

Public-Private Partnerships in Kazakhstan:
An Evaluation of the Framework and Risks of Public-Private Partnerships

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EXECUTIVE SUMMARY

Located in Central Asia, the Republic of Kazakhstan declared independence on December 16, 1991. Since it is independence, Kazakhstan has been seeking different ways to promote its social and economic development. Kazakhstan has large reserves of natural resources, which are supplemented by its industry and its transportation capacity. However, the country's relatively sparse population and its remote location present unique challenges that make traditional financing mechanisms insufficient. The Kazakhstani government therefore has been looking for creative ways to invest in economic and social development. Public-private partnerships were considered as a special type of cooperation to share risks, mainly financial risk. As a result, the Kazakhstan Public-Private Partnership Center (PPP Center) was established in 2008 under the Ministry of Economic Development and Trade, with the purpose of creating a national framework to support PPPs in Kazakhstan.

While currently there are twenty-one PPP projects at various stages of preparation and implementation within the Kazakhstan, the relatively new government has almost no experience completing PPPs. Most of the PPP projects are still undergoing feasibility studies. This report focuses on risks that the government and private partners assume in terms of the overall PPP model and structure in Kazakhstan. The report presents a brief case study of Aktau village, which could have benefited from better PPP frameworks even though no formal PPP agreement was reached.

The report presents the following research and analysis:

Public Sector Risk

- **Financial Risks:** While private partners traditionally fund concession projects, in Kazakhstan the government may provide financial support up to the amount of the total value of the project. Also the government has assumed the responsibility of funding feasibility studies for all proposed PPP projects. PPP projects often do not begin without extensive government financial support.
- **Monitoring Risks:** Considering Kazakhstan's relatively little experience with PPPs, it will need to provide training or introduce foreign experts who have a decent understanding of PPP projects to be able to monitor and evaluate the outcomes.
- **Institutional Risks:** The complex bureaucratic approval process and lack of competitive bidding system present risks that the project will not be implemented efficiently.

The private partners are facing:

- **Demand Risks:** Kazakhstan is a very large country with a relatively small population. Because of relative small population this report assumes that much of the demand for major infrastructure projects will come from freight rather than passenger traffic. International demand for Kazakhstan's resources will have large impact on the demand for rail and highways.
- **Policy Risks:** Potential private partners are worried about the uncertainty that would come with a presidential administration change. President Nazarbayev is the only president Kazakhstan has had, having risen to power during the collapse of the Soviet Union in 1991. His age and the implications of his death make the long-term policy situation uncertain.

To improve the PPP frameworks to allow for more projects and investment this report includes the following recommendations:

- **Introduce a competitive bidding process for concession projects**
- **Disperse authority to implement PPP projects to the local level and simplify the PPP preparation procedures.**
- **Diversify the financial mechanisms available to fund PPPs.**

INTRODUCTION

Kazakhstan is eager to be recognized in the same circles as wealthy developed countries. Public private partnerships (PPPs) have become a global trend. Governments in more than a hundred countries, both developed and developing, have used PPPs to build and maintain public infrastructure. Kazakhstan has large reserves of natural resources, which are supplemented by its industrial and transport capacity; however, the country's relatively sparse population and its remote location present unique challenges that make traditional methods of financing infrastructure projects insufficient. The Kazakhstani government therefore has been looking for creative ways to invest in economic and social development.

Public-private partnerships were considered as a special type of cooperation to share risks, mainly financial risk, in social and infrastructure development, and attract foreign investment. Policy documents in Kazakhstan emphasized the value for money of PPPs and the lack of public funding. Advocates for PPPs in Kazakhstan argue that that they will reduce public debt and attract more private investment into the country's infrastructure. (Mouraviev). Kazakhstan also wants to appear to be using international best practices in infrastructure development. The government's desire to be considered a developed modernized country makes PPPs attractive. Kazakhstan sees PPPs as a way to be more like developed economies such as the United States, Canada, and Europe. By implementing PPPs, Kazakhstan hopes to achieve the following benefits:

1. More cost effective and time efficient management of public infrastructure projects
2. Integration of modern technology into public infrastructure (PPP center)
3. Risk Sharing
4. More and better financing options for new projects

KAZAKHSTAN PPP Center

The Kazakhstan Public-Private Partnership Center (PPP Center) was established in August 2008. The only shareholder of the Kazakhstan PPP Center is the Government of the Republic Kazakhstan represented by the Ministry of Economic Development and Trade (MEDT). The major reasons for creating this specialized body in Kazakhstan were to ensure transparency, competency, and due diligence in the PPP project selection process; develop a framework to support PPPs in Kazakhstan; and also to accumulate expertise and experience relating to PPPs.

