Public-Private Cooperation in Fragile States

Case Study Afghanistan 3:

New Baghlan Sugar Company

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Public Private Cooperation

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Context

This case study is part of the research project on Public-Private Cooperation (PPC) in the economic reconstruction of Afghanistan. More information can be found online at: *http://www.clingendael.nl/psdn*.

Other documents on Public-Private Cooperation in Afghanistan

- Final report Public-Private Cooperation in Afghanistan
- Case study 1: Tradepoint Afghanistan Distribution Centre
- Case study 2: Baghlan Cheese Factory
- Case study 3: New Baghlan Sugar Company
- Case study 4: The Development of a Dried Fruits Value Chain

Available online at: *http://www.clingendael.nl/psdn/documents.html*.

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1. Introduction: the Public-Private Partnership in Afghanistan

Any collaboration between public bodies, such as local authorities or central government, and private companies tends to be referred to as a public-private partnership (PPP or P3). A public-private partnership describes a joint venture which is funded by the government and one or more private companies.

Public/private partnerships are considered "creative alliances" formed between a government entity and the private sector to achieve a common purpose. Other actors have joined such partnerships—including non-governmental institutions, such as health-care providers and educational institutions, non-profit organizations, community-based organizations, civil societies, private investors, companies, and factories. Worldwide under a public-private partnership many development projects have been successfully implemented including short-term and long-term projects.

In Afghanistan many examples of contract services are available where the private sector provides goods or services to government institutions. In the health sector the government has contracted out the provision of primary health-care services to non-governmental organizations in almost the whole country. The Ministry of Mines and Industries has contracted out coal, salt, copper, gold, petroleum, gems and other mines to the private sector. Almost all government institutions have some type of contract with the private sector to provide goods and services. But at all levels government officials are involved in accepting bribes and corruption to award contracts to individuals and the private sector. In some cases even international donors and International Forces are blamed for corruption and bribes in awarding contracts to national and international private companies.

According to the Ministry of Finance's Privatization Component, which occupies itself with the privatization of state-owned enterprises, around 33 formal PPP arrangements currently exist, out of which only a few are successful. Contributing factors to the failure of these partnerships have been the lack of proper mechanisms and policy regarding PPP, a limited understanding of PPP by the government, a lack of capacity and conflicting laws and regulations.

According to the Ministry of Finance's Land Titling and Economic Reconstruction Department, rules and regulations, specified mechanisms and, on the whole, expertise in how to value government property are also lacking. In some cases individuals and private investors manage to purchase government property at low rates based on personal relationships or by giving shares in their enterprises to high-ranking government officials[1] ; in other cases the property is overvalued and the cost is so high that the private sector is not interested in entering into a partnership[2].

In Afghanistan private sector development is channelled through the Ministry of Commerce and Economy, the Ministry of Finance, the Ministry of Mines and Industries and DA Afghanistan Bank. None of these currently has a strategy for PPP development. ANDS-Private Sector Development Strategy has a paragraph on PPP which states "Public private partnerships (PPPs) are a potentially useful means of addressing infrastructure and other constraints and drawing on the skills resources and efficiency of the private sector …."

The New Baghlan Sugar Factory was selected as a case study by the research team to demonstrate a successful example of a PPP in Afghanistan. Through intensive research it can be concluded, however,

[1] An example is the Sher Pur residential town in Kabul, which was a military base in the past. The municipality distributed the residential plots among high-ranking government officials for a very low price compared to the property cost in Wazir Akbar Khan. The issue received media attention for several weeks.

[2] Good examples are the government-established industrial parks where the private sector is reluctant to invest in industries, due to the high price of plots, a lack of power and the absence of a proper sewerage system

that NSBC is probably not a successful example of public and private sectors working together. Currently, the factory is not operational and the partnership is falling apart.

At the time of the case study, the NBSC was in a crucial stage of its existence. With this in mind, not all of the shareholders agreed to cooperate with the case study. Whereas the case study would have been more balanced had all shareholders participated, the authors believe that a reasonably accurate picture has emerged of the current state of the enterprise, its reasons for failure and, in particular, the dynamics of the partnership and the reasons for its failure.

2. Historical Background to sugar production in Baghlan

The Baghlan Sugar Factory (BSF) was established in 1938 by the Kingdom of Afghanistan to satisfy the domestic demand for sugar with Bank Millie Afghan as the major shareholder and 100 members of the Royal and industrial elite of the country holding the remainder of the shares. BSC was built some 250 kilometres northwest of Kabul in the Baghlan Province, an area which is considered to be the most suitable for sugar beet production. A feasibility study demonstrated that the most important resources required for operating a sugar factory, e.g. suitable agricultural land, water, coal and lime were available in plentiful supply in Baghlan and therefore the decision to invest was made in favour of this area.

The factory started sugar production for the first time in 1940. The sugar was mainly produced from sugar beet and for the first time sugar beet cultivation on a large scale started in the country. From the start of its operation the factory received raw material from small local farmers who were not eager to cultivate sugar beet and practically had to be forced by the government to grow sugar beet in order to provide a sufficient input for the factory. A sufficient input always proved to be a struggle. The failure of the wheat harvest in 1946 forced the government to allow farmers to grow wheat instead of sugar beet, and the factory had to close down. It took around 40 years to build up a supply network of farmers that was sufficient to grow sugar beet on a large enough scale to enable the industrial production of sugar. During these early years the BSF received seeds and technical assistance in sugar beet cultivation from the German company KWS SAAT AG. Until the late 1970s, Afghanistan had a small but thriving sugar industry.

The factory changed ownership in 1976, when the socialist government of Afghanistan nationalized all commercial banks and became the de facto owner of the BSF. Ownership of the factory was officially transferred to the Ministry of Light Industries and Foodstuffs. The factory achieved peak production (15,000 metric tons of white sugar) in 1978. Plans to expand the sugar production and to build a new plant adjacent to the old factory came to a standstill in 1979 when Afghanistan was invaded by the Soviet Union. After 1979 production slowed down when farmers left their fields to join the Mujahedeen in the fight against the Russians and finally the factory came to a complete standstill in 1991. Most of the equipment was lost or damaged during the civil war. However, the original plant site and machinery have been basically maintained over the years by the factory staff.

