

REQUEST FOR PROPOSALS

TECHNICAL ASSISTANCE FOR THE

AZERBAIJAN PENSION REFORMS PROJECT

Submission Deadline: May 14, 2008
4:00 PM BAKU TIME

Submission Place: Chairman
Azerbaijan State Social Protection Fund
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Baku
Azerbaijan
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SEALED PROPOSALS SHALL BE CLEARLY MARKED AND RECEIVED PRIOR TO THE TIME AND DATE SPECIFIED ABOVE. PROPOSALS RECEIVED AFTER SAID TIME AND DATE WILL NOT BE ACCEPTED OR CONSIDERED.

REQUEST FOR PROPOSALS

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Section 1: INTRODUCTION

The U.S. Trade and Development Agency (USTDA) has provided a grant to the Azerbaijan State Social Protection Fund (Grantee) to partially fund the cost of goods and services required for Technical Assistance (TA) on the proposed Pension Reforms Project (Project) in Azerbaijan (Host Country). The grant agreement is attached at Annex 4 for reference. The Grantee is soliciting technical proposals from qualified U.S. firms to provide expert consulting services to carry out the TA.

1.1 BACKGROUND SUMMARY

As of January 1, 2006, the government of Azerbaijan signed a new law “On labor pensions” which converts its state pension system into what is called a Second Pillar pension system. This converts the country from a Pay As You Go (PAYG) system (First Pillar) to a Notional Defined Contribution (NDC) and Real Funded (RF) system (Second Pillar).

The TA is to provide technical assistance to the State Social Fund of Azerbaijan (SSPF) to reform its pension system by (i) development of individually insured funded pension accounts, like 401K or individual retirement accounts in the U.S. (“Insurance Accumulation Program”), as well as (ii) a pension program within a framework of which the government would allocate a portion of the state’s strategic financial resources currently managed by the State Oil Fund of Azerbaijan (SOFAZ) to SSPF for the benefit of each individual pensioner (“Financial Accumulation Program”).

In summary, a First Pillar system is where everyone pays into the pension system based on salary and service, and all of these funds are paid to current retirees. PAYG creates a basic safety net for every citizen at retirement. This is the system Azerbaijan had prior to January 1, 2006.

In the first part of the Second Pillar system (NDC), the pension amount is based on how much each person actually paid in over their lifetime, the money is in virtual accounts, there is no cash in these accounts, and these accounts and how the money is used are not controlled by the people currently contributing to the pension system. This is the state pension system that Azerbaijan currently provides for its citizens based on the January 1, 2006, legislation and the system that is currently in place in the United States.

The second part of the Second Pillar system (RF) is where a percentage of the total contributions by each pensioner are contributed to an individual account for that person. Each future pensioner can get information on the cash in these accounts and can direct how these funds are invested. The cash in these accounts is paid only to the pensioner that opened the accounts or, at death, to their family. The Real Funded system is what SSPF wants to implement by 2010, though the law providing for this system is already in place.

The Third Pillar system allows each person to contribute a portion of their wage to voluntary accounts in private pension funds if they are not satisfied with the mandatory state pension

system. This is like what is allowed under individual 401K accounts in the U.S. Voluntary pensions are pensions taken out by individuals to provide for themselves at retirement. Contributions paid into private pension funds are invested in some way to get annuity at retirement.

The TA will make recommendations as to how the Grantee can set up individually insured funded pension accounts for citizens that would like to set up their own voluntary pension accounts, like 401K accounts in the U.S., i.e., what the Grantee is calling the Insurance Accumulation Program. Also, the TA will recommend how funds managed by SOFAZ could be set aside to fund either Real Funded accounts (under the Second Pillar) or a portion of the voluntary accounts (Third Pillar) that are set up by pensioners to provide for themselves at retirement, i.e., what the Grantee is calling the Financial Accumulation Program.

A background Desk Study for this TA is attached at Annex 2.

1.2 OBJECTIVE

The objective of the TA is to review individually insured funded pension account systems in place in various countries and design a national pension system for Azerbaijan, while taking into account the macroeconomic impacts, the management of the accounts, the range of investment options and the administration of individual accounts. The TA will also design state-funded individually insured funded pension accounts, while determining the entitlement rules/structure, how the State's portion would be valued for the individual pensioner, the timing of contributions, the legal ownership of assets, the management of the assets, and other issues.

The Terms of Reference (TOR) for this TA is attached at Annex 5.

1.3 PROPOSALS TO BE SUBMITTED

Technical proposals are solicited from interested and qualified U.S. firms. The administrative and technical requirements as detailed throughout the Request for Proposals (RFP) will apply. Specific proposal format and content requirements are detailed in Section 3.

COST will not be a factor in the evaluation and therefore, cost proposals should not be submitted; upon detailed evaluation of technical proposals, one firm will be selected for contract negotiations. The amount for the negotiated contract has been established by a Grantee cost share of U.S. \$511,400 and a USTDA grant of U.S. \$600,000, for a total of U.S. \$1,111,400.

1.4 CONTRACT FUNDED BY GRANTEE AND USTDA

The first U.S. \$511,400 of the negotiated contract will be funded by the Grantee. The remaining U.S. \$600,000 of the negotiated contract will be funded by USTDA in accordance with the terms and conditions of its grant to the Grantee. The contract must include certain USTDA mandatory clauses relating to nationality, taxes, payment, reporting, and other matters. The USTDA nationality requirements and the USTDA mandatory clauses are attached at Annexes 3 and 4 for reference.

Section 2: INSTRUCTIONS TO PROPOSERS

2.1 PROJECT TITLE

The project is called the "Azerbaijan Pension Reforms Project."

2.2 DEFINITIONS

Please note the following definitions of terms as used in this RFP.

The term "Request for Proposals" means this solicitation of a formal technical proposal including qualifications statement.

The term "Offeror" means the U.S. individual, or U.S. firm, including any and all subcontractors, which responds to the RFP and submits a formal proposal and which may or may not be successful in being awarded this procurement.

2.3 DESK STUDY REPORT

USTDA sponsored a Desk Study to address technical, financial, sociopolitical, environmental and other aspects of the proposed project. A copy of the Report is attached at Annex 2 for background information only.

2.4 EXAMINATION OF DOCUMENTS

Offerors should carefully examine this RFP. It will be assumed that Offerors have done such inspection and that through examinations, inquiries and investigation they have become familiarized with local conditions and the nature of problems to be solved during the execution of the TA.

Offerors shall address all items as specified in this RFP. Failure to adhere to this format may disqualify an Offeror from further consideration.

Submission of a proposal shall constitute evidence that the Offeror has made all the above mentioned examinations and investigations, and is free of any uncertainty with respect to conditions which would affect the execution, and completion of the TA.

2.5 PROJECT FUNDING SOURCE

The TA will be funded under a cost share from the Grantee and a grant from USTDA. The total amount of funding for this TA is not to exceed U.S. \$1,111,400.

2.6 RESPONSIBILITY FOR COSTS

Offeror shall be fully responsible for all costs incurred in the development and submission of the proposal or any other cost incurred by Offeror prior to issuance of an agreement or contract. Neither USTDA nor the Grantee assumes any contractual obligation as a result of the issuance of this proposal request, the preparation or submission of a proposal by an Offeror, the evaluation of proposals, or final selection.

2.7 TAXES

Offerors should submit proposals which note that in Annex 4, USTDA Mandatory Contract Provisions, USTDA funds are not to be used to pay taxes or duties under the laws of host country.

2.8 CONFIDENTIALITY

The Grantee will use its best efforts to preserve the confidentiality of any business proprietary or confidential information submitted by the Offeror, which is clearly designated as such by the Offeror.

2.9 ECONOMY OF PROPOSALS

Proposal documents should be prepared simply and economically, providing a comprehensive and concise description of the Offeror's capabilities to satisfy the requirements of the RFP. There is no necessity for expensive bindings, colored displays, or other promotional material unless such material is absolutely pertinent to the proposal. Emphasis should be placed on completeness and clarity of content.

2.10 SUBSTANTIVE PROPOSALS

The Offeror shall certify (a) that its proposal is genuine and is not made in the interest of, or on the behalf of, any undisclosed person, firm, or corporation, and is not submitted in conformity with, and agreement of, any undisclosed group, association, organization, or corporation; (b) that it has not directly or indirectly induced or solicited any other Offeror to put in a false proposal; (c) that it has not solicited or induced any other person, firm, or corporation to refrain from submitting a proposal; and (d) that it has not sought by collusion to obtain for himself any advantage over any other Offeror or over the Grantee or USTDA or any employee thereof.

2.11 CONDITIONS REQUIRED FOR PARTICIPATION

Only U.S. firms are eligible to participate in this tender. However, U.S. firms may utilize subcontractors from the host country for up to 20 percent of the amount of the USTDA grant. USTDA nationality requirements are attached at Annex 3.

2.12 LANGUAGE OF PROPOSAL

All proposal documents shall be prepared and submitted in the English and Azeri languages.

2.13 PROPOSAL SUBMISSION REQUIREMENTS

The **Cover Letter** in the proposal must be addressed to:

Chairman
Azerbaijan State Social Protection Fund
Zardabi Str. 80
Baku
Azerbaijan

Phone: +994 12 434-38-62

Fax: +994 12 434-38-62

An Original and eight (8) copies of your proposal must be received at the above address no later than 4:00 PM (Baku Time), on May 14, 2008.

