1. Key development issues and rationale for Bank involvement

Country Background

Azerbaijan’s economy has grown significantly in recent years. It grew at an average annual rate of 22 percent in 2003-2007. In 2008, growth slowed but nevertheless reached 10.8 percent—the oil sector grew at 7 percent and the non-oil sector at 17 percent. While oil sector growth was lower in 2008 than in the previous year due to technical difficulties, non-oil sector growth was higher in 2008 in good part due to the expansive fiscal policy of government. The figures from June 2009 indicated GDP growth rate of 3.6 percent for the first six months of 2009, including 3.4 percent growth in the oil sector, 4 percent in agriculture, and close to 6 percent in services. These growth rates are about a third of the 2008 rates due to the 2009 fiscal crisis. The crisis affected Azerbaijan through the reduction in oil revenues, freezing of global credit, and depressed economic activity in the region. Inflation is subsiding in Azerbaijan, with the double digits of the past few years giving away to low single digits in 2009 (the September year-on-year inflation rate was 2 percent).

2. The Government’s strategy to address the financial crisis has been prudent. Still, the post financial crisis environment would require the Government to put at center stage the diversification of the economy and the development of non-oil growth; non-oil export growth needs to also become a priority. This will require:
   - The design of a sustainable fiscal framework
• Improvement in the business environment and preparation of strategies to attract investors
• A sustained investment in human skills
• The implementation of regional development and inclusive growth

The Road Sector

3. In Azerbaijan, the transport sector is evolving due to the Government’s willingness to upgrade its infrastructure rapidly to reach international standards of serviceability. The development of the country’s road network supports the Government’s agenda to diversify its economy and stimulate non oil growth by improving access and promoting regional development. Diversification of the economy is one of the pillars of the current CPS (FY07-10)\(^1\) and in this post financial crisis environment, one of Azerbaijan key challenges. The support the Government has placed in infrastructure development and in road investment in particular, is based on the observed strong correlation between infrastructure development and economic growth due to increased competitiveness of the Azeri products, better regional integration and enhanced access of the rural communities to markets and health and education services. A 2006 study examining the impact of road network quality on intraregional trade in ECA identified Azerbaijan as one of the countries with the poorest road infrastructure in the region. The study also suggests that in some cases over 75% of the gains from increased regional trade could be achieved by upgrading the road infrastructure of the countries with the poorest networks.

4. The public road network in Azerbaijan comprises of slightly over 25,000 km of roads, out of which 4,500 km are in the Nagorna-Karabakh and adjacent territories, which currently are not controlled by Azerbaijan, and 2,000 km are in the Nakhchivan Autonomous Republic. The classification and numbering of the roads have been revised. State roads are divided into three classes: Major arterial roads, (M), Minor arterial roads (R), and collector and local roads. Eight roads are classified as M-roads and of these four are transport corridors linking Azerbaijan to neighboring countries and will be the backbone of the country’s motorway network:

1. Baku-Guba-Russian Border (M1 – 208km)
2. Baku-Alat-Yevlakh-Georgian border road (M2-503 km)
3. Alat-Astara-Iranian Border (M3-243 km)
4. Baku-Shamakhi-Yevlakh (M4 280km)

5. The M1 and the M3 are North-South corridors. M1 links Baku to the Russian border and M3 links Baku to Iran. The M2 and M4 are the East-West corridors. The M2, a part of the Great Silk Road, is the main route between Baku and Tbilisi and is also a part of the European route E-60, a main corridor between Western Europe and China. The M4 runs from Baku to Shamakhi and merges at Yevlakh into the M2. The World Bank, through the Highway and Highway II projects has helped the Government with the upgrade of this network already. The proposed Highway III project would support further assistance, with a focus on motorway infrastructure.

