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PERFORMANCE AUDIT REPORT

KAZAKHSTAN

**URBAN TRANSPORT PROJECT
(LOAN 3725-KZ)**

June 29, 2000

*Sector and Thematic Evaluation Group
Operations Evaluation Department*

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Currency Equivalents

Currency Unit	=	Tenge (KT)
100 Tenge	=	US\$ 0.80
US\$1	=	125 Tenge

Weights and Measures

Metric System

Fiscal Year

January 1 – December 31

Abbreviations and Acronyms

ATC	-	Almaty Tram/Trolley-bus Company
EBRD	-	European Bank for Reconstruction and Development
ICR	-	Implementation Completion Report
IFIs	-	International financial institutions
IMF	-	International Monetary Fund
MOF	-	Ministry of Finance
MOT	-	Ministry of Transport, Telecommunications and Tourism
NIIT	-	Nauchno-Issledovatel'skiy Institut dlya Transporta
PIU	-	Project Implementation Unit
PSAP	-	Policy Statement and Action Plan
TACIS	-	European Commission's Technical Assistance Program for the CIS

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Office of the Director-General
Operations Evaluation

June 29, 2000

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Kazakhstan: Performance Audit Report Urban Transport Project (Loan 3725-KZ)

Attached is the Performance Audit Report (PAR) prepared by the Operations Evaluation Department on Kazakhstan: Urban Transport Project (Loan 3725-KZ), approved in FY94 for the amount of US\$40 million. The loan was closed on September 30, 1998 fifteen months behind scheduled. An undisbursed balance of US\$ 1 million was cancelled.

The Urban Transport Project was approved when Kazakhstan was undergoing a transition to a liberalized market economy underpinned by a system of private ownership. The specific objectives of the project were to (i) help restore public transport capacity in Kazakhstan's three main cities, Almaty, Karaganda, and Shymkent, to adequate levels of service quality, and (ii) design and implement some key improvements in policies and institutions described, inter alia, in the PSAP in the urban public transport sector of the three cities. The project was amended in 1997 to include the new capital city Astana to redirect savings accrued from the cancellation of some components. To achieve these objectives, the project consisted of a physical component (75 percent of the loan) to purchase buses to the bus depots in the project cities, and an institutional component to support the implementation of the PSAP.

The objectives of the project to increase the capacity of urban public transport system and improve the institutional and policy framework were timely and relevant objectives. However, the physical components to support the government bus operations was contrary to the Bank's own strategy to foster competition and private entrepreneurship and ownership of assets in the country and in the Region as a whole. Furthermore, the physical component was less relevant to the achievement of the project objectives, since the institutional and policy reforms to introduce private entrepreneurship and competition in the sector would have been sufficient to achieve both objectives of increasing the capacity of the public transport system and improving its overall performance, as laid out in the PSAP. Thus, the PAR judges the relevance of the project as modest.

The physical component to provide new buses to support the project companies was implemented adequately, after a long and complex haggling over the procurement of the buses. The process by which the buses were procured proved to be too cumbersome and complex for the borrower. It resulted in the borrower (and the Bank) incurring substantial transaction costs to obtain and deploy them to the project companies, and for the beneficiaries to maintain them once they arrived. The buses, which arrived late, cost substantially more than what was often paid for buses in Kazakhstan. Hence, the combination of high transaction costs and purchase price diminished the usefulness and efficiency of the buses.

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The project achieved its objectives of restoring public transport capacity and improving the institutional and policy framework within which the system was organized. The deficiencies that characterized the public transport system during project identification have largely disappeared. The public monopoly regime that was the hallmark of the system has now been replaced by a competitive regime where a system of private ownership is increasingly becoming the dominant mode of ownership in public transport. In addition, many of the distortionary operating policies and unfunded mandates to provide free travel privileges to a large segment of the population have been either eliminated or replaced by other mechanisms to provide direct support to users.

The main beneficiaries from the project are the travelling public who now enjoy a full range of affordable services of acceptable quality. In addition, the deregulation of the sector that was carried out under the project has relieved the government from operating and subsidizing the provision of services. The private sector is now providing most of the service needs without subsidies, allowing the government to allocate its scarce resources for other uses. Finally, private entrepreneurs benefited from the deregulation of the sector that was carried out under the project. The public transport sector became an entry point for many entrepreneurs, after decades of central planning and working for unwieldy and impersonal state-owned corporations.

The instruments used to achieve the project objectives had differing degrees of success. The physical investment, which was the largest component, was arguably the least beneficial in terms of its impact on the overall improvement of the public transport system in the project cities. The initial idea to deploy buses in the project cities was that there was an urgent need to provide some relief to remedy the shortage of vehicles in the project cities. However, because reforms were going in parallel, the latent entrepreneurial talent had been unleashed before the buses could arrive. The tremendous increases in the supply of privately operated services rendered the project-acquired buses less critical than anticipated during project preparation to the improvement of the public transport system.

In addition, the project-acquired buses are too difficult to maintain because the beneficiaries, the bus depots in the project cities, are not familiar with the type of buses procured and do not have the capacity to maintain them. In sum, the assistance to purchase buses had limited impact in improving the capacity of the system because they made up only a small part of the total fleet in the project cities after private sector participation began, they arrived too late, cost too much for Kazakhstan standards, and are difficult to maintain with the existing institutional and technical capacity in Kazakhstan.

Most of the improvements evident today in Kazakhstan's public transport system were achieved because of the institutional and policy reforms carried out under the project. In particular, the deregulation of the sector opened the system for private sector entrepreneurship and competition, which resulted in remarkable improvements in the quality and quantity of the services provided in the project cities and throughout Kazakhstan.