The role of the PPP center includes, but is not limited to,

- Examining PPP projects at all stages of their preparation;
- Preparing recommendations for governmental agencies on the development of legislation and methodological framework for PPP projects.
- Monitoring PPP projects during the course of development and construction.
- Organizing seminars, trainings, conferences and other events relating to PPPs.

CONCESSIONS IN KAZAKHSTAN

In Kazakhstan, the interpretation for PPP is narrowed to simply mean concession. The only model that has been implemented in Kazakhstan is the Build-Transfer-Maintain (BTM). Traditionally a concession is "a public authority assigning to a private company the right to exploit a monopoly service by charging users, usually through making investments at its own risk" (Hall, et. al). This means, a private company is responsible for the design, construction,

operation, and maintenance of capital assets. According to Marlowe, et. Al (2009), the traditional concession is an agreement that

“The public partner grants the private partner full responsibility for all aspects of the design, construction, maintenance, and operations of the facility in exchange for some or all of the revenues generated by it. The public partner’s role is limited to regulating the performance, price, and quantity of the service provided. The facility remains government property, but all maintenance and capital infrastructure investments are the sole responsibility of the private partner.”

This definition implies that in a concession, an asset is constructed or renovated by a private party with the use of private funding. However, the understanding of a concession is somewhat different in Kazakhstan. The existing legislation in Kazakhstan, passed in 2010, allows the government to provide additional forms of support to a concessionaire. The government can (and often does) provide financial support to a project. The legislation limits this support to the total value of the completed project, although the legislation does not explain how to define the total value of a project.

Not only is the definition of concessions different in Kazakhstan, it is also very broad. Kazakhstan’s PPP center has considered concession projects (and also PPPs) in which a government agency or ministry partnered with a majority state-owned company. Typically this would not be considered a PPP in the developed western countries because it is simply a partnership of government entities; however, in Kazakhstan legally this case was treated as a PPP. In several other concession contracts the state has had minority ownership of the private partner. One way the state has occasionally contributed to financing was through equity ownership of the special purpose vehicle (SPV) (USAID 8). However, in recent years private companies have operated under a concession contracts with the government ministry. In general Kazakhstan has a broad understanding of PPPs and uses the term public-private partnership freely.

The majority of current concessions in Kazakhstan are in the transportation sector (road, railroad and airport), the energy sector, and in social infrastructure. Three concessions relating to railroad construction, are meant to attract a private company to manage, maintain, and operate a new railway for 25-30 years (PPP Center). Although a number of PPPs have been implemented none of have been completed. As a result, it is still too early to judge the success of these PPPs, however Kazakhstan’s legal and institutional framework is improving (Mourviev et al. 412).

