As defined by the Agreement on the Management of Fund Resources the Manager is required to control procurement of goods, services and work funded by ACF in compliance with in-house

procurement policies and regulations, and make provision in ACF Lending Agreements for compliance commitments of borrowers. At present the Manager is finalizing preparation of in-house procurement regulations and policies, is working on rules to control spending of funds and is planning on enacting them by the date of completion of the Project preparation work. The Manager's policies will allow using procurement procedures of other IDBs for implementing ACF-funded projects. In view of the above and to ensure competitiveness and transparency of the proposed policies, the Manager proposes to consider the possibility to use the World Bank Procurement Policy for the implementation of the Project under appropriate supervision by the World Bank procurement experts. The Manager does not recommend using the ADB procurement policy, because its procedures allow access to competitive bidding for suppliers from ADB member countries only, and therefore, using these procedures may prevent participation of suppliers from some of the ACF member states.

Monitoring and appraisal of the Project will be carried out by the Manager in accordance with the methodology for strategic monitoring and project appraisal, currently being developed by EDB. Monitoring procedures will require continuous collection of data on the Project implementation progress, Project risk assessment to be carried out by the Manager on a systemic basis, regular field missions by the Manager's staff to visit the Project sites.

The Project will be implemented in accordance with the Project Cycle Regulation of the Manager with due regard to specific details provided by the Regulation on the Use of ACF Resources for Providing Investment Loans. In-house policies of the Manager provide detailed procedures for project structuring, risk assessment and disbursement of funds. The above procedures require disbursement of funds to be made in tranches upon receipt by the Manager of all relevant supporting documents (e.g. agreements, proforma invoices and other documents).

In the process of Project implementation the Manager recommends to follow the environmental and social policies of ADB. Preliminary review of the Project showed that its implementation might give rise to a number of serious social consequences. ADB has sufficient experience and expertise in mitigating such impacts. The environmental and social policy of the Manager allows additional requirements to be imposed on ACF projects, including compliance with environmental and social policies of other IFIs.

3. RATIONALE FOR APPRAISAL

3.1. Social and Economic Condition of Armenia

3.1.1. General description

According to the preliminary assessment in 2012 the per capita GDP in Armenia was equal to US\$ 3,360¹. The World Bank in its classification puts Armenia into the group of "middle-income countries", but with its GNI per capita Armenia is shifted down closer to the bottom position in the group².

The Republic of Armenia is relatively highly urbanized country: 2/3 of the population are city dwellers. The biggest challenges to social and economic development are poverty and

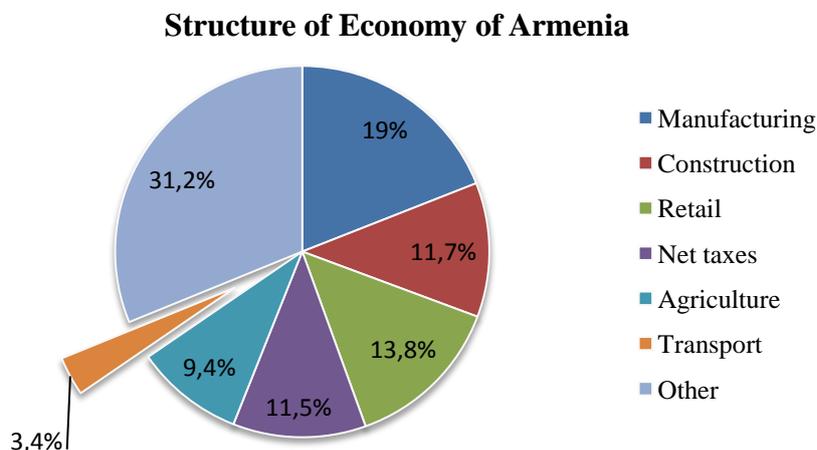
¹ World bank. Databank

² According to the classification of the World Bank, middle-income countries are countries with GNI per capita within US\$ 1,026 - 12,475.

unemployment. According to the World Bank, as of 2011 the poverty level was 35%, and the National Statistical Service of RA shows the rate of unemployment in Q3 2012 at about 16%¹.

The most important sectors in Armenia are agriculture, retail trade, construction business and manufacturing. In 2012 the shares of these sectors in the national economy were 19.0%, 13.8%, 11.7% and 9.4%, respectively². Beginning from 2008 a trend has emerged toward progressive shrinking of the share of construction in GDP (in 2008 it reached its top 25.3%) leaving ground to other sectors, such as retail trade and finance (Fig. 1).

Figure 1.



3.1.2. Macroeconomic performance

The development pattern of Armenia in the 1990s was regarded as extremely uneven, which was due to the problems of transition, as well as distortions generated by the military conflict in Nagorny Karabakh. Growth of the real GDP varied within minus 42% in 1992 to 7.3% in 1998, against the backdrop of inflation. From early 2000s growth has gained in sustainability: on the average in 2001-2007 it was equal to 12.7%³, which was both due to adaptation to the new economic realities, favorable external market conditions⁴, growth of external receipts, and to the ongoing reforms.