The PAR rates the project as *marginally satisfactory*, versus *satisfactory* in the ICR. The reason for downgrading the project is the less than optimal outcome of the bus component, which constituted 75 percent of the project loan. The PAR questions the relevance of the bus component to support state-owned bus operators when reforms were going in parallel to increase the private sector participation in the sector. The objectives of the project could have been achieved without the bus component. Second, the efficiency and net benefit of the project was reduced because of the long and complex process to procure the buses. Finally, the bus component was less efficacious than expected because when the buses did finally arrive, the private sector had already been unleashed and begun dominating service provision throughout the project cities.

The PAR rates the institutional development impact of the project as *substantial*, consistent with the ICR. The project achieved, and in some cases surpassed, its institutional and policy development objective. All the major tasks under the institutional development component were carried out, and the PSAP was implemented successfully. The institutional and policy component of the project was the underlying reason for the improved status of the public transport system in Kazakhstan. Today, Kazakhstan has one of the most vibrant private sector operations in the former Soviet states. This has to be hailed as a remarkable achievement of the project and the Bank's effort to promote policy reforms in the sector.

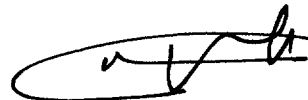
The PAR rates sustainability of the project as *uncertain*, versus *likely* in the ICR. The benefits of the project stemming from the policy and institutional reforms are sustainable. There is ample political support for the reforms undertaken, as the benefits are widely shared throughout the society. The PAR, however, downgrades the ICR rating of sustainability because it judges the sustainability of the largest component of the project, the bus component, as unlikely. The buses are not being properly maintained, consequently, they are not expected to last through their intended working life. In addition, the project bus companies are not able to cover the cost of capital to service their debt obligation, and it seems that they are unlikely to do so given the stiff competition they face from private operators and their own organizational inefficiencies.

In agreement with the ICR, the PAR rates the Bank performance as *satisfactory*. The Bank's support to improve the policy and institutional reforms to deregulate and improve the performance of the public transport system represents a good practice.

The PAR rates borrower performance as *marginally satisfactory*, versus *satisfactory* in ICR. The borrower provided a conducive political environment for the reforms to take place. However, the local governments and bus depots performed less than optimally. The local government often failed to provide the necessary local institutional support to facilitate the provision of competitive urban public transport services.

The following lessons emerge from the audit: (i) Policy and institutional reforms that are capable of unleashing private entrepreneurship and competition in the urban public transport sector may be sufficient to improve the quality and quantity of the urban public transport system; (ii) conducive institutional framework capable of defining and enforcing property rights and contractual agreements is essential for private sector to make the necessary investment to maintain and improve the quality of services; (iii) in a deficient institutional framework, organizing the provision of public transport services by providing exclusive franchise rights is not sustainable; (iv) it is important to take note of the country's circumstances and institutional capacities when designing and evaluating a procurement bid.

Attachment



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<p>This report was prepared by Mr. Binyam Reja (Task Manager), who audited the project in September 1999. Mr. William Hurlbut edited the report. Ms. Romyne Pereira provided administrative support.</p>
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Principal Ratings

	ICR	OED/EVM	PAR
Outcome	Satisfactory	Satisfactory	Marginally Satisfactory
Sustainability	Likely	Likely	Uncertain
Institutional Development	Substantial	Substantial	Substantial
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Marginally Satisfactory

Key Staff Responsible

	Task Manager	Sector Manger	Country Director
Appraisal	Jean-Charles Crochet	J. Brown	Russell J. Cheetham
Completion	Jean-Charles Crochet	Eva Molnar	Kiyoshi Kodera

Preface

This is a Performance Audit Report (PAR) of the Urban Transport Project (Credit 3725-KZ) in Kazakhstan.

The PAR was prepared by the Operations Evaluation Department (OED) based upon a review of the President's Reports, Staff Appraisal Reports (SARs), Implementation Completion Reports (ICRs), transcripts of Board proceedings, project correspondence files, Bank documents on other transport projects, and other Bank and non-Bank materials. In September 1999, an OED mission traveled to Kazakhstan, where it discussed the projects with relevant government officials, private sector representatives, beneficiaries, and professional and trade organizations. OED also discussed the projects with Bank staff in charge of project at headquarters. The kind cooperation and invaluable assistance from all the people consulted are gratefully acknowledged.

Following standard procedures, copies of the draft PAR was sent to the relevant government officials and agencies concerned for their review and comments. No comments were received.

1. Introduction

1.1 The Urban Transport Project was approved when Kazakhstan was undergoing a transition to a liberalized market economy underpinned by a system of private ownership. The underlying rationale for the project was to mitigate the effects of the then prevailing adverse macroeconomic conditions on the performance of public transport sector, and to align the institutional framework of the sector with that of the liberalizing economy.

1.2 The macroeconomic environment and the institutional and policy reforms taking place at the time of project identification had a bearing on the performance and organization of the urban public transport system in Kazakhstan. The lack of adequate fiscal revenue and foreign exchange reserves meant that the government was no longer capable of providing the requisite funding to maintain the capacity and quality of public transport services in Kazakhstan. There were very few investments to renew and maintain the fleet. Consequently, the supply of public transport diminished substantially, resulting in overcrowded buses and poor quality of services.

1.3 The institutional and policy reforms undergoing in Kazakhstan to liberalize and dismantle the command economy meant that the provision of urban public transport had to be reorganized along market principles to reflect the new political economy order and enable the sector to function more adeptly in a liberalized market economy setting. The government issued, after consultations with the Bank, a Policy Statement and Action Plan (PSAP) emphasizing the need to bring the public transport system in Kazakhstan into the fold of the liberalizing and decentralizing economy.