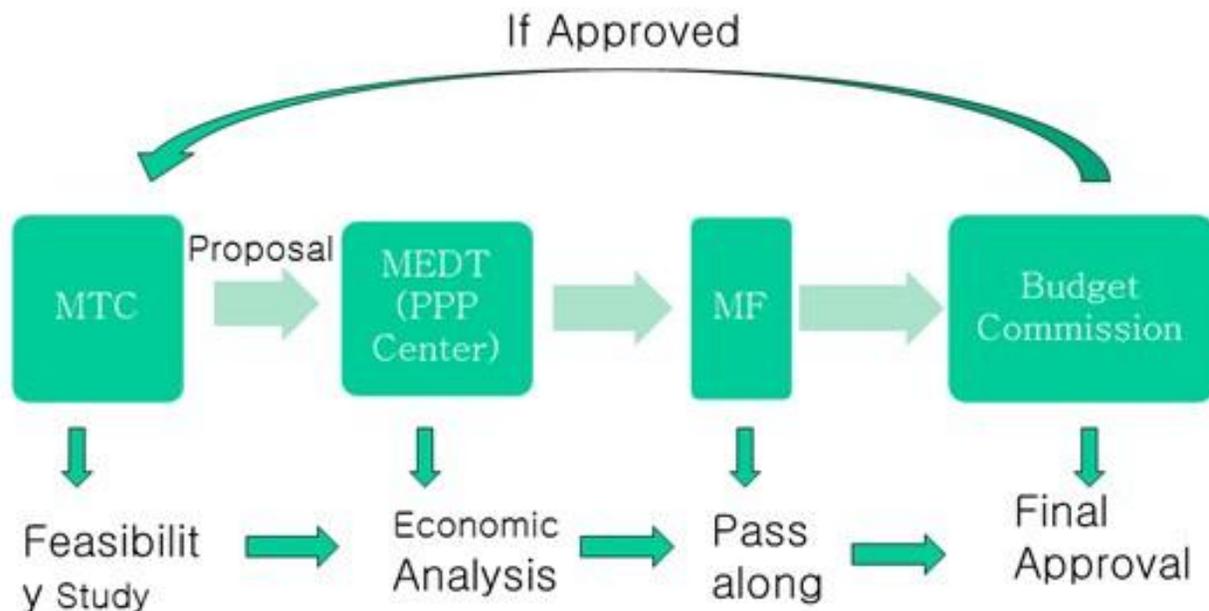
FROM IDEA TO IMPLEMENTATION

The approval process for a concession proposal is long and complex. It involves four central government offices and takes a “double-loop” route before final approval and implementation begins (as showed in the diagram below).

For transportation and communication projects, the Ministry of Transportation and Communication first submits a proposal to the Ministry of Economic Development and Trade (MEDT). With the help of the PPP Center, the MEDT provides an economic opinion of the project, which is then be passed to the Ministry of Finance (MF) via the ministry of

transportation and communication (MTC). The MF advises the National Budget Commission, which then either approves or denies the project.

If a proposal is approved, it returns to the MTC to undergo a feasible study. After completion of the feasibility study the PPP center's economists appraise the project based on the feasibility study. The MEDT also provides an economic opinion of the project. Projects that the MEDT and the PPP Center view positively are passed back to the MF, which considers the project in relation to the state budget. The MF then provides all this information to the national Budget Commission. If the Budget commission approves the project, then the partners can sign the contract and begin implementing the plan.



A CASE STUDY: THE AKTAU VILLAGE

Aktau village is a small one-company town of about a thousand people approximately 70 km outside the regional capital of Karaganda. The town's single enterprise is a cement plant that is owned and operated by a multinational company, Steppe Cement, registered in Malaysia. The cement plant relies on the town for labor and the town relies on the plant for employment. To remain competitive the plant has been modernizing its equipment. The new technology requires less labor, which means fewer members of the town can be employed there. The shrinking town is faced with high unemployment.

The road from the main highway to Aktau Village (Karaganda Oblast) is 15 km long and is riddled with potholes. It is the main artery by which cement produced at the factory is transported to its clients throughout the country. Because cement is naturally very heavy it produces a lot of wear and tear on the roads. In addition, extremely harsh weather conditions further deteriorate the road. Winter temperatures in Kazakhstan often reach -40 degrees. Significant investment is needed to maintain the road. The road is not currently being maintained as the potholes show.

The regional government relies on the town's only enterprise to maintain the town's major artery. According to Steppe Cement's CEO, when the company first purchased the plant in the late 1990s, the company agreed to pave the road, and continued to maintain the road for several years. Steppe Cement was expecting some kind of support for the government in exchange for paving the main public road into this small town, but the support never came. The original agreement was informal and did not take the form of any kind of formal PPP. Steppe Cement was likely motivated by a need for a route to inexpensively deliver its cement. Because of the lack of government support Steppe Cement is no longer maintaining the road, despite continual pressure from the regional government. The CEO explained that the government often sends its tax inspectors to find (or fabricate) violations in the Steppe Cement's books that the government could use as leverage to force the company to invest more into the town. Because the company operates legally and transparently the CEO explained that the government's efforts are a waste of time. There is clearly tension between the government and the only employer in this small town.

This is one situation where a positive PPP framework could improve Kazakhstan's development. Both the government and this private company need the road. The road is valuable to the government as the main route that the town's residents use enter and exit the city. The road is valuable to Steppe Cement as the major supply route for its cement. Improving the road quality would benefit all parties. Unfortunately, the PPP frameworks in Kazakhstan are mostly being applied on a national level. Aktau village may be too small to attract the attention of bureaucrats in the ministries of the national government. This example also illustrates why Kazakhstan has been willing to co-finance or even fully finance concessions. Private partners often cannot afford to fund the projects on their own or may be unwilling to take on a project alone. Without government financial support the projects are often not lucrative enough for private partners.