Proposals may be either sent by mail, overnight courier, or hand-delivered. Whether the proposal is sent by mail, courier or hand-delivered, the Offeror shall be responsible for actual delivery of the proposal to the above address before the deadline. Any proposal received after the deadline will be returned unopened.

Upon timely receipt, all proposals become the property of the Grantee.

2.14 PACKAGING

Each proposal must be sealed to ensure confidentiality of the information. The proposals should be individually wrapped and sealed, and labeled for content including "original" or "copy number x"; the original and eight (8) copies should be collectively wrapped and sealed, and clearly marked for content.

Neither USTDA nor the Grantee will be responsible for premature opening of proposals not properly labeled.

2.15 AUTHORIZED SIGNATURE

The proposal must contain the signature of a duly authorized officer or agent of the Offeror empowered with the right to bind the Offeror.

2.16 EFFECTIVE PERIOD OF PROPOSAL

The proposal shall be binding upon the Offeror for sixty (60) days after the proposal due date, and Offeror may withdraw or modify this proposal at any time prior to the due date upon written request, signed in the same manner and by the same person who signed the original proposal.

2.17 EXCEPTIONS

Firms agree by their response to the RFP announcement to abide by the procedures set forth therein. Material modifications in the TOR or responsibilities of the parties will not be accepted.

Any exceptions in the proposal shall be clearly identified, and shall include the scope of such exception, and its impact, on the procurement. The Grantee shall make final determination as to the responsiveness of such exceptions and their acceptability.

2.18 OFFEROR QUALIFICATIONS

As provided in Section 3, Offerors shall submit evidence that they have relevant past experience and have previously delivered advisory and technical assistance services similar to those required in the TOR.

2.19 RIGHT TO REJECT PROPOSALS

The Grantee reserves the right to reject any and all proposals and to accept or reject any or all of the items in the proposal, and to award the contract in whole or in part if it is deemed in the best interest of the Grantee.

2.20 PRIME CONTRACTOR RESPONSIBILITY

Offerors have the option of subcontracting parts of the services they propose. The Offeror's proposal must include a description of any anticipated subcontracting arrangements, including the name, address, and qualifications of consultants and subcontractors. USTDA nationality provisions are set forth in detail in Annex 3. The successful Offeror shall cause appropriate provisions of its contract, including all mandatory USTDA clauses, to be inserted in all subcontracts ensuing to ensure fulfillment of all contractual provisions by subcontractors.

2.21 AWARD

An award resulting from this RFP shall be made to the best qualified Offeror, taking into consideration the evaluation factors set forth herein; however, the right is reserved to reject any and all proposals received and, in all cases, the Grantee will be the judge as to whether a proposal has or has not satisfactorily met the requirements of this RFP.

2.22 COMPLETE SERVICES

The successful Offeror shall be required to (a) furnish all supplies, supervision, transportation, and other execution accessories, services, and facilities; (b) provide and perform all necessary labor; and (c) in accordance with good technical practice, with due diligence, and in accordance with the requirements, stipulations, provisions and conditions of this RFP and the resultant contract, execute and complete all specified work to the satisfaction of the Grantee.

2.23 INVOICING AND PAYMENT

Deliverables under the contract shall be delivered on a schedule to be agreed upon in a contract with the Grantee. The Contractor may submit invoices to the designated Grantee Project Director in accordance with a schedule to be negotiated and included in the contract. Upon approval of each invoice, the Grantee will forward the invoice to USTDA which will process payment to the Contractor. All payments by USTDA under the Grant Agreement will be made in U.S. currency.

Section 3: PROPOSAL FORMAT AND CONTENT

To expedite proposal review and evaluation, and to assure that each proposal receives the same orderly review, all proposals must follow the format described in this section.

Proposal sections and pages shall be appropriately numbered and the proposal shall include a Table of Contents. Offerors are encouraged to submit concise and clear responses to the RFP. Proposals shall contain all elements of information requested without exception. Instructions regarding the required scope and content are given in this section. The Grantee reserves the right to include any part of the selected proposal in the final contract.

The proposal shall consist of a technical proposal only. No cost proposal is required as the total value of the Grantee cost share and USTDA grant is established at U.S. \$1,111,400.

Offerors shall submit one (1) original and eight (8) copies of the proposal. Proposals received by fax cannot be accepted.

The following sections and content are required for each proposal:

- Transmittal Letter,
- Cover/Title Page,
- Table of Contents,
- Introduction and Executive Summary,
- Company Information,
- Organizational Structure, Management Plan, and Key Personnel,
- Technical Approach and Work Plan,
- Experience and Qualifications, and
- Miscellaneous.

Detailed requirements and directions for the preparation of each section are presented below.

3.1 SECTION 1: INTRODUCTION AND EXECUTIVE SUMMARY

An Executive Summary should be prepared describing the major facts or features of the proposal, including any conclusions, assumptions, and generalized recommendations the Offeror desires to make. Offerors are requested to make every effort to limit the length of the Executive Summary to no more than five (5) pages.

3.2 SECTION 2: COMPANY INFORMATION

3.2.1 Company Profile

Provide the information listed below relative to the Offeror's firm. If the Offeror is proposing to subcontract some of the proposed work to another firm(s), similar information must be provided

for each subcontractor. Offerors are requested to limit the length of the Company Profile Information to one (1) page per firm.

1. Name of firm and business address, including telephone and fax numbers.
2. Year established (include former firm names and year established, if applicable).
3. Type of ownership and parent company, if any.
4. Project Manager's name, address, telephone and fax number, if different from (1).

3.2.2 Offeror's Authorized Negotiator

Provide name, title, address, telephone and fax number of the Offeror's authorized negotiator. The person cited shall be empowered to make binding commitments for the Offeror and its subcontractors, if any.

3.2.3 Negotiation Prerequisites

1. Discuss any impact of any current or anticipated commitments which may impact the ability of the Offeror or its subcontractors to complete the TA as proposed and within the project schedule.
2. Identify any specific information which is needed from the Grantee before commencing contract negotiations.

3.3 SECTION 3: ORGANIZATIONAL STRUCTURE, MANAGEMENT, AND KEY PERSONNEL

Describe the Offeror's proposed project organizational structure. Discuss how the project will be managed including the principal and key staff assignments for this TA. Identify the Project Manager who will be the individual responsible for this project. The Project Manager must have the responsibility and authority to act on behalf of the Offeror in matters related to the proposed TA.

Provide a listing of personnel (including subcontractors and consultants) to be engaged in the project, either U.S. or local with the following information for key staff: position in the project; pertinent experience, curriculum vitae; other relevant information. If subcontractors are to be used, the organizational relationship between the firms must be described.

A manpower schedule and the level of effort for the project period, by activities and tasks, as detailed under the Work Plan shall be submitted. A statement confirming the availability of the proposed project manager and key staff over the duration of the project must be included in the proposal.

3.4 SECTION 4: TECHNICAL APPROACH AND WORK PLAN

Describe in detail the proposed technical approach and work plan. Discuss the project requirements as perceived by the Offeror. Include a brief narrative of tasks within each activity series. Begin with the information gathering phase and continue through delivery and approval of all required reports.

Prepare a detailed schedule of performance that describes all activities and tasks within the Technical Work Plan, including periodic reporting or review points, incremental delivery dates, and other project milestones.

Based on the Technical Work Plan, and previous project experience, explain when and where Offeror will require support from the Grantee. Detail the amount of staff time required by the Grantee or participating agencies and any work space or facilities needed to complete the TA.

3.5 SECTION 5: EXPERIENCE AND QUALIFICATIONS

Provide a discussion of the Offeror's experience and qualifications which are relevant to the objectives and TOR for the TA. If a subcontractor(s) is being used, similar information must be provided for the prime and each subcontractor firm proposed for the project. Relevant experience and qualifications of key staff proposed shall be provided including letters of commitment from the individuals proposed concerning their availability for contract performance.

As many as possible but not more than six (6) relevant and verifiable project references must be provided, including the following information:

- Project name,
- Name and address of client (indicate if joint venture),
- Client contact person (name/ position/ current phone and fax numbers),
- Period of Contract,
- Description of services provided,
- Dollar amount of Contract, and
- Status and comments.

Offerors are strongly encouraged to include in their experience summary primarily those projects that are similar to or larger in scope than the TA as described in this RFP.

Section 4: AWARD CRITERIA

Individual proposals will be initially evaluated by a Tender Commission of representatives from the Grantee. The Commission will then conduct a final evaluation and completion of ranking of qualified Offerors, and the Grantee shall promptly negotiate a contract with the best qualified Offeror. If a satisfactory contract cannot be negotiated with the best qualified Offeror, negotiations will be formally terminated. Negotiations shall then be undertaken with the second most qualified Offeror and so forth.

The selection of the Contractor will be based on the following criteria:

1) Expertise and Experience in Structural Pension Reforms (30% weighting)

Expertise and experience implementing structural pension reforms, including the introduction of funded individual pension accounts, particularly in developing countries.

2) Financial Expertise and Experience (20% weighting)

Financial expertise and experience, particularly:

- Experience working with international financial institutions, such as the World Bank;
- Public sector international asset management and related advisory services, particularly experience managing the assets of large state oil funds or advising large state oil funds on financial asset management; and
- Strong actuarial analysis and financial modeling skills.