3. Rehabilitation of the Baghlan Sugar Company as a PPC

In 2005 sugar consumption in Afghanistan was 5.5 Kg per capita[3] per year. The estimated demand for sugar in the country is around 137,500 MT[4] per year. The huge domestic demand for sugar in the country is the main reason for the rehabilitation of the BSC in order to decrease the dependency on imports. The initiative for the rehabilitation of the Baghlan Sugar Factory was taken by the German company KWS[5] following a conference on private sector development in Germany. The seed company had been involved with the factory in earlier years. It approached the Government of Afghanistan. KWS SAAT and the Deutsche Investitions- und Entwicklungsgesellschaft GmbH (DEG)[6] co-financed feasibility studies that were conducted by IAK AGRAR CONSULTING GMBH, KWS SAAT AG and IPRO Industrieprojekt GmbH in 2003. The feasibility studies concluded that it was technically and economically viable to rehabilitate the Baghlan sugar factory and to reintroduce sugar beet cultivation. An investment capital of 17 million EURO would be required, €10 million in investment capital and € 5 million in working capital. The potential return on the investment would be 21%.

A public-private partnership (PPP) was established in order to rehabilitate the sugar factory. The partners signed a Memorandum of Understanding (MOU) for the establishment of the New Baghlan Sugar Factory in October 2004 which made it the first privatized state company in Afghanistan.

The following shareholders mobilized an initial capital of EUR 13.6 million:

- 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 and the 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 agreement for EUR 8 million (51.3 percent)
- The German seed company KWS Saat AG agreed to contribute EUR 1 million (6.4 percent)

The actual rehabilitation of the factory started in 2004.

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 further 2 million EURO (12.8 percent) which raised the total capital for NBSC to EUR 15.6 million.

The New Baghlan Sugar Company (NBSC) started operations in 2005 after having been officially registered with AISA in January 2005 and at the Trade Court by the end of June 2005. Only then did the company become a legally established and complete private enterprise under Afghanistan's legislation. At full capacity, the factory was designed to produce 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 were envisaged by the shareholders as a mid-term objective. The brand name chosen for the sugar was "Shakare Baghlan"

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[3] WHO Oral Health County/Area Programme, WHO Headquarters, Geneva, Global Sugar Consumption Oral Health Programme.

[4] Estimation is based on CSO population, which is 25,000,000.

[5] KWS SAAT AG is a world-leading Seed Production Company, which concentrates on the development of innovative seeds. KWS ranks among the world's leading plant breeding companies and is a leader in sales of sugar beet seed in Europe and worldwide.

[6] DEG is one of the largest European development finance institutions for long-term projects and company financing. DEG's major shareholder is the KfW Bankengruppe which is under the ownership of the Federal Republic of Germany and the Länder.

meaning Baghlan Sugar, which was going to be sold in 50 kg bags through open tenders that allot contracts to wholesale distributors each year, who in turn sell the sugar to local markets and shopkeepers, predominantly in Puli Komri Bazaar and Baghlan Jaded bazaar. The intention was to change the name to Afghan Sugar Company after expanding its operations, to open more branches and to supply sugar to other provinces.

During the summer of 2005 the rehabilitation process was halted for several months during the parliamentary elections when the foreign personnel working on the installation of the equipment received death threats. Under the public-private partnership the factory produced sugar for the first time in 15 years in 2006.

On November 6, 2007 the factory became the subject of a suicide attack, potentially targeting the MPs present at the official inauguration ceremony for the factory. In all, around 70 people died and more than 100 were injured[7], among them many school children participating in the ceremony and six members of the Afghan Parliament, including key opposition figures.

4. The stakeholders and Their Contributions

The Government of Afghanistan offered to privatize the Baghlan Sugar Factory and to become a shareholder. GoA shares, including land, buildings and usable equipment, were valued at 4.6 million Euros. Although, through its contribution GoA holds 29.5% of the shares, the actual value of the property, buildings and equipment has been estimated at less than 4.6 million.

After the integration of the Ministry of Light Industries and Foodstuffs into Ministry of Mines and Industries (MoMI) and the Ministry of Agriculture, Irrigation and Livestock (MAIL) the NSBC government shares were transferred to MAIL. The Director of the Private Sector Department at MAIL, Mr Abdul Ghorbandi, currently represents GoA in the shareholders meeting which takes place biannually.

The NBSC had around 200 jeribs of land for sugar beet cultivation (an Afghan jerib is 2,000m^2). The land is not sufficient to provide an adequate input for the factory. Recently, due to the personal interest of the Minister, Mr Asif Rahimi, and reforms in the regulations concerning rain feed land, the Ministry of Agriculture, Irrigation and Livestock offered around 4,000 jeribs of rain-feed land in *Larkhabi* near the NBSC on a 40-year lease. However, most parts of the land are occupied by local commanders, and the land does not have an irrigation system. The Government has promised to evacuate the land and provide full security, but one of the private investors[8] does not believe that this is possible and considers that the cost of making the land arable is too high.

The four Afghan private investors have so far contributed only 300,000 Euros in cash out of their committed two million US$ each. Their contribution was spent on the rehabilitation and reconstruction of the factory and the operational costs, as well as the salaries for the factory staff and experts.

The German seed company KWS Saat AG has received one million Euros which has been spent on the feasibility study, the business plan and the design of the factory. Most of KWS' investment has been utilized in sending sugar beet cultivation experts, sugar production experts and other experts. In addition, KWS has pushed GoA and private investors to allow the German company IPRO Industrieprojekt GmbH to be responsible for the technical design of the factory[9]. Around € 500,000 was spent on the technical design, and around € 265,000 on field research. Although one year of extensive research took place to test the soil and to study the environment and climate for sugar beet cultivation,

[7] http://news.bbc.co.uk/2/hi/south_asia/7094434.stm
[8] Mr Sahibi.
[9] The design may have been copied from another factory, and NBSC currently faces a lawsuit for infringing copyright

unfortunately pest management was not studied properly. Later on it was accidentally discovered by Dr Wasiri and his team (Dr S. Bagher Mahmoudi and Mr Aziz) that the crop was infected by Nematodes[10] which affected the roots of the plant and caused severe damage, resulting in yield decreases. The production decreased significantly in 2007. In the initial years Alois Kuhn, the Sales Director of KWS, travelled frequently to Afghanistan. He recently retired, and has not yet been replaced. Later on he was also a part-time consultant with the German Federal Ministry of Economic Cooperation and Development, but his contract with the German Ministry has recently been terminated.