RISK ANALYSIS OF CONCESSION IN KZ

Risks for Public Partners

Financial Risk

In Kazakhstan, the government is taking on greater financial risks to improve the attractiveness of PPP projects to private partners. The extent to which the private investors are willing to participate in PPPs is highly dependent on the level of government financial support. As mentioned above, the Kazakhstani government has to partially or even fully finance the projects. This is extraordinary because in traditional cases, it is the private partner who takes on more financial risks. Traditional concessions target the private sector to provide financial investment and share the financial risks. The government typically provides the private sector with exclusive access to public facilities or to a market. While in KZ, the government seems to carry much larger burden than is typical in developed countries. The current on-hold status of multiple PPP projects in Kazakhstan indicates the reluctance of private partners to deal with large financial/capital risks. One of the key characteristics of PPPs in Kazakhstan is its heavy reliance on governmental financial involvement. PPP projects often do not go forward without extensive government financial support (Mouraviev).

Kazakhstan's less developed economy is a major reason behind the acceptance of this special type of concession in KZ. The current concession design in Kazakhstan indicates that risk sharing takes a different form than in other countries. The government is willing to take on more

risk in order to attract private firms, especially foreign firms to invest in the Kazakhstan. *Article 14 of Law on concessions* in Kazakhstan says that government can:

- a. Co-finance concession projects, and;
- b. Compensate some investment expenses of a concessionaire during the concession period.

This indicates that all of the private partner's investment expenses may be covered by the government. Currently several major PPP projects are on hold because private partners are unwilling to take on the large amounts of financial risk. While private partners traditionally fund concession projects, in Kazakhstan to government may provide financial support up to the amount of the total value of the project. Also the government has assumed the responsibility of funding all feasibility studies. PPP projects require extensive government financial support before they can be implemented. Insufficient public funding is both an obstacle and a reason why the Kazakhstani government seeks to develop PPPs. The dilemma between attracting investment and limiting public spending partially explains why progress implementing PPPs in Kazakhstan is slow.

Monitoring Ability

When implementing a PPP, monitoring is crucial to achieving a desirable outcome. Monitoring is usually the responsibility of the public partner. In Kazakhstan, the PPP center under the direction of the MEDT monitors project implementation during the concession period, which is usually 25-30 years. Governments considering a PPP should carefully evaluate their ability to effectively monitor the project's performance. "Failure to do so shifts a substantial portion of the project's risk onto the public partner"(Brown). Kazakhstan is working to improve its expertise and needs to continue to do so as the government enters into more partnerships.

To better monitor concession projects, the Kazakhstani government first should have adequate staff to evaluate construction and operations. Government monitors are expected to use their expertise to observe the contractor's performance, report feedback to the public partner, review and collect data of private partner's performance, and carry out all other monitoring activities. As important as it is, hiring experienced professionals to take on monitoring tasks could increase the financial burden of Kazakhstani government. In addition to labor cost, equipment required to monitor projects might also be costly.

The monitoring challenge might become more difficult toward the end of concession period. In a concession, a private company is responsible for the design, construction, operation, and maintenance of capital assets. The typical concession period in Kazakhstan is 25-30 years (keep in mind the country has existed for fewer than 22 years). So if the project requires major maintenance or upgrading close at the end of the concession period, the private company might be inclined to make cosmetic repairs, rather than necessary repairs, in an attempt to cut costs.

To avoid all these risks, the public partner will need experts who have a decent understanding of these projects to be able to monitor and evaluate the outcomes. If the public partner does not have experts and necessary equipment, private partners may not completely meet all the terms of

the contracts. With relatively little experience completing PPP projects, Kazakhstan faces some monitoring risks in all its P3 projects.

Institutional Risks

Institutional risks also exist. These risks stem from the complex approval process and lack of bidding system.

As explained above the process of approving a concession proposal is complicated and passes through many government departments in Kazakhstan. From submitting the concession proposal to finally receiving the approval from the National Budget Commission, the proposal goes through four central governmental offices twice. The process has several tradeoffs.

The participation of multiple stakeholders provides more a more in-depth review of the project and increases transparency. For example, the feasibility study, which may be used as a guideline during project implementation, is prepared by the Ministry of Transportation and Communication. It is then reviewed by experts from the PPP Center. With more information and research in the preparation stages, it is more likely for the project to be successful. It is also less likely for corruption to influence the project as multiple parts of the government review the project. Bribing one government official will not get the project approved because of the multiple departments through which the project must pass. There are more people who could notice corrupt behavior during the approval process. Although the process does not eliminate risk of corruption it does reduce it.

On the flip side, institution problems are likely to slow down the process. One of the characteristics of bureaucratic governance is less efficiency in terms of time. The more departments that must approve the PPP plan, the longer it will take. With long approval periods, the government risks the collapse of partnership. Private companies are often frustrated by the need to work with the government because it slows down their business and reduces profits (Conversation with Kazakhstani Professionals). The complex process could scare away some private partners.