3) Regional Expertise and Experience (20% weighting)

Expertise and experience in former Soviet Union countries, particularly Azerbaijan. Language skills, particularly Azeri and/or Russian language skills. Knowledge of SSPF's legal structure and operations and Azeri laws that would affect pension reforms.

4) Technical Approach and Work Plan (30% weighting)

Completeness, strength and clarity of the Technical Approach and Work Plan, particularly with regard to demonstration of Contractor's ability to reach project milestones.

Proposals which do not include all requested information may be considered non-responsive.

Price will not be a factor in contractor selection.

ANNEX 1

Chairman, Azerbaijan State Social Protection Fund, Zardabi Str. 80, Baku, Azerbaijan,
Phone: +994 12 434-38-62, Fax: +994 12 434-38-62

B—Azerbaijan: Pension Reforms Project Technical Assistance

POC Evangela Kunene, USTDA, 1000 Wilson Boulevard, Suite 1600, Arlington, VA 22209-3901, Tel: (703) 875-4357, Fax: (703) 875-4009. Azerbaijan: Pension Reforms Project Technical Assistance. The Grantee invites submission of qualifications and proposal data (collectively referred to as the "Proposal") from interested U.S. firms which are qualified on the basis of experience and capability to develop technical assistance to review individually insured funded pension account systems in place in various countries and design a national pension system for Azerbaijan, while taking into account the macroeconomic impacts, the management of the accounts, the range of investment options and the administration of individual accounts. The technical assistance will also design state-funded individually insured funded pension accounts, while determining the entitlement rules/structure, how the State's portion would be valued for the individual pensioner, the timing of contributions, the legal ownership of assets, the management of the assets, and other issues.

The Grantee, the State Social Protection Fund (SSPF), is the state agency with responsibility for social insurance and pensions in Azerbaijan. SSPF is an independent state agency that collects social insurance contributions (social security taxes on wages). Pensions are supposed to be financed by social insurance contributions. However, the social insurance contributions are not sufficient to provide for a decent pension. Therefore, for the funding of various categories of pensioners the Government of Azerbaijan allocates subsidies from the state budget. These subsidies constitute approximately 28% of all SSPF expenses. In order to reduce dependence on the state budget, reduce poverty levels among the elderly in Azerbaijan and improve their standard of living, savings and financial support for pensions need to be increased.

With the help of the United Nations Development Program and the World Bank, SSPF has modernized much of its operations and its management information systems. However, in order to determine uses for the increasing wealth of the State Oil Fund of Azerbaijan (SOFAZ) that do not have a negative macroeconomic effects, to develop a pension system that is a true safety net for the population and to give the citizens of Azerbaijan a concrete stake in their future, the SSPF desires to develop pension programs with individually insured funded pension accounts. One program would allow citizens to invest their own savings into personal accounts, similar to IRA or 401K accounts available in the United States. The structure of these accounts and their nature would be determined as part of the technical assistance. The second pension program would involve putting funding from SOFAZ into individual pension accounts. SSPF expects to implement individually insured funded pension accounts by 2010, so it is important that it determine the best pension system design for both individually insured funded pension accounts and state-funded individual accounts as soon as possible.

The Terms of Reference for this Technical Assistance include:

- Task 1: Pension system framework
- Task 2: Incentive elements framework
- Task 3: Actuarial and insurance framework
- Task 4: Investment framework for individually insured funded pensions
- Task 5: Structure of individually insured funded pension accounts
- Task 6: Demographic modeling
- Task 7: Modeling impact of alternative benefit program design
- Task 8: Review and analysis of domestic capital markets and their inclusion in the funded pension scheme
- Task 9: Analyze alternative investment strategies and their implementation
- Task 10: Model alternative scenarios for awards to existing pensioners
- Task 11: Pension program structural and implementation issues
- Task 12: Final report (including development impact analysis)

The U.S. firm selected will be paid in U.S. dollars from a \$511,400 Grantee cost share and a \$600,000 grant to the Grantee from the U.S. Trade and Development Agency (USTDA), for a total of \$1,111,400.

A detailed Request for Proposals (RFP), which includes requirements for the Proposal, the Terms of Reference, and a background desk study report are available from USTDA, at 1000 Wilson Boulevard, Suite 1600, Arlington, VA 22209-3901. To request the RFP in PDF format, please go to: <https://www.ustda.gov/USTDA/FedBizOpps/RFP/rfpform.asp>. Requests for a mailed hardcopy version of the RFP may also be faxed to the IRC, USTDA at 703-875-4009. In the fax, please include your firm's name, contact person, address, and telephone number. Some firms have found that RFP materials sent by U.S. mail do not reach them in time for preparation of an adequate response. Firms that want USTDA to use an overnight delivery service should include the name of the delivery service and your firm's account number in the request for the RFP. Firms that want to send a courier to USTDA to retrieve the RFP should allow one hour after faxing the request to USTDA before scheduling a pick-up. Please note that no telephone requests for the RFP will be honored. Please check your internal fax verification receipt. Because of the large number of RFP requests, USTDA cannot respond to requests for fax verification. Requests for RFPs received before 4:00 PM will be mailed the same day. Requests received after 4:00 PM will be mailed the following day. Please check with your courier and/or mail room before calling USTDA.

Only U.S. firms and individuals may bid on this USTDA financed activity. Interested firms, their subcontractors and employees of all participants must qualify under USTDA's nationality requirements as of the due date for submission of qualifications and proposals and, if selected to carry out the USTDA-financed activity, must continue to meet such requirements throughout the duration of the USTDA-financed activity. All goods and services to be provided by the selected firm shall have their nationality, source and origin in the U.S. or host country. The U.S. firm may use subcontractors from the host country for up to 20 percent of the USTDA grant amount. Details of USTDA's nationality requirements and mandatory contract clauses are also included in the RFP.

Interested U.S. firms should submit their Proposal in the English and Azeri languages directly to the Grantee by 4:00 PM (Baku time), May 14, 2008, at the above address. Evaluation criteria for the Proposal are included in the RFP. Price will not be a factor in contractor selection, and therefore, cost proposals should NOT be submitted. The Grantee reserves the right to reject any and/or all Proposals. The Grantee also reserves the right to contract with the selected firm for subsequent work related to the project. The Grantee is not bound to pay for any costs associated with the preparation and submission of Proposals.

ANNEX 2



The U.S. Trade and Development Agency

The U.S. Trade and Development Agency (USTDA) advances economic development and U.S. commercial interests in developing and middle income countries. The agency funds various forms of technical assistance, early investment analysis, training, orientation visits and business workshops that support the development of a modern infrastructure and a fair and open trading environment.

USTDA's strategic use of foreign assistance funds to support sound investment policy and decision-making in host countries creates an enabling environment for trade, investment and sustainable economic development. Operating at the nexus of foreign policy and commerce, USTDA is uniquely positioned to work with U.S. firms and host countries in achieving the agency's trade and development goals. In carrying out its mission, USTDA gives emphasis to economic sectors that may benefit for U.S. exports of goods and services.

A. Executive Summary

- Mayflower Partners recommends that the U.S. Trade and Development Agency (USTDA) provide a grant to the State Social Protection Fund of Azerbaijan Republic (SSPF) for \$1,111,400 for a technical assistance program (TA). A request for the grant was received by USTDA on November 22, 2006 through the U.S. Embassy in Baku, Azerbaijan.
- This TA is requested in conjunction with two other programs. One project is being funded by the United Nations Development Program and the other by the World Bank. The USTDA TA will be separate but complementary with these other two programs. The primary aim of this TA is to 1) assist SSPF in transitioning its current state pension system from a Pay As You Go (PAYG) structure to the development of individually insured funded pensions (which combines a Notionally Defined Contribution (NDC) and Real Funded (RF) pension structure, also called the Second Pillar in pension fund reform projects), and 2) develop a plan and strategy for allocating a portion of the State's strategic financial resources to SSPF in a Financial Accumulation Fund as a supplemental part of the pension scheme in Azerbaijan.
- SSPF, the Ministry of Finance, State Oil Fund of Azerbaijan (SOFAZ), the U.S. Embassy Baku and USAID Baku are in support of the USTDA grant. USTDA funded a TA program for Institutional Capacity Building for the State Oil Fund of the Republic of Azerbaijan (SOFAZ) which was completed in June 2006 by contractor Overture Financial Services. USTDA is presently funding Phase II of this program, also with Overture as Contractor.
- SSPF is expected to transition to individually insured funded pension accounts by 2010 and the USTDA TA would be instrumental in achieving this goal.
- U.S. export potential for asset management advisory and custody services is between \$20 million and \$74 million over the next five years, depending on oil prices, the investment returns at SOFAZ and the actual dollar amounts of assets under management.
- The likely sources of financing to implement the recommendations of the TA are the funds from the resources to be allocated by the Azerbaijan government in the future. It is expected that SSPF will have sufficient government funding and support to implement the recommendations of the USTDA Contractor.
- On July 10, 2007, the Ministry of Finance mandated Citigroup and Deutsche Bank to lead Azerbaijan's first Eurobond issue. By issuing sovereign debt in the global capital markets, Azerbaijan will be increasing the total capital available to SSPF and other government agencies for domestic government programs.
- Citigroup announced plans in June 2007 to open a representative office in Azerbaijan by the end of 2007.

- The proposed technical assistance program meets USTDA's basic funding criteria because it will have a positive developmental impact on: (1) market-oriented reforms, (2) human capacity-building, (3) technology transfer and productivity enhancement and (4) other development effects.
- Mayflower Partners reviewed one proposed Terms of Reference (TOR) for this TA from SSPF. No budget was submitted with the TOR, so Mayflower has created a draft budget.

