MILLENNIUM CHALLENGE CORPORATION
CONGRESSIONAL NOTIFICATION

September 15, 2005

PROGRAM:	Eligible Countries
APPROPRIATIONS CATEGORY:	FY 2004 Program Funds
OBLIGATION AMOUNT:	$295,300,000

In accordance with section 610 (b)(1) of the Millennium Challenge Act of 2003 (the “Act,” Pub. L. 108-199, Division D), this is to advise that the Millennium Challenge Corporation (MCC) has entered into a Compact with the Government of Georgia pursuant to Section 609 of the Act. The United States, acting through MCC, and the Government of Georgia executed the Compact on September 12, 2005. The provisions of the Compact will enter into force pursuant to Section 1.3 of the Compact, including satisfaction of certain conditions set forth in Section 4.1.

A detailed summary of the Compact follows along with a copy of the text of the Compact.

I. Introduction

Despite positive developments since the Rose Revolution, Georgia has had difficulty in building an integrated national economy, reducing poverty, and stimulating economic growth in the regions outside of the capital, Tbilisi. These regions, home to more than 40 percent of the country’s total population, have been particularly affected by declining economic conditions, with poverty rising nearly 10 percent between 1996 and 2003. This makes them home to the poorest and most vulnerable segments of Georgia s population. In some regions, more than 50 percent of rural households live below the official poverty line.

Based on the results of an extensive consultative process and consideration of other donor programs, the Government of Georgia focused its Millennium Challenge Account (MCA) Program on two impediments to poverty reduction and economic development in the regions outside Tbilisi: a lack of reliable infrastructure and the slow development of enterprises, particularly in agribusiness. The Program will work to achieve two main objectives, as follows:

- Rehabilitate key regional infrastructure, thus improving transportation for regional trade, ensuring a reliable supply of energy, and regional and municipal service delivery

- Develop regional enterprises by funding investment and technical assistance and by increasing productivity in farms, agribusinesses and other enterprises to increase jobs and rural income

The five-year, $295.3 million MCA Compact will help Georgia achieve these objectives, as outlined below.

II. Program Activities, Costs and Performance

A. Regional Infrastructure Rehabilitation Project

I. Dilapidated infrastructure, especially the poor condition of roads, unreliable gas and electricity supply, and deteriorating municipal services, was consistently indicated as a major impediment to economic growth during Georgia's consultative process. Georgia recognizes the importance of adequate and reliable infrastructure for manufacturing, commerce, improved health services and economic development in general.

The Regional Infrastructure Rehabilitation Project is designed to address chronic infrastructure challenges, with a particular focus on rehabilitating key regional transport routes, natural gas transport and distribution, and regional and municipal services. Activities under this project include:

1. **Samtskhe-Javakheti Road Rehabilitation activity** ($102.2 million) for the rehabilitation and construction of approximately 245 kilometers of a main road traversing the isolated Samtskhe-Javakheti region, including technical assistance for a road master plan, operations and maintenance planning and contracting

2. **Energy Rehabilitation activity** ($49. 5 million) for the rehabilitation of the North-South Gas Pipeline that fuels electric power generation and provides commercial and residential gas and heating services to the entire country, and for the provision of advisory services to support implementation of Georgia's energy sector strategy

3. **Regional Infrastructure Development activity** ($60. 0 million) to fund regional and municipal physical infrastructure for water supply, sanitation, irrigation, municipal gasification, roads and solid waste in the regions outside Tbilisi

B. Enterprise Development Project

Although Georgia has witnessed a significant economic expansion in recent years, growth has been concentrated in and around the capital city, Tbilisi, while economic conditions in the regions remain stagnant. Small and medium enterprises (SMEs) could be a powerful driver for economic growth in these areas. However, the performance of SMEs has been disappointing.

Of particular concern is the agriculture sector, which accounts for 16 percent of Georgia's economic output and an even larger share of employment. Georgia's diverse climactic zones and rich natural resources provide the potential for future development of the agriculture and agribusiness sectors, particularly in the regions. With increased quantity and quality, Georgian agricultural products could better compete with imported food products, thereby improving the living standards of the rural poor. Yet businesses face problems with poor technology, processing, marketing, management skills, and credit access.

