Report and Recommendation of the President to the Board of Directors

Project Number: 43923
November 2010

Proposed Loan
Poti Sea Port Corporation (Georgia)

In accordance with ADB’s public communications policy (PCP, 2005) this abbreviated version of the RRP excludes confidential information and ADB’s assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.
CURRENCY EQUIVALENTS
(as of 30 September 2010)

Currency Unit – lari (GEL)

GEL1.00 = $0.5537
$1.00 = GEL1.8059

ABBREVIATIONS

ADB – Asian Development Bank
CAP – corrective action plan
CAPEX – capital expenditure
CAREC – Central Asia Regional Economic Cooperation
DWT – deadweight tonnage
EBRD – European Bank for Reconstruction and Development
EROIC – economic return on invested capital
ESMS – environmental and social management system
FDI – foreign direct investment
GDP – gross domestic product
HSSE – health, safety, security, and environmental
km – kilometer
LIBOR – London interbank offer rate
m – meters
m² – square meter
PSPC – Poti Sea Port Corporation
RAKIA – Ras Al Khaimah Investment Authority
ROIC – return on invested capital
SR – safeguard requirement
TEU – twenty-foot equivalent unit
TRACECA – Transport Corridor Europe-Caucasus-Asia

NOTE

(i) In this report, "$" refers to US dollars.
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<th>Department/Division</th>
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<tr>
<td>Vice-President</td>
<td>L. Venkatachalam</td>
<td>Private Sector and Cofinancing Operations</td>
</tr>
<tr>
<td>Director General</td>
<td>P. Erquiaga</td>
<td>Private Sector Operations Department (PSOD)</td>
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<td>Director</td>
<td>M. Barrow</td>
<td>Infrastructure Finance Division 1, PSOD</td>
</tr>
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<td>Team leader</td>
<td>S. Shah</td>
<td>Senior Investment Specialist, PSOD</td>
</tr>
<tr>
<td>Team members</td>
<td>H. Brooke</td>
<td>Lead Professional, Office of General Counsel</td>
</tr>
<tr>
<td></td>
<td>G. Kiziria</td>
<td>Senior Country Coordination Officer, Central and West Asia Department</td>
</tr>
<tr>
<td></td>
<td>M. Manabat</td>
<td>Senior Investment Officer, PSOD</td>
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<td></td>
<td>J. Munsayac</td>
<td>Social Safeguard Specialist, PSOD</td>
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<td>M. Pascua</td>
<td>Environment Officer, PSOD</td>
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<td>S. Tu</td>
<td>Senior Environment Specialist, PSOD</td>
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<tr>
<td></td>
<td>J. Ventura</td>
<td>Investment Officer, PSOD</td>
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</table>

In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.
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# PROJECT SUMMARY

<table>
<thead>
<tr>
<th><strong>Borrower</strong></th>
<th>Poti Sea Port Corporation (PSPC)</th>
</tr>
</thead>
</table>
| **Classification** | Targeting classification: General intervention  
Sector (subsectors): Transport, and information and communication technology (water transport)  
Themes (subthemes): **Economic growth** (promoting economic efficiency and enabling business environment, widening access to markets and economic opportunities); regional cooperation and integration (cross-border infrastructure); private sector development (private sector investment)  
Location impact: National (high), regional (high) |
| **Environmental and Social Safeguards Classification** | Environment: Category B  
Involuntary Resettlement: Category C  
Indigenous Peoples: Category C |
| **Project Description** | The financial assistance involves supporting PSPC's modernization of the existing port at Poti, Georgia. It includes investment in equipment and machinery, systems and informational technology, and rehabilitation of breakwater and berths. |
| **Impact, Outcome, and Benefits** | The port of Poti is an integral nodal point of the east–west transport corridor connecting Europe to the Caucasus and Central Asia. The financial assistance will help to modernize and augment this key transport link, resulting in increased and more efficient regional trade. This will lead to greater economic growth in the region and closer regional integration in the Caucasus and Central Asia. It will also promote private sector participation and bring investment and technical expertise to a critical infrastructure asset. |
| **Borrower/ Project Sponsor** | PSPC is the borrower. PSPC was established in 1858 and has been historically owned by the state. In 2008, PSPC underwent privatization through an international competitive bidding process. The winning bidder was Ras Al Khaimah Investment Authority, which now owns 100% of PSPC. |
| **Proposed ADB Assistance** | ADB will provide a loan of $18 million from its ordinary capital resources for general corporate finance purposes. The loan will have a term of up to 6 years. The interest rate, commitment fees, and front-end fee will be determined based on procedures applicable to ADB’s nonsovereign operations, and as approved by ADB’s investment committee. |
The modernization and improvement of the port consists of several small capital investments that will be undertaken under the current PSPC management, which has demonstrated a good track record.

Implementation Arrangements

Justification / ADB Value-Added

ADB should consider the proposed loan for the port of Poti for the following reasons:

(i) Georgia has recently suffered the double shocks of the global financial crisis and war. ADB's proposed financing is critical to bringing much needed external funding into the country and increasing the confidence of the international business community in Georgia.

(ii) Georgia is a relatively new democracy and political risk is therefore perceived to be relatively high. ADB's presence will mitigate this perceived political risk for the sponsor.

