



# Report and Recommendation of the President to the Board of Directors

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Project Number: 46220-001  
July 2014

## Proposed Policy-Based Loan and Technical Assistance Grant Armenia: Infrastructure Sustainability Support Program

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## **CURRENCY EQUIVALENTS**

(as of 4 July 2014)

Currency unit	–	dram (AMD)
AMD1.00	=	\$0.0025
\$1.00	=	AMD407.85

## **ABBREVIATIONS**

ADB	–	Asian Development Bank
GDP	–	gross domestic product
KPI	–	key performance indicator
MOF	–	Ministry of Finance
MOTC	–	Ministry of Transport and Communication
MTA	–	Ministry of Territorial Administration
MTEF	–	medium-term expenditure framework
PSRC	–	Public Services Regulatory Commission
SCWE	–	State Committee on Water Economy
TA	–	technical assistance

## **NOTES**

- (i) The fiscal year (FY) of the Government of Armenia ends on 31 December.
- (ii) In this report, “\$” refers to US dollars.

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## PROGRAM AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 46220-001</b>	
<b>Project Name</b>	Infrastructure Sustainability Support Program	<b>Department /Division</b>	CWRD/CWPF
<b>Country Borrower</b>	Armenia, Republic of Armenia, Republic of	<b>Executing Agency</b>	Ministry of Finance (MOF)
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Public sector management</b>	Public expenditure and fiscal management		25.45
<b>Transport</b>	Road transport (non-urban)		2.02
	Transport policies and institutional development		8.19
	Urban roads and traffic management		2.02
<b>Water and other urban infrastructure and services</b>	Urban policy, institutional and capacity development		10.20
	Urban water supply		2.02
	<b>Total</b>		<b>49.90</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Civil society participation Institutional development Public financial governance	No gender elements (NGE)	✓
Partnerships (PAR)	Civil society organizations Implementation		
<b>5. Poverty Targeting</b>		<b>Location Impact</b>	
Project directly targets poverty	No	Nation-wide	High
<b>6. Risk Categorization:</b>	Complex		
<b>7. Safeguard Categorization</b>	<b>Environment: C Involuntary Resettlement: C Indigenous Peoples: C</b>		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>49.90</b>	
Sovereign Capacity development technical assistance: Technical Assistance Special Fund		0.90	
Sovereign Program loan: Asian Development Fund		49.00	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>0.10</b>	
Government		0.10	
<b>Total</b>		<b>50.00</b>	
<b>9. Effective Development Cooperation</b>			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to Armenia for the Infrastructure Sustainability Support Program.<sup>1</sup> The report also describes proposed technical assistance (TA) for Strengthening Management Capacity in the Road and Water Sectors, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.<sup>2</sup>

2. The Asian Development Bank (ADB) will partner with the Government of Armenia to improve road and water service provision through results-based public management and financing reforms. By focusing on critical expenditures, sustainability, and life cycle costing, investments in the two sectors will become financially more viable. The risks will be more equitably shared when investments are made through public-private partnerships. Users of the roads and drinking water supply will benefit from enhanced and sustainable services, and taxpayers will get better value for money and greater benefits from their taxes.

## II. THE PROGRAM

### A. Rationale

3. Economic growth facilitated by improved infrastructure is a government development priority.<sup>3</sup> Infrastructure assets are deteriorating fast in Armenia, and resources for their rehabilitation or replacement are limited, as confirmed during the program design phase.<sup>4</sup> The road and water sectors are particularly important, given their impact on the economy and quality of life. Under-provision or poor provision of roads limits people's access to markets, health, and education facilities. Better maintained road networks around economic hubs can improve access and create opportunities for economic integration for those in peri-urban and rural areas. Reliable access to clean water is an important factor for household well-being.

4. Armenia is a landlocked, mountainous country with an extensive road network that is underfunded and of poor quality. Frequent seismic activity and sharp seasonal temperature variations adversely affect road conditions, construction, and maintenance. The country has about 7,700 kilometers of republic, interstate, and local roads. About 3,500 kilometers of the network are managed by the central government, while the maintenance of the rest is delegated to the severely resource-constrained *marzes* and local communities.<sup>5</sup> There is inadequate information to make sound sector and investment decisions for more than half of the republic roads. Available qualitative information about roads managed by local communities is

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<sup>1</sup> The design and monitoring framework is in Appendix 1.

<sup>2</sup> As per ADB's project classification system, the program will target the following sectors, in addition to public management: (i) transport and (ii) water and other urban infrastructure and services. Under the transport sector, road transport (non-urban), urban roads, and transport policies and institutional development are the subsectors that will be addressed. Under the water sector, urban policy, institutional and capacity development, and the urban water supply are the subsectors that will be targeted. This classification has been reflected in the Program at a Glance page. For brevity and clarity in this report, the "road sector" and "water sector" will be used in reference to these subsectors.

<sup>3</sup> Government of Armenia. 2008. *Sustainable Development Program 2008*. Yerevan; Government of Armenia. 2014. *Armenia Development Strategy 2014-2025*. Yerevan.

<sup>4</sup> ADB. 2012. *Technical Assistance to Armenia for the Infrastructure Sustainability Support Program*. Manila (TA 8249-ARM, approved 10 December, \$500,000).

<sup>5</sup> "Marz" refers to administrative regions of Armenia; "local government" refers to community governments under the *marzes*.

incomplete. In the absence of data, it is difficult to monitor how efficiently the roads are maintained by public and private service providers.

5. Armenia's road asset ownership, management, and regulatory structures are segmented. The country has more than 500 national, regional, and local road managers with different levels of expertise and capacity. This creates operational and management issues, undermines economies of scale, and limits value optimization in sector investments. The central budget allocation for capital expenditure on roads, funded mainly by international development assistance, cannot meet the demand. The distortion between capital expenditures and the operating budget is also increasing. Sector analyses indicate about 1% of gross domestic product (GDP) is required to maintain the road network in its current condition, but only about 0.25% of GDP (\$25 million a year) is budgeted for operation and maintenance. ADB, the European Investment Bank, and the World Bank have invested more than \$500 million in the road sector since 2000.<sup>6</sup> However, the road maintenance budget allocations declined because of post-2009 fiscal constraints, the block allocations for new road construction, and financial management and procurement shortfalls. Four key issues need to be addressed to improve road sector effectiveness—insufficient technical information, fragmented sector management, lack of a sector regulator, and inadequate funding to achieve sustainable service delivery.

6. After Armenia became independent in 1991, most of its water and wastewater systems were in poor condition because of limited financial and management capacity. Technical and commercial water losses exceeded 85%; most households received less than 5 hours of water a day. Since 2000 the government has restructured the water sector, awarding lease and management contracts to private water operators. Substantial investments, supported by development agencies, have been made to improve the system. Despite improvements in the duration and quality of water for two-thirds of the population on the main grid, key challenges remain. About 560 communities in rural and peri-urban areas are not connected to the grid. Initial assessments indicate that about half of the existing network needs renovation, and 40,000 rural inhabitants do not have access to piped water supply. In 2008, the Organisation for Economic Co-operation and Development (OECD) estimated that about \$100 million in water and sanitation investments are needed for rural areas.<sup>7</sup> The capital investment needs for the main water supply grid for the next 5 years are estimated at about \$279 million, or 2.8% of GDP.

7. The Public Services Regulatory Commission (PSRC) regulates the water sector. All public and private owners of water assets are subject to the same regulatory regime under PSRC. Five private operators manage the drinking water supply on behalf of the government through lease or management contracts. The State Committee on Water Economy (SCWE), part of the Ministry of Territorial Administration (MTA), carries out the policy, strategy, and standards functions. However, the regulatory activities of PSRC and SCWE are not fully delineated. The separation of policy from operational management and regulation, while credible, does not address operational and financial inefficiencies. Water sector management is hampered by (i) the lack of a consolidated, complete, and current asset database to inform investment decisions, and (ii) weak government engagement with the private operators that manage water assets. Financial support to the water sector is not explicitly stated in the budget because financial reporting practices in the sector are irregular or incomplete. The sector is marked by weak public and financial management systems. The water sector needs (i) a

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<sup>6</sup> Development Coordination (accessible from the list of linked documents in Appendix 2).