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\(^1\) CPS 07-10 being currently implemented rests on four pillars – (i) improving the quality and transparency of public sector governance; (ii) supporting sustainable and balanced growth of the non-oil economy; (iii) increasing the quality and access to social services; and (iv) improving environment.
Incidentally, the Bank is supporting the upgrading of the Georgian section of the E-60 from two lanes to four lanes through a series of sequential projects: First, Second and Third East West Highway Improvement Projects.

6. Azerbaijan public road network is of comparable length with the ones of countries of similar size and population density. The total vehicle fleet in Azerbaijan was about 773,318 in 2007, with 69 private passenger cars per 1,000 inhabitants, or about one sixth of Western Europe countries. But vehicle ownership increased by more than 40% between 2004 and 2007 partly due to the fast economic growth. The road network needs additional capacity as vehicle ownership is expected to continue to grow at a fast rate. The highways are mostly in fair condition as there have been significant investments funded by the Bank and other IFIs over the last 5 years. These highways, however, would need to be upgraded to international standards in order to accommodate growing transit traffic. Main and rural roads are in poor condition and in urgent need of rehabilitation and maintenance.

Bank Involvement

7. The Bank’s support in the road sector is based on client’s request and road sector’s needs as a high percentage of the Azeri road network was and remains in poor conditions. The first Bank project, Highway Project (Credit No: IDA-35170), approved in June 2001 provided US$40 million equivalent for the reconstruction and upgrading of selected portions of the existing East West E-60 Highway (M2) from Ganja to the town of Gazakh. This road links Baku from Alyat to the Georgian border and is the main access route for entry and export of goods to and from Azerbaijan and its improvement was considered (and continues to be considered) a key priority for the sustainability of economic growth. The implementation of the Highway Project has been completed and the ratings are satisfactory (ICR: Report No: 1094, September 2009).

8. The second Bank project, Highway II, (Loan No 7356 AZ) approved in December 2005 provided a US$200 million loan for upgrade of some sections of M3 Highway between Alat and Masalli including expansion of two lanes to four lanes, financing the rehabilitation of a 124 km section of the Baku Shamakhi (M4) and improving about 120 km of access roads. The Highway II has two Additional Financings: (i) the first additional financing in the amount of US$300 million was approved in May 2008 to complete the construction of M3 Highway and to finance the rehabilitation a section of the Baku bypass which connects the M3 to the M1 Highway and (ii) the second additional financing in the amount of US$175 million was approved in June 2009 to rehabilitation of 116 km section of M6 road and of 200 km of local roads connecting rural areas to the M6 road. In total, Highway II is US$675 million of road financing for various segments of the Azeri road network.

The Road Development Strategy

9. Azerbaijan is strategically located but does not have access to a seaport. The development of its transport corridors to motorway standards is therefore a key to the country’s non-oil growth and would enhance the country’s geographical location and potential to command the main trade routes between the Central Asian Republics and the Far East on one hand, and Europe and

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2 While Georgia has a lower GDP/capita, car ownership is close to 100/1000 inhabitants.
Western World on the other. The Highway Project in 2001 and the Highway II Project in 2005 were the start of the Bank engagement in supporting the development of the road network and provided the Bank with a good understanding of the road sector’s institutions, incentives, policies and culture. The development of Azeri road sector in recent years and the substantive on-going and planned road lending program necessitate a re-examination of Bank’s support.

10. The proposed project, Highway III, is the start of a second phase in the Bank support of the Azeri road sector. Highway III is the continuation of the motorway development and is a natural follow up of the Highway Project, Highway II Project and its first Additional Financing. The Government’s objective is that M1, M2, M3 and M 4 eventually attain international motorway standards in terms of technical and geometrical specifications, traffic safety and signage, road users amenities such motorway rests stops, operating and maintenance protocols and a sustainable funding mechanism. These 4 roads total about 1230 km in length. Of the total length, about 300 km are already or in the process of being upgraded to four or more lanes. The Government plans to upgrade an additional 700 km in the next few years so that by the end of 2013 about 1000 km will be four lanes or more.