1.4 The PSAP sought to achieve four reforms: adjust tariffs to reflect costs; develop a transparent and performance-based subsidy arrangement; streamline the contractual relationship between the government and bus operators; and promote competition in the sector by removing entry barriers and liberalizing prices. In addition, the central government transferred the responsibility of public transport to regional governments, and allowed them to levy special taxes (until it repealed it a few years later) to fund public transport expenditures.

1.5 Another development that had a bearing on the performance and organization of the sector was the emergence of an informal transport sector. The combination of deficiencies in the state-owned public transport system and the prevailing economic hardship created opportunities for individual entrepreneurs to engage in the provision of public transport services, often illegally but many times under subcontract (officially or otherwise) arrangements with the state-owned enterprises. The development of this informal transport sector provided some relief to the public transport problem in Kazakhstan and laid the foundation for the subsequent development of the private sector. Many of the current route-franchise operators had their humble beginning as one-man bus operators.

2. Project Objectives: Coherence and Relevance

2.1 In view of the adverse macroeconomic environment in the country and the poor condition of the urban public transport system in the early 1990s, the Bank set out to support the government's desire to mitigate the capacity shortages facing the system and to reform the institutional and policy framework of the sector to enhance its efficiency and bring it in line with

the rest of the reforming economy. The main objectives of the project, as laid out in the Staff Appraisal Report (SAR), were to:

- Help restore public transport capacity in Kazakhstan's three main cities, Almaty, Karaganda, and Shymkent, to adequate levels of service quality
- Design and implement some key improvements in policies and institutions described, inter alia, in the PSAP in the urban public transport sector of the three cities.

2.2 The project was amended in 1997 to include the new capital city Astana to redirect savings accrued from the cancellation of some components.

2.3 To achieve these objectives, the project had the following components:

- Provision of about 300 new standard single deck urban buses (100-110) passengers capacity)
- Rehabilitation of about 550 buses and 400 trolley-buses including provision of necessary spare parts and supplies
- Provision of a limited quantity of workshop and office equipment
- Provision of training and technical assistance mainly to (i) assist the government to design and implement policy and institutional improvements included in the PSAP; (ii) assist the project companies to develop their capabilities in vehicle maintenance, operations, and finance; and (iii) assist in project implementation.

Relevance of Project Objectives and Adequacy of Components

2.4 The project's objectives to restore urban public transport capacity and improve the policy and institutional framework were relevant to the country's sectoral development goals since urban public transport is an important service in Kazakhstan used by 90 percent of the population, many of whom are poor and pensioners. Thus, there was an urgent need to improve the appalling conditions of the urban public transport system by increasing its capacity and improving its performance.

2.5 The physical investment component was less relevant to the achievement of the project objectives, since the institutional and policy reforms to introduce private entrepreneurship and competition in the sector would have been sufficient to achieve both objectives of increasing the capacity of the public transport system and improving its overall performance, as laid out in the PSAP. However, the Bank followed this strategy as part of the overall strategy of engaging the government in a dialogue on broad macro and micro economic reforms¹.

2.6 When the project was identified in 1993, international experience in the sector suggests that the private sector, working under a conducive institutional and regulatory environment, is more adept at mitigating public transport shortages than government-owned bus companies².

1. The Region, in comments to an earlier draft of the PAR, notes that "the shortage of capacity was such that the private sector (which had limited means and was wary of the institutional/regulatory environment of public transport) would never have been able to provide sufficient capacity to fulfill demand, particularly in Almaty, as argued in particular in para 5.6 of the draft PAR." The audit, however, notes the private sector, albeit informally, had begun to provide services and it was only a matter of time until it filled the gap left by the state-owned bus providers.

2. The Region, in comments to the draft PAR, notes that "the authorities in the transport sector in Kazakhstan and in city administrations were looking exclusively for organization of urban transport services at Western Europe and North America where municipal monopolies are prevalent." However, it should be noted that the government had begun deregulating the sector as far back as 1993.

Furthermore, when the project was being prepared, the Bank was working with the Government of Kazakhstan (GOK) through its policy dialogue and technical assistance project to promote the restructuring and privatization of various SOEs in the country.

2.7 In sum, the overarching objective of the project to increase the capacity of the system and improve the institutional and policy framework were timely and relevant objectives. However, the physical investment components used to achieve the project objectives were inadequate. While it may have been necessary to finance buses to provide relief to the capacity shortages, the PAR concludes that the project's approach to support the government bus operators was somewhat contradictory to the Bank's strategy to foster competition and private entrepreneurship and ownership of assets in the country. Thus, the PAR judges the relevance of the project as moderate.

3. Implementation Experience and Achievement of Project Objectives

Physical Objectives

3.1 The physical component to provide new buses to support the project companies was implemented adequately, after a long and complex procurement process. At the end, 289 buses (versus 300 projected) were purchased under the project and distributed to the four project cities. Almaty took the largest share, with 170 buses, followed by Karaganda with 56 buses and Shymkent with 40. Astana received 23 buses after the project was amended. The component to rehabilitate buses and trolley-buses, including getting spare parts, was not implemented, and the amount intended for this component was reallocated to obtain more buses.

3.2 The process by which the buses were procured proved to be too cumbersome and complex for the borrower. It resulted in the borrower (and the Bank) incurring substantial transaction costs to obtain and deploy them to the project companies, and for the beneficiaries to maintain them once they arrived. The buses, which arrived late, are considered expensive by Kazakhstan standards. Hence, the combination of high transaction costs and purchase price diminished the efficacy and efficiency of the buses.