Growth in the construction sector in 2003-2008 was funded primarily by the population, supported by large-scale inflows of cash remittances from labor migrants (they grew at an average annual rate of around 30%), which led to the increase in the share of construction in the structure of GDP from 16% in 2003 up to 25.3% in 2008.⁵ The inflow of cash transfers from abroad also boosted development of the retail trade sector where the real average growth rate in 2003 -2008 was 10.8%. The accelerated development of the sectors focused on the domestic market contributed to the deficit of the balance of payments, which in 2008 exceeded 25% of GDP. However, the inflow of foreign capital allowed accumulating international reserves.

Yet, such a **model of growth was not sustainable**, and it was confirmed by the 2008-2009 crisis. The reduction of the inflows of external funding, including money transfers, by 35% led to a drop in the GDP in 2009 by 14.1%. In such conditions financial support of the consumer market was taken up by the Government, which substantially increased expenditures on wages and salaries and social benefits. As a result ultimate consumption of households dropped by 4% only. At the same time steady reduction in investment activity was registered, and the share of investments into fixed assets diminished in 2011 to 25.3% of GDP from almost 26.3% in 2008. Economic growth in

¹ The unemployment is significantly affected by seasonal drivers; year-end unemployment data showed 18%.

² National Statistical Service of RA

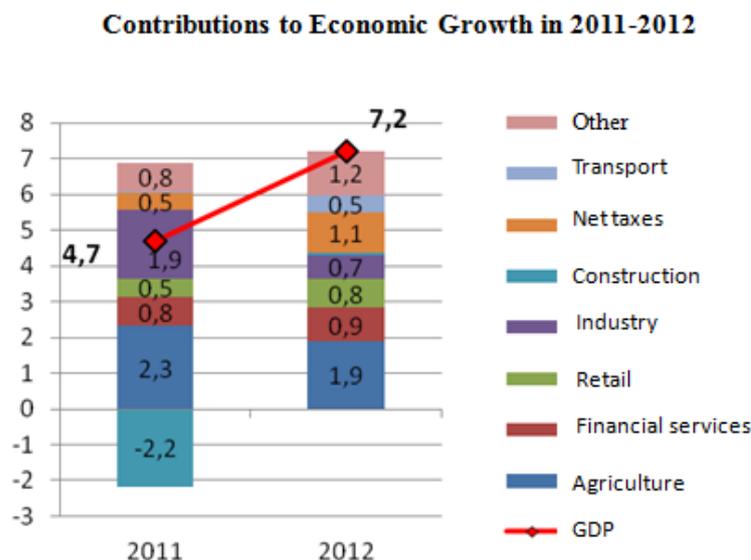
³ Growth of per-capita GDP in this period

⁴ The main export item in Armenia are non-ferrous metals, which in this period are growing in price, for some of them by a factor of 2-5.

⁵ Investments for this period grew from 25% to 40% in the structure of GDP.

2010-2012 was to a large extent driven by the post-crisis recovery of domestic demand, and somewhat by a rise in industrial production. One distinctive feature of the growth is its non-uniform pattern from sector to sector. The 2012 year-end results showed the GDP growth rate at 7.2%, which was largely due to the growth of the agricultural sector (9.3%), financial services (23.6%) and retail trade (6%). One of the most important constraints of growth is poor condition of the infrastructure facilities (including transport). It should be borne in mind, however, that transport is one of the crucial growth drivers (See Fig. 2).

Figure 2.



External exposure in the post-crisis period remains precarious. Despite some slowdown in investment activity, the high rate of ultimate consumption coupled with reduced export earnings¹ and the current money transfers, brought about further expansion of the current account deficit from 6.4% of GDP in 2007 up to 15.8% in 2009. The government modified the model of economic development by shifting its focus toward export-oriented sectors and lifting limitations on growth of domestic demand and weakening the real exchange rate, and it resulted in a certain reduction of the current account deficit, which, however, remains critically high (over 10% of GDP in 2011-2012²). The current account deficit is largely caused by the blockade of Armenia by Turkey and Azerbaijan. Development of transport links with Russia, Iran and India will, to an extent, facilitate addressing issues of the poor performance of export of goods and services, as well as problems of expensive imports.

Fiscal incentives to overcome the crisis increased external sovereign debt liabilities. The domestic demand stimulus policy based on increased public spending led to a larger budget deficit, which grew from 0.7% of GDP in 2008 to 7.6% in 2009. In 2010 it dropped to 5%. The high budget deficit during this period was funded mainly from external borrowing sources. As a result, the external sovereign debt grew to 33.4% of GDP at the year end of 2010 (from 13.6% in 2008). Amid the improving economic growth in 2011-2012 the authorities enacted an austerity policy to limit public spending, which helped to reduce the budget deficit to 2.8% and 1.6%³, respectively. However, the external sovereign debt remains high: in early October 2012 it exceeded 31% of GDP⁴.

¹ In 2009 exports dropped by 32.8%. Almost ¾ of this reduction is accounted for by a drop in production of the following items: ferrous metals, gems and alcohol, which is, primarily, due to the slump in global demand for them.

² For 2012 data are given for January-September.

³ Preliminary data.

⁴ ACF estimates. The total sovereign debt is estimated at 75% of GDP against 33.3% in 2008.

However, the efforts undertaken to consolidate the budget and its reduction should deserve positive evaluation in terms of debt sustainability of Armenia. According to the IMF estimates, provided the budget deficit remains at a level below 2% of GDP, the debt-GDP curve will turn steadily downwards¹.

