



Report and Recommendation of the President to the Board of Directors

Project Number: 51045-001
December 2017

Proposed Loan Sughdneft Limited Liability Company Sughdneft Expansion Project (Tajikistan)

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 4 December 2017)

Currency unit	–	somoni (TJS)
TJS1.00	=	\$0.113
\$1.00	=	TJS8.81

ABBREVIATIONS

ADB	–	Asian Development Bank
ESMS	–	environmental and social management system
GDP	–	gross domestic product
LPG	–	liquefied petroleum gas
RFS	–	retail fuel station
Sughdneft	–	Sughdneft Limited Liability Company
TA	–	technical assistance
US	–	United States

NOTE

In this report, “\$” refers to United States dollars.

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PROJECT AT A GLANCE

1. Basic Data		Project Number: 51045-001	
Project Name	Sughdneft Expansion Project	Department /Division	PSOD/PSIF1
Country	TAJ		
Borrower	Sughdneft Limited Liability Company		
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Energy	Oil and gas transmission and distribution		2.50
		Total	2.50
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
Environmentally sustainable growth (ESG)	Eco-efficiency		
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Organizational development	No gender elements (NGE)	✓
Partnerships (PAR)	Implementation		
Private sector development (PSD)	Private Sector Promotion of private sector investment		
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	No	Rural	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG7		
6. Nonsovereign Operation Risk Rating			
Obligor Name		Obligor Risk Rating	Facility Risk Rating
Sughdneft Limited Liability Company			
7. Safeguard Categorization Environment: B Involuntary Resettlement: C Indigenous Peoples: C			
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		2.50	
Nonsovereign LIBOR Based Loan (Regular Loan): Ordinary capital resources		2.50	
B-Loans		0.00	
None		0.00	
Official Cofinancing		0.00	
None		0.00	
Others		0.28	
Total		2.78	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan of up to \$2,500,000 to Sughdneft Limited Liability Company (Sughdneft) for the Sughdneft Expansion Project in Tajikistan.

2. The proposed loan will provide long-term US dollar debt that is currently unavailable in the market. Providing a long tenor loan will enable the company to amortize the up-front costs of its retail network expansion over longer periods, given the long asset life of the facilities. ADB's participation will also support better standards in respect of accounting, transparency, technical safety and environmental and social management systems at Sughdneft.

II. THE PROJECT

A. Project Identification and Description

1. Project Identification

3. Tajikistan has sustained high economic growth since its civil war ended in 1997. Driven mainly by agriculture and services, real gross domestic product (GDP) grew by an average of 7.2% a year during 1997–2014.¹ The post-conflict recovery was strong, aided by significant increases in remittance inflows and a favorable external environment, especially the rapid economic development in the Russian Federation. The country moved from low-income to lower middle-income status in July 2015, and its per capita gross national income (Atlas method) was \$1,280 in 2015.

4. Despite strong economic results, Tajikistan remains one of the poorest countries in Central Asia, with an estimated 29.3% of the population living below the national poverty line in 2016.² High economic growth has not translated into high private investment and employment opportunities. Outputs and exports are constrained by limited production and low value added. The economy has remained largely agrarian, with the agriculture sector absorbing 67% of the labor force, but the sector still suffers from low productivity.

5. Remittance-financed consumption is the main source of growth. Remittances have played a significant role in poverty reduction, but they are dependent on external factors affecting countries hosting Tajik migrant workers, so relying on them to sustain high growth is a significant risk. About 1 million Tajiks work abroad, mostly in the Russian Federation, which provides 95% of all remittance inflows.³ Remittances rose from 6.4% of GDP in 2002 to a peak of 49.6% in 2013. They have since fallen to 32.6% of GDP in 2016, as the plunge in the Russian ruble and the sharp recession in the Russian Federation contributed to a 43% decline in remittances in United States (US) dollar terms since 2014.⁴ The decline in remittances also reflects the return of many Tajik migrant workers because of more restrictive laws and continuing recession in the Russian Federation. From 2013 to 2016, the number of Tajik migrant workers in the Russian Federation

¹ Asian Development Bank (ADB). 2016. *Tajikistan: Promoting Export Diversification and Growth—Country Diagnostic Study*. Manila.

² Agency on Statistics under President of the Republic of Tajikistan. Macroeconomic Indicators. <http://www.stat.tj/en/macroeconomic-indicators/>.

³ Central Bank of the Russian Federation. <https://www.cbr.ru/eng/>.