3.3 There were serious disagreements between the borrower and the Bank on the selection of the supplier for buses. The borrower emphasized non-pecuniary factors when selecting a supplier, while the Bank, in accordance with the procurement guidelines, focused on getting a bid that was efficient and economical, and one that met international standards and provided an equal opportunity to all qualified bidders³.

3. The Region notes that "the Government accepted the bid evaluation methodology formulated by its consultants together with the Bank. The method was based on comparison of life cycle costs as recommended by sound international procurement practices. The non-pecuniary factors (as well as the Government letter) referred to in paras 3.3 and 3.4 of the PAR were mentioned by the Government procurement advisers and given importance only after the evaluation of the bids in order to justify a change in the ranking arrived by the Government procurement advisers. Changing the evaluation method after bid opening and evaluation is absolutely not acceptable in sound procurement." While this might have been true, the lack of adequate attention to the non-pecuniary factors prevented from procuring buses that are suitable to the Kazakhstan economic and technical circumstances.

3.4 The non-pecuniary factors the borrower emphasized were the existing fleet composition and size, drivers' and mechanics' familiarity, availability of maintenance facilities, proven reliability, and the need for training⁴. The borrower argued, in its letter to the Bank, that it considers these factors important in choosing a supplier to ensure the success of the project and, ensure the effectiveness of the buses once they arrive in the country. Thus, the government sought to award the contract to the bidder that best met these criteria. However, the bidder the government wanted to award the contract to was ranked second by the government's Bank-financed procurement advisors, and treated as "non-responsive" by the Bank's procurement team because of inconsistencies and contradictions in the bid price⁵. Consequently, the Bank rejected the government's request to award the contract to this bidder, and insisted on awarding the contract to the bidder that met all evaluation criteria. However, the lowest-evaluated bidder also proved to be problematic because it was discovered later that this bidder was violating Kazakhstan's institutions and thus disqualified and treated as non-responsive. The contract was finally awarded to the bidder ranked third by the procurement advisors, which also had the Bank's "no-objection."

3.5 Here, then, lie the contradictions in the procurement process. The Kazakhstan experience illustrates the conflict between achieving efficiency in procurement and reducing the transaction costs embedded in the procurement process. Opting for efficiency often means going for the lowest-evaluated bidder by examining, among other things, the technical, financial, and economic aspects of the bid. However, this does not account properly for efficiency because it does not include transaction costs (which are real costs) incurred when procuring goods and services, and managing them once they are procured. Without accounting for transaction costs of procurement, it is not possible to know whether the lowest-evaluated bid is indeed the most efficient bid⁶. Therefore, minimizing transaction costs may mean that some of the pure efficiency attributes of the bid may need to be eschewed in favor of a bid that is capable of minimizing transaction costs and fitting into the institutional realities of the country. Hence, there is a need to strike a balance between getting an "efficient" bid and one that minimizes the transaction costs embedded in the procurement process, and one that could be realistically supported by the available institutional capacity of the country. Only then, can we say we have an efficient bid⁷.

4. The Region notes that "the technical specification were prepared after a weeklong seminar held in July 1993 with the technical directors of all concerned bus companies and the best experts the Bank could find on this subject. The specifications were based on the bus model prevalent in the FSU at the time for high density passenger routes (the Ikarus 260) and essentially called for a modernized version of the Ikarus 260 and did not require any technology that would be drastically different."

5. As far as the commercial parts of the bidding documents, the Region comments that "they were prepared jointly by the Bank and the government's procurement advisers and that the principles of ICB were fully explained to the government during the Project Launch Workshop in April 1994 and the terms of the bidding documents were discussed over a long period until these documents were issued in July 1994."

6. The Region notes that "the costing of the bids was based on life cycle costs, including the costs of maintenance, training of mechanics and purchase of new tools. It further argues that the transaction costs embedded in the procurement process were small as the technologies were very similar to those of the bus model most important in the bus fleets at the time (Ikarus 260)."

7. The Region notes that "the discussion in para 3.3 does not apply to the case of procurement of buses under the project since the bid for which the Government wanted ex-post to use the non-pecuniary factors of evaluation, had a major inconsistency and therefore could not be found responsive under any procurement process."

Technical Assistance

3.6 Technical assistance was successfully carried out, though with some startup delays on hiring a consultant. At the end of the project, a competent local consultant emerged that is now capable undertaking complex consulting assignments in the country and throughout the region. The assistance provided by the local consultant was critical in carrying out the institutional and policy reforms, as well as in supporting the local governments to organizing the competitive bidding of routes later in the project. The international consultant, the main consultant early in the project, provided less than optimum assistance to the borrower.

3.7 The study tours and training of officials carried out under the technical assistance component helped in cultivating ownership for and deepening the understanding of the proposed reforms in the PSAP among key stakeholders, and in ensuring a speedy implementation of the reforms throughout the country.

4. Project Results

4.1 The project achieved its objectives of restoring public transport capacity and improving the institutional and policy framework within which the system was organized. While there are no quantitative data to compare the before and after scenarios, it is clear from field observations and discussions with beneficiaries and stakeholders that the public transport system in Kazakhstan has significantly improved from where it was when the project was first approved in 1994. The deficiencies that characterized the public transport system during project approval have largely disappeared. The public monopoly regime that was the hallmark of the system has now been replaced by a competitive regime where a system of private ownership is increasingly becoming the dominant mode of ownership in public transport. In addition, many of the distortionary operating policies and unfunded mandates to provide free travel privileges to a large segment of the population have been either eliminated or replaced by other mechanisms to provide direct support to users.

4.2 The main beneficiaries from the project are the travelling public who now enjoy a full range of affordable services of acceptable quality. The overcrowding of buses and long delays at bus stops have virtually been eliminated. Services are now available through out the cities within a short walking distance and with negligible waiting time for a vehicle to arrive.