B. Project Background and Description

The proposed TA would review individually insured funded pension account systems in place in various countries and design a national pension system for Azerbaijan, while taking into account the macroeconomic impacts, the management of the accounts, the range of investment options and the administration of individual accounts. The proposed TA would also design state-funded individually insured funded pension accounts, while determining the entitlement rules/structure, how the State's portion would be valued for the individual pensioner, the timing of contributions, the legal ownership of assets, the management of the assets, and other issues.

Background on Azerbaijan and SSPF

Azerbaijan has a population of 8,557,000 (April 2007 est.), with a 39.7 % real GDP growth rate (2006 est.) and GDP per capita of \$2373,3 (2006 est.). Oil and gas account for 90% of its total exports.

In 2006, there were 1.19 million people receiving labor pensions in Azerbaijan (13.9 percent of the total population). Of these, 783,400 were old-age, 276,000 disability, and 129,000 survivors pensioners. Pensions within Azerbaijan are currently an amount defined on the basis of insurance period (record) and the average wage for the last 24 months or any successive 60 months of labor activity, approximately \$68 per month, and given to seniors from the budget of the State Social Protection Fund. The average pension is 35% of the average wage of approximately \$193 per month.

The State Social Protection Fund is the state agency with responsibility for social insurance and pensions in Azerbaijan. SSPF is an independent state agency that collects social insurance contributions (social security taxes on wages). Pensions are supposed to be financed by social insurance contributions. However, the social insurance contributions are not sufficient to provide for a decent pension. Therefore, for the funding of various categories of pensioners the Government of Azerbaijan allocates subsidies from the state budget that constitute 28% of all SSPF expenses. In order to reduce dependence on the state budget, reduce poverty levels among the elderly in Azerbaijan and improve their standard of living, savings and financial support for pensions need to be increased.

With the help of the United Nations Development Program and the World Bank, SSPF has modernized much of its operations and its management information systems (MIS). However, in order to determine uses for the increasing wealth of the State Oil Fund of Azerbaijan that do not have a negative macroeconomic effects, to develop a pension system that is a true safety net for the population and to give the citizens of Azerbaijan a concrete stake in their future, the SSPF desires to develop pension programs with individually insured funded pension accounts. One program would allow citizens to invest their own savings into personal accounts, similar to IRA or 401K accounts available in the United States. The structure of these accounts and their nature would be

determined as part of the technical assistance. The second pension program would involve putting funding from the State Oil Fund of Azerbaijan into individual pension accounts. SSPF expects to implement individually insured funded pension accounts by 2010, so it is important that it determine the best pension system design for both individually insured funded pension accounts and state-funded individual accounts as soon as possible.

Background on SOFAZ

The State Oil Fund of Azerbaijan (SOFAZ) is a state-managed fund that receives oil and gas royalties and payments and invests them for Azerbaijan. The Fund is a mechanism whereby energy-related earnings are accumulated and efficiently managed. The cornerstone of the philosophy behind the Fund is to ensure intergenerational equality with regard to benefit from the country's oil wealth, whilst improving the economic well being of the population today and safeguarding the economic security of future generations.

The Oil Fund's assets stood at AZN 1,338 mln (1.538 bln USD) as of February 1, 2007. The major sources of income for SOFAZ are:

1. Proceeds generated under production sharing agreements from sales of the Republic of Azerbaijan's share of hydrocarbons;
2. Bonuses paid under the terms of production sharing agreements;
3. Acreage fees paid by foreign investors for use of the contract areas in connection with the development of hydrocarbon resources;
4. Dividends paid under the terms of production sharing agreements;
5. Revenues generated from the transit of oil and gas over the territory of the Republic of Azerbaijan;
6. Revenues generated from the transfer of assets from investors;
7. Revenues from management of SOFAZ assets;
8. Grants and other disinterested aid.
9. Other income.

SOFAZ has 60 employees and an annual labor cost of \$1 million.¹ SOFAZ sought assistance through another USTDA program TA to become a well-established global asset management organization. In July 2005, Overture arranged a visit for SOFAZ to the Alaska Permanent Fund in Juneau, Alaska. This fund administers annual payments to citizens of Alaska based on the oil revenues of the state. The TA program was successfully completed in June 2006 by Overture Financial Services of New York.

The Executive Director of SOFAZ is the Chairman of the National Committee on Extractive Industries Transparency Initiative (EITI) launched by the British Prime-Minister Tony Blair in 2003. The Committee on EITI was established in November 2003

¹ Overture Financial Services LLC, conference call April 30, 2007.

after Azerbaijan pledged full support to the Initiative and committed itself to being a pilot country for EITI.

Azerbaijan has subsequently become the first country to introduce an EITI implementation mechanism, with the Government, extractive sector companies and NGOs signing a framework document on November 24, 2005 that ensured submission of regular reports five times by both the Government and the companies beginning in early 2005, as well as collation of these reports by an independent auditor and making the auditor's findings publicly available. The six EITI reporting cycle is currently underway. 3rd EITI Conference in Oslo Norway in October 2006 concluded establishment of the multi-stakeholder Board to manage EITI at the international level and to oversee the future operation of EITI. Hailing Azerbaijan's leading role in implementation of EITI as a pilot country, the Conference selected Azerbaijan as a Board member.

As an international recognition of the transparency efforts of SOFAZ, the Fund was awarded the 2007 UN Public Service Award in the category of "Improving transparency, accountability and responsiveness in the Public Service" in June 2007. SOFAZ is the first institution in Eastern Europe and the CIS countries to be awarded the UN Public Service Award.

Background and trends in Norway's offshore state pension fund

By comparison, the value of Norway's offshore state pension fund, called the Government Pension Fund - Global, similar to SOFAZ, is currently worth \$300 billion and is expected to be worth US\$500 billion in three years. It is expected to climb to around US\$830 billion within 10 years, during which time the fund's emphasis on ethical investments will be expanded. Norway has a population of approximately 4.7 million, with one of the highest GDP per capita in the world (\$47,800). Norway's oil fund is expanding its emphasis on ethical investments in tandem with other changes to the fund including a planned increase in its equity allocation to 60 percent from 40 percent previously. The Ministry of Finance is directing the Norwegian fund's growing emphasis on ethical investments to help extend the global trend toward ethical investments. Statoil of Norway is 70.9% owned by the Government of Norway, through the Ministry of Petroleum and Energy. The remaining 29.1% shares of Statoil are owned (in descending % order) by various banks and institutional investors globally. They include State Street Bank (US) (1.88%), Bank of NY – American Depository Receipts Dept. (US) (1.57%), the Norwegian national insurance fund (1.5%), JP Morgan Chase (UK) (1.36%), Bank of New York (US) (1.03%) and various other global investment firms. Lastly, Norway's Statoil is a 7% shareholder in the BTC (Baku-Tbilisi-Ceyhan) pipeline, part of which crosses Azerbaijan and is responsible for a portion of SOFAZ's revenues.

Background on the proposed USTDA technical assistance program

As of January 1, 2006, the government of Azerbaijan signed a new law “On labor pensions” which converts its state pension system into what is called a Second Pillar pension system (described more fully below). This converts the country from a Pay As You Go system (First Pillar) to a Notional Defined Contribution (NDC) and Real Funded (RF) (Second Pillar) system.

The proposed USTDA technical assistance program is to provide technical assistance to the Government of Azerbaijan to reform its pension system by (i) development of individually insured funded pension accounts, like 401K or individual retirement accounts in the U.S. (“Insurance Accumulation Program”), as well as (ii) a pension program within a framework of which the government would allocate a portion of the state’s strategic financial resources currently managed by SOFAZ to SSPF for the benefit of each individual pensioner (“Financial Accumulation Program”).

In summary, a First Pillar system is where everyone pays into the pension system based on salary and service, and all of these funds are paid to current retirees. PAYG creates a basic safety net for every citizen at retirement. This is the system Azerbaijan had prior to January 1, 2006.

In the first part of the Second Pillar system (NDC), the pension amount is based on how much each person actually paid in over their lifetime, the money is in virtual accounts, there is no cash in these accounts, and these accounts and how the money is used are not controlled by the people currently contributing to the pension system. This is the state pension system that Azerbaijan currently provides for its citizens based on the January 1, 2006 legislation and the system that is currently in place in the United States.

The second part of the Second Pillar system (RF) is where a percentage of the total contributions by each pensioner are contributed to an individual account for that person. Each future pensioner can get information on the cash in these accounts and can direct how these funds are invested. The cash in these accounts is paid only to the pensioner that opened the accounts or, at death, to their family. The Real Funded system is what SSPF wants to implement by 2010, though the law providing for this system is already in place.

The Third Pillar system allows each person to contribute a portion of their wage to voluntary accounts in private pension funds if they are not satisfied with the mandatory state pension system. This is like what is allowed under individual 401K accounts in the U.S. Voluntary pensions are pensions taken out by individuals to provide for themselves at retirement. Contributions paid into private pension funds are invested in some way to get annuity at retirement.

The proposed TA will make recommendations as to how SSPF can set up individually insured funded pension accounts for citizens that would like to set up their own voluntary

pension accounts, like 401K accounts in the U.S., i.e., what SSPF is calling the Insurance Accumulation Program. Also, the TA will recommend how funds managed by SOFAZ could be set aside to fund either Real Funded accounts (under the Second Pillar) or a portion of the voluntary accounts (Third Pillar) that are set up by pensioners to provide for themselves at retirement, i.e., what SSPF is calling the Financial Accumulation Program.