The German Government, through DEG, invested its two million dollars to purchase machinery, to run the factory during the sugar production seasons and to organize a sugar beet cultivation campaign in 2006, 2007 and 2008. DEG and/or the German Government were represented by the German Ambassador in past years. At present it is unclear who is in charge at the German Embassy, because the Embassy did not respond to any correspondence.

The NBSC also benefited from a comprehensive, German-funded aid package to the Food and Agriculture Organization (FAO) to provide technical assistance to farmers in the project area so as to ensure the supply of sufficient quantities of high quality sugar beet to the factory. The project "Rehabilitation of the Sugar Industry in Baghlan: Technical and Managerial Support for Small Family Farmer Participation in Sugar Beet" had a budget of €1 million (USD 1, 335, 810), donated by the Government of the Federal Republic of Germany, and a scheduled duration of three years. The purpose of the project was to set up the general organizational framework for the existence of a reliable source of raw materials to NBSC, at the same time benefiting the local rural population through agricultural diversification, enhanced incomes and the creation of agricultural employment opportunities. The project activities started on 15 February 2005 and were completed in December 2008.

An FAO report at the beginning of the mission, in 2005, already concluded that the factory was facing severe problems. The report stated that the factory would only be able to contract sugar beet production from a fraction of the land they had targeted and this would be for many years to come. Farmers were not interested in growing sugar beet under the conditions the NBSC offered. The cost estimations for labour would need to be doubled. The FAO studies further concluded that the factory used a benchmark price for sugar which was too high.

Technical assistance, particularly in the areas of building the human capacity of key technical staff at the factory, was provided by the German Government through two other German organizations: Internationale Weiterbildung und Entwicklung GmbH (InWEnt) and the Centrum für Internationale Migration und Entwicklung (CIM). The German Centre for International Migration, through German Trust Funds, paid the salaries of the foreign engineers who were providing technical assistance during the rehabilitation of the factory. InWEnt – Capacity Building International, Germany supported the capacity building of Afghan personnel by upgrading the qualifications of local engineers to become sugar technologists and training Afghan farmers to become field advisors and coordinators for the envisaged contract farming. They contracted a German engineer to provide the training.

The management of the NBSC is currently in the hands of Mr Zazai, the general manager of the company, and Mr Wasiri, the technical director. The position of director of administration and finance manger are both filled by local Afghans. Mr Wasiri, an Afghan with German nationality, was the Managing Director in the start-up phase of the company. He was officially employed by FAO as a sugar beet expert/consultant from February 15th, 2005 up to May 31st, 2007. In the start-up phase of the enterprise he played a vital role. Both Mr Zazai and Mr Wasiri take part in the shareholders meetings. Currently the technical director and general manager receive their salaries from CIM.

[10]Nematodes are sugar beet parasites which infect the roots and cause serious damage to the crops worldwide

5. Current State of the Enterprise

During the establishment of NBSC, all parties involved in the project were optimistic about the economic viability and profitability of sugar production in Afghanistan. The project received a great deal of media attention. The NBSC was selected by the research team as a successful example of PPP in Afghanistan. Through this study it may be concluded that NSBC is indeed not a successful example.

After four years in operation the factory is struggling to survive. The Afghan private investors, who lost their confidence in the prospect of a profitable enterprise, proposed to dissolve the factory during the annual shareholders meeting which took place in June 2009. They did not manage to win the required 70% of the votes as the representatives of MAIL, DEG and KWS all voted against liquidation. Due to political reasons the Government of Germany pressurized KWS and GoA not to support liquidation. DEG offered to purchase the private investors' shares at a low rate which they did not accept[11]. In a second shareholders meeting on 22 July 2009, DEG offered 30% of the actual cost to Afghan private investors for their shares.

The identification and analysis of the problems which the factory is currently facing can provide a valuable insight into agro-business development in Afghanistan. In the following the reasons for the failure of the enterprise are discussed.

5.1 Lack of raw material

The main reason for the failure of the enterprise is the lack of sufficient raw material. The factory has a processing capacity of 600-800 tons of sugar beet per day. To run NBSC to its full capacity, sugar beet cultivation needs to be promoted on a commercial scale.

The land originally owned by the factory was not sufficient to cultivate sugar beet on a commercial scale. The factory had to rely on contract farming to secure the required input.

In the initial phase, around 1200 small farmers expressed an interest in allocating land for sugar beet cultivation. However, in 2006 when the company engaged in the contracting process for the first time, only 260 producers agreed to join NBSC's supply chain. The financial conditions offered by NBSC were not seen by farmers as sufficiently attractive to justify the substitution of their traditional crops and to compensate for their perception of sugar beet planting risks.

The price which the factory offered for the sugar beet - 10 USD/ton, excluding inputs - was far too low to be attractive for farmers. Moreover, field research identified that the sugar beet plant is highly susceptible to diseases and parasites. These reasons discouraged farmers from allocating land for sugar beet under the financial conditions offered by NBSC[12].

In 2006 when the renovation of the factory was complete, the results of the sugar beet campaign were very disappointing. A large part of the crop was lost due to drought and the remainder was seriously affected by pest and disease. The beet variety promoted by the NBSC showed a low resistance to the nematodes virus which severely damages the roots of the plant. However, the first white sugar was produced. No farmers agreed to plant sugar beet under the conditions offered by NBSC in 2007. A relatively small number of farmers were requested to participate in field trials, but their projected yield was nowhere near sufficient to supply the factory. In this year the factory announced a sugar beet campaign, and then did not agree to purchase the sugar beet, which damaged the trust of the farmers.