(iii) Development of the transport sector is the key to the development and economic growth of Georgia. ADB's proposed financing will play an important role in developing a sector that has been underinvested to date.

(iv) The Poti seaport is a key infrastructure link in the transport corridor connecting Central Asia with the Caucasus and to Europe and beyond. Strengthening and augmenting this key nodal point will improve connectivity and make trade more efficient in the region, leading to greater economic growth and regional integration.


(vi) The proposed loan will be ADB's first nonsovereign intervention in the infrastructure sector in Georgia and will further strengthen the relationship between ADB and Georgia.

NSO Rating 9
I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Poti Sea Port Corporation.

II. BACKGROUND AND RATIONALE

A. Sector Background

1. Economic Overview

2. Georgia is endowed with good natural resources, strong human capital, and is located at a strategic crossroads between Europe and Asia. The Georgian economy has benefited tremendously from structural reforms, macroeconomic stabilization, anticorruption efforts, taxation changes, and economic liberalization measures undertaken since early 2002. These have dramatically improved the business environment. In 2010, Georgia was 11th in the ease-of-doing-business ranking published by the World Bank. The real gross domestic product (GDP) grew by an average of 9.7% during 2002–2006, peaking in 2007 at 12.2% (Table 1). In 2008, however, the underpinnings of economic growth and stability in Georgia were severely shaken by the twin shocks of war with the Russian Federation and the global financial crisis. Before these shocks, GDP expansion had been projected to be 8%–9% in both 2008 and 2009. The war damaged infrastructure and disrupted several sectors of the economy, including construction and transport, dampening overall growth. The global economic downturn led to a decline in foreign direct investment (FDI) and a drying up of private international borrowing. The situation was aggravated by a decline in remittances, a slowdown in Georgia's export markets, and the curtailing of lending by the country’s banks. GDP growth dropped to 2.1% in 2008.

3. At the peak of its economic difficulties during the first half of 2009, the country’s real GDP contracted by 7.8%. However, positive year-on-year growth during the third and fourth quarters of 2009 in such sectors as transport, construction, and financial intermediation, as well as a slight rebound in workers remittances and a modest yet encouraging increase in FDI, helped limit the real GDP contraction for the year overall to 4.0%

Table 1: Georgia Economic Indicators, 2005–2009

<table>
<thead>
<tr>
<th>Item</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices (GEL billion)</td>
<td>9.8</td>
<td>11.6</td>
<td>13.8</td>
<td>17.0</td>
<td>19.1</td>
<td>18.5</td>
</tr>
<tr>
<td>GDP ($ billion)</td>
<td>5.1</td>
<td>6.4</td>
<td>7.7</td>
<td>10.2</td>
<td>12.8</td>
<td>11.1</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>5.9</td>
<td>9.6</td>
<td>9.4</td>
<td>12.2</td>
<td>2.1</td>
<td>(4.0)</td>
</tr>
<tr>
<td>Consumer price inflation, average (%)</td>
<td>5.7</td>
<td>8.3</td>
<td>9.2</td>
<td>9.2</td>
<td>10.0</td>
<td>1.7</td>
</tr>
<tr>
<td>Population (million)</td>
<td>4.5</td>
<td>4.5</td>
<td>4.4</td>
<td>4.4</td>
<td>4.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Exports of goods, FOB ($ million)</td>
<td>1,092.1</td>
<td>1,472.4</td>
<td>1,666.6</td>
<td>2,088.2</td>
<td>2,427.9</td>
<td>1,476.0</td>
</tr>
<tr>
<td>Imports of goods, FOB ($ million)</td>
<td>(2,007.6)</td>
<td>(2,686.6)</td>
<td>(3,685.9)</td>
<td>(4,984.1)</td>
<td>(6,261.2)</td>
<td>(4,231.1)</td>
</tr>
<tr>
<td>Current account balance ($ million)</td>
<td>(420.7)</td>
<td>(762.7)</td>
<td>(1,235.4)</td>
<td>(2,009.2)</td>
<td>(2,915.4)</td>
<td>(1,695.8)</td>
</tr>
<tr>
<td>Foreign exchange reserves, excluding gold ($ million)</td>
<td>386.7</td>
<td>478.6</td>
<td>930.8</td>
<td>1,361.2</td>
<td>1,480.2</td>
<td>1,227.9</td>
</tr>
<tr>
<td>Foreign direct investment ($ million)</td>
<td>483</td>
<td>542</td>
<td>1,076</td>
<td>2,015</td>
<td>1,564</td>
<td>788</td>
</tr>
<tr>
<td>Total external debt ($ million)</td>
<td>2,088</td>
<td>2,657</td>
<td>3,503</td>
<td>4,243</td>
<td>7,734</td>
<td>8,397</td>
</tr>
<tr>
<td>Exchange rate, average (GEL:$)</td>
<td>1.92</td>
<td>1.81</td>
<td>1.78</td>
<td>1.67</td>
<td>1.49</td>
<td>1.67</td>
</tr>
</tbody>
</table>

( ) = negative, FOB = free on board, GDP = gross domestic product.
Sources: Economist Intelligence Unit, Fitch Ratings, Georgia Department of Statistics.