General Background on Three Pillar Pension Systems

The first pillar - This pillar provides social safety net support to everyone.

The second pillar - This pillar emphasizes savings and growth of pension capital.

The third pillar - This pillar encourages additional savings and capital development.

The first pillar (PAYG)

Pay-as-you-go system is based on the principle of obligation of young generation to contribute to the social welfare of the older population. The pensions paid out during a certain period are financed from the contributions of employees and employers during the same period. In a pay-as-you-go pension system, no pension capital is set aside for future pension payments. In this pillar, the total contributions paid by both employer and employee are used to pay pensions to current pensioners. The aim of this pillar is to give elderly people an adequate share of the national income of a given period and to secure a standard of living for elderly people.

One form of implementation of this pillar is a wage based pension scheme. This means that the pension of a person is based on some sort of formula related to salary and service years, regardless of the paid contributions.

The second pillar (NDC + RF)

NDC: A Notionally Defined Contribution scheme is an alternative way for pay-as-you-go solidarity system to calculate the pension benefits. This system is called notional because the accounts of the insured individuals exist only on paper. The money does not exist in any real account. However, the benefit payable from the NDC scheme is based on this notional account balance, and the notional account balance is based on actual contributions made to the solidarity system by the insured person, or on the insured person's behalf. However, there are no accumulated contributions to pay pensions to the insured person when he or she retires. In this system the insured persons' contributions accumulated on their NDC accounts are directed to pay pensions to current retirees just like in pay-as-you-go solidarity system.

The notionally defined contribution scheme is a different way of expressing the formula for calculating pension amounts in a solidarity system. Instead of calculating benefits based on average wage and years of service, notional scheme calculates benefits by accumulating, on paper, the mandatory contributions made by (or on behalf of)

participants in the solidarity system. Thus, the NDC has been designed to assure a closer link between contributions and benefits. It differs from a wage based pension system.

The indexing procedures in NDC model are linked to the changes in wages, GDP growth, inflation rates in the country economy and other factors. In this system, the insured persons have the opportunity to get information related to their accounts.

Real Funded (RF): The goal of this scheme is to establish a diverse system with opportunity to increase the social security of insured persons. Joining the funded pension scheme gives everyone an opportunity to provide for a higher old-age pension. Funded pension management policy implies that a certain part of the social insurance contributions (as some percentage of employee's salary) is allocated to individual retirement saving account and invested in the financial and capital markets until the employee reaches retirement. In the framework of this system, information on the amount of social insurance contributions made to each insured person's account is being registered and the real money is being accumulated on those accounts. All the social insurance payments contributed by insured persons are only used for their own pension pay-outs in the future.

When the insured person has reached the age allowing her/him to apply for the old-age pension, the total sum of the pension capital accumulated in the funded scheme is then used for the old-age pension calculation. When the insured person passes away before applying for the old-age pension, both the accumulated pension capital and the profit derived from capital investments in the framework of this system are paid to his/her family members. In the funded pension scheme, the employees have the right to receive information on their account and control over how the contributions are invested.

The third pillar (voluntary)

This pillar enables insured persons to build up their own personal capital as pension provision by contributing some portion of their wage to the voluntary accounts in the private pension funds if they are not satisfied with the mandatory state pension system. Voluntary pensions are pensions taken out by individuals to provide for themselves at retirement. Contributions paid into private pension funds are invested in some way to get annuity at retirement. This pillar is just an old age pension scheme. It does not include disability, sickness and work injury benefits.

The pension reform concept in Azerbaijan links the third pillar with introduction of private pension funds. The private pension funds are more likely to focus on maximizing investment returns to be attractive to the population. These pension funds, especially those in developing countries, can foster the development of financial markets within a country by creating demand for financial products and institutions.

According to the January 1, 2006 legislation, an individual account is opened in the Fund's system for the purposes of the individual recording of the paid social insurance fees for each insured person. This account consists of two sub-accounts:

1st sub-account – it is an insurance part of an individual account and is for recording of certain portion of the paid social insurance fees (this is a virtual accumulation element, because no real money is collected in the insurance part of an individual account, only the amount of the paid social insurance fees are shown here).

2nd sub-account – it is an accumulation part of an individual account and this sub-account, which is opened in a bank, is for collection of certain portion of the paid social insurance fees and funds from its investing (this is a real accumulation, because real money is collected in the accumulation part of an individual account and income is obtained from its investing).

C. Project Sponsor

The State Social Protection Fund (SSPF) is an independent state agency (i.e. central executive authority) responsible for implementation of public administration in the field of mandatory social insurance and labor pensions in Azerbaijan Republic. SSPF will be the Project Sponsor and Grantee for the USTDA grant. SSPF, like other ministries and independent agencies, reports to the Cabinet of Ministers and the President of Azerbaijan Republic. The Chairman of SSPF and his deputies are appointed to their posts by the President of Azerbaijan Republic. SSPF has 2,658 employees at present. SSPF currently has 1,193,500 pension recipients and the average monthly pension payment is 60AZN (approximately USD 69.77 per month).

In accordance with “The Concept of Pension Reform in Azerbaijan Republic” approved by the President of the country in 2001, SSPF, as an integrated executive authority, combined the functions of collecting mandatory social insurance contributions, conducting personified recording of these funds, appointment of pensions based on personal accounts data as well as functions of financing and control of payments.

Besides, according to the concept of pension reform, the system of the state social assistance and benefits (national assistance for those not involved in the system of mandatory social insurance) has been separated from the pension insurance system. At present, state functions in the area of pension insurance are performed by the State Social Protection Fund and those in the field of state social assistance and benefits are exercised by the Ministry of Labor and Social Protection of Population.

SSPF's Budget and Funding Process

The projected SSPF revenues (income) for 2007 are \$1.062 mln. So far, SSPF is not a self-financing institution and the budget deficit (approx. 27% of the budget revenues) is covered by the transfers from the state budget. The budget of SSPF is adopted by the Parliament and is controlled by the Chamber of Accounts which is under and reports to the Parliament.

The State budget and the budget of SSPF are adopted separately by the Parliament. Every year from the state budget a definite transfer is being allocated for SSPF the amount of which is subject of negotiations with the Ministry of Finance. The Ministry of Finance as the central executive authority in the field of state finances directly participates in the implementation of the state pension-insurance policy.

During the stage of initial preparation of the budget, the Ministry of Finance and SSPF are clarifying the amount to be transferred from the state budget to the SSPF's budget. The transfer is determined in the amount of the deficit of the SSPF's budget. That is, the transfer amount consists of the negative difference between total amount of the SSPF's income (social insurance fees collected from entities) and its expenses including

payments to beneficiaries. Afterwards, the draft budget of the SSPF is prepared and submitted to the Parliament. The Parliament approves the SSPF's budget in the form of a law of the Azerbaijan Republic. The Chamber of Accounts is only the supreme controlling body and is revising the Fund's activities in an established period of time. The Chamber of Accounts does not prepare the budget. The Fund carries out its transactions itself within the budget approved by the Parliament. Also, during a budget year (this is the calendar year), the Ministry of Finance remits the transfer amount to the Fund's account on a monthly basis.

Currently, the SSPF's main income includes only social insurance fees and transfers from the state budget. The Fund has offices and fixed assets and does not possess any other assets since it is not engaged in investment activity. The value of its fixed assets is 6,446,535 AZN (approximately USD 7,410,000) as of 1 January 2007. The Fund's income and expenses are in the same amount. 1 AZN equaled approximately USD1.16 as of April 25, 2007.

The Fund's budget for 2007 was approved as follows:

Total income – 920,190,000 AZN, including,

- social insurance fees to be collected – 670,730,000 AZN
- transfer from the state budget – 248,240,000 AZN
- other income (receipt on partial payment of sanatorium tickets) – 1,220,000 AZN

Total expenses – 920,190,000 AZN, including,

- pension payments – 846,850,500 AZN
- other payments and expenses – 73,339,500 AZN

The main purpose of the next stage of the pension reforms is possession by the Fund of free assets, effective placement of these assets and their use for pension payments. For these purposes, collection of real funds in accumulation accounts (applying real accumulation element) is provided for.

The Fund does not have its own bank accounts and the income and expenses of the Fund's budget are executed through its accounts in the state treasury system, which is subordinated to the Ministry of Finance. Social insurance fees paid by employers as well as transfers from the state budget by the Ministry of Finance are collected in these accounts.

The Chamber of Accounts does not have any relation to execution of the Fund's income and expenses, as well as conduction of its financial transactions. The Chamber is a controlling body and only revises the Fund's activity during established period of time.

D. Project Sponsor's Capabilities and Commitment

SSPF is fully committed to implementing the proposed USTDA technical assistance program and must, under the legislation enacted on January 1, 2006, implement the reforms necessary to ensure that an NDC and RF pension system (Second Pillar) is in place for all citizens of Azerbaijan.

Additionally, Dan Stein, Regional Director, Europe and Eurasia at the U.S. Trade and Development Agency, met personally with Salim Muslumov, Chairman of SSPF, Shahmar Movsumov, Executive Director of SOFAZ, the U.S. Ambassador to Azerbaijan, USAID-Baku, and the U.S. State Department Coordinator of Assistance, Near Asia, in early February 2007. Each of these parties agreed with USTDA funding of the TA and support implementation of the proposed pension reforms. SSPF officially informed the U.S. Government of its support of and request for funding for this project in its November 21, 2006 letter to U.S. Trade and Development Agency.