The impact of the ACF Loan on debt sustainability is estimated as negligible. Acceptance of the ACF Loan in the amount of US\$ 100 mln (1% of GDP) on the proposed terms and conditions will not increase significantly the aggregate national debt service burden.

At the same time, debt sustainability requires consolidation of budget expenditures, which imposes certain limitations on the government's investment capacity. Budget limitations imposed on investments are further exacerbated by poor flexibility of the budget, since in the context of the high poverty level there is no possibility to cut down on social spending. Furthermore, sustainable development and attracting foreign investments that do not contribute to building up external debt liabilities require substantial investments into infrastructure. Overall, despite the high growth rate and fiscal consolidation efforts in 2012, the economy of Armenia is still extremely sensitive to external impacts. It is demonstrated by the high external debt service burden and strong reliance on the incoming money transfers, as well as by the current account deficit.

In view of the above, the proposed ACF Loan for the modernization of roads will help ensure adequate level of investments into infrastructure. Given the relatively significant share of transport in the structure of GDP, building of the road infrastructure should promote economic diversification and reduce exposure of the economy to external adverse impacts. In addition, construction projects will contribute to creating new jobs and, to a certain extent, will promote growth of the GDP. A more specific estimate can be provided at a later stage of the project preparation process.

3.2. Status of the Transport Sector

Transportation of commodities, materials and products is carried out by two principal routes: via Georgia (Ayrum – Sadakhlo and Bagratashen – Sadakhlo) and via Iran (Agarak – Norduz). The Georgian route is currently the preferred alternative, because the Black Sea ports Poti and Batumi are the closest ones with access to sea and link Armenia with its major trading partners, i.e. Russia, CIS, Europe and the Americas; the available railroad provides unhindered and low-cost options for delivery of containerized cargoes to the above seaports; rail-enabled ferries provide crossing service from Poti (Georgia) to Ilyichevsk (Ukraine) and from Poti to port Kavkaz (Novorossiysk, Russia); trucking routes to destinations in Russia and CIS pass through the checkpoint Verkhniy Lars, as well as by ferry via Poti (e.g. Ukraine, Poland); in winter time, when the road through Verkhniy Lars is rough, an alternative route may be chosen: by ferry service Poti - Novorossiysk; trucking traffic routes to Europe mostly pass by the ferry service in Poti to any port of your choice, as well as via Turkey (checkpoint "Sarpi").

Freight from Middle East and Far East, as well as other Asian countries are delivered to Armenia mainly via the Iranian port Bandar-Abbas located in the Persian Gulf. It is an expensive route, because the motor road runs across almost the whole territory of Iran (2,360 km). The road from Meghri to Julfa, then via the Caspian ports Bandar-e Anzali and Nowshahr, next by ferry to the Russian cities Olya, Astrakhan and Makhachkala linking Armenia with Russia, may be considered as alternative to the Georgian road to be used only in case of emergency.

¹ <http://www.imf.org/external/pubs/ft/scr/2013/cr1334.pdf>

Figure 3. Transport Route Map of Armenia



Source: Technical Assistance Consultant's Report. ADB

Armenia fundamentally depends on imports (in 2011 the share of imports in the GDP was 48.1%¹), and a considerable part of its price is transport costs.

The transport system of Armenia is very inefficient in terms of logistical infrastructure. Most of the infrastructure was built during Soviet times and was designed to channel some freight traffic flows across the eastern and western borders of Armenia. In the current political context (economic and political blockade of the country by Azerbaijan and Turkey) all trading corridors are congested in the North and South, which creates a situation where one part of the existing infrastructure is overloaded, whereas the other facilities are, in fact, idling and gradually fall out of service.

The climate in Armenia (continental with heavy snowfall and low temperatures in winter) adversely affects the performance of the Armenian transport system and contributes to increasing domestic transportation costs.

Also, the considerable transport costs in Armenia are due to the high wear rate of the existing infrastructure. According to the Global Competitiveness Index 2012-2013, the condition of the road infrastructure in Armenia ranks 80th (of 144 countries), railroad infrastructure - 63rd, airport and airfield infrastructure - 69th (scoring 3.7, 2.6 and 4.7, respectively, per scale 1 to 7).

The principal government agency responsible for management of the Armenian transport system is the Ministry of Transport and Communications of RA. The Ministry is required to work out strategic development plans for the transport sector, prepare transport support programs, draft national regulatory documents and legislation. The responsibility for hands-on development of the programs and implementation control of the projects in the transport infrastructure area rests with the relevant departments of the Ministry.

¹ World development indicators. World bank.

In 2011 the Armenian transport system handled 9.7 mln tons of various freight and cargo (33.6% by rail, 50.9% by motor roads, 0.1% by air, 15.4% by pipelines) and 249.8 mln passengers (0.2% by train, 82.9% by public transport, 7.2% by taxi cabs, 0.7% by air, 9% by electric transport)¹.

Road Infrastructure. Following the collapse of the USSR the Republic of Armenia inherited a relatively extended and ramified road network. The total length of public roads at the end of 2011 was equal to 7,749 km. Of them roads of a total length of 1,730 km are transnational, 4,057 km – national, 1,962 km – local².