⁴ ADB. 2016. *Asian Development Outlook 2016: Asia's Potential Growth*. Manila; and ADB. 2017. *Asian Development Outlook 2017: Transcending the Middle-Income Challenge*. Manila.

fell by 35.3%. Some 333,391 Tajiks have been banned from working in the Russian Federation for up to 5 years.

6. Tajikistan has a poor record of providing small and medium-sized enterprises with access to finance. In its Doing Business 2017 report,⁵ the World Bank ranks Tajikistan 118th out of 190 countries for access to credit, down from 109th in 2016. Since 2014, Tajikistan's banking system has recorded losses, and a sharp rise in nonperforming loans has reduced bank capital, reducing their appetite to do more business. High interest rates and short loan maturities have discouraged many small and medium-sized enterprises from undertaking long-term productive investments—hindering job creation and compounding the economic problems of an already fragile economy.

7. Further, with more than 70% of loans denominated in foreign currency, businesses bear the risk of currency mismatch. Because of these factors, credit to the private sector dropped by 13% in 2016. On top of a business slowdown, the depreciation of the somoni by nearly 50% since the beginning of 2015 has resulted in a sharp rise in nonperforming loans, from 29.9% at the end of 2015 to 54.7% at the end of September 2016. This resulted in the average ratio of bank capital to risk-weighted assets falling to 5.4%, less than half the regulatory requirement of 12.0%. Four banks faced possible insolvency, limiting access to deposits and preventing the timely settlement of payments and tax liabilities. To maintain confidence in the banking system, the Government of Tajikistan recapitalized these four banks in December 2016 at a cost of nearly \$500 million, equal to 7.1% of GDP.

8. ADB's Private Sector Operations Department has been exploring opportunities in Tajikistan since 2007, and has benefited from reforms undertaken by ADB's Central and West Asia Department—especially work to improve the investment climate by reducing the cost of doing business, strengthening the protection of doing business, and increasing business innovation and productivity.⁶ ADB's Private Sector Operations Department has focused on identifying projects poised for expansion, which have high potential for job creation. This is based on (i) the nascent private sector; (ii) the conservative view adopted by local commercial banks, which only provide working capital and/or short-term loans (stunting long-term investment and leading to high opportunity costs, resulting in the loss of jobs and tax revenues); and (iii) the increase in the unemployment rate, as thousands of migrant workers return from the Russian Federation. It is within this context that the project was identified.

9. Sughneft is engaged in wholesale and retail operations of liquefied petroleum gas (LPG), petrol, diesel, oil, and lubricants; and owns and operates six retail fuel stations (RFSs) in the Sughd province. It plans to expand its retail footprint in the region by adding seven new RFSs and associated petroleum handling and storage facilities, and by increasing its distribution fleet and mobile testing labs during the period 2017 – 2021. Sughneft approached the Asian Development Bank (ADB) for financial support for its business expansion plan and to provide long-tenor financing that matches its long-fixed asset life, since only working capital finance or short-term loans are available at present, which cannot be used for expansion financing because of the asset–liability mismatch.

⁵ World Bank. Ease of Doing Business in Tajikistan. <http://www.doingbusiness.org/data/exploreconomies/tajikistan>.

⁶ ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan and Grant for Subprogram 2 to the Republic of Tajikistan for the Investment Climate Reforms Program*. Manila.

2. Project Design

10. (Confidential information redacted).

3. Borrower

11. (Confidential information redacted).

12. (Confidential information redacted).

13. Integrity due diligence was conducted.⁷ (Confidential information redacted).

B. Development Impact, Outcome, and Output

14. **Impact.** The project would contribute to ensuring energy security and efficient use of energy which remains a strategic goal of the National Development Strategy.⁸

15. **Outcome.** The project will have the following outcome: increased availability of fuel in Sughd province. Sughdneft's business expansion plan requires new employees for the operation of RFSs, and Sughdneft's business expansion has the potential to create direct jobs, including jobs for women.

16. **Output.** Successful implementation will result in the expansion of fuel distribution capacity in the Sughd province. The construction activities for new RFSs will create temporary direct and indirect employment opportunities.⁹

C. Alignment with ADB Strategy and Operations

17. **Consistency with ADB strategy and country strategy.** The project is consistent with ADB's Midterm Review of Strategy 2020, which identifies poverty reduction and inclusive economic growth and infrastructure development as two of the four strategic priorities of ADB operations.¹⁰ The project is also aligned with ADB's country partnership strategy for Tajikistan, 2016–2020, which highlights investment climate reforms and skills development to increase productive employment.¹¹

18. **Consistency with sector strategy and relevant ADB operations.** The project facilitates improved access to longer tenor financing, which matches the asset life of the company's facilities. Under a recent country diagnostic study for Tajikistan,¹² ADB identified limited access to finance and its high costs as the most important factor inhibiting private investment and job creation. The proposed financing will help address some of the challenges to growth identified in the country diagnostic study.

