PUBLIC-PRIVATE PARTNERSHIPS IN ECONOMIC DEVELOPMENT: THE NEW BAGHLAN SUGAR COMPANY

Case study prepared for the Enabling Environment Conference

I. BACKGROUND

Sugar production and the sugar market in Afghanistan

Sugar production in Afghanistan dates back to the 1930s, when Afghan investors, with technical support from a German company, established the Baghlan Sugar Factory (BSF). At the time, it was a purely private investment with the then private Bank-e-Milli as the principal owner. (Bank-e-Milli then held approximately 80 percent of the shares.) From the start of operations in 1940, small farmers in the area were the main suppliers to the factory. BSF was nationalised in 1976, at the same time as all major industries and banks in the country, and ownership of BSF was officially transferred to the Ministry of Light Industry and Foodstuffs. It continued working at full capacity until 1979, when the Soviet invasion and the ensuing civil war slowed down production, which eventually came to a complete standstill in 1991. Although much of the equipment was lost or damaged during the war years, the original plant site and machinery were basically maintained by the factory staff throughout the decade following the end of production. Currently, 100 percent of the domestic demand for sugar, approximately 830,000 metric tons (MT) per year, is covered by imports. Due to the high transport costs of imported sugar, domestic market prices for sugar are high. Under these conditions, local sugar production should be a viable business opportunity. It was in this context that the idea for the restructuring of BSF was born.

The New Baghlan Sugar Company

With the regime change in late 2001, the Afghanistan Transitional Authority (ATA) realigned government policies toward private sector driven economic development, including a decision in favour of privatisation of state-owned enterprises. As part of this policy, and encouraged by an expressed interest in re-engagement in the sugar industry from a German seed company, the Government of Afghanistan (Ministry of Light Industry and Foodstuffs) approached a number of Afghan businessmen, encouraging them to invest in the rehabilitation of the old Baghlan Sugar Factory.

Negotiations to conclude a **public-private partnership agreement for the re-establishment of the Baghlan Sugar Factory** were initiated in 2002. A detailed feasibility study was carried out in 2003, which was very positive overall about the prospects of reviving sugar production in the area. Given the size of the investment required, additional partners were brought in. The agreement for the establishment of the New Baghlan Sugar

Company (NBSC), signed in October 2004, mobilised initial capital of EUR 13.6 million, and included the following investors:

- The **Government of Afghanistan** (through the Ministry of Light Industry and Foodstuffs, succeeded by the Ministry of Agriculture in 2006) contributed the value of the land, buildings and machinery of the existing Baghlan Sugar Factory, valued at EUR 4.6 million (29.5 percent)

- **Four Afghan private investors** signed a total capital of EUR 8 million (51.3 percent)

- The **German seed company KWS Saat AG** signed EUR one million (6.4 percent)

In June 2005, The **German Deutsche Investitions- und Entwicklungsgesellschaft mbH (DEG)** through funding from the German Bundesministerium für Wirtschaftliche Zusammenarbeit (BMZ) signed a joint venture agreement with the existing shareholders, contributing a total of EUR two million (12.8 percent). **This raised the total signed capital for NBSC to EUR 15.6 million**.

NBSC also benefits from a comprehensive, German funded aid package in the form of technical assistance: the **Food and Agriculture Organisation (FAO)** provides technical assistance to farmers in the project area to ensure the supply of sufficient quantities of high quality sugar beets to the factory. Technical assistance, particularly in the areas of building human capacity of key technical staff at the factory, is also provided through Internationale Weiterbildung und Entwicklung GmbH (InWEnt) and the Centrum für Internationale Migration und Entwicklung (CIM).

NSBC started operations in 2005 after having been officially registered with AISA in February 2005. Once the factory is operating at full capacity, it is planned to produce up to 15,000 MT of sugar per year, thus becoming an important economic activity in the area, providing not only direct employment opportunities, but contributing indirectly to additional economic activities and jobs. Given the much larger domestic demand for sugar, an expansion of the factory and a diversification of the production are envisaged by the shareholders as a mid-term objective.

Actual production of sugar started only in 2006 with a trial production of 300 MT of sugar. Production was curtailed significantly in the first season due to plant disease affecting the sugar beet crop, sufficiently serious to dissuade farmers to commit to further production. Technical advisers are working intensively with farmers to ensure conditions for a more successful season in 2007.