[11] Private investors

[12] The package offered by the NBSC was free sugar beet seeds, fertilizers on loan (farmers had to return the loan after yield) and technical advice

In 2008 only 50 tons sugar[13] was produced by the NBSC, which generated a turnover of 14,000 USD. In comparison, the operational costs of one sugar producing campaign (continuous functioning of factory for 100 days) are around 900,000 USD[14] ; a staggering operating loss.

Due to the presence of the nematodes virus, in 2009 no sugar was produced at all.

TABLE 1. PRODUCTION OF SUGAR

Year	Ha cultivated under contract	Production Sugar beet/ton	Production Sugar/ton
06	256.3	3627	307
07	-	-	-
08	60	800	50
09	-	-	-

The government recently donated around 4,000 jeribs of land in the Larkhabi area of Baghlan to the NBSC for sugar beet farming, but the land was occupied by warlords and did not have an irrigation system. The private investors did not agree to bear the costs for making the land arable.

In the history of the factory, it always had problems in obtaining a sufficient input. Whereas in the past the GoA was able to pressurize the farmers into producing sugar beet, this is no longer the case. Due to the confiscation of land from large landowners in the Soviet period, only small farmers exist in the area which made it more difficult for the factory to secure the required contracts.

5.2 Economic viability of the enterprise

After four years of operation the factory is still running at a loss. The production cost for one ton of sugar is estimated at around 12,000 USD (due to low productivity) while the revenue per ton of sugar sold is 400-500 USD[15]. Economically it is not viable to produce sugar at NBSC at present. According to the business plan it would take 5 years for the factory to make a profit, but that prognosis has not been met. It may take years to balance the production cost and revenue. It remains questionable whether sugar from Baghlan could ever become competitive with imported sugar. Worldwide it is known that sugar from sugar beet is too expensive compared to sugar from sugar cane.

The German feasibility study worked with an international benchmark price that was too high and did not correctly assess the opportunity costs for farmers.

The feasibility study was far too optimistic regarding the availability of raw material. For the factory to be economically viable, it would need sugar beet cultivation on a commercial scale, through contract farming. The NBSC, however, is nowhere near this level of commercial sugar beet production. Assumptions in the feasibility study were also far too optimistic regarding the price for raw material; it estimated that at € 20-23 for the raw material, the factory would be profitable. However, it also acknowledged the risk attached to the dependency of the factory results on the ex-factory sugar price. A fluctuation of 10% in the ex-factory price would have a considerable negative impact on the company's results.

[13] Mir Jan Sahibi, NBSC shareholder
[14] Interview with Mr Sahibi
[15] Interview with Sahibi, an Afghan private investor

Even with the total production at a maximum capacity, it may still have been difficult for the factory to become profitable, as sugar can only be produced on 100 days a year. Product diversification would have been a way to divide the operation costs over different products, thereby making the enterprise economically viable. The original plan intended to have an alcohol production facility within the factory, but that plan never materialized.

The feasibility study estimated that it would require € 13-15 million to rehabilitate the factory; with the government property valued at € 4.6 million, which was valued at '0' in the business plan, and the private investors not contributing their total promised capital, the enterprise was seriously underfinanced, even though other parties (not shareholders) have contributed more than originally planned. On the other hand, with the lack of input, it would not have made any business sense to continue running the factory at high losses.

5.3 Lack of ownership in management

In the first year of the operation the company had to rely mainly on international staff. The daily management was in the hands of Dr Karim Waziri, an Afghan with German nationality, who was assisted by Alois Kuhn, the sales director, and as such a representative of KWS Saat. The latter was not part of the management team. Dr Wazari and Mr Kuhn were both involved with the NBSC from the beginning. After five years, Waziri was replaced by a local Afghan as the general manager, while remaining involved as Technical Director. Alois Kuhn was hired as a part-time consultant at the German Federal Ministry of Economic Cooperation and Development, but his contract was recently terminated.

A lack of ownership in the management of the factory could have caused a lack of urgency in addressing factory issues, as these issues must have become apparent in 2005 when FAO brought out a report that clearly addressed the problems. Neither the Afghan private investors, nor the GoA were aware of the conclusions of the FAO report. None of the shareholders participated in the daily management / management team of the factory. Dr Waziri was not a representative of one of the shareholders; he was an employee, appointed to run the factory, and he received a salary from FAO during this time. The institutional shareholders may have felt a lesser sense of (personal) ownership as they did not have a real stake in the factory. The Afghan private investors who should have had a feeling of ownership did not display any such sense until recently.

5.4 Attracting Technical Capacity for the factory

One of the major problems which the company faced at the start-up was to find professional staff who could rehabilitate and operate the factory. Although sugar production was not new in Afghanistan, experts in sugar producing technology were no longer available in the country.

In 2004 KWS SAAT and InWEnt reached an agreement to train six Afghan engineers in sugar producing technology at the 'Sugar Institute' of the Technical University of Berlin. Due to the unavailability of suitable and committed candidates only two chemical engineers were selected and sent to attend the training course. NBSC had to bring in seven additional experts and technicians from Germany, Hungary, Slovakia, and Iran during the rehabilitation and sugar production campaigns paying high wages and incentives, thus increasing the production costs.

Finding and keeping skilled labourers has also been a challenge for the factory. Apart from up to 300 unskilled workers during the peak of the sugar beet harvest, the company needed approximately 40-50 skilled technical and administrative staff on a permanent basis. One of NBSC's recruitment strategies has been to find and repatriate former factory staff who had migrated to Pakistan and Iran[16], which again required higher costs than estimated.

[16] Dr Waziri

5.5 The valuation of government property

The GoA contribution and shares consist of 35 hectares of land, buildings and equipment of the old BSF. It took over two years to reach an agreement on the value of these assets. Initially GoA insisted upon a valuation of € 10 million. The final valuation made by a commission formed by the Ministry of Finance, the Ministry of Light Industries and Foodstuffs, Mostofiat, and the Ministry of Agriculture put the value of the government contribution at 4.6 million, judged to be well above the real value of the property and the more than 60-year old equipment. As a matter of fact, the original feasibility study put their value at '0'.