SOFAZ received a grant from USTDA for a technical assistance program completed in June 2006. This TA was focused on institutional capacity-building for SOFAZ's asset management capabilities. It was a successful program and laid the groundwork for continuing work with USTDA on technical assistance to SSPF. One of the outcomes of the SOFAZ TA was that Bank of New York was appointed Global Custodian for all of SOFAZ's securities custody needs as a result of an internationally competitive bid process. SSPF itself has been actively involved with UNDP and the World Bank on two long-term technical assistance programs (described below) which have served to revamp SSPF's physical facilities, information technology systems and personnel training.

UNDP Project

The "Capacity Building for the SSPF of Azerbaijan" project has a total budget of \$7.395 mln, of which \$5.29 mln has been spent. The project is in its fourth phase and has published a recent report, "Capacity building for the State Social Protection Fund of the Republic of Azerbaijan, Project report (January, 2007)".

The total budget of \$7.395 mln has been funded \$1.9 mln by UNDP and \$5.495 mln by the Government of Azerbaijan. This joint UNDP-SSPF project has spent its funds for the establishment of software for the system of personal accounts in the sphere of social insurance, development of computer infrastructure, construction of modern regional branch offices, paper forms, and consultancy services. According to the last agreement between SSPF and UNDP, the fourth phase should finish in December 2007. The project objectives have been:

- Significantly increase the managerial and technological capacity of the State Social Protection Fund of Azerbaijan Republic (SSPF);

- Improve efficiency of the social insurance and pension provision systems in Azerbaijan Republic;
- Maintain transparency in social insurance and pension provision systems;
- Automate major business processes and data exchange procedures;
- Set up efficient communication between the SSPF headquarters and local branches;
- Establish a strong foundation for introduction of the Real Funded pension scheme;

Some results have been:

- Computer management system designed at Stage I & II in the pilot regions will be set up at the local branches of SSPF.
- New software linking Personal Accounts System with the financial management system of SSPF will have been developed.
- In the framework of the E-governance program of Azerbaijan Republic, new modules will be developed that will enable data sharing with other involved state agencies.
- Shifting to a new pension system based on individually insured funded accounts. Improvement of the financial sustainability of SSPF, significant improvement of the transparency of SSPF activity leading to higher level of collaboration between population and SSPF. Growth of public satisfaction with the state policy in the social protection area.

Other Activities:

- Announcement of Project bids for procurement of computer equipment and system software; announcement of the tenders for the establishment of the Social Insurance Card Printing Center. Printing and distribution of the Social Insurance Cards.

World Bank project

There is a joint World Bank-SSPF project – “Pension and social assistance” which is to support expansion of the UNDP project impact on the whole territory of Azerbaijan. The total budget of the project is \$5 mln. Within the project, SSPF has procured 86 servers, 1600 thin client sets, 540 laser printers and other equipment which is used in the branches of SSPF. So far \$1.760 mln have been spent on the project needs. The remaining part of the credit will be used for the establishment of the back-up center, training, public campaign, procurement of power generators and some office equipment.

E. Implementation Financing

This technical assistance program will provide direct and valuable input to SSPF to implement its planned pension reform program. With funding from the resources to be allocated by the Azerbaijan government in the future, it is expected that SSPF will have sufficient government funding and support to implement the recommendations of the USTDA Contractor. SSPF and the Azerbaijan government have also already shared the cost of over \$5 million of upgrades to its operating systems through the UNDP TA program.

On July 10, 2007, the Ministry of Finance mandated Citigroup and Deutsche Bank to lead Azerbaijan's first Eurobond issue. By issuing sovereign debt in the global capital markets, Azerbaijan will be increasing the total capital available to SSPF and other government agencies for domestic government programs.

Azerbaijan has one of the world's fastest growing economies, and the government expects gross domestic product to grow by 36 percent this year. Ratings agency Fitch upped Azerbaijan's credit rating in February to 'BB+' from 'BB', with a stable outlook, citing strong economic growth underpinned by rising oil production.

F. U.S. Export Potential

Direct U.S. exports which could arise as a result of this TA are primarily in the information and communications technologies (ICT) and financial services sector. Azerbaijan is a potential growth market for U.S. information technology firms, asset management firms, banks, pension funds, insurance companies and other non-bank financial institutions. Most U.S. exports to date have been in the oil and gas technologies equipment sector.

The United States-Azerbaijan Chamber of Commerce (USACC) hosted a U.S. Trade Mission to Azerbaijan for leading U.S. firms specializing in Information and Communications Technologies (ICT) on October 1-4, 2006. One of the participants of this trade mission - Booz Allen Hamilton - recently became a winner of the tender by the Ministry of Information Technologies and Communication of Azerbaijan for doing the feasibility study for Regional Innovation Zones in Azerbaijan.

U.S. companies joining the Trade Mission were Lockheed Martin Corporation, Oracle Corporation, Symantec Corporation, Harris Corporation, Science Applications International Corporation (SAIC), Trimble Navigation Inc., Omni Communications Inc., and Booz Allen Hamilton.

At the moment, SSPF doesn't intend to purchase additional computer systems since the general computerization of the system is underway as part of the joint project with the World Bank (SSPF currently has 2,282 computers in its system). However, as additional reforms are implemented and as older systems become obsolete, SSPF may procure additional computer systems.

Potential U.S. export earnings from the financial services sector could include:

- 1) advisory fees for asset management,
- 2) advisory fees for global custodian services,

About half of the global administrators for organizations like SSPF, which have 401K-like accounts, are based in the U.S. Also, roughly half of the 20,000 global asset management firms are based in the U.S. Therefore, there is a 50% chance that SSPF and SOFAZ will choose at least some asset management, administration or custodian firms based in the U.S. for their financial management needs.

There are two components to the export value of this proposed TA. The first component is potential asset management and administration fees for the proposed individual investment accounts (similar to 401K accounts) that are expected to be introduced in Azerbaijan. The second component is related to the proposed Financial Accumulation Fund to be overseen by SOFAZ for SSPF's account.

Assuming 1,300,000 registered insured persons in Azerbaijan, and they set up individually insured funded pension accounts, then each person would choose the asset allocation of their pension investments. Assuming allocation of approximately USD 300 on the individual account of each insured person will mean one-third of SOFAZ's assets are managed in the Financial Accumulation Fund, the current asset value would be \$300-500 million.

Assuming approximately one-third of SOFAZ's assets are managed in the Financial Accumulation Fund, the current asset value would be \$300-500 million. The assets under management are expected to grow substantially over the next five years due to rising oil prices and due to growing returns on investment of existing financial assets. If SOFAZ's assets are \$18 billion in the next five years, then one-third allocated to SSPF could be \$6 billion. Therefore, assuming assets under management between \$300 million and \$6 billion in the next five years, asset management advisory fees of 30-60 b.p. for the Financial Accumulation Fund could be between \$900,000 and \$36,000,000 per annum. Custodian fees for the Financial Accumulation Fund would be between ½ and 1 b.p. per annum, resulting in \$150,000 - \$6 million per annum.

Potential U.S. exports depend on how SSPF and SOFAZ set up the 401k-like accounts and how much they invest in and how they choose to manage the Financial Accumulation Fund. For the two components listed above, there is a total U.S. export potential of between \$20 - \$74 million over the next five years, depending on oil prices, the investment returns at SOFAZ and the actual dollar amounts of assets under management.

Since there is no domestic debt market in Azerbaijan and SOFAZ is not allowed to trade in foreign equities directly right now, trading income for investments in domestic and foreign debt and equity securities is expected to be minimal at present but will increase with changes to investment guidelines and local laws over time. SOFAZ is currently the largest foreign exchange trader in Azerbaijan and it currently uses local banks for foreign exchange trading between USD and EUR to AZN trades and London-based banks for AZN to USD and EUR trades. This, too, could change as the local capital market evolves and becomes more interested in interest rate hedging, foreign exchange hedging and other risk management techniques.

Additionally, SOFAZ has two Requests for Proposal out now, one for portfolio management and another to acquire a general ledger accounting system. After three rounds of proposals, the last three companies in the running for the portfolio management business are two U.S. firms, Sungard and Thomson, and a third firm from Scandinavia with offices in Chicago. The portfolio management business is worth approximately \$2 million per year.

G. Foreign Competition and Market Entry Issues

In 2005, Azerbaijan imported most of its goods and services from Russia 17%, UK 9.1%, Singapore 9.1%, Turkey 7.4%, Germany 6.1%, Turkmenistan 5.8%, Ukraine 5.4%, and China 4.1%, and the remainder from other countries².

With regard to foreign competition to provide technical assistance to SSPF, UNDP, World Bank and the Asian Development Bank all have active technical assistance programs in Azerbaijan now.