11. Going forward, the Bank’s support to the Government would bifurcate into: (i) development of motorway network and transport corridors linking Azerbaijan with Georgia in the west and Central Asia through the Caspian sea in the east, Russia to the north and Iran to the south; and (ii) upgrading main, secondary, connecting and local roads as a part of regional strategy to promote economic growth and access to social services. The Highway III project would focus on the role of the existing motorway and the development of the future motorway grid. The Project would address motorway issues (i) commonly encountered around the world; and (ii) specific to Azerbaijan. In addition, capacity development would be targeted to motorway operations and maintenance. The technical assistance for the proposed Highway III project would be motorway specific and would complement but not replace the more general road sector wide technical assistance activities currently on-going under Highway II. It should be noted that many countries similar to Azerbaijan in terms of size, such as Croatia and Slovakia, have bifurcated the development of their roads into motorway and regional roads and have good results. Motorway and non motorway have different technical standards and maintenance needs. Specifications and safety standards, development objectives, methods of financing and human resource requirements could also be different. Given the country’s capacity limitation, the bifurcation would also allow a more focused capacity building and institutional development to facilitate the modernization of AzerRoad Service JSC (ARS).

12. The Bank support of regional road development started with the second Additional Financing for Highway II. This financing would rehabilitate a section of the M6 together with 200 km of local roads connecting rural areas into M6. In Azerbaijan up to 45% of regional and local roads, which play an important social and economic role in rural areas, are life expired. In a number of regions, the poor road condition hampers all-year links between territorial units. The connecting roads that link the rural areas with the main transport corridors are also in poor conditions. The development of regional roads should be in parallel to the motorway development to maximize development impact. Bank support for regional roads could follow the pattern developed under the second Additional Financing to the Highway II project and would have a different development objective than motorway development.
2. Proposed objective(s)

13. The project development objective:

To contribute to a more efficient, safer and improved road network by upgrading a portion of the existing network to motorway standards and initiating institutional steps for the management of the nascent motorway networks.

Monitoring Indicators: The tentative project development indicators would include: (i) decrease in vehicle operating costs in the project area; (ii) decrease in traffic fatalities in the project area; and (iii) adoption of a Motorway Operating code as a proxy for initiating institutional steps for better motorway management. The intermediate outcome indicators would include: (i) upgrading the M4 highway from 2 lane to 4 lane; and (ii) rehabilitating 30 km four-lane section of M3.

3. Preliminary description

14. **Component 1** - Motorway Construction: (i) Upgrading a 124 km section of the M4 Highway between Baku and Shamakhi, from 2 lanes to 4 lanes; and (ii) Rehabilitation of an existing 30 km section on the M3 north of Alat that is already 4 lanes.

**Component 2** - Institutional Development through Technical Assistance to: (i) review the existing institutional structure and propose restructuring options with a focus on better management of the motorway network; (ii) review road sector maintenance funding options and possibly introducing user pay principles for the motorway network; (iii) develop a motorway design, operation and maintenance code; and (iv) develop a pilot traffic safety program along the M3 section financed under component 1.

**Component 3** - Project Implementation: This will finance the incremental cost for the operation of the ARS PIU or to finance the consulting firm contract for the implementation of this proposed project.

4. Safeguard policies that might apply

The proposed Highway III project has been classified as environment category A for screening purposes. The Regional Environmental Review (RER) for upgrading the M4 to 4 lanes has been cleared by the Bank, disclosed and consultations were completed in 2009. The rehabilitation of M3 will be described in an annex to be added to the existing RER, which would be re-disclosed by the end of January 2010. There is a preliminary design for the M4 upgrade and a detailed design for the first 30 km of M4 close to Baku. The Environmental Assessment (EA) with Environmental Management Plan (EMP) for this section will be prepared and
disclosed prior to project appraisal. The Resettlement Policy Framework (RPF) will be finalized and disclosed prior to Appraisal.

5. Tentative financing

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<td>International Development Association (IDA)</td>
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6. Contact point

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