1. Country and Sector Background

Azerbaijan is the largest country in the South Caucasus region, and with a population of 9.5 million, it is the most populous. Over the past decade, Azerbaijan has experienced many of the same challenges as other CIS transition economies including deterioration in infrastructure and service provision and increasing inequality. Infrastructure attrition in Azerbaijan has been particularly acute in rural areas, and the poor quality of public infrastructure, exacerbated by a weak public expenditure framework, has been one of the factors impeding development since the mid-1990s. Roughly 45 percent of the main and regional roads are in poor condition, impeding social and economic development and limiting growth prospects in rural areas of the country. Since independence, oil and gas discoveries have given Azerbaijan new means for combating poverty and developing a diversified, sustainable middle-income economy.

In recent years, Azerbaijan has continued its path of economic growth and poverty reduction. Growth has averaged 13.1 percent from 2004-2012. Poverty levels have dramatically reduced from 49 percent in 2001 to 6 percent in 2012. However, these achievements mask large regional disparities, and disparities between urban and rural areas. According to the State Statistics Committee, the population is 9.296 million (2012), of which 47 per cent are living in rural areas. Seventy per cent of the poor in Azerbaijan are from rural areas.

Lack of access to quality local infrastructure, including water supply and sanitation infrastructure and local roads, can restrict the dividends from growth. Inadequate road infrastructure serves as a barrier for rural populations to access services and markets. Access to water in rural areas is also
a challenge. Azerbaijan inherited a relatively extensive water supply system from the former Soviet Union. As a result, 95 percent of the population in Baku and 83 per cent of those living in secondary cities and small towns are connected to piped water. However, centralized piped water supply systems are rare in rural areas, where less than 33 per cent of the population has a piped water supply. Access to sanitation is also problematic in rural areas. Water treatment facilities are sometimes dysfunctional or lacking completely.

Improving rural livelihoods is also essential to promoting shared prosperity in Azerbaijan. Although oil drives high rates of growth, the oil sector represents only 1 percent of total employment. On the other hand, agriculture accounts for only 6 per cent of GDP, but it provides employment for roughly 39 per cent of the workforce and generates two-fifths of household incomes in rural areas. Development of infrastructure and support to non-oil livelihoods is a priority for the Government of Azerbaijan. Azerbaijan’s development strategy, “Azerbaijan: Vision 2020” builds on the country’s latest socio-economic achievements and provides a framework for its transition from a traditional economy to a knowledge-based, competitive and diversified economy. The Government’s commitment to balanced development that pays proper attention to the development of regions and rural areas is reflected in its State Program for Socio-Economic Development of the Regions of Azerbaijan.

**Sectoral and Institutional Context**

There are a number of factors contributing to the relatively higher incidence of poverty and inferior living conditions in rural Azerbaijan which this project will address. These include restricted access to basic infrastructure, particularly rural roads which hinder security of farmers’ livelihoods and basic services – including health, education and rural water supply - as well as an under-developed agricultural and non-farm rural economy.

Deficiencies in basic infrastructure (roads, water, and energy) in rural areas serve as an obstacle to poverty reduction by discouraging people and businesses from residing in or investing in rural space. Despite the tripling of government investment in basic infrastructure since 2006, there are still important gaps in terms of access and quality of public services between urban and rural areas. While rural poverty reduction depends on increasing incomes from agriculture and the diversification and growth of the non-farm rural economy, there are significant constraints facing the development of both sectors. Currently, employment in rural areas does not guarantee a route out of poverty; the working poor account for 60% of the rural poor compared to 50% for the whole country and 35.6% in urban areas. This is due to the poorly paid and seasonal nature of employment in rural areas, the lack of non-farm rural enterprises and the numerous constraints farmers face in maximizing income earned from agriculture. A key constraint is the weaknesses in infrastructure provision such as rural roads, irrigation and drainage systems. Irrigation is particularly problematic, with at least 50% of all irrigated land damaged due to the effects of salinity resulting from degraded irrigation and drainage systems.