On July 10, 2007, the Azerbaijan Finance Ministry mandated Citigroup and Deutsche Bank as joint lead-managers for its debut eurobonds, the ministry's official statement says. The ministry plans to issue debut eurobonds in September – October of 2007, according to the statement. The total face value of the issue equals \$300 mln.³

Citigroup recently announced (June 2007) that it is applying for approval for a representative office to be opened in Azerbaijan by the end of 2007 and hopes to convert the rep office to a full branch within 12 months. Citigroup is currently in the process of gathering the required documents from various legal entities. Citigroup changed its official stance on Azerbaijan since the start of this Desk Study, when it initially responded to Mayflower Partners that it did not have immediate plans to open in Azerbaijan. Citigroup manages Azerbaijan from its Moscow and Istanbul offices. Citigroup bid for the Global Custody business of SOFAZ and lost on the first round of proposals. Societe Generale was in the final running for the Global Custody RFP partly because they had a local office in Baku.

Auerbach Grayson & Company, a New York-based brokerage firm that specializes in international securities trading for U.S. institutional investors, has an exclusive local broker partner agreement with Bank Standard of Azerbaijan. Salim Kriman, chief executive officer, Bank Standard stated in June 2006 that "Auerbach Grayson and its worldwide network will greatly expand our relationships with international financial institutions, and give Bank Standard an important role in introducing institutional investors to Azerbaijan's publicly-traded markets".⁴ According to our research, other than Citigroup, no other U.S. investment managers or mutual fund companies have plans to open in Azerbaijan. They may still pursue business in Azerbaijan, but may manage the relationships there from offices in London or other locations.

At the moment, only JP Morgan and Bank of New York have current relationships with SOFAZ. SOFAZ does much of its trading in London, according to Overture. There were 44 banks in Azerbaijan as of January 2005, with total asset of roughly \$1.5 billion or 25%

² CIA World Factbook, April 17, 2007.

³ <http://www.bakutoday.net/view.php?d=39574>, July 11, 2007.

⁴ <http://www.financetech.com/news/showArticle.jhtml?articleID=189401554>, June 16, 2006.

of GDP.⁵ Many other foreign banks operate in Azerbaijan, including Societe Generale, Dresdner Bank, HSBC, and Credit Lyonnais/Credit Agricole, all with asset management divisions as part of their global business lines.

External asset managers of SOFAZ are Deutsche Bank AG and Clariden Bank (Credit Suisse). Both external managers operate under a fixed income mandate. SOFAZ has trading arrangements with various financial institutions and banks such as Barclays (UK), BNP Paribas (France), Deutsche Bank, Dresdner Bank (Germany), JP Morgan (USA), HSBC (GB), Credit Suisse (Switzerland), Royal Bank of Scotland (GB), Society Generale (France), and Commonwealth Bank of Australia.

Deutsche Bank was a custodian for SOFAZ in 2002 – before the custodian business share of this bank was purchased by State Street Corporation of the USA, which has been custodian for SOFAZ since 2003. In 2005, after open competition, the custody contract of SOFAZ was awarded to The Bank of New York. SOFAZ investment assets were transferred in October, 2006 from the former custodian bank to the new accounts with the Bank of New York. BONY is handling the SOFAZ account out of London and is charging approximately \$1-2 million in fees per year. BONY is merging with Mellon Bank, subject to approval, in July 2007. Mellon is known as a premier asset management firm globally.

⁵ Fact Sheet: Azerbaijan, U.S. Department of Commerce, BISNIS representative in Azerbaijan, January 2005.

H. Developmental Impact

The proposed technical assistance program meets USTDA's basic funding criteria because it will assist SSPF in reforming its state pension fund. The SSPF reform project will have a positive developmental impact on: (1) market-oriented reforms, (2) human capacity-building, (3) technology transfer and productivity enhancement, and (4) other developmental effects.

Market-oriented reforms: The SSPF reform project will transition SSPF from a first pillar to a second pillar pension system. Enabling legislation for this transition was already enacted into law and SSPF will use the proposed technical assistance program to plan how it will, by 2010, 1) allow citizens to make their own investment choices for a portion of their retirement income by establishing individually insured funded pension accounts, 2) manage these accounts, 3) set up and manage a Financial Accumulation Fund with funds and management expertise from SOFAZ, 4) introducing institutional changes that transition SSPF from a state-owned and managed pension system to one that allows pensioners choices of investments. Measurements of the success of these reforms in 2010 could be: how many individual insured funded pension accounts were established, how much USD equivalent is under management in these accounts, how many investment choices (number of funds, types of financial securities or investment classes) do pensioners have in 2010 compared to 2007, what were the average returns for each investment choice, how much money was transferred from the Oil Fund to insured persons.

Human capacity-building: The SSPF pension reform project will help SSPF staff to improve their knowledge of how other countries and sub-sovereign entities have implemented the same types of pension systems. The TA Contractor is expected to recommend training of SSPF staff to assist them in the process of designing management systems for the new accounts and pension system. Measurements of this criteria could be, by 2010: how many SSPF employees were directly involved in setting up the new individual pension account systems, how many employees were trained in new IT systems to managed the new individual pension account systems.

Technology transfer and productivity enhancement: The SSPF reform project will finalize implementation of SSPF's new technology platforms which have been provided through the UNDP and World Bank projects and will begin the process of funding and managing the new accounts. Measurements of this criteria could be, by 2010: how many total insured persons are being served with the new individual accounts, how many SSPF staff are required to manage the new pension system (i.e. was there a reduction in staff now needed to service insured persons and pensioners).

Other developmental effects: The SSPF reform project is in line with other transparency and governance initiatives in which the government of Azerbaijan has been involved, including the Extractive Industries Transparency Initiative. By reinvesting Azerbaijan's

oil wealth in the social welfare programs of its people, Azerbaijan will improve its macroeconomic and political stability, and grow its domestic capital market by offering more financial investment options to citizens for their pension funds. There will also be greater certainty in state budgeting since there will be greater transparency of the funds under management with SSPF. Measurements of this criteria could be: what is the typical monthly pension amount of pensioners in 2007 compared to 2010, adjusted for inflation, what were the investment returns to SSPF in 2007 compared to 2010.

I. Impact on U.S. Labor

Providing government pensions is an inherently sovereign, governmental function and therefore could not be provided by U.S. companies. Also, since asset management for SSPF is not currently done by U.S. firms, the proposed expansion of asset management opportunities will not compete with U.S. labor, but instead potentially lead to higher U.S. employment.

The proposed technical assistance program is not expected to provide: (a) any financial incentive to a business enterprise currently located in the United States for the purpose of inducing such an enterprise to relocate outside the United States; (b) assistance for any project or activity that contributes to the violation of internationally recognized workers rights; and (c) direct assistance for establishing or expanding production of any commodity for export by any country other than the United States, if the commodity is likely to be in surplus on world markets at the time the resulting productive capacity is expected to become operative and if the assistance will cause substantial injury to United States producers of the same, similar, or competing commodity.

J. Justification

The proposed technical assistance program meets USTDA basic funding criteria in the areas of market-oriented reforms, human capacity-building and technology transfer and productivity enhancement. Azerbaijan is an important partner to the U.S. in the Caspian region. In fiscal year 2006, approximately \$61 mln was budgeted by all U.S. government agencies for assistance programs in this country. U.S. Treasury Department advisors are providing technical assistance to the government on budget policy and tax administration. The U.S. Embassy in Baku has positive recommendations regarding SSPF and its director. USTDA's Director for Eastern Europe, Dan Stein, met with the executive directors of SOFAZ and the Ministry of Finance and they are all in agreement with SSPF that this TA is needed. SSPF, SOFAZ and MOF are looking for international advice regarding implementation of a more fair and equitable pension system for the average citizen of Azerbaijan. This TA will help to quantify the costs and benefits of more pension reforms in Azerbaijan and lead the way to implementing successful reforms before 2010.

K. Terms of Reference and Budget

Mayflower Partners reviewed one proposed Terms of Reference (TOR) for this TA from SSPF. No budget was submitted with the TOR, so Mayflower has created a draft budget. The proposed TA should begin as soon as possible in order to meet the goal of instituting individually funded pension accounts for all interested citizens of Azerbaijan by 2010.

Scope of Work

Set forth below are distinct tasks to analyze, model and assist in the implementation of both the Insurance Accumulation Project (setting up individually insured funded pension accounts) and the Financial Accumulation Project (exploring how SOFAZ may deposit some oil revenues with SSPF for disbursement through the pension system) in Azerbaijan.

With Respect to the Insurance Accumulation Project:

Task A - Pension system framework (5% of total labor)

The Contractor shall provide an analytical framework, based on the experience of other countries, for the assessment of the desirable features of pension provision in the Republic of Azerbaijan.

1. Review of pension reform experiences in other countries, including but not limited to Kazakhstan, Sweden, Norway, Chile, Latvia, Estonia, Lithuania, and other countries, especially those with significant oil revenues,
2. Analysis of defined benefit, defined contribution, forced savings, non-forced savings, public and private pension schemes.
3. Analysis of the relationship between funded and Pay-As-You-Go schemes.
4. Analysis of the specific asset management arrangements of each of the countries analyzed, with extensive details on asset managers, how they are engaged and managed by the state pension authorities, their fees, their returns to their investors and information on the government oversight and regulations of each of these pension systems.

Task B - Incentive elements framework (5%)

1. In coordination with the Grantee, the Contractor shall set out the advantages and disadvantages of alternative fiscal regimes for encouraging individually insured funded pensions, including, for example, tying health and programs in the hope that workers will pay the combined contribution in order to be eligible for health benefits.

2. The Contractor shall describe in detail how other countries have created the incentives for individuals to save under individually insured funded pension accounts.
3. The Contractor shall analyze the impact on the State budget and the financial operating environment of Grantee.