5. Real GDP growth has continued to strengthen during the first half of 2010, despite weaker than projected FDI inflows and spillover effects from instability in the eurozone. Nonetheless, based on two consecutive quarters of solidly expanding economic activity and the resumption of credit growth supported by a gradual lowering of interest rates, the International Monetary Fund revised its projections for full-year 2010 growth from 2.0% to 4.5%.2 Real GDP growth is projected to moderate in 2011 to 4.0% before increasing to 5.0% in 2012.

2. Transport Sector

6. Georgia is at a strategic land and maritime crossroads between Europe and Asia, a natural transport route connecting vast global regions and potential markets of more than 1 billion people. Georgia offers the shortest direct east–west link between Europe and the countries of the Caucasus and Central Asia and also connects the Russian Federation to the north and Turkey and Iran, via Armenia, to its south.

7. Georgia provides a central link in the Transport Corridor Europe–Caucasus–Asia (TRACECA),3 which along with the Central Asia Regional Economic Cooperation (CAREC) program, seeks to revive the historical route of the Silk Road by building a modern land and sea transport corridor connecting the three regions.4 The western end of the corridor begins in Eastern Europe (Bulgaria, Romania, and Ukraine) before crossing Turkey and the Black Sea to the port of Poti in Georgia. It uses the land transport network of the southern Caucasus to reach Baku in Azerbaijan, where it crosses the Caspian Sea via ferries (Baku–Turkmenbashi, Baku–Aktau) and reaches the railway networks of Central Asian states of Turkmenistan and Kazakhstan. The transport networks of these states are connected to destinations in the Kyrgyz

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3 The TRACECA program was launched in Brussels in May 1993 to implement a program to develop a transport corridor on a west–east axis from Europe to Central Asia. TRACECA members include the European Union, Armenia, Azerbaijan, Bulgaria, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Romania, Tajikistan, Turkey, Turkmenistan, Ukraine, and Uzbekistan. http://www.traceca-programme.eu/en/home/
4 The CAREC program is a partnership of Afghanistan, Azerbaijan, the People's Republic of China, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, Uzbekistan, and six multilateral institutions: ADB, the European Bank for Reconstruction and Development, the International Monetary Fund, the Islamic Development Bank, the United Nations Development Programme, and the World Bank.
Republic, Tajikistan, and Uzbekistan, and reach the borders of Afghanistan and People’s Republic of China.

8. Georgia is the transport hub for the southern Caucasus region, (comprising the countries of Armenia, Azerbaijan, and Georgia) and a key link in a route connecting the landlocked Central Asian countries of Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan to important markets through its rail and road system and Black Sea ports. Its location gives Georgia a competitive advantage and makes transport one of its most dynamic economic sectors. In 2009, the sector had an output of about GEL1.12 billion or 6% of Georgia’s GDP, employed more than 39,000 people and moved 21.4 million tons of cargo.

9. Georgia has about 1,500 kilometers (km) of roads in its main network, 70% of which are in good to fair condition. The east–west highway through Azerbaijan and Georgia is important for cargo moving from the southern Caucasus and Central Asia to the Black Sea ports of Poti and Batumi and to the Georgia–Turkey border for further transshipment. Georgian Railways, with 1,583 km of fully electrified railway network track, connects the country’s main seaports to Azerbaijan and Armenia and is a key part of the east–west transit corridor. Georgian Railways is 100% government-owned and is the country’s largest taxpayer and employer.

10. Georgia’s ports, in conjunction with its railroad and highway systems, oil and gas pipelines network and airports constitute the vital infrastructure that connects origin and destination markets. The development of infrastructural capabilities in Georgia will play a critical role in the establishment of a transregional transport, communication and energy corridor, which is an indispensable precondition for the economic development of the broader Caucasus and the Central Asia region.

3. Ports in Georgia

11. Georgia has three main ports; Poti, Batumi, and Kulevi on its Black Sea coast. Georgia’s Black Sea ports handle the majority of cargos flowing from and to the three states of southern Caucasus. Georgia has privatized all its main ports which are now 100% foreign-owned. Total cargo handling by the Georgian ports reached 11.3 million tons in the first half of 2010, which is 20.2% higher than for the same period of 2009 and 21.5% higher than first half of 2008.

12. Batumi, both an oil terminal and a general purpose seaport, is owned by KazTransOil, a subsidiary of KazMunaiGaz, the national oil company of Kazakhstan. Crude oil and oil products make up 80%–90% of its traffic. The port has an annual capacity of 18 million tons for oil and 2.3 million tons for dry cargo. Kulevi is a new specialized oil port built in 2008 and is owned by Soccar, Azerbaijan’s national oil company. It has a capacity of 10 million tons for oil and mainly stores and ships oil and oil products, principally from Azerbaijan.