<sup>7</sup> OECD and Environmental Action Programme Task Force. 2008. *National Policy Dialogue on Financing Strategy for Rural Water Supply and Sanitation in Armenia*. Yerevan.

functional alignment for the agencies working in the sector, with a regulator that has the capacity and systems to undertake tariff reforms when needed and enforce performance targets; (ii) transparent and rationalized transfers and subsidies to the water sector for financial sustainability; (iii) sound financial management and internal audit; and (iv) improvements in business processes, including for asset management.

8. The government, in collaboration with ADB, the European Union, German development cooperation through KfW, OECD, and the World Bank, is rigorously reviewing the water sector to guide the reforms planned for 2016 onward. Areas for early attention include (i) streamlined institutional framework for policy, regulation, asset management, service delivery, and dispute resolution functions; (ii) sector-wide strategies for tariffs, metering, nonrevenue water, and asset management and maintenance; and (iii) system and capacity enhancements for more efficient planning, budgeting, procurement, contract management, and allocative efficiency.

9. The government has been working with development agencies and the private sector to improve road and water supply infrastructure, but competent capital investment and maintenance needs far exceed the resources available. In addition, the current systems can benefit from significant efficiency enhancements to receive better value from expenditures. Both sectors are acutely underfunded, and the government's long-term planning and sector management capacity is limited. Improved sector management and service delivery in road and water supply requires (i) integrated sector management informed by sound asset management; (ii) effective financial management and additional financing options; and (iii) aligned department and agency responsibilities, functions, and accountabilities to help achieve targets in each sector. These findings echo the lessons from ADB's ongoing initiatives in the road and water sectors, the country programming, and other development partners' experiences in Armenia.

10. The program will support the government's development agenda on sustainable infrastructure provision as articulated in the Armenia Development Strategy 2014–2025; the Medium-Term Expenditure Framework, 2014–2016; and the Republic of Armenia Government Program.<sup>8</sup> It is also aligned with ADB's Midterm Review of Strategy 2020; the Water Operational Plan, 2011–2020; the Sustainable Transport Initiative Operational Plan; and the development priorities identified in the country operations business plan, 2014–2016.<sup>9</sup> The program will introduce a cross-sector approach, where sector and finance ministries collaborate at all four levels of results-based management—planning, budgeting, implementation, and monitoring. To support the reforms, ADB will partner with the Ministry of Finance (MOF) for optimal resource mobilization, the Ministry of Transport and Communication (MOTC) for the national road network, MTA for regional coordination, and PSRC and SCWE for drinking water supply. These implementing agencies will undertake the institutional and policy reforms detailed in the design and monitoring framework (Appendix 1).

11. The core development challenge has been the limited impact that sector investments, delivered through the sector agencies, have had on Armenia's road and water sector sustainability. Finance, water, road, and regulatory agencies will be equally engaged in this program's results. The program will complement sector interventions by ADB and other

<sup>8</sup> Government of Armenia. 2012. *Medium-Term Expenditure Framework 2013–2015*. Yerevan; Government of Armenia. 2012. *Republic of Armenia Government Program*. Yerevan.

<sup>9</sup> ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila; ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila; ADB. 2011. *Water Operational Plan, 2011–2020*. Manila; ADB. 2010. *Sustainable Transport Initiative Operational Plan*. Manila; ADB. 2013. *Country Operations Business Plan: Armenia, 2014–2016*. Manila.



development partners, and incorporate the lessons learned in program design for realistic baselines, adequately funded and achievable program targets. The program will provide a more integrated approach and an opportunity to undertake deeper, more sustainable reforms in the two sectors. The policy matrix in Appendix 4 sets forth the preconditions for the release of two tranches under the loan. The program was designed in close coordination with the development partners that support Armenia's road, water, and public management sectors, including the European Union, German development cooperation through Deutsche Gesellschaft für Internationale Zusammenarbeit and KfW, the United States Agency for International Development, and the World Bank to optimize synergies and avoid duplication.<sup>10</sup> The program team's findings were regularly shared with civil society, service user organizations, public and private service providers, academia, and development partners during the design phase through workshops, seminars, and bilateral meetings. These stakeholders were then consulted specifically on the importance, relevance, and achievability of the proposed reforms, and their feedback was incorporated in the program design. This participatory approach will continue during loan implementation to ensure program results are achieved as Armenia's development needs evolve.

## **B. Impact and Outcome**

12. The impact will be improved service delivery in the road transport and water supply sectors. The outcome will be results-based management systems implemented in the road transport and water supply sectors.

## **C. Outputs**

13. **Output 1: Sector management systems improved.** The segmented sector structure is a common binding constraint for the two sectors. To enable informed and efficient management of the road sector, the program will support the government in establishing a road council (an MOTC-led, multi-agency advisory body for coordination of road maintenance policies and investment decisions across the country). The road council will comprise management representatives from the ministries of economy, finance, nature protection, territorial administration (which coordinates regional infrastructure), and other ministries and agencies as required. MTA will lead a multi-agency working group, which will review the roles of key water sector agencies to align their responsibilities and functions more effectively. Results of this review will inform the preparation of Armenia's next water sector strategy with a financing plan. The Water Code 2002 and related legal acts will be aligned with the new water sector strategy to provide the required legal guidance for the developing sector.

14. **Output 2: Strategies and processes to allocate investments more efficiently developed.** The government will adopt a financing strategy for road maintenance and implement it from 2015 onwards through a participatory process. The road council will, as part of its coordinating function, validate road maintenance expenditures, which will be developed based on road asset management principles. Quantitative and qualitative performance indicators will be included in the medium-term expenditure framework (MTEF), 2015–2017 for both the road and water sectors to institutionalize results monitoring. To improve financial planning, transparency, and accountability in the water sector, the government will (i) fully exercise its shareholder role by requiring transparent and complete financial reports from water

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<sup>10</sup> Development Coordination (accessible from the list of linked documents in Appendix 2).

sector operators and by using this information for financial planning, and (ii) explicitly state the amounts and objectives of water sector subsidies in budget publications.

15. **Output 3: Regulatory frameworks improved.** Sector development targets may be met more consistently in the long run if the sector is regulated according to clearly defined standards. To improve service standards and better safeguard user rights, MOTC's regulatory mandate will be defined for Armenia's entire road network, including state, republic, and local roads. MOTC will establish a regulatory department to carry out this mandate. Furthermore, MOTC will adopt a streamlined system to receive feedback from users and redress grievances. It will be implemented by the regulatory department. PSRC, which regulates the water sector, will adopt a similar system to address water user concerns and service delivery failures.

16. **Output 4: Monitoring systems strengthened.** Regulatory systems are only as good as the results they generate, which should be monitored through complete, verifiable, up-to-date information systems on assets and financial positions. A geo-referenced video inventory of the country's road network will be completed during the program period. For better informed policy and investment decision making, international roughness index of all roads will be monitored annually. To improve oversight of drinking water supply assets, SCWE will implement an asset management system and improve information sharing between the public and private agencies. The internal audit capacity within the key counterpart agencies will be developed to support better links between budget and audit, as well as between audit reports and policy decisions. Regularly updated performance data will better inform policy and financial decisions; they will be shared with key stakeholders in a timely manner to keep beneficiaries engaged in ensuring service quality. MOTC, PSRC, and SCWE will develop and implement public information plans to increase accountability, improve customer service, and enable better informed and broader-based public engagement with the service providers.

#### **D. Development Financing Needs**

17. The government has requested a loan in various currencies equivalent to SDR 31,770,000 (\$49,000,000 equivalent) from ADB's Special Funds resources to help finance the program.<sup>11</sup> The loan will have a 25-year term, including a grace period of 5 years, an interest rate of 2.0% per annum during the grace period and thereafter, and such other terms and conditions set forth in the draft loan agreement. The loan proceeds will be used to finance the full exchange cost (excluding local taxes and duties) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources.

18. The loan will be released in two tranches, subject to compliance with the agreed-upon tranche release conditions in Appendix 4. The first tranche in the amount of SDR12,967,000 (\$20 million equivalent) will be released upon loan effectiveness; the second tranche in the amount of SDR 18,803,000 (\$29 million equivalent) is expected to be released in the third quarter of 2015. The loan size and tranche amounts are justified by (i) the nature and sequence of reforms that are required; (ii) cost of implementing these reforms; (iii) the government's resources for development expenditure and financing needs (Table 1); and (iv) the time required to undertake the reforms.