4.3 In addition, the deregulation of the sector that was carried out under the project has relieved the government from operating and subsidizing the provision of services. The private sector is now providing most of the service needs without subsidies, allowing the government to allocate its scarce resources for other uses. The experience in Kazakhstan shows that public transport services could be provided by the private sector without subsidies, although public monopolies and government subsidies had traditionally dominated the sector.

4.4 Finally, private entrepreneurs benefited from the deregulation of the sector that was carried out under the project. The public transport sector became an entry point for many entrepreneurs, after decades of central planning and working for unwieldy and impersonal state-owned corporations.

How were the objectives achieved?

4.5 The instruments used to achieve the project objectives had differing degrees of success. The physical investment, which was the largest component, was arguably the least beneficial in terms of its impact on the overall improvement of the public transport system in the project cities. The initial idea to deploy buses in the project cities was that there was an urgent need to provide some relief to remedy the shortage of vehicles in the project cities. However, because reforms were going in parallel, the latent entrepreneurial talent had been unleashed before the buses could arrive. The tremendous increases in the supply of privately operated services rendered the project buses less critical than anticipated during project preparation to the improvement of the public transport system⁸.

4.6 In addition, the project buses are too difficult to maintain because the beneficiaries, the bus depots in the project cities, are not familiar with the type of buses procured and do not have the capacity to maintain them. Although, Kazakhstan has substantial technical capacities and facilities to maintain buses, it does not have the kind of technology and expertise required for maintaining the project-financed buses. The Bank tried to support training and technical assistance program to bolster the depot's capacity to maintain the buses, but the depots, especially the ones in Almaty, have not followed the recommendations from the technical assistance study for a better maintenance program. As a result, maintenance in the Almaty depots remains hopelessly deficient⁹.

Policy and Institutional Reforms

4.7 Most of the improvements evident today in Kazakhstan's public transport system were achieved because of the institutional and policy reforms carried out under the project. In particular, the deregulation of the sector opened the system for private sector entrepreneurship and competition, which resulted in remarkable improvements in the quality and quantity of the services provided in the project cities. In May 1993, while the project was being prepared, the government formally deregulated the road transport sector to allow the private sector to provide transport services under a licensing arrangement.

4.8 The initial response to the policy reforms to deregulate the sector came from former bus drivers who were already providing services under an "informal" contract with the government-owned bus depots, but wanted to make their operations official by acquiring a business license. But the majority of informal operators actually were individuals who lost their jobs or whose income had diminished because of the economic hardship during the transition to a market economy. That is, the prevailing high unemployment and underemployment provided an army of people willing and able to engage in the provision of informal transport services, which resulted in substantially expanding the services and allowed for variegated services to emerge in Kazakhstan.

8. The Region notes that "most of the growth in private sector activities occurred in fact after the urban transport reforms were enacted in mid 1996 and implemented from mid 1997 until 1998, and that, therefore, the growth in private sector activities took place well after the buses arrived." However, the audit's findings suggest that substantial informal operations were emerging in the project cities as far back as 1993.

9. The Region notes that "the buses were not "too difficult to maintain" since in terms of technology they are similar to a bus model (Ikarus 260) which the companies has maintained adequately for years beforehand. The Region further notes that a review of bus maintenance was carried out in the spring of 1998 under Dutch Trust Fund financing and that this review concluded that buses were well maintained in Karaganda and Shymkent."

4.9 Later in the project, the Bank supported a rationalization effort to broaden the scope for private sector participation in the sector. With the support of the project's technical assistance team, the government formulated and issued a regulatory decree in 1996 to provide an institutional basis for the provision of competitive public transport services. The chosen institutional framework was what is called in the literature, competition for the market or competitive bidding, where potential providers, including the government-owned bus depots, compete for route franchises in order to gain monopoly rights to provide services in accordance to the stipulation of the contract. This arrangement was designed to bring "order" to and consolidate the seemingly fragmented public transport operation, which was dominated by individual owner-operators, route associations and small, start-up private firms. In addition, it was felt that this arrangement would create stability in the market so that it would induce the private sector to make long-term investment to improve the quality of services, and it would ensure continuity of reliable services¹⁰.

4.10 Although it was not part of the project nor the PSAP, the government, in addition to deregulating the sector, pursued a divestiture program of the state-owned bus depots in order to respond to the decaying nature of the bus companies and to complete the commercialization of the public transport system. The main impetus for this policy came when the central government repealed the taxing powers of local governments to finance the provision of public transport services under subsidy. The first step in the process of the divestiture program was to corporatize the bus depots under a joint stock company format, where the shares would be owned by the respective Oblast (regional) governments. The Oblast would then in turn sell the shares to the private sector. Most of the bus depots outside of Almaty have been privatized in this format. However, the bus depots in Almaty and those bus depots in Shymkent and Karaganda with substantial amount of the project buses are falling behind in the privatization process. In Shymkent, for example, while three of the four bus depots have completed their privatization process, the one that received all the forty new buses under the project continues to be full owned by the government.

4.11 In this sense, the unintended effect of the project buses was to delay or hamper the privatization process. Because the depots have debt obligation under the project, it is not possible to privatize them unless the private sector also assumes their debt. However, this would not be realistic in Kazakhstan since the cost of the buses is high compared to what the private sector would be willing to pay. In addition, the project buses have created new interest groups in the depots that benefit from the existing arrangement, thus making it even more difficult to pursue privatization. Hence, the government may be forced to continue holding on to the buses, unless it decides to assume its losses and exit from the sector.