13. The port of Poti is Georgia’s main port and has been in operation since 1858. Port of Poti is a multi functional port handling all kinds of cargos. It also plans to expand by building a new container port in the near future which will increase its capacity. Poti lies on the shortest route between Central Asia, the Caucasus, and Europe and gives that region’s landlocked nations’ access to the Mediterranean Sea via the Bosphorus. It has significant strategic and cost advantages over its competition. More significantly the advantage of using Poti as a transit port does not depend on lower port charges but rather on its more efficient rail, land and sea linkages.
B. Project Identification and Selection

14. The Government of Georgia made development of Poti port a key priority and privatized it in April 2008 to bring in greatly needed external financial investment and technical and managerial expertise. The international competitive bidding process attracted interest from many major operators, including Dubai Ports. The Ras Al Khaimah Investment Authority (RAKIA) emerged as the winning bidder, acquiring an initial 51% ownership of the port and expanding its stake to 100% in 2009.

15. ADB’s Central and West Asia Department and Private Sector Operations Department identified the port of Poti as a candidate for financing and held meetings with RAKIA in late 2008. The sponsor was interested in ADB participation because they wanted an institution they believed would help mitigate some of the political risks they perceived they faced in operating a recently privatized asset in a volatile region. The sponsor also valued ADB’s experience in the transport sector and its growing presence in Georgia. The sponsor is now implementing a port modernization program for which they are seeking external funding from ADB. Liquidity for such financings within Georgia and in the international commercial markets is constrained.

C. Alignment with ADB Strategy and Operations

1. Consistency with Strategy 2020

16. The financial assistance is consistent with Strategy 2020, ADB’s long-term strategic framework, which emphasizes ADB’s support for infrastructure projects, private sector development, and regional cooperation. An efficient port system is a key factor in improving a country’s competitiveness and attracting investment.

2. Consistency with the Country Strategy

17. ADB’s country strategy for Georgia is now being prepared. The financial assistance is aligned with ADB’s interim operational strategy 2008–2009 for Georgia, which encourages private sector development, investment in the transport sector, and improvement of regional connectivity. The financial assistance is also strongly aligned with the central theme of the Government of Georgia’s development agenda, which is private-sector-led growth.

3. Consistency with the Transport Sector Strategy

18. The financial assistance is consistent with ADB’s sustainable transport initiative operations plan, which encourages private sector investment in the transport sector and investment in cross-border transport hubs that promote regional economic integration by enabling growth in trade.

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6 Presentation of the Georgia country partnership strategy to the Board is expected in late 2011 or early 2012.
III. THE PROJECT

A. Project Description

1. The Sponsor

19. RAKIA is a state entity owned by Ras Al Khaimah (RAK), which is one of the seven emirates comprising the United Arab Emirates. The prime objective of RAKIA is the sustainable economic development of RAK by making and managing sound investments in RAK and internationally. RAKIA operates domestic and international business units involved in transport, free trade zones, manufacturing, energy, education, and technology. RAKIA is a professionally run organization with each business unit acting independently and is managed by an experienced industry specialist who is responsible for the performance of its portfolio companies.

20. The mission of RAKIA’s transport business is to build and operate nodal transport points in emerging markets. Other investments of this kind include interests in an airport in Georgia and a port in India. In Georgia, RAKIA has made investments in Poti’s port and the first free industrial zone in Georgia. RAKIA sees attractive business opportunities in Georgia and is committed to further investments. RAKIA’s long-term credit rating is the same as that of the emirate of Ras Al Khaimah itself, which Fitch reaffirmed in March 2010 at A, with a stable outlook.

2. Port of Poti

21. The port of Poti is the only true universal port in Georgia and handles both dry cargo and container traffic to and from several countries (Table 2). The cargo passing through this international hub reflects the economies of the nations its serves along the TRACECA corridor and mainly consists of minerals and agricultural products. Appendix 5 describes in greater detail the different cargoes passing through the port.

Table 2: Origin and Destination of Cargo Traffic for Port of Poti

<table>
<thead>
<tr>
<th>Countries of Origin</th>
<th>Countries of Destination</th>
</tr>
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<tbody>
<tr>
<td>Turkey</td>
<td>Azerbaijan</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Georgia</td>
</tr>
<tr>
<td>Georgia</td>
<td>Armenia</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Italy</td>
</tr>
<tr>
<td>India</td>
<td>Tajikistan</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>Turkey</td>
</tr>
<tr>
<td>Guinea</td>
<td>Ukraine</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Turkmenistan</td>
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<tr>
<td>Tajikistan</td>
<td>Bulgaria</td>
</tr>
<tr>
<td>Others</td>
<td>Other</td>
</tr>
</tbody>
</table>

Source: Poti Sea Port Corporation.

22. The 49-hectare port has operating wharves and storage facilities and is protected by a breakwater. Road and railway connections are good and most of the cargo arrives or leaves by rail. The port has International Standard Quality Management System Compliance Certificate ISO 9001:2000. Appendix 3 describes port infrastructure in detail.

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23. PSPC provides (i) cargo handling operations (containers, bulk, general cargo, and liquids); (ii) port services (towing, sanitation services, ship tying, watchman’s service, and water supply to ships); and (iii) repairs and ancillary services (crane repair and installation, intraport carriage, utility services, dockers services, etc.). It handles dry bulk cargo carriers, container carriers, lighter carriers, railway and motor ferries, liquid cargo carriers, tankers, and other types of ships. Cargo includes grains, minerals, construction materials, metals, chemicals, food products, diesel, kerosene and 20-foot and 40-foot containers.