In 1994 - 1996 the total length did not change, and no new roads were built. The motor road density in Armenia has not changed over the last three years either, and at the end of 2011 it was 279 km per 1,000 km².

Automobile transport is the key transportation facility in Armenia both for freight and passengers. Between 2007 and 2010 in Armenia there was an increasing trend in the share of motor traffic (from 57% in 2007 to 59% in 2009), but in 2011, due to dramatic reduction of the domestic trucking traffic, this indicator dropped to 50.9%.

The road infrastructure is basically focused on the national logistic needs: in 2011 its share was 78.5%. The share of export traffic via road infrastructure is 4.9%, and import traffic accounts for 16.6%. However, recently the coverage of foreign trade by motor transport in Armenia has grown: e.g. in 2011 motor transport traffic accounted for 4.9% of the total export and 15.6% of import traffic, whereas in 2007 these numbers were equal to 4.8% and 11.9%³, respectively.

The key problem with the road network of Armenia is progressive deterioration of the infrastructure. At the same time in recent years budget allocations for the infrastructure maintenance did not increase, and expenditures for renewal of the existing roads and construction of new ones were reduced. In the beginning of 2010 the most acute problems with condition of the motor road infrastructure were registered in regional and local networks: more than 62% of such roads required rehabilitation and overhaul. The national and transnational high-speed motorways were in a better condition: only 10% of them were in need of urgent repair and rehabilitation⁴. Transnational highways of Armenia measured in 2009 on the average scored 5 by IRI⁵ scale, which shows that the quality of pavement is "medium-low".

The motor road network in RA is characterized by a high and constantly increasing number of road accidents. In 1994 - 1996 the number of the accidents in Armenia grew by 16% from 2,002 to 2,319 annually⁶.

Top priority projects for the development of the Armenian transport system are construction of the "North-South" road corridor linking the southern border of Armenia with Georgia; development of a sustainable public transport system in Yerevan; rehabilitation and expansion of rural motor road networks in Armenia; rehabilitation of road sections on the route Antaramaj - Dzoravank - Dprabak - Aygut - Martuni - Getik - Ttudzhur - Chambarak - Aghberk - M14. The implementation of these projects will be financed by international financial organizations.

The implementation of the road projects in Armenia brings substantial economic benefits: the weighted average traffic speed increase on certain roads after rehabilitation projects is equal to 38.4%; reduction of transport costs on these roads varies from 20 to 50%⁷.

The Armenian resettlement laws and regulations are in general consistent with the requirements imposed by resettlement policies of international financial organizations⁸. However,

¹ Statistical yearbook of the Republic of Armenia (2012)

² Ibid

³ Estimates based on the Statistical yearbook of the Republic of Armenia (2012)

⁴ Armenia's Transport Outlook 2011. Asian Development Bank

⁵ International roughness index

⁶ Armenia's Transport Outlook 2011. Asian Development Bank

⁷ Estimates based on public information on road improvement projects of the International Bank for Reconstruction and Development and of the Asian Development Bank in Armenia (Lifeline Roads Improvement Project, Rural Roads Rehabilitation Project, North-South Road Corridor)

⁸ Resettlement and compensation policies of the World Bank and Asian Development Bank (WB OP 4.12, ADB)

there are differences in terms of the protection of unregistered land use rights (in RA the absence of such rights invalidates compensation claims) and in terms of compliance with transparency requirements for resettlement procedures and land buy-out (the Armenian legislation does not require mandatory publication of interim results of resettlement and property buy-out). As a rule large-scale infrastructural projects supported by international financial organizations in Armenia are implemented on the basis of IFO resettlement policies. The costs of resettlement and land buy-out in the context of road improvement projects in Armenia are location-specific and vary from 3% to 35% of the total project cost¹.

Selection of construction contractors for implementing road improvement projects in Armenia (including of the projects supported by the International Bank for Reconstruction and Development, the Asian Development Bank and the European Bank for Reconstruction and Development) is mainly performed on the basis of the national policy for competitive evaluation, selection of consultants and construction managers is conducted in accordance with International Competitive Bidding rules. In implementation of road improvement projects in Armenia the following consulting companies have been involved: SAFEGE and Egis International, Corsan Corviam Construcccion, which is responsible for construction operations for the "North-South" project.

One significant constraint hampering the development of the road infrastructure of Armenia, alongside with the insufficient funding, is low performance quality of local construction organizations (obsolete construction equipment and lack of skills) and material suppliers for motor road construction.

3.3. Project Description

The Project makes provision for allocation of funds by the EurAsEC Anti-Crisis Fund in the form of an investment loan for rehabilitation of a section of the transport corridor as part of the investment project "Construction of North-South Road Corridor".

The "North-South" Road Corridor links Central Asia and India with Iran, Georgia, Russian Federation and Europe. The corridor passes across Armenia from South to North (Meghri-Kapan-Goris-Yerevan-Ashtarak-Gumri-Bavra), links up with the Georgian road leading to seaports Poti and Batumi (Black Sea) and on toward Russia, CIS and EU. The "North-South" road is part of the transnational motorway AH 82 interlinking such Central Asian countries as Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

As a result of the proposed comprehensive development project, the road route Europe-Caucasus-Asia will be improved in the zone of junction between West Europe and Eastern Europe. The quickest shortcut route of the corridor, 449 km in length, in its final stretch on the territory of Georgia runs along the road Akhaltsykhe-Batumi, which is currently in need of rehabilitation. The corridor meeting the relevant international engineering standards is the most comfortable and shortest route for transit from Iran via Georgia to Russia and CIS.