The Enterprise Development Project is designed to address two of the key constraints faced by SMEs in agribusiness and other sectors in the regions, namely the need for additional long-term risk capital and the need for improved skills and capacity in enterprises to recognize and take advantage of market opportunities. Activities under this project include:

1. **Georgia Regional Development Fund activity** ($32.5 million) for a professionally and independently managed investment fund to provide long-term risk capital and technical assistance to SMEs, primarily in the regions outside Tbilisi, and for activities to identify and encourage legal and policy reforms needed to improve the investment environment

2. **Agribusiness Development activity** ($15.0 million) for technical assistance and grants to farmers and agribusinesses that supply products to the domestic market and the provision of services for disseminating information on regional market prices and volumes

C. Measuring Outcome and Impact

The Monitoring and Evaluation (M&E) Plan provides the methodological approach, management structures, tasks and timelines, and performance indicators for monitoring progress toward achieving the Compact goal, project objectives, activity outcomes and sub-activity outputs. It also provides the framework for evaluating the impact of the program on beneficiaries, disaggregated by gender and age, where appropriate. The M&E Plan will be complemented by an Activity Monitoring Plan to track activity and sub-activity outputs and process benchmarks.

The overall objective of Georgia’s MCA Program is to increase economic growth and reduce poverty in the regions of Georgia, with a particular emphasis on the Samtskhe-Javakheti region. The Program’s success will be measured by the incremental increase in financial benefits from each activity, as well as reductions in both the poverty incidence and the poverty gap in the Samtske-Javakheti region.

Within five years, it is estimated that the Program will benefit nearly half a million Georgians and could indirectly impact the lives of a quarter of the population. The Program is also expected to reduce the incidence of poverty in the Samtskhe-Javakheti region by 12 percent. Other benefits include an expected increase of about $37 million in annual income to households and $27 million in business revenue nationwide through the Enterprise Development Project, as well as a reduction in technical losses from the gas pipeline from five percent to approximately two percent, with a significantly reduced risk that a major pipeline accident could cut off critical winter heat to hundreds of thousands of households.

D. Program Administration and Control

The MCA program will be administered by MCG, an independent legal entity ultimately accountable for the success of the Program. A Supervisory Board consisting of members of Government, parliament, the private sector, and civil society will oversee MCG’s professional management unit. The management unit will also be advised by a Stakeholders' Committee consisting of representatives from municipal government, the private sector and civil society. MCC will retain approval rights at a number of key decision points during implementation, including key procurements, project budgets, major re-disbursements and key personnel decisions, in addition to its observer status on the MCG Supervisory Board.

For the Road Rehabilitation activity, an international project management firm will work in conjunction with the Road Department of the Ministry of Economic Development in Georgia. For the Energy Rehabilitation activity, a project management consultant with experience in rehabilitating pipelines will manage the pipeline rehabilitation work, in conjunction with the Georgia Gas International Company (GGIC). The Municipal Development Fund, the project implementation unit for an existing World Bank project, will implement the Regional Infrastructure Development activity, with support from the World Bank. Independent project managers selected through open and transparent international tenders will manage each of the remaining projects. A professional firm with substantial prior experience conducting non-asset based financing and investment in transitional economies or similar business environments will manage the Georgia Regional Development Fund activity. The Agribusiness Development activity will be managed by a development organization selected according to detailed selection criteria developed by MCG, with MCC support.

Fiscal and procurement management will be managed by an internationally recognized, private sector accounting firm chosen in a competitive process. The Fiscal/Procurement Agent will provide professional services for (1) funds control, disbursement documentation and management, cash management and accounting; and (2) the planning, management and supervision of the procurement processes contemplated under the MCA Program. World Bank procurement guidelines, as modified by MCC, will serve as the basis of a procurement agreement that will govern all procurements under the Compact.

III. Assessment

A. Economic Analysis

Georgia's MCA Program has an overall economic rate of return (ERR) of 17 percent, calculated as a weighted average of each component.