5. Outstanding Challenges

5.1 Kazakhstan's urban public transport has come a long way from where it was in the early 1990s when the country started its transition to a market democracy. The benefits from the Urban Transport Project have been a tremendous boon to the capacity of the urban public transport system and affording the travelling public choices of affordable public transport services of acceptable quality. Despite these achievements, however, Kazakhstan's urban public transport

10. The Region notes "the reforms were intended to stimulate competition and efficiency of state-owned enterprises and to provide a structure in which the private sector could develop. The extent of private sector activities was very limited before the reforms and there was no need to bring order to private activities that had barely started."

system still has some unfinished business in deepening the reform process: to rationalize the organization of the industry, and to complete the privatization of the remaining bus depots.

The Industrial Organization of Public Transport in Kazakhstan

Competition for the market or Competition in the Market

5.2 Currently, an array of providers in cities through Kazakhstan fiercely compete with each other to provide services of different quality to the travelling public. These providers have different cost structures and, therefore, different market characteristics. On one extreme are the government-owned bus depots, which have large fixed investment in buses and depots. At the other extreme is the individual owner-operator who uses an old, depreciated minibus, whose fixed cost is close to zero. Between these extremes are some start-up small firms with their own fleet of buses.

5.3 The dominant mode of asset ownership and organizational structure in Kazakhstan's urban public transport is the individual owner-operators who are organized under a route association, or who sublease from a franchise holder for the right to operate on his franchise routes. Many of the franchise holders do not own their own fleet of buses, rather they sublease their exclusive franchise right to owner-operators. Because the 1995 regulation under Decree 737 makes it "illegal" to operate without a franchise right, the owner-operators have to belong to a route association with a franchise right or sublease the right to operate from a franchise holder. In this way, the owner-operators can legitimize their operation.

5.4 The result of the route association and sub-franchise mode is that what started out as a competition *for* the market through a competitive bidding of franchise route rights, has largely turned to a competition *in* the market where the individual owner-operators compete for passengers on the route. However, because the route associations have a high degree of control over the operating practices of the owner-operators, the arrangement does not have many of the problems, such as headrunning and interloping, associated with public transport systems that are organized under the competition *in* the market mode.

5.5 Moreover, the objective of organizing the industry under competition *for* the market did not fully materialize because of the poor design of the route structure by the regulatory bodies, which have poor operating practices when it comes to designing, awarding, and enforcing route rights. The design of routes is such that there are many overlaps among the different routes tendered. For example, if a private operator wins a franchise right to operate on a certain route, that does not mean he will be the exclusive provider on that route, even though that was what he was promised when he bid for the route franchise. The regulators, often under pressure from the municipal governments and rent-seeking activities from potential providers, design an overlapping route to franchise it to another provider. Although the new routes may not overlap completely, there is a high degree of overlap between the old and new routes, often up to 80%. In some cases, however, the routes are identical. If the first franchise route was issued for conventional bus service, the regulator often issues a new franchise for minibus service on the same route, arguing that this is a different service than the conventional bus service, which of course is not as far as the travelling public is concerned. As a result, the first winning bidder has a new, unexpected competitor on the route where he is supposed to be the exclusive provider. Therefore, the competition *for* the market attempt really does not hold here if the regulator has a discretionary, and somewhat arbitrary, power to change the structure of the route and allow a new competitor to enter the market.

Contract and Property Rights Enforcement in Kazakhstan's Urban Transport

5.6 The main challenge facing the public transport system in Kazakhstan is the lack of an appropriate institutional framework capable of defining and enforcing the property and contractual rights governing public transport operations and investment decisions of private providers. The institutional framework in Kazakhstan's urban public transport is such that the regulatory bodies have substantial discretionary and arbitrary power when designing and enforcing contract and property rights affecting the operation of urban public transport and investment decisions of the private sector. Although the government is to be commended for its decision to deregulate the sector, the current situation shows that it has not reoriented appropriately its residual role in a manner that is conducive for the private sector to flourish and make long-term investment in the sector. Consequently, the private sector has not evolved to where it makes the necessary large-scale and long-term investments in order to maintain and improve the quality of services it provides. In particular, this will be more problematic when it comes to replacing the current aging fleet of private buses, where the private sector will need a better institutional framework to make the necessary investments.

5.7 The franchisees' property right to the routes they have won through competitive bidding process is routinely violated when the regulators arbitrarily erode the contractual rights that is supposed to provide them the exclusive rights to operate in the route. Without property rights to a minimum level of passengers afforded through the route franchises, the private sector is proving to be unwilling to make a large-scale investment in order to maintain and improve the quality of services. That is, if the regulator has discretionary and arbitrary powers to change the structure of the route and allow a new competitor to enter the market, the initial winning bidder will refrain from making the necessary investments, whose returns depend on a certain volume of passengers. The result of this kind of arbitrary regulatory framework is what we see today in Kazakhstan's urban public transport system, where owner-operators using old vehicles with very little fixed investment, dominate the provision of urban public transport.

5.8 Therefore, in order for the private sector to improve and maintain the quality of services provides, the government needs to carry out institutional strengthening and reform with respect to how contracts and property rights are designed and enforced. The arbitrary redrawing of route structure in response to political pressure and rent-seeking activities have to cease if the private sector is going to have any confidence in the regulatory regime to which it is subjected to. If the private sector feels that its investments are subject to expropriation by the regulator in the form of creating arbitrary route structure, it would not make the necessary large-scale investment that are needed to improve the quality of the services.

Privatization of State-Owned Bus Depots

5.9 In addition to opening up the system for private sector entrepreneurship and competition, the government has restructured and privatized some of the state-owned bus depots. In the Soviet era, a single, amalgamated monopoly operator provided public transport services in Kazakhstan. During the transition to a market democracy, the government delegated the responsibility of public transport to local governments, and set the stage for the restructuring and privatization of the system. The local governments in turn made each bus depot in their municipalities a legal entity, and corporatized them into a joint-stock corporations to begin the privatization process.