19. The 2009 economic crisis and the countercyclical fiscal package increased the financing

<sup>11</sup> The government's Development Policy Letter is in Appendix 3.

gap. The public debt-to-GDP ratio jumped from 16.4% in 2008 to 43.6% in 2013.<sup>12</sup> Public debt service is projected to continue its upward trend. The government's fiscal consolidation process, initiated after the economic recovery of 2010–2011, reduced the budget deficit from 7.6% of GDP in 2009 to 1.5% in 2012 and 0.4% in 2013. A new package of tax amendments for excise, income, and mining taxes was approved in 2012. The package aims to increase revenues, thus enabling higher public expenditures for development. The planned budget deficit for 2014 is 2.3% of GDP, and is projected to be 2.0% of GDP in 2015.<sup>13</sup> The government expects to reduce the budget deficit despite the 8% rise in public spending, largely because of higher public sector salaries and pensions envisaged in 2014.<sup>14</sup>

**Table 1: State Budget Financing Gap for 2013, 2014 (Planned), 2015 (Projected)**

Item	Amount (\$ million)			Share of GDP (%)		
	2013	2014	2015	2013	2014	2015
1. Revenues and grants <sup>a</sup>	2,603.5	2,802.9	3,125.9	25.0	24.0	23.6
2. Expenditure	2,643.6	3,075.6	3,390.7	25.4	26.4	25.6
of which development expenditure <sup>b</sup>	268.9	226.2	281.4	2.6	1.9	2.1
3. Overall fiscal balance (1–2)	(40.0)	(272.7)	(264.8)	(0.4)	(2.3)	(2.0)
4. Debt repayment, of which	531.2	514.2	536.2	5.1	4.4	4.1
4.1 External public debt <sup>c</sup>	220.9	188.5	169.5	2.1	1.6	1.3
4.2 Domestic public debt	310.3	325.7	366.7	3.0	2.8	2.8
5. Financing gap (excluding domestic debt) (3–4.1)	261.0	461.3	434.3	2.5	4.0	3.3

( ) = negative, GDP = gross domestic product.

Note: GDP for 2013 = \$10,416.1 million, 2014 = \$11,656.0 million, and 2015 = \$13,235.9 million. \$1 = AMD409.64 for 2013 and \$1 = AMD405.26 for 2014 and 2015. Numbers are rounded and may not sum precisely. The government's planned development expenditure in program areas, preparedness to undertake the envisaged reforms, absorptive capacity vis-à-vis the debt-to-GDP ratio, and expected development assistance have been assessed for this analysis.

<sup>a</sup> Excluding the proposed program loan from the Asian Development Bank.

<sup>b</sup> Includes expenditures on transport, road network, and communication; and housing and public utilities.

<sup>c</sup> The sale of Armenia's first eurobonds in September 2013 (\$700 million in 7-year bonds at 6.25%) enabled early repayment of a \$500 million loan to support its 2009 anti-crisis program. The loan, with 15-year maturity and an interest rate 300 basis points above the London interbank offered rate, was provided by the Russian Federation.

Sources: 2014 State Budget Law; Medium-Term Expenditure Framework, 2014–2016; National Statistical Service; International Monetary Fund (IMF). 2013. IMF Country Report 13/238.

20. The government's overall financing needs (excluding domestic debt) in 2014 are \$461.3 million and are projected to be \$434.3 million for 2015. The largest development expenditure item is social protection at 6.9% of GDP in 2013, 7.7% in 2014, and 7.6% in 2015. Expenditure on transport, road network, and communication and on housing and public utilities constituted 2.6% of GDP in 2013 and is planned to be 1.9% in 2014 and 2.1% in 2015 (Table 1). Expenditure on water was about 0.5% of GDP for 2013, a level that is expected to be maintained in 2014.<sup>15</sup> Expenditure for transport, road network, and communication was about 1.4% of GDP in 2013 and is expected to be about 1.5% of GDP in 2014. The current annual level of financing for the public road network is \$62 million–\$68 million (0.62%–0.68% of GDP).

<sup>12</sup> Source: National Statistical Service of the Republic of Armenia.

<sup>13</sup> Government of Armenia. 2013. *Medium-term Expenditure Framework 2014-2016*. Armenia. The government's access to domestic and international financial markets is limited. It has raised \$700 million from eurobonds, \$440 million of which were allocated to repay a Russian Federation loan of \$500 million. Armenia graduated from the International Monetary Fund's concessional funding in March 2013; its graduation from the World Bank list is under discussion. This will increase the cost of funds and strain the fiscal space for infrastructure.

<sup>14</sup> Source: 2014 State Budget Law. <http://www.minfin.am>

<sup>15</sup> It is envisaged at 0.4% of GDP per annum for the Armenia Development Strategy implementation period from 2013 to 2025.

This includes financing for rehabilitation, which is considered periodic road maintenance, but excludes road improvement, reconstruction, and new construction works such as the North–South Road Corridor Project. Improvements in policy and operational systems are expected to create fiscal space, reduce the financing gap with prudent financial management, and improve the value-for-money of road investments through better prioritization and monitoring of results.

## **E. Implementation Arrangements**

21. MOF is the executing agency. The implementing agencies are the MOF, MOTC, MTA, PSRC, and SCWE with the responsibilities described in para. 10 and the program design and monitoring framework in Appendix 1. A steering committee, chaired by the executive director of the Foreign Financing Project Management Center in MOF and comprising working-level implementing agency representatives, will oversee day-to-day implementation of program activities. The proceeds of the loan will be disbursed to Armenia as the borrower in accordance with ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*.<sup>16</sup> The program implementation period is from November 2013 to September 2015.

## **III. TECHNICAL ASSISTANCE**

22. The Capacity Development TA for Strengthening Sector Management Capacity in Road and Water Sectors will be attached to the loan to support the government in effective and timely implementation of tranche 2 policy actions. The TA is estimated to cost \$1,000,000, of which \$900,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources). The government will provide counterpart support in the form of staff, office, administrative and logistics support, interpretation, and other in-kind contributions. It will be implemented from TA effectiveness, expected to be in November 2014, to September 2015. MOF will be the executing agency and ADB will oversee implementation.<sup>17</sup>

23. The TA outputs will include (i) a consolidated drinking water supply sector strategy with a financing plan for Armenia; (ii) draft amendments to align relevant legislation with the drinking water supply sector strategy; and (iii) a financing strategy for road maintenance. The TA will also provide training and technical advice to MOF, MOTC, SCWE, and PSRC to (i) implement results-based budgeting in water and roads, including development and analysis of key performance indicators (KPIs); (ii) disseminate and implement the public information plans for road and water users; (iii) develop and manage the water asset register; and (iv) prepare risk-based audit plans and conduct performance audits in the two sectors.

24. The TA will require 16 person-months of international and 34 person-months of national consulting services through short-term and co-sourcing arrangements.<sup>18</sup> The government has welcomed co-sourcing as it will allow for on-site and longer-term engagement of experts for knowledge and skills transfer rather than capacity substitution by consultants, as has been the case to date. The team of international and national consultants will consist of (i) public financial management specialists, (ii) road transport and water supply economists, (iii) a public utilities regulatory affairs specialist, (iv) water sector engineers, (v) road engineers, (vi) a data and systems management specialist, (vii) internal audit specialists, and (viii) a legal expert. The

<sup>16</sup> ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

<sup>17</sup> Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

<sup>18</sup> Co-sourcing involves combining services from within and outside a business to achieve the same goal. In this case, it refers to technical experts working with experts in counterpart agencies to deliver certain outputs and expedite the capacity transfer process.

internal audit specialists will be recruited through an audit firm. International consultants will be recruited through a firm using quality- and cost-based selection with a quality–cost ratio of 80:20 and simplified technical proposals. National consultants will be engaged individually since the required qualifications are diverse and difficult to source from one consulting firm. The consultants will prepare regular progress reports, and TA deliverables will be made available in Armenian and English. All consultants and resource persons will be recruited in accordance with ADB's *Guidelines on the Use of Consultants* (2013, as amended from time to time). All disbursements will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).

#### **IV. DUE DILIGENCE**

##### **A. Economic and Financial**

25. Public financial management and economic analysis of Armenia have been conducted as part of the loan design background work and the upcoming country partnership strategy. The identified gaps have been incorporated into the program design, including the importance of prudent financial management as well as adequate resources for a sustainable road network.