5.6 Legal obstacles in the ownership of government property

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 on the relationship between the Government and the other shareholders of the company. The Ministry of Finance has so far refused to authorize the legal transfer of property to NSBC on the basis of the fact that, according to the Afghan Constitution, foreigners or foreign entities are not allowed to own land in Afghanistan. The Government argues that should the company become bankrupt and the assets have to be distributed among the shareholders, the German shareholders could theoretically become the owners of part of the land. The private investors, DEG and KWS, need the property title to enable the company to apply for loans from national and international banks and other financing institutions which require the land titles and the company's property as collateral.

6. Dynamics of the partnership

This case study was conducted based on the assumption that NBSC is a successful example of a public-private partnership. After intensive research the conclusion can be drawn that this may not be so. The factory is at present non-operational and due to the disappointing results of the enterprise the partnership is falling apart.

The New Baghlan Sugar Co. (NBSC) was established as a PPP with four categories of shareholders:

1) The Government of Afghanistan, the Ministry of Agriculture, Irrigation and Livestock

2) The Government of Germany, through DEG

3) Afghan private investors, and

4) Foreign private investors.

6.1 Objectives

The overall objective of the project was to revive sugar production in Afghanistan after thirty years of war, in order to decrease the dependency on imports, by creating a sustainable enterprise which would generate jobs by reviving sugar beet cultivation and thereby generating an income for farmers. The strategy for developing a domestic sugar industry in Afghanistan further pursues the objective of ultimately building a state of the art industry that can successfully compete with sugar imports from the world's leading sugar exporters.

In the tables below an overview is given of the objectives which the different partners had with the PPC, and the results:

1. Government of Afghanistan (GoA)/MAIL

Objective	Status and Discussion
1. Rehabilitation of the Baghlan Sugar Factory and the development of the sugar sector in Afghanistan.	1.1. Factory is completely rehabilitated, new buildings constructed, machinery installed and sugar producing technology experts and technicians trained. The factory now has the capacity to produce 15,000 tons of white sugar annually. 1.2. The factory will not produce any sugar in 2009 as no sugar beet has been cultivated. The economic viability of the factory is questionable.
2. To provide employment opportunities to people	2.1 The factory provided employment in 2006-2008 for around 200-300 unskilled labourers during the sugar campaign. The employment is not sustainable as the factory is currently not operational. 2.2. NBSC is providing permanent full-time employment to around 50 persons. Sustainability is now questionable.
3. To contribute to economic growth in the region	3.1 A huge investment of 15.6 million dollars has been made in one province, but it still needs to be determined how much of this money has been sent out of the country in the form of salaries, incentives, equipment, inputs and compensation for international experts. 3.2 From an economic point of view the company has not attained the projected development indicators. It never achieved the high level of production, the provision of job opportunities for local residents and the creation of additional income for farmers. Since the factory is currently non-operational and there is no return on the investment, it actually has an adverse effect on economic growth.
4. To attract foreign aid and foreign investment in Afghanistan	4.1 In a sense the NBSC attracted foreign aid in terms of the FAO project with the value of € 1 million from the Government of Germany. KWS invested € 2 million while DEG, in order to support the partnership, put up € 2 million and became a shareholder.
5. To reintroduce sugar beet cultivation in the area	5.1 Sugar beet cultivation returned to the region after 30 years. Even though cultivation is on a small scale, it is good for demonstration purposes and further work extension. Around 8 sugar beet extension workers received training and they provide technical advice to farmers.
6. To develop the private sector (in agriculture) and to assist this sector	6.1 This project failed to contribute to private sector development as this sector has lost its investment as well as its confidence in the Partnership, and the factory may continue as a public enterprise.

2. Government of Germany (GoG)/DEG

Objective	Status and Discussion
1. Supporting GoA in economic growth and private sector development	1.1 The GOG did meet its objective to support GOG and private sector development; however, since the economic viability of the enterprise is now questionable, the assistance has so far not led to sustainable results, other than capacity building.
2. A presence in the North to support the military mission	2.1 The German government has achieved this objective; through the rehabilitation of NBSC it ensured its presence in the North 2.2 NBSC received a great deal of media attention as a successful partnership in private sector development; however, if the news of its failure is published GoG will lose credibility at the national and international level.
3. Encouraging the German Private Sector to invest in Afghanistan, and to support this private sector	3.1 The KWS presence in the partnership is evidence that GoG was able to encourage the German private sector to invest in Afghanistan, but the continuation of this interest is questionable as the factory has not become profitable. 3.2 The German private sector partner KWS did benefit from the partnership as it received support for its plans to find a new market. However, since the enterprise has so far failed to make a profit, the real benefits are minor.

3. Afghan Private Investors

Objective	Status and Discussion
1. To invest in a sector where a good potential for a return on the investment exists	1.1 According to the business plan the company would make a profit in the fourth year of its operation. In 2008 the production cost of one ton sugar was 12,000 USD while the revenue generated was 500 USD per ton of white sugar. In 2009 there was no production at all. It will take much longer for the company to make a profit. 1.2 Investment in the sugar sector proves to be a long-term investment; a profit can only be made after 5-10 years of the investment.
2. Expansion of the factory to other regions	2.1 The private sector is questioning the economic viability of the enterprise and has lost interest in expansion plans.

4. German private investor/KWS SAAT

Objective	Status and Discussion
1. To find a new emerging market for its seeds, particularly sugar beet	1.1 KWS managed to sell half a million EURO worth of sugar beet seeds and other inputs required for the FAO project, but for an international company which holds more than 40% of the world market share in seeds, this amount is negligible. For now, KWS has failed to find a substantial new market for its seeds.
2. To invest in the sugar processing industry, to expand this business in Afghanistan and to make a profit	2.1 The factory is still running at a loss and has not been operational this year; for the time being the expansion plan to meet the demand for sugar in local markets does not seem realistic and feasible.

It can be concluded that in the start-up phase of the enterprise, and over a period of time, the objectives of the partners matched each other, but at this point in time and in the light of the difficulties in making the enterprise viable, they are now digressing.