24. Current port customers are broadly divided into (i) forwarding companies (cargo handling and warehousing); (ii) agency companies (port and other service); and (iii) lessees (leasing, repair of fixed assets, and ancillary services). Major international forwarding companies and agencies such as the Maersk Line, Barwil Georgia, Pace Georgia, and ZIM account for the majority of port business.

3. Competition

25. Other Black Sea ports in Georgia, the Russian Federation, Turkey and Ukraine provide Poti with its main competition. Appendix 4 describes the other main Black Sea ports. Competitive advantage for ports often depends on location, access to principal trade routes, and the quality of their hinterland connections. Poti boasts both a strategic location and relatively good rail and road transport links.

26. Poti seaport’s competitive advantage in connecting to its main hinterland markets in Armenia, Azerbaijan, and Georgia is substantial. Ports in the Russian Federation and Ukraine do not have direct or reliable road or rail connections. The Turkish Black Sea ports of Samsun and Trabzon might compete but face capacity constraints and lack good rail connections with Poti’s main market. Batumi is largely a liquids port, lacks suitable space for expansion, and has poorer, higher-cost rail and road links with these markets. The huge infrastructure investment required makes it unlikely that a new port will be built in Georgia any time soon. All the factors above and the fact that necessary infrastructure required to change the current underlying competitive dynamics will take a long time to emerge limits the potential for serious competition for Poti port’s southern Caucasus traffic over the 6-year life of the ADB loan.

27. The route from Central Asia through Poti is via ferry across the Caspian Sea to Baku and then by rail to the port. Poti is on the shortest land-sea route between Central Asia and Western Europe. Central Asian traffic is expected to grow as infrastructure along the TRACECA corridor improves.

28. Poti has tariff advantage in addition to the overall lower transport costs which customers in Armenia, Azerbaijan and Georgia have when using the port of Poti as their shipping route. The tariff levels indicate that PSPC may have room to increase its tariffs over time.

4. Port Development

29. Poti seaport cargo is well diversified with a balanced mix of containers, bulk, and liquids. It also has a fair mix of export and import traffic and is expected to grow from 2011 onwards with the projected recovery of the economies of its hinterland areas in Armenia, Azerbaijan, Georgia and of Central Asia.  

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30. Poti has to capitalize on its natural competitive advantage and meet its full potential. The current port, though running relatively well is in need of modernization to make the port safer and more efficient. PSPC management has identified a comprehensive infrastructure and systems investment strategy for the development of the port to meet the current and future demand.

31. The main components of the development strategy are (i) construction and rehabilitation (commissioning of berth 15, rehabilitation of breakwater, car terminal, new road and rail connectivity construction, etc.); (ii) purchase of modern equipment and machinery (cranes, tug boat, fire trucks, etc.); and (iii) upgrading of systems (security, terminal operations, vessels traffic management, etc). ADB financing will partly help fund this development strategy, which on successful implementation will lead to better port productivity, augmented capacity and safer operations.

32. PSPC’s strategic vision is to develop Poti into a world class port and enhance the international competitive position of the port and its southern Caucasus hinterland. RAKIA is also developing the Caucasus’ first free trade zone next to the port, with which it should enjoy significant synergies. ADB assistance at this stage is only for the development of the existing port. RAKIA has indicated an interest in approaching ADB to help fund the port expansion.

5. Output and Outcome

33. The output of the financial assistance will be to help modernize the operations of the port of Poti. The outcome of the financial assistance will be to increase the traffic volumes handled by the port of Poti.

B. Development Impact

1. Contribution to Economic Growth and Poverty Reduction

34. Ports are key facilitators of trade and economic growth. The port of Poti is the largest in Georgia and the main access point to the Mediterranean and beyond for Azerbaijan and Armenia. The port is also a central infrastructure link in the transport corridor connecting Central Asia with European and other international markets. ADB's proposed financing in port of Poti will play an important role in developing one of the key nodal points for the region’s transport corridor, which has suffered from a lack of investment. It will strengthen and augment the port’s vital contribution to connectivity in the southern Caucasus region, make trade more efficient, and lead to greater economic growth.

35. A better functioning port is an economic catalyst, boosting productivity and economic growth by providing faster and greater access to markets and resources, enhancing links within and between businesses, and increasing trade and overall economic efficiency. The greater economic activity resulting from increased connectivity, traffic, and commercial activities will help indirectly to reduce poverty in Georgia and the southern Caucasus region.

2. Private Sector Development

36. The government of Georgia has privatized some infrastructure assets to bring in greatly needed investment, technical knowledge, and private sector efficiency. The port of Poti is seen as an early privatization success story and ADB assistance will reinforce this model. Given the port’s high profile in the Georgian economy, its continued successful operation and development is expected to encourage further privatization and foreign investment.
3. Economic Sustainability

37. The financial assistance’s direct and indirect economic benefits will be significant, given the strong positive correlation between improved port transport and economic growth. The economic benefits will primarily accrue to Georgia and to the port’s hinterland areas in Armenia and Azerbaijan. Since the financial assistance involves the modernization of an existing port, it is not meaningful to segregate the incremental economic benefits accruing from the financial assistance alone with precision. For such cases, the Evaluation Cooperation Group 12 recommends using the annual economic rate of invested capital (EROIC) method in evaluating economic performance rather than economic internal rate of return. The calculated annual economic rate of invested capital for the port of Poti ranges from 18% to 22% for 2010 to 2016, which is higher than the social discount rate of 10%. 11