Institutional capacity at the local self-government level to address these urban-rural disparities are emerging and in need of support. Key institutions at the local level in Azerbaijan include Municipalities and Local Executive Committees. Local Executive Committees (ExComm’s) represent the various agencies and line Ministries of Central Government and are primarily
focused on regulatory functions and the development needs of larger settlements. While elected Municipal Councils were established by law in 1995, they are still relatively new institutions with limited responsibility (for roads, parks, cemeteries and some aspects of social care) and financial capacity to support the provision of critical rural infrastructure. AzRIP is well placed to support the developing decentralization agenda through mobilizing local communities to work closely with both ExComm authorities and municipalities in the development of infrastructure in underserviced rural communities. Aside from the decentralization agenda, AzRIP-2 further reinforces a range of other Government strategies and programs.

2. Objectives

**Project Development Objective**
The Project Development Objective is to improve access to and use of community-driven rural infrastructure and expand economic activities for rural households. This would be achieved through: (i) financing demand-driven, community-identified priority rural infrastructure investments; (ii) strengthening the capacity of communities in partnership with municipalities and local support institutions to effectively identify, plan and implement their development priorities; (iii) building opportunities for rural employment and livelihood support services; and, (iv) supporting project management capacity in order to coordinate, plan, monitor, program and supervise a wide range of community driven activities.

3. Rationale for Bank Involvement

In terms of rationale for Bank engagement, AzRIP-2 AF not only builds on the successful implementation of the original project, but also the experience with Community Driven Development operations elsewhere in the region and globally. Beyond Azerbaijan, the World Bank has supported a range of successful Local and Community Driven Development (CDD) activities across ECA that finance improved service delivery, infrastructure provision and income generation in countries as diverse as Kyrgyzstan, Poland, Croatia and Russia. These projects respond to the infrastructure and service deficits that arose during the transition era following the privatization of collective farms and local industries previously responsible for social infrastructure and service provision. They also respond to a need to support alternative, more participatory and transparent forms of local governance. These projects build on global best practice by the Bank to support participatory decision making, local capacity building, and community control of resources through CDD. Over the last decade, the Bank has increasingly used CDD projects across a range of countries to address critical infrastructure needs and the current global CDD portfolio amounts to approximately $2bn of Bank investment per year.

4. Description

**Project components**
AzRIP-2 AF is a multi-sector investment loan with a total investment cost estimated at $86 million, of which $50 million is financed by IBRD. AzRIP-2 AF is designed to extend delivery of community rural infrastructure to two new rayons, to scale up the livelihood pilots and to launch a pilot connector roads initiative, engaging with clusters of communities and enhancing rural road connectivity. The Project has three components:
Component A - Rural Community Infrastructure. This component will finance demand-driven micro-projects (MPs) in rural infrastructure. MPs eligible for finance through Project proceeds would increase access to, and quality of, local economic and social infrastructure, such as roads, rural water supply and irrigation, schools, clinics and markets. Costs to be supported from the project include identification, design, construction, rehabilitation, and initial operation and maintenance of the investment. Potential investments include basic economic (e.g., rehabilitation of secondary roads, potable water systems, irrigation infrastructure, electricity transformers) and social (e.g., school and clinic rehabilitation and construction) infrastructure, based on priority needs identified by communities. The project will target rural communities (greater than 1,000 and less than 10,000 people – with smaller communities open to clustering with neighboring communities to achieve scale) in regions that meet established selection criteria and have a higher relative incidence of poverty. The average size of MPs will be US$ 70,000, while MPs over US$85,000 will require prior review. Current micro-project cycle procedures will be maintained in AzRIP-2 AF, including local governance arrangements involving local authorities and sectoral line ministry representation in project screening and approval and public and private sector linkages for key operation and maintenance medium-term projections. Under the AF, second and third community project grants will be mobilized for eligible communities. A new connector roads pilot will target areas where communities have successfully implemented an intra-community road rehabilitation project and where the connector road (between communities or linking communities to rayon centers or highways) falls under the jurisdiction of the Municipality. This pilot will engage with clusters of at least three and up to six communities for the purpose of local road rehabilitation.