6.2 Added value of each of the partners

For an enterprise of this scale, an investment is required, in terms of capital and resources that any single party could not have made, to lessen the risk for each of the single parties.

In addition to their capital investments, the added value of the German Government and the German investor was to bring in the required know-how, as all sugar production and expertise in sugar beet cultivation had either left the country or ceased after thirty years of war.

The added value of the GoA was that it owned the Sugar Factory. It was anticipated that it would be able to remove any legal obstacles, but that did not occur; on the contrary, it gave rise to certain legal issues. Due to low capacity and a lack of resources, in addition to organizational changes that resulted in responsibility for the private enterprise shifting from one ministry to another, it was unable to contribute actively to the project.

The Afghan private investors were mainly asked for their added capital, and they were easily convinced by the expertise of the foreign consultant which concluded in the feasibility studies that the enterprise should provide a return on the investment within 5 years. The added value of private sector investors can be skills, resources and the efficiency required to run a private enterprise; however, that was not the case here.

In conclusion: the partnership has failed where it was supposed to be strong: it could have benefited from the skills, resources and efficiency of the private partner, but it did not. Little private money was actually invested; the donor ended up paying for everything.

Inputs by the Partners

GoA / MAIL	Afghan private partners	GoG / DEG	German private investor
Land and buildings Know-how concerning Laws and regulations	Capital	Capital to pay for human resources Expertise in PPC	Know-how concerning seeds for sugar beet cultivation Seed inputs Feasibility studies Management skills Know-how concerning sugar production

Additional inputs provided by other parties:

- Feasibility studies: IAK AGRAR CONSULTING GMBH, IPRO Industrieprojekt GmbH
- Know-how concerning factory design: IPRO Industrieprojekt GmbH
- Know-how concerning sugar production: INWENT
- Know-how concerning farmers' organizations and training: FAO, paid for by the German government

6.3 The Afghan private investors saw NBSC as a business opportunity

Most (Afghan) private investors are interested in enterprises with a quick return on their investment. The development of the sugar sector is a long-term economic activity. Currently, in Afghanistan other business opportunities, e.g. in construction, export and import, banking, services delivery (logistics, transportation, hotels etc.), that would generate a higher ROI at a much quicker rate are available. In addition, agri-business projects are vulnerable to a number of natural factors (e.g. the availability of irrigation, humidity, drought, climatic changes, the seasons, the availability of agricultural inputs, pests and diseases etc.) which makes the risk of losses relatively high.

This lack of a (short-term) return on investment is one of the reasons, and perhaps the most important one, that the Afghan private investors are no longer interested in NBSC. They have not been actively involved with the management of and the strategic planning for the factory. They participated in the shareholders meetings (receiving a reimbursement of travel costs when they took place in Germany) and they received financial reports. They did not have any expertise in the field of sugar beet cultivation. They had considered this business opportunity purely for its return on investment (ROI) and trusted the financial projections given in the feasibility studies as they relied on the input of renowned German companies. For various reasons, one of the most prominent being a lack of trust with regard to the other partners, the investors withheld their promised investment.

6.4 The (passive) role of the Afghan Government

During the compilation of this research study the private investors reported that the government has shown limited interest to date in supporting the project, despite the fact that the company is in line with government policies, has been able to mobilize substantial local and international capital, and there is an enormous potential for economic growth and job creation in the area. Not only did the government not seem to show any real interest in turning the factory into profit, but in effect it slowed down the process of getting the NBSC off the ground. In 2005 the Government of Germany and the GoA signed a bilateral agreement on the Promotion and Protection of Investment (APPI) which has still not been ratified by the Afghan Parliament, thus depriving the German investors of a risk guarantee from the Afghan government.

When asked, Mr Ghorbandi, Director of Private Investment, MAIL, explained that according to the private sector development strategy, GoA cannot take an active role. It has to play a passive role in order to support the private sector. Legally, the GoA is no longer allowed to own large enterprises or to hold majority shares in PPCs. He insists that GoA does provide support to factories, agri-businesses and farmers, and has shown its support to NBSC in particular by allowing the factory to lease 4000 jeribs of land on a 40-year lease contract. This land was in effect useless as it did not have an irrigation system and the ownership was challenged by local warlords. There were two particular problems in which the GoA was expected to step in, but it actually slowed down or hampered the process: the valuation of the government property and legal obstacles to the ownership of government property.

It does not seem that GoA has actively represented the interest of either the farmers, or the Afghan private investors, and neither does it seem that it has actively contributed to PSD.

GoA lacks the means, in terms of funds and capacity, to be of more assistance and has only been involved with the factory from a distance.

6.5 The German Government paying for everything

The Government of Germany has actively contributed to the enterprise through project funding for several of its organizations/institutions, e.g., DEG, KWS Saat, CIM, INWENT, etc., and UNFAO. However, parts of its contribution seem to have benefited German private enterprises and German consultants by covering the costs of feasibility studies, factory design, salaries for experts, training, seeds, etc., which is seen by the Afghan private investors as being unfair.

It is unclear how actively DEG, as the main interface for the GOG and the coordinator of the different funding contributions, has been involved with the enterprise, and how actively it has been involved in the management/strategic decisions of the factory. It seems that it has handed full responsibility and authority to two individual consultants.

At present GoG, through DEG, is assuming responsibility for the survival of the factory by proposing to purchase the shares of the Afghan private investors. When DEG manages to buy the Afghan private investors' shares, it will become the majority shareholder of NBSC with 64.1% of the total shares. However, it will still not be able to own the companies' assets.

Compared to the original feasibility study, the GoG has contributed far more than originally envisaged, and it has also covered most of the additional costs.

6.6 Lack of trust among the shareholders

As the drama unfolded, the research study showed that the partnership was hampered by a lack of trust between the shareholders. All four parties have lobbied against the others due to conflicting interests at a certain point in time. For instance, in matters of land titles and farmers' subsidies from the government, KWS and the Afghan private investors formed an alliance against the GoA. In the purchasing of inputs, machinery, tools and equipment, or any other technical services, DEG and KWS created an alliance to involve German companies. In the last shareholders meeting where the Afghan private investors proposed the liquidation of the company, KWS, DEG and GoA voted against this motion due to German government pressure and politics.