II. ISSUES

Although all parties involved in the project remain optimistic about its future success, viability and profitability, the NBSC has been struggling with a number of problems as it seeks to ramp up production. These problems provide some valuable insights into the establishment of PPS and into agro-business development in Afghanistan in general.

The relationship with Government

Although the rapid privatisation of state-owned enterprises is official government policy, implementing this policy in the case of NBSC has proven to be a major challenge. Problems stem from the following factors:

- **Lack of support for the project within government institutions***:* Private local and foreign investors alike report that Government has shown little interest to date in supporting the project, despite the fact that a) it is fully in line with the official government policy, b) it has mobilised substantial local and international capital and c) it is investing in an industry that has a huge potential for the Afghan economy. The general impression is that of not only an overall lack of interest, but even hostility on the part of government officials. This attitude has substantially slowed down the process of getting the NBSC off the ground.

  An illustrative example of Government’s seeming indifference is the fact that **a bilateral Agreement on Promotion and Protection of Investment (APPI), signed in April 2005 by the German and Afghan Governments has still not been ratified by the Afghan Parliament**, thus depriving German investors (including KWS in the case of NBSC) of the opportunity to obtain a risk guarantee from the German Government. The ratification and effectiveness of the agreement would create incentives for German investors to engage in a country still considered very high risk, without additional costs or risks to the Government.

  The unsupportive attitude of Government vis-à-vis the NBSC project is also illustrated by the following points:

- **Unclear roles and responsibilities**: Government had initially nominated the Ministry of Light Industry as a shareholder in the factory. Given the history of the nationalisation of the old Baghlan

Sugar Factory in 1976, the investment agreement between the Government and the other shareholders explicitly protected the new investors from any eventual claims of the original, pre-1976 proprietors of the factory. Nevertheless, and although it is now part of Government under the authority of the Ministry of Finance, Bank-e-Milli claimed ownership at the beginning of negotiations. The issue had to be brought in front of the Supreme Court and the President, who decided ultimately in favour of the signed agreement. The final agreement now involves only the Ministry of Agriculture as the government shareholder. It took the Government nearly two years to settle this internal issue, and in the meantime no agreement could be signed with the other investors. The resumption of sugar production was delayed accordingly.

- **The valuation of government property**: The government contribution and share in the project consist of the value of the land (35 hectares), buildings and equipment of the old Baghlan Sugar Factory. It took over two years to reach agreement on the actual value of these assets, with Government initially insisting upon a valuation of EUR 10 million. The final agreement valued the government contribution at EUR 4.6 million, judged well above the real value of the more than 60-year old equipment and facilities.

- **Legal obstacles to the transfer of government property to the company**: To date, land and property titles have not been legally transferred to NSBC. This has been a major subject of contention and has negatively impacted the relationship between Government and the other shareholders of the company. The Ministry of Finance has so far refused to authorise the legal transfer of property to NSBC on the basis of the fact that, according to the Afghan Constitution, foreigners are not allowed to own land in Afghanistan. The Government argues that, should the company go bankrupt and the assets distributed among shareholders, the German shareholders could theoretically become owners of part of the land.[1]

  In order to resolve this issue, the German stakeholders sent an official letter to the Ministry of Finance stating that should the company go bankrupt and remaining assets distributed among shareholders, the foreign investors would not exercise any claim on the land, taking only the cash equivalent of the value of their share of assets. As of March 31, this issue was reportedly still unsettled. DEG and KWS have made it clear that, should additional capital be called for, they will not transfer any additional capital until the transfer of the title deeds has occurred.

  How this issue will be finally resolved is understandably of major interest for those considering possible joint ventures involving foreign and Afghan investors.

Management and technical capacity for the factory

Finding and keeping well trained and skilled workers has been a challenge for the factory. Apart from up to 300 unskilled workers employed during the peak times of sugar beet harvest, the company employs approximately 40 skilled technical and administrative staff on a permanent basis. One of NBSC's recruitment strategies has been to find and repatriate former factory staff that had migrated to Pakistan and Iran. During the first campaign in 2006, the company drew also upon international technical expertise from Germany, Hungary, the Czech Republic and Iran. In addition, the company has finally been able to recruit a number of new staff, including a General Manager with the right educational background and experience.