The motorway M2 (southern route of the "North-South" corridor) is the only overland route linking Armenia with Iran, and in future it may be used as a transit link from India and Iran leading westwards (Table 1). It is noteworthy that at this point transit traffic from Iran and Georgia along the "North-South" is not very busy. In addition, the capacity for increasing the traffic is limited by the available alternative routes via Azerbaijan and Turkey. This motorway for transnational freight and passenger traffic is important in the current context because of the closed borders of Armenia with Azerbaijan and Turkey. The bulk of the transnational traffic today is represented by passenger service, and most of freight is carried by rail and pumped by pipelines. However, as has already been indicated, recently a steady growth of transnational freight road traffic has been observed in RA.

Safeguards Policy Statement)

¹ Estimates based on public information on road improvement projects of the Asian Development Bank in Armenia (Rural Roads Rehabilitation Project, North-South Road Corridor)

Table 1. Main Transnational Routes from Armenia to the West

Yerevan-Bavra-Akhaltskha-Batumi-Poti			
	160.9	117.0	172.0 70.0
Route	Total	Territory of Armenia	Territory of Georgia
Yerevan-Batumi	449.9	160.9	289.0
Yerevan-Poti	519.9	160.9	359.0
Yerevan-Bavra-Akhaltskha-Khashuri-Poti-Batumi			
	160.9	117.0	76.0 215.0 70.0
Route	Total	Territory of Armenia	Territory of Georgia
Yerevan-Batumi	638.9	160.9	478.9
Yerevan-Poti	568.9	160.9	408.9
Yerevan-Bagratashen-Tbilisi-Khashuri-Poti-Batumi			
Route	Total	Territory of Armenia	Territory of Georgia
Yerevan-Batumi	696.7	205.7	491.0
Yerevan-Poti	626.7	205.7	421.0
Yerevan-Gogovan-Tbilisi-Khashuri-Poti-Batumi			
	169.2	130.0	142.0 215.0 70.0
Route	Total	Territory of Armenia	Territory of Georgia
Yerevan-Batumi	726.2	169.2	557.0
Yerevan-Poti	656.2	169.2	487.0

The implementation of the "North-South" Road Project will facilitate pursuing 4 important development objectives for the domestic transport network of Armenia. *First*, access roads to Yerevan will be enlarged, and thereby traffic congestion will be eliminated on two of the four access roads to the city. *Second*, one of the most important roads will be rehabilitated; it links Yerevan and Gumri, its throughput capacity is currently inadequate and, furthermore, it is extremely worn down. *Third*, development of the proposed corridor will enhance tourist attractiveness of remote locations of Armenia. And *fourth*, this project will contribute to reducing transport overheads for the whole of the Armenian transport system and will improve accessibility of remote areas.

At this point the "North-South" road corridor almost throughout its length represents a two-lane highway (one lane each way), and on the sections Yerevan-Ashtarak (18.4 km) and Yerevan-Ararat (38 km) a four-lane road has been built (two lanes each way). Overall, the "North-South" corridor is extremely worn down, and its throughput capacity is very low, especially on the northern and southern stretches; in addition, in winter the traffic very often is halted because of heavy snowfalls.

The total cost of the comprehensive "North-South" Road Corridor Project is estimated at US\$ 962 mln, of which US\$ 500 mln will be provided by the Asian Development Bank. The funding of

the investment program will be provided on the basis of the financing framework agreement signed between the Government of Armenia and the Asian Development Bank on 15 September 2009. Under the above agreement the Asian Development Bank agrees to finance the "North-South" Road Corridor Project in the amount of US\$ 500 mln (in the form of a multi-tranche financial instrument). The Agreement makes provision for funding the comprehensive project from the following sources:

Table 2. Project Funding Scheme

Source of finance	Total (US\$ mln)	%
Asian Development Bank	500.0	50.5
Including:		
Ordinary capital resources	440.0	
Special capital resources	60.0	
Japan International Cooperation Agency (JICA) - funds transferred for management by ADB	70.0	
Government and other sources of cofinancing	492.0	49.5
Including ACF resources	100	
Total:	1062	100

Resources of the EurAsEC Anti-Crisis Fund are expected to be borrowed for financing the implementation of phase 4 of the Project.

3.4. Financing needs of the Project

Total requirement in funding phase 4 of the Project **for which ACF funds are expected to be provided**, is equal to about US\$ 100 mln (it is contemplated to build over 30 km of roads). The amount required and the length of the motor road will be determined more exactly upon completion of the detailed FS with due consideration of complexity of the construction site terrain.

Funding is expected to be provided from two sources of finance: (a) national budget of the Republic of Armenia - 20% of its total cost in the form of tax exemption, as well as allocation of funds for land buy-out and resettlement programs, and (b) ACF resources - 80%.