5.10 However, there are still the Almaty bus depots and in the bus depots in Shymkent and Karaganda that received the project buses, which continue to be owned by the respective oblast

governments. These government-owned bus companies are not only in financial trouble, but also they are misfits in the overall urban public transport system operating in Kazakhstan. The private sector continues to dominate service provision in cities through out Kazakhstan, and the role of the bus depots continues to diminish. Therefore, there is a need to proceed with the privatization effort and bring the completion of commercialization of the sector.

5.11 At the time of the audit mission, the government was thinking of contracting out the management of the bus depots to the private sector to boost the profitability of the depots. While this may improve the situation somewhat by bringing savings from eliminating inefficiencies, the fundamental issue of the competition the bus depots face from the private sector will continue. Hence, unless the government issues the undesirable policy to restrict private participation in the sector, the fate of the state-owned bus companies is continuous decline and losing money in the presence of a vibrant private sector.

6. Ratings

Outcome

6.1 The PAR rates the project as *marginally satisfactory*, versus *satisfactory* in the ICR. The reason for downgrading the project is the less than optimal outcome of the bus component, which constituted 75 percent of the project loan. The PAR questions the relevance of the bus component because supporting state-owned bus operators was not needed when reforms were going in parallel to increase the private sector participation in the sector¹¹. The objectives of the project could have been achieved without the bus component.

6.2 Second, the efficiency and net benefit of the project was reduced because of the process through which the buses were procured. The long delays and complicated procurement process substantially increased the transaction costs of obtaining the buses, thereby reducing the net benefit and efficiency of the bus component¹².

6.3 Finally, the bus component was less efficacious than expected because when the buses did finally arrive, the private sector had already been unleashed and begun dominating service provision through out the project cities¹³.

6.4 However, the institutional and policy component of the project provided substantial benefits to Kazakhstan's urban public transport, and hence the reason for maintaining the *marginally satisfactory* rating as opposed a lower rating. The reforms carried out under the

11. The Region notes that "private sector participation in the sector happened much later in the project cycle after the 1996 reforms." However, as mentioned previously, the audit's findings suggest that the private sector emerged much earlier, as far back as 1993.

12. The Region notes that "the way the Government handled procurement of buses did delay the time by which the benefits of the project materialized but that this did not decrease substantially the benefit and efficiency of the project."

13. The Region notes that "the private sector was only prevalent in Shymkent and not in other project cities when the project cities arrived. The Region further claims that it was only in the later part of 1997 and 1998 that the private sector substantially developed in the project cities."

project had a remarkable success in creating an environment for private sector entrepreneurship and competition in the provision of public transport.

Institutional Development Impact

6.5 The PAR rates the institutional development impact of the project as *substantial*, which is consistent with the ICR. The project achieved, and in some cases surpassed, its institutional and policy development objective. All the major tasks under the institutional development component were carried out, and the PSAP was implemented successfully.

6.6 The institutional and policy component of the project was the underlying reason for the improved status of the public transport system in Kazakhstan. Today, Kazakhstan has one of the most vibrant private sector operations in the former Soviet states. This has to be hailed as a remarkable achievement of the project and the Bank's effort to promote policy reforms in the sector.

Sustainability

6.7 The PAR rates sustainability of the project as *uncertain*, versus *likely* in the ICR. The benefits of the project stemming from the policy and institutional reforms are sustainable. There is ample political support for the reforms undertaken, as the benefits are widely shared throughout the society. The passengers, the new entrepreneurs, and the government all have benefited from the reforms carried out under this project. The passengers have good services, entrepreneurs have business opportunity, and the government does not have to provide subsidies for the provision of services. Thus, there is no reason to believe that the reforms will be reversed.

6.8 However, the PAR downgrades the ICR rating of sustainability because it judges the sustainability of the largest component of the project, the bus component, as unlikely. The bus depots, especially the ones in Almaty, which received three-fifth of the project buses, are not properly maintaining the buses. Consequently, the buses are aging rapidly and are not expected to last through their intended working life of 10-12 years. In addition, the bus depots are not able to cover the cost of capital to service their debt obligation, and it seems that they are unlikely to do so given the stiff competition they face from private operators and their own organizational inefficiencies. The bus depots continue to lose passengers to private operators, and as a result, it is becoming harder for them to capture enough passengers to cover their long-run average costs.

Bank Performance

6.9 In agreement with the ICR, the PAR rates the Bank performance as *satisfactory*. The Bank's support to improve the policy and institutional reforms to deregulate and improve the performance of the public transport system represents a good practice. The Bank made use of the Bank's experience and lessons in designing and promoting a reform program to deregulate and liberalize the public transport system.

6.10 Moreover, the Bank's quick response to the crisis in Kazakhstan's urban public transport is commendable. The project was prepared and approved on a "fast track" approach because of the government's demand for quick delivery.

Borrower Performance

6.11 The PAR rates the borrower performance as *marginally satisfactory* versus *satisfactory* in the ICR. The borrower provided a conducive political environment for the reforms to take place. This was crucial, because experience suggests that political commitment at the highest level is important for reforms to take place and be sustainable. As such, the government's commitment to the reform process was essential for the achievement of the project objectives.

6.12 However, the local governments and bus depots performed less than optimally. The local government often failed to provide the necessary local institutional support to facilitate the provision of competitive urban public transport services. The regulation of the system was often ad hoc and arbitrary. There is a lack of transparency and good practice in the design and award of route franchises.