Component B - Technical Assistance for Rural Infrastructure and Livelihoods. This component will fund support services for micro project implementation and scale up the support to livelihoods. The objective of the component is to enhance the capacity of engaged local stakeholders, including communities, local authorities, Regional Grant Approval Committees, Project Assistance Teams and staff in the Regional Operations Offices in micro-project program development. Stakeholder capabilities in functions of contracting, procurement, financial management, and participatory monitoring and evaluation will be strengthened. Livelihood support services are being piloted in six communities selected among communities that successfully implemented economic infrastructure projects under AzRIP and meet eligibility criteria described in the OM. These livelihood support services include mobilization and organization of Common Interest Groups, identification of income generation activities, preparation of business plans and training in business management for community group members. Under the AF, the livelihood support will be scaled up to extend to 36 communities, diversify the set of pilots and assess options for future support.

Component C - Project Management and Results Monitoring. This component will finance the administrative and operational project implementation and management costs, including overheads of Project Management Unit (PMU) professional staff as well as PMU and Regional Operations Offices (ROO) and their associated support staff, project outreach, support to Regional Grant Approval Committees (RGACs) and the establishment of a new Regional Office to support expanded coverage of the AF in new rayons. AzRIP-2 AF will continue current practice of regular and rigorous project monitoring and evaluation using mixed quantitative and
qualitative methods and results based indicators implemented on multiple levels – project, rayon and community. AzRIP-2 AF will also maintain the intensive effort of physical verification of works and technical aspects of sub-project implementation.

5. Financing

The Lending Instrument for the project is a Specific Investment Loan (SIL) of US$50 million. The loan will be single currency (US dollar denominated), variable spread loan, with a maturity of 17 years inclusive of 4 years of grace, a front end fee of 0.25 percent, with repayments linked to commitment.

<table>
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<tr>
<th>Project Components</th>
<th>Project cost</th>
<th>IBRD financing</th>
<th>% financing</th>
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<td>2. Component B: Technical Assistance for Rural Infrastructure and Livelihoods</td>
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<td>3. Component C: Project Management and Results Monitoring</td>
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**Total Baseline Costs**
- Physical contingencies
- Price contingencies

<table>
<thead>
<tr>
<th>Total Project Costs</th>
<th>Interest During Implementation</th>
<th>Front-End Fees</th>
<th>Total Financing Required</th>
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6. Implementation

**Institutional and Implementation Arrangements**

The proposed project builds on the ongoing AzRIP design, and its institutional and implementation mechanisms which proved to be successful in terms of achieving results on the ground. The project will be under the general management of the State Agency for Agricultural Credits (SAAC), which is the Ministry of Agriculture’s agency for overseeing international rural development projects. Day-to-day management of the project will be delegated to the Project Management Unit (PMU) constituted within the SAAC. The PMU has successfully implemented the on-going AzRIP. It reports to the Director of SAAC and would have direct responsibility for management, administration and coordination of the proposed project. The PMU has developed the necessary experience and competence to manage all core functions including program management, regional coordination, community mobilization and facilitation, capacity building, training, procurement, financial management and monitoring and evaluation, including environmental monitoring. The project implementation arrangements are described in detail in the Operational Manual (OM). The PMU comprises core staff, including the Director, Deputy
Director, community development specialists, procurement, financial management, M&E and MIS and engineers. In order to ensure successful implementation, AzRIP-2 AF will further strengthen the PMU with additional training. The PMU has acquired solid experience in procurement and has established a reliable and effective accounting and internal control systems under AzRIP. The PMU will continue to use these arrangements for the financial management of AzRIP-2 AF. The PMU is planning to retain existing accounting software and accounting staff.