Until a new General Manager was successfully recruited in March 2007, the company's day-to-day operations were managed by the General Manager of the old Baghlan Sugar Factory. Since he did not have the experience and education for the running of the new factory, his decision-making authority was limited. This meant that shareholders, often fairly removed from the local situation, had to take decisions on day-to-day management issues of the factory. Although the problem was not dramatic as the factory did not work at full capacity during 2006, NBSC's experience highlights the investors' **challenges** regarding **the lack of local management capacity**.

Key issues with regard to human capacity are:

- It is difficult to **attract highly skilled Afghan staff to posts outside Kabul**, where access to quality education for children, health care, acceptable living conditions and levels of personal security do not compare to the capital.

- The deteriorating **security situation in Baghlan has made the work and recruitment of expatriate staff more difficult and costly**. For example, at times, the German technical staff could not leave the factory compound, and the expatriate FAO staff had to adhere to strict security regulations, including driving in convoys, when carrying out their field work with local farmers.

  The company coped as best it could by offering in-house training and sending staff for specialised training abroad.

- **In-house training of locally recruited staff** was one response to this difficulty. NBSC conducts its own training with the risk of losing staff it has invested in to better paying parties (NGOs or international organisations); this has occurred only once so far, with an NBSC-trained accountant leaving the company shortly after completing his training.

- The company has also sent two young Afghan graduates from Mazar University for a one-year **specialised training abroad in sugar technology** at the Technical University of Berlin, Germany. The graduates returned in time for the 2006 campaign, to which they contributed successfully. They are still working for NBSC. While the experience with training Afghans abroad has been very positive, and NBSC is keen to continue the programme, **the main challenge remains to identify suitable candidates with the appropriate educational background**. The initial training target was to send seven young Afghans for higher qualifications, but NBSC was only able to identify two qualified candidates.

Technical Issues

A series of other issues have plagued efforts to move rapidly toward production levels foreseen at the outset. A number of problems resulted in an **insufficient supply of the factory with sugar beets**. Given the potential impact on future production, they are noteworthy.

- **Low skill levels of participating farmers**: Since the production of sugar had come to a complete stop in 1991, the great majority of local farmers were no longer familiar with the cultivation of sugar beets. NSBC is therefore dependent on a successful reintroduction of sugar beet production in the area to ensure a reliable, high quality supply of sufficient quantities of raw materials. FAO has taken on the technical support of farmers in the area. This includes credit to farmers for inputs and extension workers providing technical assistance on an ongoing basis. The German seed company KWS is responsible for the testing, introduction and supply of seeds of suitable high yielding sugar beet varieties to local farmers.

  The plant diseases and insect infestation that caused widespread crop failure in 2006 did not occur on all plots and were attributed mainly to the very poor conditions of the soil after years of overexploitation and of vegetable monoculture production by farmers (who did not adhere to proper crop rotation methods) as well as poor farming methods. Overall, an average of 19 to 20 MT of sugar beets per hectare was produced, against the original expectation of 40 MT. As a result, and although FAO covered the financial losses of the participating farmers,[2] farmers are now very reluctant to plant sugar beet. **High quality, large-scale beet production will only be possible in the area, if the project manages to improve people's understanding of good farming methods**.

- **Unrealistic price expectation of farmers**: Given the poor results of the initial season, conflict has emerged between farmers and the company over the pricing of raw sugar beets, which has not been resolved to date. The initial price foreseen was US$ 26 per ton of raw sugar beets. In the face of the poor experience of 2006, the farmers insisted on a price of US$ 40 per ton. NBSC agreed to pay US$ 30 per ton[3] and additional incentives (transportation costs, upfront payments on beet production, etc.) for the 2007 harvest.[4] However, farmers have not agreed to this price. As a result, the shareholders have now decided not to enter into agreements with the farmers in 2007 and only continue with trial sugar beet production.

- In order to become more independent from local farmers, the company is trying to **lease 3,000 ha of government land, which it wants to sublease to landless farmers of the area for sugar beet production**. If successful, the main supply side constraints could be overcome, thus allowing the factory to work at a higher capacity.[5] In addition, NBSC has also decided to explore the possibility of **importing raw sugar for processing** at the factory, until the local production issues are resolved.