3.5. Project Current Status Description

The Government of the Republic of Armenia has adopted the Program of Economic Development of the Republic of Armenia for 2013-2015. The "North-South" Road Corridor construction project is submitted as key priority for the development of road and transportation networks. Up till now the Asian Development Bank has provided funding for 3 phases of the "North-South" Road Corridor construction project.

The construction work funded by the **first tranche** was divided into two construction components:

The first component plans development of the road Yerevan-Ashtarak (18.4 km), the second component - rehabilitation and widening of the road Yerevan-Ararat (38 km). October 12, 2009 the Asian Development Bank and the Republic of Armenia signed a loan agreement on financing development work on these roads. April 27, 2012 competitive bidding evaluation was completed for the first and second tranches to award contracts for civil works on the above roads. Construction activities have not begun yet, because the process of land transfer is still ongoing.

The total need for financial resources for funding phase 1 was equal to US\$ 70 mln, of which amount US\$ 60 mln was provided as a loan extended by the Asian Development Bank, and US\$ 10 mln was allocated by the Republic of Armenia from its own resources (Table 2). Thus, the average unit cost of 1 km of road is equal to US\$ 1.24 mln.

The **second tranche** is intended for funding the rehabilitation of the northern road Ashtarak-Talin (41.9 km). The loan agreement for the second tranche has been signed with the Asian Development Bank for US\$ 140 mln. The total cost for the second tranche is US\$ 210 mln. (Table 2). At present land transfer procedures are being executed for the second tranche; following completion the contractor will proceed with project implementation.

The **third tranche** will provide funding for construction activities on the road Talin-Gumri (total length 46 km), preparation of a FS for the fourth tranche as part of the comprehensive project package and a long-term plan for the development of the motor road network of RA, including a road asset management system and administration of transport system maintenance services. The total cost of the Project is US\$ 221.5 mln, of which amount US\$ 180 mln is expected to be provided by ADB. A loan agreement for this tranche has not been signed yet.

Table 3. Project Funding Structure

Financial plan for the first tranche			
Source of finance		Total, (US\$ mln)	%
A	Asian Development Bank Special capital resources	60.0	86
B	Cofinancing by RA	10.0	14
	Total	70.0	100.0
Financial plan for the second tranche			
Source of finance		Total (US\$ mln)	%
A	Asian Development Bank Ordinary capital resources	170.0	81
B	Cofinancing by RA	40.0	19
	Total	210.0	100.0

The cost of construction of the whole corridor, according to preliminary calculations, is estimated at about US\$ 1.2 bln. Today under two loan agreements, US\$ 230 mln has been disbursed.

3.6. Projected Economic Benefits

Detailed economic and financial forecasts will be presented when the site for road rehabilitation is approved and FS is prepared along with a financial model. For a similar¹ project (e.g. Osh-Asfana road rehabilitation) implemented by the World Bank in Kyrgyzstan, the following forecasts of transport costs reduction were provided (Table 4).

Table 4. Projected Economic Benefits

Indicator	Car	Pickup truck	Van	Bus	Light truck	Medium truck	Heavy-duty truck	Truck tractor	Total
Average daily traffic (pcs)	3.759	553	104	2	423	180	142	20	5.183
User costs after completion of the Project (US\$ per km)	0.22	0.22	0.55	1.18	0.19	0.26	0.44	0.65	0.65
User overheads before completion of the Project (US\$ per km)	0.24	0.27	0.64	1.36	0.22	0.29	0.49	0.74	0.74

In addition to the direct economic benefits, such as reduction of transport costs and time *en route* for passenger and freight traffic due to improved pavement, the Project will bring about significant indirect economic advantages. The Project addresses one of the most important structural problems, which is transport isolation. Lower cost of freight transportation and, as a consequence, diminished overheads of foreign trade operations will have a positive impact on the economic structure by reducing the balance of payments deficit. The above objectives will be achieved by means of the following: reducing the cost of the transport component in the price of imports (including its non-elastic portion) and decreasing overheads incurred in export operations, which improves competitiveness of the exported goods on external markets.

For Armenia improved transport infrastructure constitutes a significant factor for creating a better business environment attracting foreign investments.

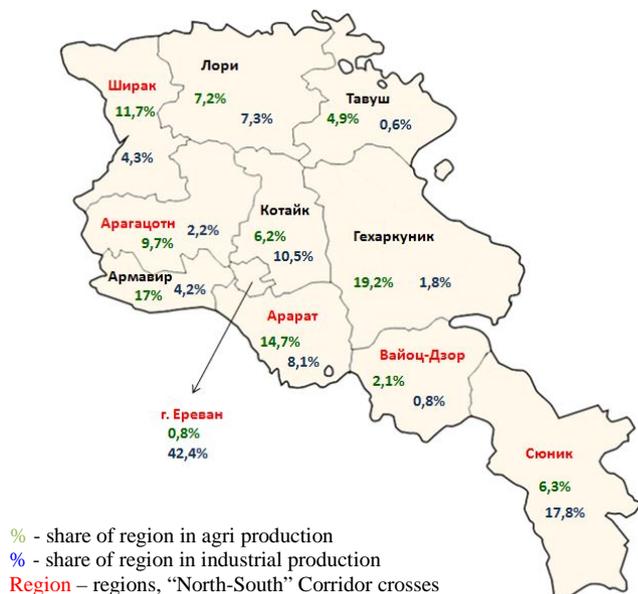
In the course of project implementation new jobs will be created (estimated, based on the reference project, at up to 7,000), which will contribute to reduction of unemployment in Armenia. Furthermore, business activity will be expected to rally due to the development of roadside small businesses (including in remote areas of the country) that will also provide additional employment. Improved employment will, to a certain extent, advance progress on poverty reduction objectives.