Risks for Private Partners

Demand Risk

Most of the PPPs in Kazakhstan are infrastructure projects, where high capital investment is expected. Investment projects in Kazakhstan are not financially attractive to many private companies. Private companies involved in investment projects tend to be reluctant to take more financial risk. The major reason is that the revenue from these infrastructure projects is highly dependent on unstable demand of services.

Kazakhstan is a very large country with a relatively small population. Because of sparse population much of the demand for major infrastructure projects will come from freight rather than passenger traffic (although there are exceptions, such as the Astana-Borovoye highway). Freight that might be transported could include oil, and other mineral resources. Demand for oil or other resources depends on world commodity prices. For example, if oil prices drop dramatically demand for Kazakh oil will also go down. This will affect the use of new Kazakh rails and highways that could be used to transport oil. In the case of the Aktau airport passenger

terminal, which is being built as a PPP project, much of the international traffic will likely be businessmen with ties to the oil industry. Falling value and falling demand for oil could affect future revenue for this terminal. The same is true for other commodities extracted in Kazakhstan.

Policy Risks

The policy situation in Kazakhstan is largely dependent on President Nursultan Nazarbayev. Nazarbayev is the first and only president that has ruled Kazakhstan, having come to power before the break up of the Soviet Union. While authoritarian leaders are often brutal and seek only to accumulate wealth, Nazarbayev seems to be genuinely interested in Kazakhstan's future. Despite this fact, he is still an authoritarian leader. Kazakhstan's lawmakers understand that President Nazarbayev sets the direction of policy within the country. Although the president seems healthy, no one lives forever. He is in his mid 70s and has not yet named a successor. People have speculated that his daughter could succeed him; however there is a high degree of uncertainty relating to succession. The president controls policy. A new president could dramatically shift the political climate, which would also affect business and PPPs.

A number of foreign professionals in Kazakhstan expressed that political uncertainty is a factor limiting investment (Conversation with Kazakhstani Professionals) If Nazarbayev dies in a year and the political situation changes investments could lose a lot of value. In the context of PPPs there is also high risk. Nazarbayev will not likely live 10 more years, but most PPP contracts last 25 years or more. The death of the president could significantly impact PPP projects. A new president could assume greater control over the economy and nationalize projects. Or a new president could implement other policies that reduce the profitability of a PPP project. Unfortunately investors cannot be sure what will happen. This is a major risk for private entities seeking to partner with the government in a long term PPP project.

CONCLUSIONS & RECOMMENDATIONS

PPPs are an effective way to develop infrastructure in the special context of Kazakhstan; however, the PPP design and process could be revised in order to build a more cooperative and mutually beneficial partnership.

Recommend for the PPP center in KZ

- **Introduce a competitive bidding process for concession projects**

According to legislation, a private company or the state may propose a PPP project (traceca 6); however, base the literature and personal contact, none of the PPPs being implemented or studied were proposed by the private sector. In the authors' personal conversations with businessmen in Kazakhstan there is no competition in the bidding process. The state writes the contract for a specific company without considering competitive bids. The traditional concession method applies a competitive bidding process to increasing the leveraging and bargaining power of the public partners. We believe the PPP Center could mitigate some risks by perfecting the current bidding process, thus freeing itself from so much of the risk.

- **Disperse authority to implement PPP projects to the local level and simplify the PPP preparation procedures.**

Currently, all the PPP projects being implemented or undergoing feasibility studies have to be evaluated and approved by the PPP center in the MEDT of central government. As

mentioned in the previous section, a PPP proposal has to go through four national departments twice to get final approval. Moreover, economists and experts from each department have to make evaluation and provide recommendations and opinions one by one during the process. It is extremely time consuming and ineffective. To solve this problem, the PPP Center could establish PPP offices in regions and provide training to regional offices increase local expertise. By empowering regional governments, the authority to enter partnership projects will be closer to the actual stakeholders. The preparation procedures will be simpler and the time associated with circulating paper work will be shortened.

- **Diversify the financial mechanisms available to fund PPPs.**

The current design of concession allows the government to compensate some investment expenses of concessionaires during the concession period. The rationale for this policy was to increase the attractiveness of PPP projects in Kazakhstan. However, the government could provide other incentives for the private sectors to be more involved, such as revenue sharing, tax exemptions, government guaranteed loans, etc.

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