⁷ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

⁸ Government of Tajikistan. 2016. *National Development Strategy of the Republic of Tajikistan for the Period of up to 2030*. Dushanbe.

⁹ The design and monitoring framework is in Appendix 1.

¹⁰ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

¹¹ ADB. 2016. *Country Partnership Strategy: Tajikistan, 2016–2020*. Manila.

¹² ADB. 2016. *Tajikistan: Promoting Export Diversification and Growth—Country Diagnostic Study*. Manila.

D. Project Cost and Financing Plan

19. (Confidential information redacted).

E. Implementation Arrangements

20. (Confidential information redacted).

F. Projected Financial and Economic Performance

21. (Confidential information redacted).

III. THE PROPOSED ADB ASSISTANCE**A. The Assistance**

22. ADB will provide a senior secured corporate finance loan of up to \$2,500,000 with a tenor of up to 7 years, including a grace period of 2 years. The loan will carry an interest rate (as well as fees) as determined by ADB's Investment Committee. (Confidential information redacted).

B. Value Added by ADB Assistance

23. ADB's participation will provide Sughdneft with a long-term US dollar loan currently unavailable in the market. In Tajikistan, limited access to finance and high finance costs are major constraints to private investment. Providing Sughdneft with a long tenor loan will enable the company to amortize the up-front costs of its retail network expansion over longer periods, aligned with the long asset life of the facilities. ADB's engagement will show case to other companies in Tajikistan the viability and benefits of such funding thereby stimulating other transactions and consequently economic growth. ADB's participation will also support better standards in respect of accounting, transparency, technical safety and environmental and social management systems at Sughdneft.

C. Risks

24. (Confidential information redacted).

D. Technical Assistance

25. (Confidential information redacted).

IV. POLICY COMPLIANCE**A. Safeguards and Social Dimensions**

26. In compliance with ADB's Safeguard Policy Statement (2009), the project is classified as category B for environment, and category C for involuntary resettlement and indigenous peoples. The requirements for general corporate finance will apply for this project. A compliance audit of the corporate and facility level environmental and social management practices of Sughdneft was undertaken by a qualified and experienced external expert. The audit recommended corrective actions to ensure that procedures and operations are adequate and comply with ADB's Safeguard Policy Statement and other social requirements. The potential environmental and social impacts

of the project have been identified and effective measures to avoid, minimize, mitigate, and compensate for the adverse impacts are incorporated in the safeguard reports and plans. Sughdneft will adopt an ESMS satisfactory to ADB before the first ADB disbursement. Sughdneft will designate qualified environmental and social staff and train staff on the ESMS to enhance implementation of the ESMS.

27. **Environment.** Sughdneft does not have specific corporate codes for environmental management, but follows the requirements of local legislation and ensures compliance with all relevant permissions and authorizations. It also provides safety training for all staff in accordance with regulatory requirements. Impacts associated with the construction of the RFSs are expected to be temporary and of short duration, such as increased ambient dust and noise level, waste generation, vegetation clearing, and risks associated with occupational health and safety. These could be minimized by implementing best practices in construction engineering and planning. Potential operational impacts may occur from petrol leaks of underground storage tanks and the piping system, which may result in soil and groundwater contamination. Petrol and LPG vapor releases from operations may form a flammable atmosphere if mixed with air in certain proportions, and may result in unsafe conditions on RFSs and in nearby communities. International best practices and guidelines (e.g., the International Finance Corporation's Environment, Health, and Safety Guidelines for Retail Petroleum Networks)¹³ will be adopted at the engineering design and operational stages of the project, to minimize potential environmental and safety impacts. An oil and water separator will be installed for the new RFSs to achieve the desired water treatment result. The environmental management plan will include monitoring for leakage and spillage, emissions, effluent, and occupational hazards.

28. **Involuntary resettlement.** Sughdneft's lands for its current facilities were allocated from state land or through the purchase of land use rights from former land users. The audit found no outstanding land issues in Sughdneft's handling terminal and six RFSs covered by the audit. For the proposed development of new RFSs, Sughdneft will apply to the government for the allocation of unencumbered state-owned land plots or purchase existing RFSs from private entities. The land procurement for the RFSs is not expected to entail involuntary resettlement impacts. Sughdneft will conduct the planned land and assets procurement in accordance with the ESMS, aligned with the requirements of ADB's Safeguard Policy Statement.