Reduction of transport overheads by improving road safety, higher traffic speed and fuel saving, will lower the cost of products, including food. Given the fact that the North-South Road Corridor will link areas characterized by a varying degree of involvement in farming activities, it should be assumed that non-agricultural locations might expect improved food supplies, which will enhance food security. Bearing in mind that poor population is most vulnerable to food market volatility, regular food supplies will definitely be conducive to improved social protection of poor communities.

Since the proposed road links locations that in the aggregate account for almost 50% of farming produce, this sector might be expected to improve its productivity.

¹ Total amount of financing for the above project is equal to US\$ 120 mln.

Figure 4.



In addition, proposed development of the transport corridor will facilitate transport accessibility of social infrastructure (health care and education) for rural communities of Armenia. Thus, the project will contribute to improvement of the economic structure in terms of enhancing its resistance to external impacts, and will also address the most acute social and economic problems, i.e. high rates of poverty and unemployment.

3.7. Project Consistency with ACF Mission

The Project will contribute to improvement of economic sustainability of the Republic of Armenia (new export and transit opportunities will emerge, as well as added tax revenues).

The “North-South” Road Corridor will improve road links between Europe, Caucasus and Asia at the Eastern Europe - Western Asia junction; increased traffic flows, including transit services, will boost budget revenues and reduce cost of export of Armenian goods both to Russia and Europe (via Georgia), and to Iran.

The “North-South” Road Corridor will facilitate integration between countries of South Europe, Central Asia and Europe. The North-South Road Corridor Project will intensify traffic flows along the route Russia-Iran-India on newly built and improved existing motor roads. The principal international agreement promoting integration in this sector is the "Agreement on International “North-South” Transport Corridor", signed 12 September, 2000 in St. Petersburg by the governments of Russia, India, Iran and Oman, with a view to improving efficiency of transport links for passenger and freight traffic along the international corridor "North-South". The Project will expand opportunities for export of products from Armenia, as well as for transit of freight from India, Iran and Oman to destinations in Russia. Detailed projections on increasing freight traffic flows will be provided upon completion of FS.

3.8. Project Financing Scheme

The Borrower of the proposed investment loan will be the Republic of Armenia, represented by the Ministry of Finance of RA, and the agency responsible for implementation of the Project will be the Ministry of Transport and Communications of the Republic of Armenia represented by the Project Implementation Unit established at the Ministry.

The borrowed ACF funds constitute a sovereign loan and are an integral part of the sovereign liabilities of the Republic of Armenia. The Republic of Armenia will reflect the funds borrowed from ACF, in its national budget as a source of funding the budget deficit as budget expenditures for the purposes of financing the National Investment Project, and will also include budget allocations in the volume needed to service and repay the borrowed Fund resources. The above funding scheme conforms to the Regulation on the Use of ACF Resources for Providing Investment Loans.

The Project will generate extra revenues for the Republic of Armenia by reducing operation expenses, as well as by collection of taxes generated by the infrastructure facilities and from increasing traffic along the corridor. Priority road sections of the corridor will be determined during the preparation of FR.

In the context of rapid growth of external borrowing and debt exposure to external impacts, a zero limit for non-preferential lending was agreed upon under the IMF program, effective to June 2013, for the total portfolio of external sovereign and government-guaranteed loans. RA assumed commits to refrain from borrowing and issuance of guarantees for loans that may reduce the average grant-element for the above portfolio to a level below 30% (the current average grant-element is equal to 32%).

The above requirements contained in the IMF program will necessitate approval by the ACF Council for departure from the Indicative Terms and Conditions for ACF financial credits, since the ACF indicative terms and conditions for investment loans in Armenia are equivalent to a grant-element of 13.9%, which is below the IMF-established threshold of 30%.

In view of the above and given the need for meeting the required size of the grant-element of at least 30%, as well as for compliance with the funding terms and conditions tendered by the other Project participants (ADB, EIB), the Manager recommends to agree the following funding conditions for the requested Loan:

- Interest rate - 1.65% per annum
- Front-end fee - 0.2% of loan amount.
- Commitment fee - none
- Maturity - 20 years, including 5 years of grace period
- Cofinancing amount due from Beneficiary - US\$ 25 mln (20% of project cost)

In this case the grant-element should be equal to 32.58% (net of risk premium to be determined upon completion of Project FS).

3.9. Government Support

The application for funding the Project has been filed by the Ministry of Finance of RA. The Project will be implemented by a responsible agency designated by the Ministry of Transport and Communications of RA (Project Implementation Unit “North-South”).

The national budget finances one portion of the Project in the amount of taxes to be levied in the process of implementation, approximately 20-25% of the total cost.

Government financing is performed on the basis of the agreements and acceptance reports signed as requested.

The list of regulatory, legal documents and articles pertaining to the Project, is given in the Table (see below).

Table 5.