C. Environment and Social Dimensions

1. Environment

38. The financial assistance involves the provision of a loan for general corporate finance purposes. ADB’s Safeguard Policy Statement (2009) requires that a project of this nature undergo a corporate audit of its current environmental and social management system (ESMS) and formulate a corrective action plan (CAP). The audit reports and the CAP are provided in Supplementary Appendixes A, B, and C. Gamma, an independent consulting firm, prepared the environmental audit report on PSPC’s existing operations. The audit found that PSPC operates in compliance with national Georgian legislation and the International Convention for the Prevention of Pollution from Ships, and the Convention on the Protection of the Black Sea from Pollution. It also confirmed that PSPC has the capacity and dedicated resources required for environmental management. The transaction has been classified as category B for environment following the Safeguard Policy Statement.

39. Since September 2009, the borrower has implemented a comprehensive ESMS that has appropriate policies and procedures, adequate staffing and training, as well as a grievance-redress mechanism to address both environmental and involuntary resettlement issues. PSPC has also taken measures to reduce the environmental impact of its current operations. These included (i) construction of collector and treatment systems for industrial wastewater and storm water, (ii) provision of personal protection equipment for personnel, and (iii) testing and safety training. Currently air pollutant concentrations do not exceed limits, except for dust, especially during unfavorable meteorological conditions. The spread of air pollutants is minimized through preventive measures under the ESMS. Hazardous waste is removed by licensed contractors and the separation of wastes is implemented properly through labeled containers. Biological impacts are found to be insignificant. Positive findings include the port’s role in generating employment of local people and in improving socioeconomic conditions in the city of Poti.

40. A time-bound CAP has also been identified that incorporates the recommendations of the audit and is an integral part of the revised ESMS. It includes control measures to cut air emissions, reduce impacts to the aquatic environment, decrease the risk for oil product and liquid chemical spills, and improve waste management practices. As of July 2010, the borrower has retained professional services to monitor atmospheric air quality, water quality, soil contamination, and noise. The results will be reported regularly in the ESMS reporting system. A health, safety, security, and environmental (HSSE) division includes PSPC’s health care, ecology, safety and security, watchmen, and firefighting departments. The grievance-redress

11 The ECG’s GPS-PSIO has set 10% as the threshold for satisfactory economic performance.
mechanism has long been part of a community engagement program and has been formalized under the HSSE division’s general manager.

2. **Social Dimensions**

41. The port of Poti was constructed in 1858 on state-owned land. Expansions and rehabilitation took place in 1889, 1907, and the mid-20th century. The allocation of the port land complied with Georgian laws and involved no physical or economic displacement since the area was primarily vacant swamp. The ongoing modernization program will be confined to the existing port facility and will not require any land acquisition or involuntary resettlement. No communities in the vicinity can be considered indigenous peoples, as defined in the Safeguard Policy Statement. The central control tower of the port is a cultural heritage structure and is protected by Georgian laws but will not be affected by the rehabilitation and modernization.

42. PSPC complies with the national labor code, which embodies all eight International Labour Organization conventions on core labor standards, equal remuneration for men and women and prohibition of all forms of discrimination. Measures to provide better working conditions, a safer environment for its employees, and to improve corporate governance at the port are being implemented. They include better internal labor and safety policies covering recruitment, compensation and benefits, training, and development programs. PSPC is also establishing an employee relations unit to address and resolve employee concerns over work conditions, compensation, and conflicts.

43. PSPC has an HSSE management system, which is implemented by the HSSE division. The division also handles social safeguard issues as part of the environmental and social impact assessment. While the port modernization is category C with respect to involuntary resettlement, PSPC has adopted an ESMS that includes policy principles and procedures covering involuntary resettlement.

44. Since new management took over in 2008, PSPC has conducted several rounds of consultations with stakeholders on the port operations. It will continue to engage along these lines of communication. PSPC has established good relationships with Poti’s local government and the general community. The ESMS adopted by PSPC includes requirements to prepare resettlement plans in the event that the port activities trigger Safeguard Policy Statement requirements. The summary poverty reduction and social strategy is in Appendix 2.

D. **Capital Expenditure and Financing Plan**

45. PSPC has a long-term plan to implement its modernization strategy which includes making key investments over time. Construction risk will be low because the civil works element is relatively small. Experienced vendors will install the equipment and machinery. Individual capital investments will be flexibly timed and spaced out to minimize disruption to port operations. The work will be tendered and be competitively priced.

46. PSPC’s current 3-year capital expenditure plan (2010–2012) is expected to be funded by loans and PSPC’s internally generated cash or equity. The debt financing for this capital expenditure plan is expected to come from the proposed ADB loan and from a loan from the European Bank for Reconstruction and Development, which was closed in early 2010.