26. Water sector financial assessments indicated that water and trading losses are high, and tariffs fall short of full cost recovery. Water operators receive 21% of their annual income as explicit and implicit subsidies from the government and bilateral assistance to Armenia from France and Germany. The financial losses accumulated until 2013 were about \$75 million, or 0.75% of GDP. Greater transparency in public subsidies, tariff calculation, technical and financial losses, and the overall financial situation of the water sector is expected to increase the incentives for water companies to reduce water losses. This can reduce the size of the government's annual (explicit and implicit) subsidy to the sector—estimated at 0.1% of GDP—and free resources for regular maintenance, repair, and upgrading of infrastructure, thus improving service provision to the population.<sup>19</sup> The introduction of a consolidated water assets register will increase the information available for investment planning.

27. Improved qualitative and quantitative KPIs for the road and water sectors in the budget process are expected to result in more efficient budget allocations. The KPIs have been linked with the planning and budgeting processes during the program preparatory phase, as demonstrated in the MTEF, 2014–16 and the 2014 Budget Law. The link between the KPIs and the implementation and monitoring processes will be further strengthened during the program period. Risk-based performance audits and better qualified auditors will improve the quality of audits. The appointment of independent non-executive members to the MOTC and SCWE audit committees (including from civil society organizations) will further strengthen the internal audit system.

##### **B. Governance**

28. The legal and regulatory framework for public financial management is developing. Management of treasury operations has improved, with almost all government expenditures going through a single account. Armenia has adopted the Law on Internal Audit based on international good practice, and the establishment of internal audit departments and committees

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<sup>19</sup> Yerevan Djur is using its own resources to finance 40% of the regular maintenance, repair, and upgrading of water infrastructure, while the other utilities are heavily dependent on development partner financing.

in sector agencies is under way. Program budgeting reforms are ongoing. The Budget System Law was adopted, with a coding system for program-based budget classifications. Budget reporting remains largely input-oriented. The Law on Internal Audit has not been fully implemented because of weak capacity in the Ministry of Finance and in the internal audit units. A weak internal control environment can lead to fiduciary risks. The program will help build planning, budgeting, performance, and financial monitoring capacity in the two sectors to strengthen the public financial management and internal control environment.

29. Armenia has improved the legal and institutional frameworks for public procurement. The Procurement Law went into effect on 1 January 2005, leading to the introduction of procurement procedures. The Road Map for Finalizing e-Procurement Reform in the Republic of Armenia, 2013–2015 was adopted, and a procurement support center was established in 2013 to review procurement processes and provide procurement training and advice. However, the center’s capacity is limited. The transparency of procurement has improved since 2011 with tender and procurement announcements made through media outlets and the internet, and the engagement of the procurement appeals council. The oversight of contracting arrangements in road and water supply sectors need to be restructured and strengthened to align the incentives of the government and contractors. The program will help upgrade procurement outcomes by improving contract oversight.

30. The government’s efforts to fight corruption have had limited success. The Anti-Corruption Monitoring Commission, set up in 2009, oversaw the implementation of the Anti-Corruption Strategy and Action Plan, 2009–2012. The Anti-Corruption Council is responsible for approving anticorruption policies and coordinating related activities. However, it has not produced a report since 2011. The program will help strengthen transparency in public expenditure. ADB’s Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and MOF.

### **C. Poverty and Social**

31. The program is expected to have a positive indirect impact on the poor and nonpoor as it will strengthen the efficiency, predictability, and transparency of public resource allocations and use in the road and water sectors. Efficiency gains from better resource and expenditure management in these sectors will improve the quality, coverage, and delivery of public services. Better-maintained road networks will increase access and create more opportunities for economic and social integration. A better managed and regulated water network will broaden the beneficiary base and improve service quality. Sector-specific, time-bound public information plans and diligently implemented grievance redress mechanisms will better inform and empower road and water users. Program characteristics are not amenable to gender design. No adverse impact on poor and vulnerable groups from the policy reforms is envisaged under the program.

### **D. Safeguards**

32. The program supports policy reforms and institutional and capacity strengthening in road and water sector management. In compliance with ADB’s Safeguard Policy Statement (2009), the program is classified under category C for impacts on the environment, involuntary resettlement, and indigenous peoples.

### **E. Risks and Mitigating Measures**

33. Major risks and mitigating measures are summarized in Table 2 and described in detail

in the risk assessment and risk management plan.<sup>20</sup> The integrated benefits and impacts of the program are expected to outweigh the costs with the existing mitigating measures.

**Table 2: Summary of Major Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigating Measures</b>
Different levels of capacity in MOTC, SCWE, MTA, and MOF to implement budget processes may delay adoption of results-based management in the transport and water supply sectors.	TA is attached to the program to build capacity and improve budgetary and management skills in these agencies.
Lack of consensus on reforms might delay program implementation.	Stakeholders, including professional and advocacy groups, service providers, and users were consulted during program design. Public information plans were adopted by MOTC, PSRC, and SCWE to inform and consult stakeholders.
Budget planning is not linked to performance; asset monitoring and internal audit practices are not able to prevent fiduciary risks.	The program will continue to support government to improve budget-performance linkages and the TA will provide extensive capacity building for internal audit.
Weak implementation of procurement contracts, including performance-based ones.	Training on contract management, procurement will be provided to implementing agencies under the attached TA and ongoing regional TAs. <sup>a</sup>
The legal and regulatory framework for anticorruption is adequate but implementation is weak, which reduces the incentives to fight corruption.	The program will help increase budget information available to the public, thus increasing accountability and transparency.

MOF = Ministry of Finance, MOTC = Ministry of Transport and Communication, MTA = Ministry of Territorial Administration, PSRC = Public Services Regulatory Commission, SCWE = State Committee on Water Economy, TA = technical assistance.

<sup>a</sup> Asian Development Bank (ADB). 2012. *Technical Assistance for Developing Procurement Capacity for Improved Procurement Outcomes into Regional Cooperation*. Manila (TA 8262-REG); ADB. 2014. *Technical Assistance for Improving the Capacity and Integrity of Procurement Processes in Central and West Asia into Regional Cooperation*. Manila. (TA 8665-REG).

Sources: ADB. 2013. *Armenia Governance, Institutional, and Corruption Risk Assessment*. Yerevan; ADB estimates.

## V. ASSURANCES

34. The government and the MOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents. The government and the MOF have agreed with ADB on certain covenants for the program, which are set forth in the loan agreement.

## VI. RECOMMENDATION

35. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan in various currencies equivalent to SDR31,770,000 to Armenia for the Infrastructure Sustainability Support Program, from ADB's Special Funds resources, with an interest charge at the rate of 2% per annum during the grace period and thereafter; for a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

29 July 2014

Takehiko Nakao  
President

<sup>20</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

### DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
<p><b>Impact</b> Improved service delivery in the road transport and water supply sectors</p>	<p>At least 50% of the road network (interstate, republic, and local roads in km) is satisfactory or better in riding quality (as measured by IRI <math>\leq</math> 4) by 2020 (2012 baseline: 41%)</p> <p>65% of households have access to 24-hour water supply in 2020 (2012 baseline: 59%)</p>	<p>Long-term development strategy of the government</p> <p>Annual budgets</p> <p>MOTC, SCWE annual reports</p> <p>Poverty and social snapshot reports of the National Statistics Service</p>	<p><b>Assumptions</b> Second wave of water reforms are seamlessly implemented</p> <p>Investments in road transport and water supply sectors continue to meet the Armenia Development Strategy 2025 targets</p>
<p><b>Outcome</b> Results-based management systems implemented in the road transport and water supply sectors</p>	<p>MTEF and budget processes, outturn reporting, and audit processes incorporate sector performance targets by September 2015</p>	<p>Internal audit annual plans of MOTC and SCWE for 2015</p> <p>MOTC's and SCWE's 2015–2017 MTEF submission to MOF</p> <p>MTEF 2016–2018</p> <p>2015 budget message</p>	<p><b>Assumption</b> Government remains committed to program budgeting</p> <p><b>Risks</b> Different levels of capacity in agencies responsible for various components of the budget cycle</p> <p>Lack of consensus on reforms delays the adoption of full results-based management in the two sectors</p>
<p><b>Outputs</b> 1. Sector management systems improved</p>	<p>1.1 Road council, a ministerial body on national road maintenance, established with clearly identified mandate for allocative efficiency by March 2014</p> <p>1.2 Organogram and departmental terms of reference to streamline road sector agencies approved by MOTC by March 2014</p> <p>1.3 MTA-led functional review of key water sector agencies initiated by March 2014 and completed by December 2014</p> <p>1.4 Water supply and sanitation sector strategy with financing plan approved by December 2014</p> <p>1.5 Government decision taken to align the Water Code 2002 and related legal acts with the functional review recommendations and the water sector strategy by June 2015</p>	<p>Published government decision</p> <p>MOTC organogram; updated departmental terms of reference by function and accountability</p> <p>MTA reviewed organogram and agencies' terms of reference by function and accountability</p> <p>Published government decision</p> <p>Published government decision</p>	<p><b>Assumption</b> Draft reports of KfW sector review and strategy study, and the World Bank water sector tariff study are available in time</p>
<p>2. Strategies and processes to allocate investments more efficiently</p>	<p>2.1 Financing strategy for road maintenance 2015 budget targets adopted by December 2014</p> <p>2.2 RAM-based road maintenance expenditure validated by the road</p>	<p>Official Gazette of the Republic of Armenia</p> <p>Road council letter endorsed by all council</p>	<p><b>Assumptions</b> Financing strategy for road maintenance adopted by October 2014</p>



Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
developed	<p>council by September 2015</p> <p>2.3 A KPI-based MTEF adopted for road and water sector with quality indicators by August 2014</p> <p>2.4 An explicit policy statement on government's shareholder role in the water sector included in the MTEF by July 2014</p> <p>2.5 Water sector subsidy objectives explicitly stated in the budget, and classified accurately by August 2014</p>	<p>members</p> <p>MTEF 2015–2017</p> <p>MTEF 2015–2017</p> <p>2015 budget message</p>	Timely availability of consolidated financial information
3. Regulatory frameworks improved	<p>3.1 Regulator functions of MOTC specified for state, republic and local roads by March 2014</p> <p>3.2 Sector regulator set up by MOTC for the entire road network of Armenia by April 2014</p> <p>3.3 A streamlined user feedback and grievance redress system adopted in PSRC and MOTC regulatory body by March 2014</p>	<p>Government decision</p> <p>Government decision</p> <p>MOTC, PSRC orders on adopting the system; MOTC, PSRC websites</p>	
4. Monitoring systems strengthened	<p>4.1 Video inventory of 1,500 km of all interstate and republic roads maintained, and 100% of rehabilitated roads in Armenia prepared by March 2014 and the entire road network by January 2015</p> <p>4.2 SCWE approved calculation framework for water sector's financial position and financing flows (cash and noncash) by February 2014</p> <p>4.3 Risk-based audit planning adopted in road and water sectors by February 2015</p> <p>4.4 Road asset management system, including a road video inventory, adopted as a tool for investment decisions by November 2014</p> <p>4.5 Annual IRI monitoring process adopted by April 2014 and implemented from 2015 onwards</p> <p>4.6 Action plan for water supply asset management approved by January 2014</p> <p>4.7 Water asset register protocol for assets managed by state-regulated operators completed by December 2014</p> <p>4.8 Budget-linked regular road and water sector KPI monitoring (including IRI) endorsed by the government by January 2015</p> <p>4.9 Audit committees appointed in MOTC and SCWE with independent</p>	<p>Video library maintained by the Armenia road directorate and transport project implementation unit</p> <p>SCWE instruction</p> <p>Budget documents MOTC and SCWE audit plans</p> <p>Government decision Geo-referenced asset management database videos available on the MOTC website</p> <p>Government decision</p> <p>SCWE's action plan</p> <p>Water asset register screenshots</p> <p>Government decision</p> <p>MOF order on audit committee staff</p>	<p><b>Assumptions</b></p> <p>Availability and willingness of skilled and experienced persons to serve as non-executive audit committee members</p> <p>Government remains committed to timely public dissemination of sector information</p>

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
	<p>non-executive members by January 2015</p> <p>4.10 Enhanced internal auditors qualification procedures adopted from February 2014</p> <p>4.11 A practice-based component in the certification for the internal auditors of MOTC piloted from July 2014</p> <p>4.12 The latest complete audited financial statements of the water operators (closed joint stock companies) published on the SCWE website from March 2014</p> <p>4.13 Public information plan adopted and implemented for roads and water sectors from March 2014</p> <p>4.14 Explicit composition and inter-utility comparison of water supply tariffs made publicly available by February 2014</p>	<p>requirements; audit committee meeting minutes</p> <p>MOF order</p> <p>Government decision</p> <p>SCWE website</p> <p>Public information plans Updated websites</p> <p>Revised PSRC website</p>	
<b>Activities with Milestones</b>			<b>Inputs</b>
<p>1.1. Terms of reference of the road council identified by March 2014</p> <p>1.2. MTA and MOTC road network maintenance coordination plan drafted by the end of March 2014</p> <p>1.3. Recommendations provided for enhancing SCWE capacity for policy, strategy, public-private partnerships, asset register management responsibilities by the end of March 2014. Staff with requisite skills to manage public private partnership contracts, assets appointed by December 2014</p> <p>1.4. Staff appointed for road network management in all <i>marzpetersans</i> (provincial administrative offices) in accordance with MOTC's job descriptions from April 2014</p> <p>1.5. Provisions for adequate financing of maintenance and loan servicing identified for future water sector public-private partnership contracts by February 2015</p> <p>2.1. Performance indicators for government's shareholder role in water utilities established by April 2014</p> <p>2.2. An explicit policy statement on government's shareholder role in the water sector, stating water subsidy objectives, prepared by June 2014</p> <p>2.3. Government policy on its shareholder role in water sector formally communicated to Board members by August 2014</p> <p>2.4. Latest annual reports of water companies published on website from February 2014</p> <p>2.5. KPIs developed under the TA for road and water sectors integrated in annual budgets starting with the 2014 budget<sup>a</sup></p> <p>2.6. Financial information framework with financing gap developed by SCWE for water sector operators by December 2013</p> <p>2.7. Financial information framework for MTEF 2015–2017 used by SCWE and MOF by July 2014</p> <p>2.8. Actions and targets with tariffs based on its shareholder role and the sector's financial position developed by SCWE and MOF by October 2014</p> <p>2.9. Water sector financing flows (including exemptions) explicitly presented in the government's 2015 budget message by December 2014.</p> <p>3.1. Road network data collected by MOTC and its regulatory activities reported, starting with 2014.</p> <p>4.1. Internal audit committee established in SCWE by February 2014.</p> <p>4.2. Decree on initiating the RAM reform process submitted for approval by April 2014.</p> <p>4.3. MOF order amended to include independent, non-executive members in audit committees by February 2014</p>			<p>ADB loan: \$49 million</p> <p>ADB TA: \$0.9 million</p>

ADB = Asian Development Bank, IRI = international roughness index (meter/kilometer), KPI = key performance indicator, MOF = Ministry of Finance, MOTC = Ministry of Transport and Communication, MTA = Ministry of Territorial Administration, MTEF = medium-term expenditure framework, PSRC = Public Services Regulatory Commission, RAM = road asset management, SCWE = State Committee on Water Economy, TA = technical assistance.

<sup>a</sup> ADB. 2012. *Technical Assistance to Armenia for the Infrastructure Sustainability Support Program*. Manila (TA 8249-ARM, approved 10 December, \$500,000).

Source: Asian Development Bank.

**LIST OF LINKED DOCUMENTS**

<http://adb.org/Documents/RRPs/?id=46220-001-3>

1. Loan Agreement
2. Sector Assessment (Summary): Multisector
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Attached Technical Assistance
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

## DEVELOPMENT POLICY LETTER


 MINISTRY OF FINANCE OF THE REPUBLIC OF ARMENIA  
 M I N I S T E R

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*10.03.2014 № 1/12.5-2/3551-14*

To: Mr. Takehiko Nakao  
 President of Asian Development Bank

*Subject: Request for ADB's support for the government's agenda on sustainable infrastructure provision-Development Policy Letter*

Dear President Nakao,

I am writing to you to request ADB assistance in our efforts to improve the financial and physical sustainability of the road transport and water supply infrastructure, through enhanced results-based management.

This letter explains Armenia's recent economic developments; provides information on reforms that are being implemented by the Government of the Republic of Armenia in the areas of public financial management and water supply and road transport systems; donor support to our reforms in these areas; and how the proposed program addresses infrastructure sustainability through improved results-based management.