The project institutional arrangements at the national level include also the project Working Group established by the SAAC to review the OM on a quarterly basis and adopt revisions, as required. The WG includes representatives of the Ministries of Economic Development and Agriculture, the Parliamentary Commission on decentralization, Regional Grant Approval Committees and civil society.

At the regional level, the PMU will be supported by the Regional Operations Offices (ROOs) which are the PMU representatives in the project zones to support and monitor the community project portfolio. The ROOs have been operating as umbrella offices, incorporating Project Assistance Teams (PATs) and Regional Grant Approval Committees (RGACs) in one location, under the coordination of a Program Specialist functioning as an extension of the PMU. This has worked well, and the same approach will be adopted for AzRIP-2 AF. The PATs are currently functioning as the Service Providers for providing community mobilization, training and consultancy services for communities. The RGACs will continue to review the project proposals for approval, while the technical design companies will help to develop local capacity for infrastructure development and maintenance.

7. Sustainability

This project will continue to use the AzRIP model which has demonstrated sustainability by using an integrated approach to infrastructure development which combines sound economic analysis in selection of micro-projects, solid engineering design and attention to social dynamics and environmental sustainability. Operations and maintenance plans prepared by communities will allow them to identify potential funding gaps and develop financing mechanisms and strategies for long-term maintenance requirements.

8. Lessons Learned from Past Operations in the Country/Sector

The proposed project is an Additional Financing, with the same PDO, project design and institutional arrangements as AzRIP-2, which is successfully achieving its development objective and has been recognized as a high quality operation delivering tangible results on the ground and improving people’s lives. The project builds on the AzRIP design and institutional and implementation mechanisms with day-to-day management under the aegis of the existing PMU. Building on lessons learned in AzRIP, rayons that have demonstrated successful results from AzRIP micro-project implementation will be eligible to request further support for complementary rural infrastructure investments under a second and third generation window in Component A. Under Component B, pilot work on livelihoods will be scaled up, targeting communities that have successfully implemented economic infrastructure projects under AzRIP and be conditional on feasibility and market assessments. Probable areas of support would be
business development services, local organizational capacity strengthening and market and institutional linkages.

9. Safeguard Policies (including public consultation)

The project does not raise any significant adverse environmental concerns. Experience derived from the original AzRIP indicates that positive environmental impacts resulted from the implementation of such micro-projects as improved irrigation, water supply and sewerage systems. The potentially adverse environmental impacts of AzRIP-2 AF are mainly associated with civil works during micro-projects implementation, and include, inter alia, dust, noise, soil and water pollution, generation of waste materials, waste disposal (including medical waste), damage to soil by excavation works.

*Environmental Assessment.* These potential negative environmental impacts trigger the Operational Policy OP 4.01. The impacts are minor and can be prevented or minimized through appropriate preventive actions and mitigation measures. Therefore, the project is classified as environmental category ‘B’, requiring partial assessment. Since micro-projects are not pre-identified and will be determined in the course of project implementation by applicant communities through intensive participatory processes, an environmental management framework will be applied which will establish screening mechanisms and govern the process of development and implementation of specific mitigation plans. The Environmental Management Framework for the original AzRIP has been updated by the Borrower to address impacts from the newly proposed activities to strengthen rural livelihoods and to reflect the expanded geographical coverage. The updated EMF has been updated, discussed with stakeholders and will be publicly disclosed by the Borrower.

AzRIP-2 AF will be implemented by the same PMU which is implementing AzRIP-2. Capacity for the EMF implementation has been built under the original project through series of training regularly provided to the PMU, its Regional Offices and potential beneficiary communities. The PMU Environmental Specialist is responsible for training delivery, assists the Regional Offices and applicant communities throughout the whole cycle of micro-project development and implementation and closely supervises implementation of specific preventive and mitigation measures by project beneficiaries. The same good practice will continue under AzRIP-2 AF.

10. List of Factual Technical Documents

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