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12 The core labor standards are a set of internationally recognized basic rights and principles at work. Georgia has ratified the International Labour Organization’s fundamental conventions.
47. The ADB loan will be a general corporate finance facility. The focus of the corporate finance facility is expected to help partly fund the company in the course of its planned capital expenditure to modernize. The modernization is expected to include the rehabilitation of the breakwater which will be implemented by Boskalis International using state-of-the-art technology. It is also expected to involve rehabilitation of berth 15 for handling bulk cement and grain; and the purchase of equipment which will improve safety and raise port productivity.

E. Implementation Arrangements

1. Management

48. The sponsor has brought in an experienced chief executive officer and key managers to execute its strategy for change and growth while the rest of the port continues to be run by the same pre-privatization employees who have operated it for many years.

49. PSPC will implement the port modernization strategy. Given limited availability in Georgia, most highly specialized equipment will likely be imported from abroad. Civil works will be largely done by local contractors. The new management has already demonstrated a positive impact on the ground by improving port operations and rehabilitating berth 14 in less than a year. PSPC also managed a net profit in 2009 despite a very challenging macroeconomic environment.

2. Anticorruption Policy

50. The sponsor and borrower have been advised of ADB’s Anticorruption Policy (1998, as amended to date) and its Policy on Combating of Money Laundering and the Financing of Terrorism (2003). Consistent with its commitment to good governance, accountability, and transparency, ADB will require PSPC to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism and covenant with ADB to refrain from engaging in such activities. The loan documentation between ADB and PSPC will further allow ADB to investigate any violation or potential violation of these undertakings. Noncompliance by the borrower with any of the undertakings and covenants mentioned above will allow ADB to seek immediate prepayment of the ADB loan.

3. Project Performance Monitoring, Reporting, and Evaluation

51. PSPC will be required to submit quarterly unaudited financial statements and annual financial statements audited by an internationally reputable accounting firm (or its affiliate), based on International Financial Reporting Standards. ADB will monitor progress with respect to PSPC’s updated business plans and operational budgets, and report on progress and make occasional site visits to the port. Appendix 1 contains the design and monitoring framework, including the relevant performance indicators.

F. Projected Operational and Financial Performance

52. The financial projections show that PSPC generates adequate cash flows to service ADB debt under base case and downside scenarios. PSPC’s projections have a 15-year time horizon but ADB analysis has focused on the proposed 6-year life of the loan, which is expected to mature in 2016. The base case assumes that port traffic will grow as economic growth recovers in the Caucasus and Central Asian region (footnote 10). This is line with the historical growth rate of PSPC over the last 10 years.
53. PSPC generates the bulk of its revenues directly from port traffic with additional income from leased berths to third parties under long-term contracts. Current tariffs are assumed to escalate at rates that are lower than the 2003–2009 average inflation rates in Georgia of 7.57%\(^\text{13}\) and the 6.0% inflation forecast for 2010 and 2011.\(^\text{14}\)

54. In the base case, PSPC is expected to generate strong cash flows that will enable it to service its debts during the term of the loan. Projected financials also indicate healthy efficiency. The base case return on invested capital, the ROIC is projected at a range higher than the weighted average cost of capital of PSPC.

55. An independent traffic study at the port was conducted for ADB by KPMG, London and Jacobs Consultancy, London. Their findings were in line with PSPC projections. The financial projections were subjected to sensitivity tests to see how the loan would perform under several scenarios. The sensitivity tests show that financial assistance to PSPC is bankable and can maintain satisfactory debt service capacity even under adverse scenarios.

IV. THE PROPOSED ADB ASSISTANCE

A. The Assistance

1. Instrument and Amount

56. The proposed ADB assistance will consist of a corporate finance loan of up to $18 million. The loan will be funded using ADB’s ordinary capital resources without government guarantee.

2. Terms and Conditions

57. The loan will have a tenor of 6 years and the loan will carry an interest rate as well as commitment and front-end fees to be determined by ADB’s investment committee. The loan agreement will set out the appropriate representations and warranties, covenants (including affirmative, negative, financial, and informational), events of default and security (validly created and perfected in a manner satisfactory to ADB). The loan agreement will also contain conditions precedent to disbursement, including all necessary government and shareholder consents and approvals and compliance with ADB policy and safeguard standards.

3. Compliance with Investment Limitations

58. The transaction, once approved and signed, will increase ADB’s projected nonsovereign exposure by end of June 2011 to $5.8 billion. Additionally, the proposed transaction will increase the nonsovereign exposure to Georgia to $33 million, or 0.6% of the total nonsovereign exposure, and increase nonsovereign exposure in the ports, waterways, and shipping subsector to $18 million, or 0.3% of the total nonsovereign exposure. The proposed financing is within ADB’s approved medium-term, country, industry, single obligor, and group exposure limits for nonsovereign transactions. Indicatively, the transaction would increase the nonsovereign portfolio weighted average risk rating as at 30 June 2010 from 7.40 to 7.43.

B. Justification for ADB Assistance

59. The proposed loan merits ADB’s support for the following reasons:


(i) Georgia has suffered a double shock from the global financial crisis and war. This has resulted in a lack of funding for Georgian projects from international financial markets. ADB’s proposed financing not only provides critically important short-term funding but is also expected to help increase confidence in the international business community about investment in Georgia.