- **Lack of regulation of use of agricultural land**: Rice production in the area has considerably increased over the last years. Formerly, Government controlled how much land was allowed to be used for rice production, given the high irrigation needs. This regulation no longer exists and rice production has increased, creating a competition for land for other crops and increasing demands on the irrigation systems.

III. CONCLUSIONS

The technical challenges left aside, the problems NBSC has faced during its start-up phase (and in part continues to face) are of considerable interest from the perspective of public-private partnerships.

1. Government is clearly still struggling with operationalising its privatisation policy. In its interaction with local and international investors, government institutions are in all appearances disinterested and unsupportive. This joint venture has taken a long time to get started and has been burdened with unnecessary and costly complications. This is particularly alarming when one considers the importance of local and international investments into the domestic economy for the mid-term development and political stability of the country.

The formal transfer of assets from Government to the company would be an important signal for not only the shareholders of the company, but also for any investors considering joint ventures with Government.

2. In addition, roles and responsibilities of the various government agencies have been subject to ongoing negotiations and shifts. At the same time, the legal basis for privatisation and the transfer of property to private owners is still subject to interpretation – and in this case, the situation is complicated by the question of foreign ownership of land.

Clarification of the question of the right of Afghan companies with foreign shareholders (whether minority or majority investors) to purchase land would be an important step to set the stage for more domestic-foreign joint ventures. Overall, resolution of the problem of access to land by foreigners is an important consideration for the improvement of the climate for foreign investment.

3. Attracting and keeping qualified staff to positions outside Kabul remains a major challenge for any enterprise. The low level of skills has proven to be a major constraint and the number of possible solutions is limited.

As NBSC looks to the future, cautious optimism prevails. As one of the stakeholders of NBSC put it, "these are not unusual obstacles and problems in a situation such as that of Afghanistan – they will eventually be sorted out." However, the process NBSC has been through illustrates the amount of patience and energy that stakeholders in a privatisation or PPP-type project need to have in order to get their business off the ground.

IV. DISCUSSION QUESTIONS

1. What are the principal challenges Government and potential investors face in entering into joint ventures (public-private partnerships)? To what extent do difficulties result from a lack of clarity on roles and responsibilities? How can signatories to such agreements increase the confidence level of all parties and how can they be sure that agreements will be respected?

2. What could be done to shorten the negotiation phases of privatisation projects, particularly with regard to:

a) Clearer roles and responsibilities of various government agencies?

b) Transparent and uniform procedures for the valuation of government property?

c) Smoother and transparent processes, procedures and criteria for transferring government property?

d) A more positive and proactive role of Government in facilitating and supporting much needed private investment in the domestic economy?

3. How representative is the case in terms of difficulties on the transfer of land titles? To what extent has foreign ownership of domestic Afghan companies been a constraint to the transfer of land titles?

4. How severe is the lack of management skills in Afghanistan today? Where is the constraint felt most acutely?

5. What options and potential options exist for the training of skilled workers and management?

6. What could be done to increase incentives for qualified staff to move outside Kabul?

7. What potential exists for the establishment of PPPs? Would this instrument be of interest for the partial privatisation of state-owned enterprises? How does the establishment of PPPs articulate with the Government's privatisation policy?

8. What are the success factors for launching PPPs in Afghanistan today? What changes in laws, regulations and administrative procedures are required?

This case study was prepared based on a series of interviews with the Directors and management of New Baghlan Sugar Company, as well as technical advisers from the Food and Agricultural Organisation (FAO) and KWS Saat AG involved in the project.

---

[1] However, since NBSC is registered as a local company, this argumentation should not apply. This is a question that has been raised in other cases; the proposed resolution of this issue is to prohibit the ownership of land in Afghan companies when foreign shareholders are in the majority.

[2] Under the FAO-supported programme, supply credits were extended to farmers, with the expectation that repayments would serve to constitute a crop risk insurance fund. Given the poor productivity because of plant disease, farmers were not required to reimburse at the end of the first season the credit extended.

[3] It takes 8.2 to 9 tons of sugar beets to produce one MT of refined sugar. The price of refined sugar in the Dubai market is currently just under US$ 300.

[4] It takes 8.2 to 9 tons of sugar beets to produce one MT of refined sugar. The price of refined sugar in the Dubai market is currently just under US$ 300.

[5] Government has been slow in responding to the request of NBSC to lease currently unused government land.