29. **Indigenous peoples.** The 2010 census of Tajikistan showed that the country has more than 80 ethnic groups (nationalities)—84.2% Tajiks and 13.9% Uzbeks, with other ethnic nationalities such as Kyrgyz, Russians, Turkmens, and Tatars making up the balance. This pattern is similar in the Sughd province, where 84% are Tajiks, and the remainder are Uzbeks, Kyrgyz, Russians, Tatars, Turkmens, and others. All these ethnic nationalities settled in the region many years ago; are fully integrated with the Tajiks; and have the same access to land and natural resources, health and education systems, and social security status. The development of new RFSs in Sughd province will not have impacts on indigenous peoples.

30. **Other social dimensions.** The project is categorized as having no gender elements. Sughdneft offers equal employment opportunities to men and women. Sughdneft and its contractors will comply with national labor laws and, pursuant to ADB's Social Protection Strategy

¹³ International Finance Corporation. 2017. *Environmental, Health, and Safety Guidelines for Retail Petroleum Networks*. http://www.ifc.org/wps/wcm/connect/10f87e804885591b81f4d36a6515bb18/Final+-+Retail+_Petroleum+_Networks.pdf?MOD=AJPERES&id=1323152536731.

(2001), will take measures to comply with internationally recognized core labor standards.¹⁴ Sughdneft's annual environmental and social performance report will also report on (i) its compliance with such laws, and (ii) the measures taken. Information disclosure and consultation with affected people will be conducted in accordance with ADB requirements.¹⁵

B. Anticorruption Policy

31. Sughdneft was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

C. Investment Limitations

32. The proposed loan is within the medium-term, country, industry, group, and single exposure limits for nonsovereign investments.

D. Assurances

33. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),¹⁶ ADB will proceed with the proposed assistance upon establishing that the Government of Tajikistan has no objection to the proposed assistance to Sughdneft. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the ADB Board of Directors.

V. RECOMMENDATION

34. 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 of up to \$2,500,000 from ADB's ordinary capital resources to Sughdneft Limited Liability Company for the Sughdneft Expansion Project in Tajikistan, with such terms and conditions as are substantially in accordance with those set forth in this report and as may be reported to the Board.

Takehiko Nakao
President

13 December 2017

¹⁴ ADB. 2003. Social Protection. Manila (adopted in 2001).

¹⁵ Summary Poverty Reduction and Social Strategy; and Safeguards and Social Dimensions Summary (accessible from the list of linked documents in Appendix 2).

¹⁶ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned with			
National Development Strategy 2016–2030: Ensuring energy security and efficient use of energy. ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome Increased availability of fuel in Sughd Province	By 2025: a. Volume of LPG supplied annually increased to 6,084 tons (2017 baseline: 2,566 tons) b. Volume of diesel supplied annually increased to 1,498 liters (2017 baseline: 632 liters) c. Volume of petrol supplied annually increased to 1,404 liters (2017 baseline: 592 liters) d. Number of jobs provided during operations increased to at least 87 (35% females) (2017 baseline current number of employees: 57) e. Number of jobs provided to women during operation increased to at least 31 (2017 baseline: 16)	a.–e. Sughdneft's annual monitoring reports	Lower-than-expected demand for fuels
Output Expansion of fuel distribution capacity in Sughd Province	By 2024: 1. Number of retail outlets increased to 13 (2017 baseline: 6) 2. Number of jobs provided during construction is at least 50 (2017 baseline: 0)	1.–2. Sughdneft's annual monitoring reports	Construction delays caused by force majeure events
Key Activities with Milestones			
Expansion of energy distribution capacity in Sughd Province			
1. Complete execution of legal documentation by January 2018. 2. Ensure first retail outlet under the expansion project is operational by June 2018.			
Inputs Asian Development Bank: \$2.5 million (loan) Others: \$0.28 million (equity)			
Assumptions for Partner Financing NA			

LPG = liquefied petroleum gas; NA = not applicable.

^a Government of Tajikistan. 2016. *National Development Strategy of the Republic of Tajikistan for the Period of up to 2030*. Dushanbe.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=51045-001-4>

1. Sector Overview
2. Client Information
3. Details of Implementation Arrangements
4. Contribution to the ADB Results Framework
5. Financial Analysis
6. Economic Analysis
7. Country Economic Indicators
8. Summary Poverty Reduction and Social Strategy
9. Safeguards and Social Dimensions Summary
10. Findings of the Corporate Safeguards Audit: Environmental and Social Management System Arrangements

Supplementary Document

11. Integrity and Tax Due Diligence Disclosure