Furthermore, private investors argue that KWS brought in its own experts to conduct the feasibility study and the design study, and also sold its seeds and other inputs to FAO to make a profit. They consider that the value placed on this expertise/know-how is too high. Other German companies and organizations were also involved during different stages of the rehabilitation process. The Afghan investors accuse IPRO Industrieprojekt GmbH, which was contracted to prepare the technical design of the factory, of having infringed the copyrights of another sugar factory in Europe. The research team has not received any input during the research from the German investors, nor from the German government, which would counter these accusations. Suffice it to say that the trust between the different shareholders has been severely damaged over the years, and apparently no one has taken any notice of and made any efforts to resolve the growing dissatisfaction between the partners.

6.7 Lack of involvement of farmers

Considering the importance of the inputs to the factory, the role of farmers was underestimated in setting up the enterprise. That the factory was facing severe problems in receiving sufficient inputs, among other things, was apparent to an independent researcher who carried out an evaluation for FAO in 2005. In hindsight it is clear that the conclusions in the FAO report were ignored. No farmers' associations were established - which FAO had planned to do - as that would have required active farmers, and there were none. The contractual conditions regarding prices and risk sharing in contracts with farmers were outside the purview of FAO, which was limited to playing an advisory role in that regard. FAO acted as an advocate for the farmers, but it was not a shareholder in the enterprise and did not have an active stake, even though it paid the salary of the general manager at the time.

7. Conclusions and recommendations

Even though the problems facing the NBSC are currently serious, the enterprise may yet be saved or even turned into a successful endeavour if a comprehensive plan is made and measures are immediately implemented. Several conditions and strategies to save the enterprise, and the required contributions from each of the partners, are outlined below in subsections 1 and 2. In subsection 7.3 recommendations are made as to how to make PPCs in Afghanistan successful, based on the lessons learnt from NSBC.

7.1 How can the enterprise be successful?

Improve corporate governance as well as financial and managerial systems

The enterprise will need to update the business plan and re-evaluate capital requirements, as well as the financial needs based on a current understanding of the market, in order to assess how much extra capital would be required in order to save the enterprise.

Strong leadership is required to diagnose management and administrative issues and to make a plan to address them. A strong financial management system is the most important requirement for the factory to ensure transparency and accountability in all matters related to procurement, fund utilization, sales and other financial transactions. High managerial positions in the factory need to be refilled through a transparent recruitment process as one way to cope with organizational failure is to change the leadership and management of the enterprise.

The enterprise needs to be subjected to a financial audit. After four years the NBSC has not been subjected to a financial audit from an independent party to confirm that no corruption or fraudulent actions have taken place. Regular financial audits will not only ensure transparency and accountability in utilized funds, but also identify any weaknesses in the financial management system.

Full support within government institutions

The GoA should play a more active role. It is not sufficient that GoA contributes in terms of land and buildings. The GoA has to create a good business environment for all the shareholders. The Department of Agriculture Extension at MAIL can play a role in providing improved seeds, technical assistance and inputs for the farmers. The bilateral agreement on the promotion and protection of investment (APPI) signed in April 2005 by the German and Afghan Governments needs to be ratified as soon as possible so as to provide German investors with the opportunity to obtain a risk guarantee. The ratification and effectiveness of the agreement would create incentives for German investors to engage in a country which is still considered to be a very high risk for investment, without additional costs to the Government. In addition, the Government could provide incentives (subsidies) for sugar beet cultivation and raise taxes on imported sugar (only when the factory comes to a certain minimum level of production that will satisfy local needs).

A comprehensive plan for sugar beet research and extension

It is necessary to remove the root causes of all problems relating to the 'unavailability of raw material'. Since it is not economically viable to import sugar beet from Uzbekistan, Pakistan and Iran for sugar production in Afghanistan, the only option is to introduce sugar beet cultivation at a commercial and domestic level. For this purpose a research station is required to introduce the best varieties and improved farming systems. Controlling pests is another challenge that needs to be addressed. FAO, GoA, Agriculture Research Institutions, and other NGOs can play a vital role in this area.

Contracting out land to the private sector for commercial sugar beet cultivation

It is necessary to introduce sugar beet cultivation on a commercial scale using agricultural mechanization and to encourage the private sector to invest in the 4,000 jeribs of land allocated by the GoA. This can stimulate commercial sugar beet cultivation in the area and can also further develop the private sector.

Diversify products to make the enterprise economically viable

It is necessary to diversify the factory's processing capacity. Currently the factory is only producing white sugar, while after careful market and technical surveys it is apparent that other products such as juices, pickle, jams and marmalades, medical alcohol, conserved food, and dairy processing can also be produced. This will help the factory to obtain an additional surplus as well as providing work for the labour force during those days when sugar beet is not processed.

Lower personnel costs

It is necessary to assess the operational costs of the factory during processing; it is assumed that too many expatriates are being brought in to run the factory which increases production costs. It will be vital to have all positions within the factory occupied by local Afghan staff.

7.2 The best contribution from the partners

<u>Government of Afghanistan</u>

The Government of Afghanistan could revalue the property which it has contributed in this partnership. A commission should be established which is made up of independent experts who can determine the real value of the land and buildings. This will somehow return the lost trust of private investors in GoA.

1. GoA could provide technical assistance, input, subsidies and financial benefits to those farmers who want to engage in sugar beet cultivation.
2. GoA could find a solution to land titles by amending land titling constitutions or making an exception for NBSC.
3. GoA could adopt a strategy of gradually phasing out so as to hand the enterprise over to solely private investors to encourage entrepreneurship, creativity and innovation which is not possible in traditional set-ups where government bureaucracy and several other hurdles exists.
4. GoA could, in addition, free funds (possibly from other sources) to invest in the enterprise.

<u>The German Investors KWS and DEG</u>

1. KWS could revise the business plan and reassess the operational strategy, the financing requirements, the management of factory and the operational costs as well as introducing different options.
2. KWS could take an active role in establishing a research station and help farmers to grow sugar beet; this will not only support the NBSC in terms of supplies but will provide a potential market for KWS seeds in Afghanistan.
3. GoG should pressurize GoA to resolve land titling and other problems.
4. KWS and DEG could convince GoG to fund the construction of an irrigation system to make the newly acquired land arable.
5. DEG and KWS should take a look at their own contributions to ensure that the funding is used properly and transparently, and to consider making an additional investment.