**A. Armenia's economic performance**

**Armenia has made significant progress in recovering from the global crisis.** Economic recovery continued in 2013, with GDP growth at 2.6% in the first nine months of 2013, although lower than 7.2% recorded in 2012. Industry, agriculture, and services were responsible for the stronger performance, as construction declined.

**Despite the progress there were some important challenges for the economy in 2013.** The primary negative factor which affected economic performance is high inflation, primarily due to price increases in electricity and imported gas from July 2013. Inflation peaked at 9.2% in August and dropped gradually to 5.6%, slightly above the Central bank's target band of 4% +/- 1.5 percentage points. This in turn forced the Central Bank to raise the refinancing rate to 8.5%, which restrained growth.

Unfortunately, construction of the North-South highway was slower than planned, which in turn also contributed negatively on economic growth.

We remain committed to our structural reform agenda which will provide additional impetus to growth and will make it steadier. We have drafted a new Armenian Development Strategy 2025 to guide our efforts to ensure sustainable growth. The main goal of the Armenian Development Strategy is to create more high-productivity jobs through reforms to: (i) further improve the business environment; (ii) deepen the financial sector; (iii) further develop industry and export-promotion institutions; (iv) improve labor market conditions; (v) upgrade and develop infrastructure in water, irrigation, transport, and electricity; (vi) promote human capital development through better education and healthcare; (vii) strengthen social protection through a new pension system and other forms of assistance; and (ix) modernize public administration and governance, by improving the efficiency and transparency of decision-making and civil society participation.

## B. Public Financial Management Reforms in Armenia.

We believe that a sound public financial management system is key to achieving Armenia's development objectives. The purpose of the reforms being implemented by the Government is to increase the efficiency of public expenditure management through (i) strengthening fiscal discipline, which will contribute to macroeconomic stability and predictability of the budget system; (ii) guaranteeing the linkage of funds to main policies and priorities through following up on strategic approaches; (iii) guaranteeing efficient, effective and economic use of funds; and (iv) ensuring accountability in public spending. The ultimate goal is to improve the quality, and timeliness of delivered services.

Substantial activities have been undertaken by the Government in recent years covering all areas of public financial management, including: introducing program based budgeting; establishing a government financial management information system; tightening internal controls; and having modern accounting, procurement, and debt management procedures. Since 2012, all budgetary authorities plan their budgets in a program budget format (including non-financial indicators describing results) and present monitoring reports. The development of "program passports" has started, as an important tool for linking sector policy and the budget. Program classifications of public expenditures have been introduced and program classifications have been integrated with systems based on other classifications. An internal public finance supervision and audit mechanism has been established as a condition for ensuring the targeting and effectiveness of budgetary expenditures.

With further public finance management reforms and introducing and applying budget planning, monitoring and accountability tools, a comprehensive public finance management strategy for the period 2011-2020 was approved by the government of Armenia in 2010. The strategy is intended to form the basis for stronger coordination of various reform elements to ensure proper sequencing across the financial management cycle.

Although program classification of the budget has already been developed, further work is required to fine-tune its content. One of the cornerstones of program budgeting reforms is that the budget not only be seen as a financial document, but also a sector policy document for sector specialists of budgetary agencies.

The full introduction of internal public finance supervision will ensure transactions comply with proper financial management, transparency, expenditure and targeting effectiveness, savings and the requirements of relevant legislation. In the next two years, the full introduction of internal audit in all state organizations and local self-governing bodies will be completed, and a unified electronic information system will be created, which will allow for the implementation of all phases of internal audit with the use of relevant computer software. To complement this work, efforts are also needed for capacity building.

### **C. The Government's commitment for public investments in support infrastructure**

**We believe that public investments play a significant role in increasing the overall potential for development of the country and improving the quality, efficiency and accessibility of public services.** To ensure an adequate level of public investment, it is important to have an effective management system for the entire public investment management cycle and to improve it continuously through selecting programs within a sectors' priorities framework, and assessing and implementing supervision functions.

**The road and water sectors feature prominently in the government's development agenda given their direct social and economic impact.**

**In the transport sector**, it includes improving transport links of secondary towns with each other and with Yerevan, and reducing disparities between Yerevan and the rest of the country in accessing potable water. The transport sector priorities identified in the Armenian Development Strategy includes reconstruction of the North-South road and at least one road connecting each settlement with the rest of the country; strengthening of road subsector management; improving public transport services; and developing eco-friendly transport. The Government Program for 2013–2017, the medium-term action plan, also calls for an increase in public funds allocated to maintenance and rehabilitation of roads and for more efficient utilization of these funds. The primary issues in the management of non-current assets would be introducing a unified register for public non-current assets and introducing a non-current assets management plan in all organizations of the public sector.

**In the water sector**, the Armenian Development Strategy sets priorities to enhance the reliability and effectiveness of water systems operations, improve the continuity and quality of water supply and mitigate regional disparities via an investment target of 0.4% of GDP. The government is currently initiating a second generation of reforms based on experiences during the last decade, and the development scenarios and recommendations by various donor-funded studies. The main objectives of the reform initiatives are to (i) achieve full cost recovery for the sector; (ii) assure financing for necessary capital investments; (iii) improve efficiency of water utilities with particular focus on water loss reduction; and (iv) agree on legal, institutional and financing options for communities not included in the service area by the water utilities. The first milestone for sector reform will be in 2016 when new PPP contracts for service providers are to be concluded. The water sector investment policy also includes developing a special approach to include the 560 rural communities, where water supply is not currently provided by specialized organizations.



#### **D. Donor assistance**

We have been working closely with all partners, including ADB, to mobilize resources enabling us to plan and execute public expenditure projects in support of infrastructure development, but the assessed needs in these sectors far exceed the resources available to address them. The proposed new program complements and builds on efforts by other donors in their support of the infrastructure sector.

The proposed Infrastructure Sustainability Support Program from ADB will help us strengthen results-based management systems to address sector management constraints and to better define and meet road and water sector development priorities. The program will introduce a cross-sectoral approach for sector and finance ministries, scaled up to all four levels of results-based management—planning, budgeting, implementation, and monitoring—within and between sectors.

#### **E. Our Request to ADB**

**Dear President Nakao,**

In the recent months, we have been working closely and productively with ADB colleagues whom we believe share our views on the important role of public investments for sustainable and inclusive economic growth. In particular, we strongly agree on the need to improve service delivery in the road transport and water supply sectors.

The program will help us (i) improve these sectors' management systems, (ii) develop and implement strategies and processes for greater allocative efficiency in investment decisions, (iii) improve regulatory frameworks, and (iv) implement complete, verifiable, up-to-date information systems on assets and financial positions. To help finance the program, we request that ADB provide a loan from its Special Funds resources in the amount of \$49 million equivalent. Of this amount, we would request that \$20 million equivalent be disbursed after completion of the Tranche 1 policy actions (expected within the first half of 2014), with the balance of \$29 million equivalent to be disbursed after completion of the Tranche 2 policy actions (expected within the first half of 2015).

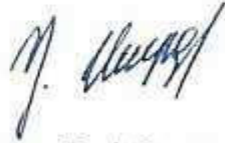
We also request a technical assistance (TA) grant of \$900,000 to support the program which will help the government ensure effective and timely implementation of Tranche 2 policy actions of the Program. The TA will help produce: (i) a consolidated drinking water supply sector strategy with financing plan that will coordinate the second wave of water sector reforms in Armenia; (ii) draft amendments to align relevant legislation with the drinking water supply sector strategy; and (iii) develop a financing strategy for road maintenance. The TA will also provide training and technical advice to the Ministry of Finance, the Ministry of Transport and Communications, State Committee for Water Economy, and to the Public Services Regulatory Commission in (i) implementing results-based budgeting in water and roads, including development and analysis of key performance indicators; (ii) developing and disseminating public

information plans for roads and water users; (iii) collecting data for, and managing of, the water asset register; and (iv) preparing risk-based audit plans and conducting performance audits.

We look forward to working together to improve the sustainability of infrastructure investments and related service provision in roads and water sectors through enhanced results-based management.

We look forward to continuing our fruitful cooperation.

Sincerely Yours,

A handwritten signature in black ink, appearing to read 'Davit Sargsyan', written in a cursive style.