Ref. # of Document and Date of Ratification	Description
11 March, 2010 N 446-H	Articles of the Investment Program Organization "North-South".
26 October, 2009 N 892-A	Statute of the Organization's Council
Executive Order of the President of RA HX-48-H of 9 March, 2006	On accession to the intergovernmental agreement on "North-South" Transport Corridor in St. Petersburg
August 06, 2009 N 968-A	On construction of North-South Road Corridor
23 October, 2001 ZO-248	Law on public non-profit organizations
6 August, 2009 N 968-A	On construction of North-South Road Corridor
ZO-248 23 October, 2001	Law on public non-profit organizations
22 December, 2011 N 1919 –H	On execution of national budget of 2012
23 December, 2010 N 1748 – H	On execution of national budget of 2011
24 December, 2009 N 1522 - H	On execution of national budget of 2010
09/07/1998 429	Statement on national budget spending in performing under credit program.
Executive Order of MFE of 04/02/2008 80-C	Financial statements
21 November, 2002 N 1809-H	Statute of the Ministry of Transport and Communications of RA

3.10. Preliminary Project Risk Assessment

Table 6.

Category	Evaluation	Description	Reduction measures	Assessment following reduction measures
Project risks	Medium	In the course of the Project implementation events may occur that could entail inflation of the cost of the Project as compared with the relevant parameters of FS.	These risks can be reduced, if the Manager takes part in negotiations on the terms and conditions of the General Contract, as well as by means of independent evaluation of FS by the Manager's consultant.	Low
Environmental risks.	High	The Project may have an adverse impact on the environment.	To reduce these risks it is recommended to perform an EIA in line with the ADB's policies, and, if necessary, environmental audit of the Project should be conducted by the Manager's consultant.	Medium

Social risks	High	The Project may have an adverse impact on the social structure of communities along the road corridor.	To reduce these risks it is recommended to perform social assessment in line with the ADB's policies, and, if necessary, an independent audit of the Project should be conducted by the Manager's consultant.	Medium
Operating risks	Medium	In certain situations implementation of the Project may not result in reducing overheads and increasing revenues accruing from the transport tax collection in expected amounts.	In order to reduce such risks it is recommended to conduct progress monitoring under the supervision of a technical consultant.	Low
Legal risks	High	In the process of implementation and funding of the Project, risks may arise related to the need for permits, licenses and other documents to be obtained by the Project participants because they may be required by the national laws of the Republic of Armenia or international agreements, as well as in connection with the proposed execution of the lending agreement and associated documents.	To reduce the above risks it is proposed to invite a legal consultant for the Manager.	Medium
Corruption and fiduciary risks	High	Corruption perception index of Armenia according to Transparency International indicates improvement: in 2012 Armenia was placed in the 105th position of 183 countries rated, as compared with 129th position in 2011. However, in the process of funding the Project potentially various corruption and fiduciary risks may arise in connection	Reduction of the above risks is expected to be achieved by implementing proper procurement policies on the basis of competitive and transparent procedures. It is recommended to invite an independent technical consultant for monitoring preparation and implementation of the Project. Furthermore, the Project Cycle Regulation of the Manager makes	Medium

		with alleged inappropriate use of funds.	provision for compliance verification procedures including identification of corruption risks, structure of ownership and ultimate owners of the participating companies. To ensure reduction of corruption risks the Manager will conduct a follow-up due diligence of the participating companies.	
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Appendix 1. Application of the Republic of Armenia for ACF investment loan with Project Concept Note.

Appendix 2. Map of the Republic of Armenia showing a road section of the “North-South” Road Corridor

Ministry of Finance of the Republic of Armenia

MINISTER

Ref. # 1215-186-1170 of 19/12/2012

Resources Manager of Anti-Crisis Fund of Eurasian Economic
Community – Eurasian Development Bank

Republic of Kazakhstan, 050051 Almaty,
Dostyk Ave, 220
Phone: +7 (727) 244-4044
Fax: +7 (727) 244-6570

The Ministry of Finance of the Republic of Armenia hereby expresses an interest in raising investment funds from the Anti-Crisis Fund of the Eurasian Economic Community (hereinafter the Fund) in the amount of up to US\$ 100 million for financing the project “Construction of “North-South” Road Corridor – Phase IV” in the Republic of Armenia to be implemented in cooperation with the Asian Development Bank by the Ministry of Transport and Communications of RA.

In view of the need for our approval to start preparation of the proposed investment project as required by the Fund’s policy, we will appreciate if you consider examination of the Project Concept enclosed herewith, which has been developed in accordance with the Regulation on ACF Investment Loans approved by the Fund Council.

The enclosed Concept provides complete and reliable information on the Ministry of Transport and Communications and the investment project, and has all the necessary supporting documents. We hereby give our consent for potential validation of the data provided in the Concept, and are ready to submit any support documentation. We undertake to inform the Fund Resources Manager of any changes in the said information, if any, as well as of all substantive developments in the financial condition of the Beneficiary and to submit per your request all the necessary documents, that may be required in support of the above, and/or any other reasonable information requested.

Enclosure: Concept of Investment Project (7 pgs)

Signed

V. Gabrielian

Appendix 2.

Map of the Republic of Armenia showing the project road of the “North-South” Road Corridor to be rehabilitated and developed with ACF funding (marked in red).