<u>Afghan private investors</u>

1. Afghan private investors should invest the remaining part of their investment. They are holding shares worth one million Euro but have contributed 300,000 Euro each.
2. Private investors should bolster their knowledge of sugar technology to avoid future confusion, cases of fraud and the possibility of corruption.

7.3 Recommendations for PPCs in Afghanistan

The enterprise's potential economic viability needs to be assessed in a feasibility study and/or a business plan; when larger investments are required, a third party evaluation with local and market expertise employing due diligence may be required to assess the validity of basic assumptions and hypotheses. It should be considered whether to have an independent party conduct the feasibility study and/or the business plan, instead of the future beneficiaries.

The enterprise's corporate governance should be agreed upon and understood by all partners and procedures for financial reporting and the appointment of management staff should be established and implemented. It should be taken into consideration that local counterparts are not familiar with financial reporting and financial auditing practices that are commonly used in Western, developed markets. They can easily be persuaded by professional reports and financial prognoses, but may not be able to counter certain assumptions and/or to identify certain fallacies.

All shareholders should take an active role in shareholders meetings and demand accountability from the appointed management for planning and results. The role of each of the shareholders/partners and their contributions has to be agreed upon from the start and the partners have to be held accountable in fulfilling their commitments and responsibilities at the shareholders meetings. Regular financial audits by independent parties should be made to 'monitor and evaluate' the proper use of donor funds and the progress of the enterprise as well as ensuring proper financial management. These could be a requirement by donors, but could also be part of the corporate governance system.

Private Sector Development projects require the input of private sector investors. The private sector partners should ideally be involved in the daily management and operation of the enterprise as they have the experience to deal with the dynamics of operating a business; however, that would require knowledge concerning the sector in question. Strong leadership of the enterprise is required, in particular during the start-up and early phases of a newly established enterprise so as to set up managerial and financial systems and procedures, to diagnose management and administrative issues and to develop a strategic plan to address these issues. A financial management system is the most important requirement for an enterprise to ensure the transparency and accountability of the management in all matters related to procurement, the utilization of funds, sales and other financial transactions. The managerial positions in the enterprise need to be filled through a transparent recruitment process and appointed by the shareholders, as a method for dealing with organizational failure is to change the leadership and management of the enterprise.

In enterprises that rely solely on agricultural input, the creation of backward linkages is one of the most important and most often underestimated aspects of the operation. Similarly, in other types of businesses, the purchasing of raw materials can be a problem in Afghanistan which does not have any raw material (plastic/cardboard/paper industry, etc.) production industry and almost everything has to be imported**.**

The PPC can be a first step towards full privatization, but in this case the Government of Afghanistan has to be more actively involved in these early stages of privatizing the enterprise and its active involvement should be visible for the local population. The full support of GoA institutions should be ensured. The GoA should have an active role in the development of the enterprise if it acquires ownership. It should actively work on creating an enabling environment. The Ministry of Agriculture's Department of extension can play a role in providing improved seeds, technical assistance and inputs for farmers. The GoA can provide incentives for farmers concerning the cultivation of certain crops. The GoA can levy taxes on imported products (only when the enterprise attains a certain minimum level of production that will satisfy local needs).

The Government of the Netherlands could enter into a bilateral agreement on the promotion and protection of investments in order to decrease the risks for Dutch investors.

8. Source material

List of Documents Reviewed for this case study

#	**Document**
1	Afghanistan National Development Strategy Focus on Privatization
2	Ministry of Commerce and Industry's Strategy for Private Sector Development
3	Case Study 'Reconstruction of the Sugar Sector in Afghanistan' by Dr Klaus Klennert InWEnt – Capacity Building International, Germany Rural Development, Food, and Consumer Protection
4	'The investment climate in Afghanistan exploring Opportunities in an uncertain environment' Finance and Private Sector South Asia Region World Bank, 2005
5	'Feasibility Study of the Baghlan Sugar Factory Afghanistan' July 2003, IAK AGRAR CONSULTING GMBH
6	FDI.net Special Report – 'Sweet Success' Published June 7, 2005 www.fdimagazine.com
7	'Rehabilitation of the Sugar Industry in Baghlan: Technical and Managerial Support for Small and Family Farmers Participation in the Sugar Beet Supply Chain' www.fao.org/world/Afghanistan
8	'Afghan Sugar Factory Rehabilitated and Begins Sugar Production' www.afghamania.com/en/news
9	'Magazine for Development Cooperation' Interview with Alois Kühn, KWS SAAT AG www.inwent.org/E+Z/content/archive-eng
10	FAO mission report – Rehabilitation of Baghlan Sugar Factory
11	'The Growing Role of Contract Farming in Agri-food Systems Development' Drivers, Theory and Practice, Carlos Arthur B. da Silva, Ph.D. FAO Agricultural Management, Marketing and Finance Service Agricultural Support Systems Division

List of people interviewed

#	Name	Position/Organization
1	Dr Wassiri	Technical Director NSBC
2	Mr Kakar	Deputy Director Private Sector Development – MAIL
3	Mr Ghorbandi	Director of Private Sector Development, MAIL and GoA representative in NBSC
4	Mr Hamayoon Shaheem	Private Sector Advisor – MAIL
5	Mr Amir Jan Sahibi	NBSC Shareholder
6	Dr Najebullah	Privatization Component Manager, USAID/Land Titling and Economic Reconstruction in Afghanistan Project, Ministry of Finance
7	Mr Saifullah Abid	Regional Economic Cooperation Advisor, Ministry of Finance
8	Mr Amir Jan Sahibi	NBSC Shareholder
9	M. Aslam (on the telephone)	Food and Agriculture Organization of the United Nations
10	Mr Siraj (on the telephone)	Food and Agriculture Organization of the United Nations
11	Alois Kuhn (via email)	Former KWS employee