Davit Sargsyan



## POLICY MATRIX

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
<b>Output 1: Improved sector management systems</b>					
<b>Roads:</b>					
To enable informed and efficient management of the road sector, (i) the Government establishes the Road Council, the MOTC-led advisory body for coordination of road maintenance (1.1) and (ii) MOTC organogram and departmental terms of reference are each updated to streamline the road sector agencies (1.2)	<p><b>(1.1)<sup>a</sup> Complied with.</b> The Government Decree #264-A on the establishment and the charter of the Road Council was approved on 13 February 2014.</p> <p><b>(1.2) Complied with.</b> The Government Decree #268-N was approved on 13 March 2014 and published in the Official Gazette on 26 March 2014. MOTC ministerial order N132-A was signed upon promulgation of the decree, as per government procedures. MOTC provided the updated organogram, departmental terms of reference.</p>	<p>(i) Published Government decision</p> <p>(ii) Published Government decision approving the establishment of a regulatory body in MOTC, and MOTC ministerial order approving updated organogram and departmental terms of reference by function and accountability</p>			
<b>Water:</b>					
To streamline water supply agencies' responsibilities and functions, MTA initiates a review of key water sector agencies by function and accountability (1.3)	<p><b>(1.3) Complied with.</b> The Government approved a resolution mandating the MTA to conduct a review of the functions performed by key water sector agencies and the terms of reference for the</p>	Government resolution mandating MTA to conduct the review (including MTA terms of reference)	To facilitate long-term planning for the water supply sector, the Government approves each of (i) a sector strategy with financing plan (1.4); (ii) the streamlining of water sector agencies'	<b>(1.4)</b> No current strategy for the (drinking) water supply sector. SCWE will develop a sector strategy for short, medium and long-term sector development by December 2014	<p>(i) Government protocol decision</p> <p>(ii) Government protocol decision</p> <p>(iii) Published Government decision</p>

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
	review as per the Prime Minister's Order N134-A dated 24.02.2014 and a working group established with Government Decree #192-A on 17 March 2014. The working group held its first meeting on 17 March and the meeting minutes were provided to ADB.		functions (1.3); and (iii) alignment of the Water Code 2002 and related legal acts with the functional review recommendations and sector strategy (1.5)	(1.3) Recommendations will be approved by the government by December 2014  (1.5) Implications, including institutional, for the Water Code 2002 and related legal acts, emerging from sector strategy from 2016 onwards will be identified by June 2015	
<b>Output 2: - Strategies and processes for greater allocative efficiency in investment decisions</b>					
			<p><b>Roads:</b></p> <p>To improve the allocative efficiency of investment decisions in the road sector, the government adopts a Financing Strategy for Road Maintenance with 2015 budget targets (2.1)</p> <p>Road Council, the MOTC-led advisory body, validates RAM-based road maintenance expenditure (2.2)</p> <p>The Government adopts a key performance indicator (KPI)-based</p>	<p>(2.1) The financing strategy will be developed by MOTC, in consultation with MOF, and with TA support</p> <p>(2.2) TA 8249 provided advisor and capacity development support on RAMs. Program CDTA will further support creation of a complete RAM for the entire public road network</p> <p>(2.3) MOF-MOTC working group has developed KPIs, which</p>	<p>Government Protocol Decision; Annex to 2015 road maintenance program submitted to MOF/Government</p> <p>Road Council letter endorsed by all members of the Road Council</p> <p>Published Government decision on MTEF 2015-2017</p>

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
			<p>MTEF 2015-2017 for road sector with quality indicators (2.3)</p> <p><b>Water:</b></p> <p>To improve policy effectiveness, transparency and accountability in the water sector, (i) the Government explicitly presents in its budget message a policy statement on its shareholder role (including its financial objective as shareholder) in the water sector and the objectives of the water sector subsidies (2.4), (ii) SCWE and MOF develop actions and targets with tariffs based on its shareholder role and the sector's financial position (2.5) and (iii) the Government adopts a KPI-based MTEF 2015-2017 for water sector with quality indicators (2.3)</p>	<p>were incorporated into MTEF 2014-16 and the 2014 Budget. Government Decree is required to adopt these KPIs, to be a part of the MTEF</p> <p><b>(2.4)</b> MOF will include a policy statement on its shareholder's role in the water sector in the budget message submitted to the Parliament by September 2014</p> <p><b>(2.3 &amp; 2.5)</b> The SCWE will (a) calculate the aggregate financial position and financing flows for the sector, and (b) prepare indicators for water quality to be included in the MTEF for 2015-2017 by February 2014. The government will include this information in the budget message and in the MTEF</p>	<p>(i) Draft 2015 Budget Message (ii) Draft 2015 Budget Message (iii) Published Government Decision on MTEF2015-2017</p>

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
<b>Output 3: Regulatory Frameworks</b>					
<p><b>Roads:</b></p> <p>To improve service standards and better safeguard user rights, (i) regulatory functions of MOTC specified for interstate, republic and local roads (3.1) and (ii) MOTC formally sets-up a sector regulator for the entire road network of Armenia (3.2)</p> <p>To enhance its role as regulator of the road sector, a streamlined user feedback and grievance redress system adopted by MOTC (3.3)</p>	<p><b>(3.1) Complied with.</b> Government Decree #265-N was approved on 13 February, as amended with Government Decree (#268-N) on 13 March 2014. It was published in the Official Gazette N15 (1028) on 26 March 2014.</p> <p><b>(3.2) Complied with.</b> MOTC ministerial order was adopted by the Order 132-A on 8 April 2014 upon promulgation of Decree #268-N, as per government procedures.</p>	<p>(i) Published Government Decree (ii) Published Government Decree MOTC Order</p>			
<p>To enhance its role as regulator of the road sector, a streamlined user feedback and grievance redress system adopted by MOTC (3.3)</p>	<p><b>(3.3) Complied with.</b> Adopted by the MOTC Order 88-A on 11 March 2014 and posted on their website. (May be accessed at <a href="http://mtc.am/pages.php?lang=1&amp;id=196&amp;page_name=seniority_decision">http://mtc.am/pages.php?lang=1&amp;id=196&amp;page_name=seniority_decision</a>)</p>	<p>MOTC Order on adoption of the user feedback and grievance redress system MOTC website screenshots showing public disclosure of the system</p>			
<p><b>Water:</b></p> <p>To enhance its role as regulator of the water sector, PSRC adopts a streamlined user feedback and grievance redress system (3.3)</p>	<p><b>(3.3) Complied with.</b> Adopted by the PSRC Order 56-HN on 20 February 2014, as amended by the PSRC Order 68-HN on 7 March</p>	<p>Updated PSRC Order on user feedback and grievance redress mechanism, and PSRC website screenshot showing</p>			

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
	2014. It was posted on their website. (May be accessed at <a href="http://psrc.am/am/?nid=87">http://psrc.am/am/?nid=87</a> )	public disclosure of such mechanism			
<b>Output 4: Implementation monitoring systems</b>					
<p><b>Roads:</b></p> <p>Video inventory created for 1,500km of interstate and republic roads, and 100% of roads rehabilitated in Armenia in 2013, to be maintained by ARD and PIU, MOTC in a video library (4.1)</p> <p>To enable better informed decision-making for policy and investment purposes, annual international roughness index (IRI) monitoring process adopted (4.5)</p>	<p><b>(4.1) Complied with.</b> CDs with required video samples of geo-referenced road footage and list for 1500 km of maintained and 100% (119 km) of rehabilitated roads were provided by MOTC in February and March 2014, with MOTC Chief of Staff letter 09/17/3231-14 certifying the submission.</p> <p><b>(4.5) Complied with.</b> Government Decree #263-N was approved on 13 March 2014 and published in the Official Gazette N15 (1028) on 26 March 2014.</p> <p>The process was adopted by the MOTC Order 131-A on 8 April 2014, upon promulgation of Decree 263-N.</p>	<p>CD providing at least 1 minute of video footage of each road section, with each such road section identified</p> <p>Map/list of roads stretches with completed video processing</p> <p>Updated Published Government decision</p>	<p><b>Roads:</b></p> <p>Video inventory created of the entire road network, to be maintained by ARD and PIU, MOTC in a video library (4.1)</p> <p>To enable better informed decision-making for policy and investment purposes, (i) road asset management system, including a road video inventory, adopted as a tool for investment decisions (4.4), and (ii) annual IRI monitoring process implemented from 2015 onwards (4.5)</p> <p>Budget-linked regular road sector KPI monitoring (including</p>	<p><b>(4.1)</b> Network inventory will be completed throughout 2014.</p> <p><b>(4.4)</b> ARD and Transport PIU have started using the GPS video inventory tool.</p> <p><b>(4.5)</b> ARD currently conducts IRI monitoring for about 1500 kms annually</p> <p><b>(4.8)</b> KPIs have been developed and incorporated into MTEF.</p>	<p>CD providing at least 1 minute of video footage of each road section, with each such road section identified</p> <p>Map/list of roads stretches already completed video processing</p> <p>(i) Published Government decision (ii) GPS enabled asset management database videos available on the MOTC website</p> <p>Published Government decision</p>