(ii) Georgia is a relatively new democracy and political risk is therefore perceived to be relatively high. ADB, being a multilateral bank with strong and growing relationship with Georgia is seen as being well placed to help mitigate this perceived political risk for the sponsor.

(iii) The port will provide long-term employment opportunities for the people of Poti, where few such opportunities now exist. PSPC is recognized as a good corporate citizen and is committed to investing for the long term future of the port and the people of Poti.

(iv) The proposed loan will be ADB’s first nonsovereign intervention in the infrastructure sector in Georgia. It will further strengthen the relationship of ADB with one of its newest developing member countries. This loan will also be ADB’s first private sector intervention in the port sector after 11 years.

(v) The development of the transport sector is key to the long-term economic development in Georgia, which seeks to capitalize on its natural role as transit country located at a crossroads of the Caucasus, Central Asia, and Europe. ADB’s proposed investment in Poti port, which is an important nodal point, will help develop a crucial sector that has suffered from a lack of investment.

(vi) The port is a key infrastructure link in the transport corridor joining Central Asia and Europe through the Caucasus. Strengthening and augmenting it will improve regional connectivity and cooperation, make trade more efficient, and generate economic growth. It will also complement work being done by ADB in strengthening the Central Asian section of the same transport corridor.\(^\text{15}\)

(vii) The proposed financial assistance is aligned with the emphasis in Strategy 2020 (footnote 5) on infrastructure development, private sector development, and regional integration. It is also strongly aligned with the central theme of the development agenda of the Government of Georgia, which is private sector-led growth. It also conforms to ADB’s interim operational strategy 2008–2009 for Georgia, which encourages private sector development, investment in the transport sector, and improvements to regional connectivity.

C. Risks and Mitigation Measures

60. The financial assistance has been assigned a risk rating for nonsovereign operations of NSO 9. Given that ADB currently has very little nonsovereign exposure in Georgia and none in the port subsector, the project will improve the country and sector diversification of ADB’s nonsovereign portfolio.\(^\text{16}\) The key risks and mitigating measures are summarized below.

(i) **Sponsor and management risk.** The capability of the sponsor and management of PSPC will be an important factor in determining the results of the

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\(^{16}\) ADB made an equity investment of $7.4 million and a loan of $36.1 million in Colombo Port, which was very successful. The loan has been repaid and ADB exited the equity with a profit. ADB. 1999 Report and Recommendation of the President to the Board of Directors: Proposed Loan and Equity Investment for the Colombo Port Development Project. Manila.
port modernization effort. The sponsor, RAKIA is highly rated A by Fitch and PSPC has brought in experienced management from outside. This has already shown positive results on the ground. The port is still largely staffed by seasoned pre-privatization employees who have been running it successfully for many years. PSPC managed to rehabilitate berth 14 successfully in less than a year and to maintain profitability in 2009 despite a very tough macroeconomic environment.

(ii) **Competitive environment.** The strong competitive position of the port, particularly during the loan term, and its competitive tariff structure partly mitigates the market risk related to traffic, tariff, and competition. Port of Poti is seen as having significant competitive advantage in its main hinterland market of Armenia, Azerbaijan, and Georgia because of its superior geographic location and better transport linkages. However, the emergence of stronger competition against Poti in the future cannot be fully discounted.

(iii) **Market risk.** The traffic of Poti is expected to grow as the economy of its hinterland is forecasted to grow and the new management of PSPC implements a more business friendly commercial strategy. The traffic projections have been validated by an independent traffic study and the ADB loan is expected to be serviced even under adverse traffic scenarios. The Poti tariffs’ projected increases are conservatively assumed to be below projected inflation rates.

(iv) **Foreign exchange risk.** The port revenues and costs are denominated in dollars for the most part, the same currency as the ADB loan. This risk is not considered significant.

D. **Assurances**

61. Consistent with the Agreement Establishing the Asian Development Bank, the Government of Georgia will be requested to confirm that it has no objection to the proposed assistance to PSPC. No funding will be disbursed until ADB receives such confirmation. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

V. **RECOMMENDATION**

62. 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 a loan of up to $18,000,000 to the Poti Sea Port Corporation from ADB’s ordinary capital resources, with interest to be determined based on the procedures applicable to ADB’s nonsovereign operations, a tenor of up to 6 years, and such other terms and conditions as are substantially in accordance with those set forth in this report and as may be reported to the Board.

Haruhiko Kuroda  
President

15 November 2010
## DESIGN AND MONITORING FRAMEWORK

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<td>Increase in economic integration of Georgia with the Caucasus and Central Asia</td>
<td>The average growth in Georgia’s annual trade(^a) with Azerbaijan, Armenia, and Central Asia is 6% in the 2010–2015 period(^b)</td>
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<td>Increase in traffic volumes handled by port of Poti</td>
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ADB = Asian Development Bank, EBRD = European Bank for Reconstruction and Development, ESMS = environmental and social management system, FDI = foreign direct investment, Q = quarter.

a Trade is defined as the sum of the dollar value of imports and exports between two countries.
b Baseline annual average growth rate is 5% for 2004–2008.

Layout of Port of Poti

Figure A3.1: Layout of Port of Poti

Source: Poti Sea Port Corporation
Figure A3.2: View of Poti Port