The base case return on the Samtskhe-Javakheti Road activity is estimated to be 20 percent, based on enhanced agricultural surplus and reduced vehicle operating costs. The base case return on the Energy Rehabilitation activity is estimated to be 11 percent. By rehabilitating the North-South Gas Pipeline, it was assumed that Georgia could avoid additional expenditures on gas purchases and reap returns from selling carbon credits for the reduction of greenhouse gas emissions under the United Nations Framework Convention on Climate Change. The base case return on the Regional Infrastructure Development activity is estimated to be 12 percent, on the assumption that improvements in regional and municipal services resulting from improved infrastructure would ease bottlenecks that constrain economic activity, perpetuate market fragmentation, impose numerous transaction costs on business, and lower productivity.

The base case return on the Georgia Regional Development Fund activity was calculated to be 24 percent. This ERR captures economic benefits that include anticipated net profit, wages, taxes and payments to local suppliers from the enterprises in which the Fund is expected to invest. The base case return on the Agribusiness Development activity is estimated to be 12 percent. The activity's efforts to identify, introduce, and anchor appropriate innovations in primary agriculture and agribusiness is expected to (1) mitigate problems of incomplete information, credit constraints, and risk perceptions and management, leading in turn to increased productivity, profitability, and incomes, and (2) facilitate and increase meaningful coordination among stakeholders in key agricultural value chains, permitting them to take advantage of larger, more integrated vertical economies.

B. Consultative Process

In developing the MCA Program, Georgia engaged in a broad, meaningful and participatory consultative process that was unique in its recent history. When Georgia was notified of MCA eligibility in May 2004, the government formed a Millennium Challenge working group, representing key Government ministries, parliament, civil society, NGOs and private business, to discuss and agree on the priority areas for MCA support. This working group identified infrastructure rehabilitation and investment in selected industry sectors as priority areas, initiated a broad outreach program, and solicited feedback from the general public. The working group conducted five regional forums, initiated extensive media coverage, and conducted roundtables as part of the consultative process. Its outreach effort resulted in more than 500 specific proposals being submitted to the government, many of them reiterating the need for infrastructure rehabilitation and promotion of agriculture development.

More recently, MCG has hired a public outreach officer and has begun holding weekly outreach events to keep stakeholders and citizens informed. Regular updates of meetings and events are placed on the MCG website. Prior to initiating formal negotiations with MCC in June 2005, MCG held several all-day forums for stakeholders, NGOs, civil society and donor organizations to review and elicit additional feedback on each of the proposed activities.

C. Demonstration of Government Commitment

The MCA Program has received a high degree of financial and other support from Georgia's President and Prime Minister, the Ministers of Economy, Energy, and Agriculture, and members of Parliament. Continued high-level Government involvement is assured with the governance structure of the Supervisory Board of MCG, chaired by the Prime Minister, and composed of high-level cabinet and parliament members and a representative from the President's administration.

D. Sustainability

In the Regional Infrastructure Rehabilitation Project, the key issue for sustainability across all the Project Activities will be the ability of national and local authorities to provide long term maintenance on capital investments. These concerns have been addressed in the design of each Project activity through the provision of technical assistance, where necessary, to aid local institutions in planning and budgeting for the maintenance of roads and municipal infrastructure and to enhance their ability to sustain a supportive policy environment in the energy sector.

For the Road, Georgia committed to funding road maintenance in an amount appropriate for the existing road network. For the Energy Rehabilitation activity, Georgia committed to certain measures to address past liabilities and current collection problems of the GGIC, the pipeline owner and operator, to help ensure improved cash flow for pipeline maintenance once rehabilitation is complete. It has also committed not to sell, transfer or pledge the Pipeline and/or a controlling interest in GGIC during the Compact's five-year term without prior consent from MCC. For the Regional Infrastructure Development activity, the operations manual requires that all proposals for investment be submitted with a plan for funding operations and maintenance (based on a combination of user charges and local and national Government budget support). The Government of Georgia will, in certain cases, provide a commitment letter evidencing financial support in whole or in part for certain projects in certain cities.