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
<p>To improve service provision and transparency, MOTC approves and implements (through corresponding updates to its website) a comprehensive public information plan (PIP) for the road sector (4.13)</p> <p><b>Water:</b></p> <p>To improve policy effectiveness, transparency and accountability in the water sector, SCWE approves calculation framework for calculation of water sector's financial position and financing flows (cash and non-cash) (4.2)</p> <p>To improve oversight and management of drinking water supply assets, SCWE approves an asset</p>	<p><b>(4.13) Complied with.</b> PIP was adopted by the MOTC Order 56-A on 18 February 2014, as amended with the Order 90-A on 13 March 2014.</p> <p><b>(4.2) Complied with.</b> The framework was adopted by the SCWE Order 208-A on 28 December 2013, as amended by the SCWE Order 33-A on 11 March 2014.</p> <p><b>(4.6) Complied with.</b> The Action Plan was adopted by the SCWE Order 14-A on 31 January 2014.</p>	<p>MOTC ministerial order approving PIP, which shall indicate the information to be disclosed and frequency of disclosure; MOTC website screenshots showing disclosure of information pursuant to PIP</p> <p>SCWE Order on calculation framework</p> <p>SCWE Order approving the action plan</p>	<p>IRI) endorsed by government (4.8)</p> <p>To improve service provision and transparency, MOTC discloses all required information in accordance with its approved PIP (4.13)</p> <p><b>Water:</b></p> <p>To improve oversight and management of drinking water supply assets, SCWE completes assets</p>	<p>IRI measurements are being conducted by ARD in about 1500 kms annually. It is anticipated that IRI measurements will extend to all paved roads</p> <p><b>(4.13)</b> MOTC started posting information on its website.</p> <p><b>(4.7)</b> SCWE will provide a standard exchange format for utilities' to share their asset information with SCWE</p>	<p>MOTC website screenshots showing actual disclosure of information pursuant to its PIP</p> <p>SCWE legal act on asset register and requirement for periodic updates thereto, and screenshot of asset</p>

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
<p>management action plan (4.6)</p> <p>To improve service provision and transparency, SCWE and PSRC each approves and implements (through corresponding updates to its website) a comprehensive public information plan (PIP) (4.13). PIP for SCWE shall require disclosure of, among others, the latest complete audited financial statements of the water operators (Closed Joint Stock Companies) on its website (4.12). PIP for PSRC shall require disclosure of, among others, composition, and comparison of tariffs between various operators (4.14)</p>	<p><b>(4.12) Complied with.</b> Most recent audit reports of all 5 operators for FY2012 are published on the SCWE website as of 13 March 2014. (May be accessed at <a href="http://www.scws.am/index.php?menu1=240&amp;menu2=241">http://www.scws.am/index.php?menu1=240&amp;menu2=241</a>; <a href="http://www.scws.am/index.php?menu1=240&amp;menu2=244">http://www.scws.am/index.php?menu1=240&amp;menu2=244</a>)</p> <p><b>(4.13) Complied with.</b> PSRC PIP was adopted by the PSRC Order 56-HN on 20 February 2014, as amended by the PSRC Order 68-HN of 7 March 2014. SCWE PIP was adopted by the SCWE Order 20-A on 14 February 2014, as amended by the SCWE Order 34-A on 11 March 2014.</p> <p><b>(4.14) Complied with.</b> PSRC functions and tariff policy set forth with the</p>	<p>SCWE and PSRC Orders approving PIPs, which shall indicate the information to be disclosed and frequency of disclosure SCWE and PSRC website screenshots showing actual disclosure of information pursuant to PIP</p>	<p>register of assets managed by state regulated operators (4.7)</p> <p>Budget-linked regular water sector KPI monitoring endorsed by Government (4.8)</p> <p>To improve policy effectiveness, transparency and accountability in the water sector, SCWE and PSRC disclose all required information in accordance with their respective approved PIPs (4.13)</p>	<p>by September 2014</p> <p><b>(4.8)</b> KPIs have been developed and incorporated into MTEF</p> <p><b>(4.13)</b> SCWE will publish the latest audited financial statements (for FY 2013) on its website by February 2015</p>	<p>register</p> <p>Published Government decision on MTEF 2015-2017</p> <p>SCWE and PSRC website screenshots showing actual disclosure of information pursuant to respective PIPs</p>

TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
<p><b>Roads and Water:</b></p> <p>To improve qualifications of internal auditors, the government adopts a requirement for all qualified internal auditors to pass continuous professional development (CPD) programs each year, in order to remain qualified (4.10)</p>	<p>PSRC Order 56-HN on 20 February 2014, and as amended by the PSRC Order 68-HN on 7 March 2014. (May be accessed at <a href="http://psrc.am/am/?nid=87">http://psrc.am/am/?nid=87</a>)</p> <p><b>(4.10) Complied with.</b> Government Decree #176-N was approved on 13 February 2014 and published in the Official Gazette issue N10 (1023) on 5 March 2014.</p>	<p>Published Government decision (<a href="http://www.arlis.am">www.arlis.am</a>)</p>	<p><b>Roads and Water:</b></p> <p>To improve standards of certification for internal auditors, the Government will pilot the inclusion of a practice-based component in the certification for the internal auditors of MOTC (4.11)</p>	<p><b>(4.11)</b> Currently, certification of internal auditors is based on classroom training (30 hours) and a multiple choice examination. With this pilot, the internal auditors in MOTC will have to demonstrate practical competence in conducting audit tasks to renew their certification by February 2015. The internal audit IT software recently implemented can be the source of verification of internal auditors' practical competence</p> <p>MOF will (i) draft necessary instruments to initiate the pilot by June 2014, and (ii) identify core competences that would have to be demonstrated by internal auditors during</p>	<p>- MOF ministerial order on piloting practical component for certification of internal auditors in road and water sectors - List of core competencies for internal auditors/criteria - List of MOTC and SCWE internal auditors certified under the pilot (with personalized documentary evidence for competence)</p>



TRANCHE 1			TRANCHE 2		
Policy Actions	Status of implementation (as of 1 July 2014)	Documentary Evidence	Policy Actions	Status of implementation	Documentary Evidence
			<p>To improve internal audit effectiveness and oversight, appoint audit committees in MOTC and SCWE and include non-executive members in their composition (4.9)</p> <p>MOTC and SCWE approve risk-based audit annual plans for road and water sectors (4.3)</p>	<p>audit field practice by December 2014</p> <p><b>(4.9)</b> The audit committee in MOTC and SCWE have been established but they are dormant and only include executive members.</p> <p><b>(4.3)</b> This will be supported by audit specialists engaged through co-sourcing arrangements under the ADB TA from June 2014-June 2015. The co-sourcing will enable skills transfer and the capacity to create future audit plans in-house</p>	<ul style="list-style-type: none"> <li>- Revised MOF ministerial order mandating appointment of non-executive members and specifying eligibility/qualification requirements</li> <li>- Minutes of meetings of the audit committees in MOTC and SCWE showing consideration of audit findings and recommendations, and participation of non-executive members in their composition</li> </ul> <p>Annual risk-based audit plans approved by the respective head of audit unit for each of MOTC and SCWE</p>

ADB = Asian Development Bank, ARD = Armenia Road Directorate, CDTA = capacity development technical assistance, GPS = global positioning system, IRI = international roughness index (meter/kilometer), KPI = key performance indicator, MOF = Ministry of Finance, MOTC = Ministry of Transport and Communication, MTA = Ministry of Territorial Administration, RAM = road asset management, MTEF = medium-term expenditure framework, PIP = public information plan, PIU = project implementation unit, PSRC = Public Services Regulatory Commission, SCWE = State Committee on Water Economy, TA = technical assistance, TOR = terms of reference.

<sup>a</sup> The notation (1.1) and subsequent numbering of the same format refer to the policy conditions as listed in the program design and monitoring framework (Appendix 1).