6.13 Finally, the bus depots, especially the ones in Almaty, failed to improve their organizational capacity and incentive structure to carry out maintenance. In addition, the non-transparent operating practices of the bus depots may be contributing to their financial difficulties. The collection of fare revenues and compensation of the employees are shrouded with secrecy and lack transparency.

7. Lessons Learned

7.1 The following lessons and sub-lessons emerge from the audit.

7.2 *Policy and institutional reforms that are capable of unleashing private entrepreneurship and competition in the urban public transport sector are sufficient to improve the quality and quantity of the urban public transport system.*

- Policy and institutional reforms are as important, or, even more important, than physical investments.
- If the private sector is able and willing to meet the capacity shortage in the sector, investments in government-owned bus companies duplicate or crowd out private sector investment.
- Investments undertaken to increase state-owned bus companies' bus fleet and to enhance their organizational capacities are ineffectual in making them as competitive as the private sector.
- Since private operators display significant market advantages over state-owned bus companies, the latter will continue to lose passengers to private operators, making it impossible to reverse their fortunes, even with new investments.
- Investments undertaken to support state-owned enterprises when the country is making a transition to a market economy hinder the privatization process by creating debt obligations and new interest groups.

7.3 *A conducive institutional framework capable of defining and enforcing property rights and contractual agreements is essential for private sector to make the necessary investment to maintain and improve the quality of services.*

- The private sector will refrain from making large-scale, long-term investments if it perceives the regulatory body has discretionary power to violate the contractual agreement and property rights by arbitrarily redrawing the structure of the route.

7.4 *In a deficient institutional environment, organize the provision of public transport services by providing exclusive franchise rights to operators is not sustainable*

- What started as a competition *for* the market system through a competitive bidding for franchise route rights may turn into competition *in* the market if the franchisee sub-leases his route rights to individual, owner-operators, who compete for passengers in the route.
- In the absence of a private sector willing and able to make large-scale investment, competition *for* the market creates absentee franchise holders who do not make the necessary investment to provide services.

7.5 *It is important to take note of the country's circumstances and institutional realities when designing and evaluating a procurement bid.*

- Like any other contract, procuring for buses has transaction costs that are partly a function of the institutional endowment of the beneficiaries and implementing agencies.
- The lowest-evaluated bid should not only reflect the pure efficiency of the bid, but it should take into account the transaction costs embedded in obtaining and absorbing the goods or services in question.
- The design and evaluation of procurement bid should be based on lifecycle cost of the buses, reflecting the technological and institutional capacity to maintain the buses.

Basic Data Sheet

URBAN TRANSPORT PROJECT (CREDIT 3725-KZ)

Key Project Data (amounts in US\$ million)

	<i>Appraisal Estimate</i>	<i>Actual or current estimate</i>
Total project costs	42.2	39.6
Loan amount	40.0	38.97
Cofinancing	0.6	0.6
Cancellation	-	1.03
Date physical components completed	6/30/96	9/30/98
Economic rate of return	N/A	N/A

Cumulative Estimated and Actual Disbursements

	<i>FY95</i>	<i>FY96</i>	<i>FY97</i>	<i>FY98</i>
Appraisal estimate (US\$M)	24.5	39.6	40.0	-
Actual annual	0.0	13.9	35.5	39.0
Actual as % of estimate	13%	35%	89%	98%
Date of final disbursement	12/31/98			

Project Dates

	<i>Original</i>	<i>Actual</i>
Identification (EPS)	-	March 10, 1993
Preparation	-	March 20, 1993
Appraisal	-	June 20, 1993
Negotiations	-	Dec. 17, 1993
Board presentation	-	April 7, 1994
Signing	-	June 8, 1994
Effectiveness	Sept. 6, 1994	Feb 6, 1995
Midterm review	July 1995	Not warranted*
Project completion		
Loan Closing		

* By the time a mid term review could have been held, the project had been simplified to two components, the main bus contract was under execution, and many of the policy reforms had been enacted by Government Resolution 773 of June 1996.

Staff Inputs (staff weeks)

<i>Stage</i>	<i>Weeks</i>	<i>Actual</i>
		<i>US\$ (thousand)</i>
Preparation to appraisal	12	34
Appraisal	43	128
Negotiations through Board approval	13	45
Supervision	123	335
Completion	4	20
Total	195	577

Mission Data

Stage of project cycle	Month/year)	No. of persons	Days in field	Specialized staff skills represented	Performance rating		Types of problems
					Implementation Status	Development impact	
Through appraisal	Mar 93	5	26	TE, FA, E, Op			
Appraisal-Board	June 93	3	14	TE, E			
Pre Board approval	Mar 94	2	10	TE, Pr	S	HS	Pr
Supervision 1	Jul 94	2	11	TE, FA	S	S	Pr
Supervision 2	Nov 94	1	TE	U	S		
Supervision 3	Sep 95	1	7	TE	U	S	Pr
Supervision 4	Mar/Apr 96	1	8	TE	S	S	Pr, PM
Supervision 5	Jul 96	2		TE, FA	S	S	
Supervision 6	Nov 96	2	17	TE, E	S	S	
Supervision 7	Apr 97	3		TE, E, FA	S	S	
Supervision 8	Oct 97	2	9	TE, E	S	S	
Supervision 9	Apr 98	2	12*	TE, E			
Supervision 10	May/Jun 98	1	FA				
Supervision 11	Jul 98	2	TE, E				
Completion	May99	1	12	TE	S	HS	

TE: transport economist
Pr: procurement
E: engineer
FA: financial analyst
Op: operations specialist

HS: Highly satisfactory
S: Satisfactory
U: Unsatisfactory

Pr: procurement
PM: project management

**Main purpose of mission was to prepare Road Transport Restructuring Project*