In the Enterprise Development Project, neither the Georgia Regional Development Fund (GRDF) activity nor the Agribusiness Development activity (ADA) is intended to be fully sustainable beyond Compact completion. When the Compact ends, the GRDF will enter a five-year "wind down" phase of asset management and liquidation, with its distributions used to support approved charitable, educational or social development programs in Georgia. The ADA will cease direct operations when the Compact ends. Nonetheless, both Activities are expected to enhance business expertise and build successful companies. This contributes to sustainability at the individual enterprise level and strengthens market mechanisms that will remain long after the Compact concludes. In addition, the Activities are expected to increase the level of financial investment in the regions, thereby perpetuating competitive economic growth.

E. Environmental and Social Impacts

The Road Rehabilitation activity is a "Category A" project. One section consists of a significant rehabilitation that will upgrade a lightly traveled seasonal road for inter-regional cargo traffic and other transport, which may introduce potentially significant negative impacts following construction. In addition, there are two new road sections, including one that will pass an environmentally-sensitive wetland area. MCC has provided 609(g) funding for the development of a full Environmental and Social Impact Assessment.

The Energy Rehabilitation activity is a "Category B" project. It is expected to impact the environment positively through a significant reduction in greenhouse gas emissions and an increase in energy reliability that should reduce use of less clean and less safe alternative fuels, such as biomass and kerosene. Nevertheless, the works would present both an occupational and a public health risk if safety precautions are not followed, and some resettlement may be required for public safety and rehabilitation needs where encroachment onto the pipeline right-of-way has occurred. The Compact requires an environmental audit of GGIC, a focused project Environmental Assessment to include a resettlement plan framework, and an Environmental Management Plan that incorporates health and safety procedures.

The Regional Infrastructure Development activity is a "Category B" project although it may fund "Category A" activities, In addition to the requirement that all funding from the activity be consistent with World Bank safeguards and MCC environmental guidelines, the Compact requires that the Municipal Development Fund, which will be the implementing entity and currently implements a similar World Bank project, include an environmental and social impact assessment expert on staff.

Due to the nature of the GRDF, it is not possible to assess potential environmental and social impacts at this point. The Compact requires that GRDF investments comply with MCC environmental guidelines. To help compliance the GRDF manager will be required to develop investment guidelines and an environmental review process and monitoring check-list.

The ADA is a "Category C" project. It is not likely to have adverse environmental or social impacts. The Compact will specify the environmental review criteria for the ADA and describe the environmental sustainability principles to be used for agricultural and agribusiness technical assistance.

F. Donor Coordination

The MCA Program complements efforts by other donors currently active in Georgia, The MCA Program envisions direct collaboration with the World Bank's Municipal Development Fund for the implementation of the Infrastructure Facility. Its proposed infrastructure rehabilitation activities will complement efforts by the World Bank, EBRD, USAID, KfW and other donors that are currently active in road transport, energy, and municipal services.

The Compact's proposed Enterprise Development activities would complement the efforts of the World Bank, EBRD, UNDP, USAID, USDA, FAO, IFAD DFID, KfW and other donors that are currently active in agriculture, financing and business development.

IV. Summary and Conclusion

The Georgia Program focuses on the rehabilitation of critical regional infrastructure and the provision of grants, long-term capital and technical assistance to spur the development of enterprises, particularly in agribusiness. The Program enjoys broad support from civil society and is well coordinated with the goals of the Government of Georgia and of other donors.

The Regional Infrastructure Rehabilitation Project has the potential to improve living conditions and the business environment by dramatically improving basic services in the regions outside Tbilisi. In addition, the Samtskhe-Javakheti Road is intended to integrate more fully an isolated ethnic minority population into the greater Georgian economy and society. The Enterprise Development Project complements these efforts by significantly expanding the reach of advanced training in agricultural production, processing, and agribusiness and increasing the availability of longer term risk capital to entrepreneurs.

This Program will have a positive impact on economic growth and will contribute to the reduction of poverty in Georgia.