Task C - Actuarial and insurance framework (5%)

1. The Contractor shall set out the advantages and disadvantages of requiring individuals to purchase whole life annuities with their accumulated pension funds;
2. The Contractor shall report on the desirability of encouraging the development of a market for life insurance and annuities, and the preconditions for achieving this;
3. The Contractor shall discuss appropriate role of the Government of Azerbaijan in supporting the provision of these insurance services.

Task D - Investment framework for individually insured funded pensions (5%)

1. The Contractor shall discuss the advantages and disadvantages of a simple national default age-based lifestyle investment strategy sponsored by the Grantee for participants in the funded pension scheme arrangement;
2. The Contractor shall set out the options for domestic and foreign currency investments in Azeri funded pension funds, make recommendations for target ranges of domestic versus foreign currency investments, and explain the advantages and disadvantages of these investment choices with respect to inflation, liquidity and returns;
3. The Contractor shall discuss the advantages and disadvantages of alternative options for domestic Azeri investments within funded pensions.

Task E - Structure of individually insured funded pension accounts (15%)

1. The Contractor shall review the advantages, disadvantages and practicalities of using the Grantee's modernized individual accounting system for funded personal pension accounts;
2. The Contractor shall consider alternative possibilities, including account administration by international service providers;
3. The Contractor shall make recommendations for funded personal pension accounting and administration system.
4. The Contractor shall analyze the options for implementing funded personal pension accounts alongside the existing PAYG system.
5. The Contractor shall make recommendations for how the funded personal pension accounts will be financed, how they will be allocated to individual accounts, how pensioners could choose a Pension Accumulation Fund (AF) to manage his/her pension savings, how many AFs should be allowed by Grantee and whether there should be a default state Fund for all who fail to designate an AF manager. If so,

- explain how this state Fund would function and be organized with respect to Grantee oversight.
6. The Contractor shall make recommendations to Grantee on whether Asset Management Companies (AMCs) should be chosen for the AFs or if SOFAZ and its agents should take on the asset management of the AFs.
 7. The Contractor shall make recommendations for timing of phase-in of AFs and expected budget consequences to Grantee.

With Respect to Financial Accumulation Project:

Task F - Demographic modeling (10%)

- a) In coordination with the Grantee, the Contractor shall identify “pools” of entitlement among current and future Azeri citizens and residents, and establish demographic basis for modeling the cost of allocating deferred individual benefits under the pension program, this task should take into account various high/medium/low scenarios for Azeri population growth rate, which was 0.8% p.a. as of August 2006⁶, and make high/medium/low assumptions regarding the refugee population;
- b) The Contractor shall model different options for benefit structures and present implications under varying assumptions on the State’s financial resources, size of the individual benefit entitlements, frequency of benefit contributions, vesting of ownership to the participant and limitations, thereof;
- c) The Contractor shall analyze the implications on participation in the formal economy based on entitlement rates, estimated “drawdown schedules” and participant demographics;
- d) The Contractor shall identify and recommend the guidelines and requirements for individuals to participate in the pension program;
- e) The Contractor shall illustrate potential valuation impact of different qualification rules for entitlement on budget of Grantee, state budgets and state resources;
- f) The Contractor shall discuss and make explicit assumptions about eligibility of expatriate workers in Azerbaijan and Azeris abroad, and returning emigrants.

Task G - Modeling impact of alternative benefit program design (10%)

The Contractor shall consider alternative benefit program designs and include them in the Base Model:

- a) Likely cumulative real value (and as a percentage of basic State pension) of individual entitlements for twelve years after retirement for beneficiaries of differing ages;
- b) Macroeconomic balance and individual standard of living implications of term pension benefit ending after 144 months;

⁶ International Finance Corporation, Azerbaijan at a Glance, August 12, 2006.

- c) Standard of living implications in retirement for contributors in younger population cohorts who may not benefit from the dividend compared with those who do (implications of dividend no longer being offered after given number of years);
- d) Hypothetical “permanent” dividend that could be distributed as pension contribution supplement in “perpetuity”.

The Contractor shall provide one or more working simulation models to illustrate the hypothetical costs and benefits of a range of alternative assumptions for the deferred individual dividend on the above mentioned variables.

Task H – Review and analysis of domestic capital markets and their inclusion in the funded pension scheme (10%)

The Contractor shall discuss Azerbaijan’s domestic capital markets (including short- and long-term debt, equity, foreign exchange, hybrid securities such as convertible debt) by providing the following information:

1. Review the current stage of development of the domestic capital markets in Azerbaijan;
2. Discuss which types of domestic investments should be made available to the funded pension scheme;
3. Discuss the potential role of domestic pension investments to foster the development of the domestic financial markets and the economy of Azerbaijan;
4. Discuss the issues which may constrain the ability of domestic markets and the domestic economy to absorb pension investments and recommend how they may be alleviated;
5. Discuss the advantages and disadvantages of holding different allocations between domestic and international currency investments in the Azeri funded pension scheme;
6. Recommend guidelines for managing risks taken by or on behalf of individual participants in the Azeri funded pension scheme. The guidelines should provide targets for domestic and international investments allocations for each individual pension investor’s aggregate investments as well as domestic versus international investment target allocations for the fund itself.

Task I - Analyze alternative investment strategies and their implementation (10%)

The Contractor shall analyze the following and make recommendations to the Grantee regarding:

- a) risk and return implications of alternative investment strategies; the preferences of the sponsoring entities will be analyzed and presented. The financial and behavioral aspects of risk taking, expected financial rewards for individuals as well as the fiduciary responsibilities of the plan sponsors will be presented to the sponsoring

- entities. Issues surrounding the framework for investment risks taken for the management of portfolios will be recommended and discussed;
- b) advice on foreign exchange and macroeconomic balance management implications of conversion of funds and also virtual accounts from foreign currency into Manat term payments shall be provided;
 - c) recommendations on legal obligations of Grantee in respect of individuals' virtual accounts shall be provided;
 - d) several alternatives for the investment management will be presented. This presentation would include but not be limited to:

1) The use of a so-called "lifestyle" model of asset allocation which would provide a mechanism for the automatic switching of the risk profiles of individual virtual accounts at a set number of years before normal retirement date to reduce uncertainty of dividend benefit as retirement approaches.

2) The use of a minimum risk, low return investment strategy pursued throughout the length of the period for which the virtual accounts existed.

Task J - Model alternative scenarios for awards to existing pensioners (10%)

The Contractor shall consider alternative scenarios for awards to existing pensioners and include them in the base model:

- a) analyze cost (in relation to GNP, in US\$) of granting same nominal value awards to existing pensioners as to contributors;
- b) suggest framework for analyzing impact on macro economy of alternative policy choices for the dividends for both contributors and pensioners. Policy alternatives would include both variations in monetary value and phasing of 144 month term awards;
- c) using official projections and demographic projections for participation in formal economy over years ahead, model implications of alternative policy choices for the dividends for both contributors and pensioners;
- d) technical report summarizing issues that may arise from giving beneficiaries right to choose between accepting 144 month term award or purchasing whole life annuity from insurance company shall be present.

Task K - Pension program structural and implementation issues (10%)

The Contractor shall provide:

- a) advice on legal framework for individual account structure, ownership rights and transfer of rights shall be provided. This will include legal issues surrounding the transfer of ownership to the Grantee and then to individuals;
- b) advice on technical implementation issues with respect to virtual personal accounts;

- c) advice on operational issues such as communication, funding, drawdown procedures and foreign exchange conversion issues shall be provided
- d) an analysis of the current collections process for transfer of contributions to Grantee and the various future collections options available to Grantee as the second and third pillar reforms are implemented (including using the Azeri banking system to receive contributions from employers and individuals directly).

Task L – Final report (5%)

The Contractor shall prepare and provide to the Grantee and to USTDA a Final Report in accordance with Annex II of the Grant Agreement. Each of the above tasks in the Terms of Reference must be distinctly set forth in the Final Report in a substantive and comprehensive manner, and shall include all corresponding deliverables. The Final Report shall contain an executive summary. In addition to any other required deliverables in accordance with Annex II of the Grant Agreement, the Contractor shall provide both the Grantee and USTDA with 6 printed copies each of the Final Report on CD-ROM. The CD-ROM version of the Final Report will include:

- Adobe Acrobat readable copies of all documents;
- Source files for all drawings in AutoCAD or Visio format; and
- Source files for all documents in MS Office 2000 or later formats.

All reports will be produced in both English and Azeri. The Final Report shall be prepared in accordance with the Grant Agreement.

- The Final Report will include a section titled “Expected Host Country Developmental Outcomes”. This section will describe the benefits that the Host Country can expect to receive by implementing the recommendations of the USTDA-funded Technical Assistance Program. The discussion should be divided into “direct outcomes” and “final outcomes”. Some examples of quantifiable measurements of direct and final outcomes are listed in the Developmental Impact section of this report.

TA Program Budget

The total proposed budget is \$1,111,400. A breakdown of costs is presented in Attachment I.

As such, the Contractor shall provide the following minimum staff for the study:

1. Project Director
2. Project Manager
3. Two (2) Senior Consultants

4. Two (2) Junior Consultants
5. Two (2) Local Financial and Legal Advisory Subcontractors

The budget assumes one project director at \$2,000/day, one project manager at \$1,800/day, two senior consultants at \$1,500/day, two junior consultants at \$1,000 and two local financial and legal advisory subcontractors at \$1,000/day.

It is assumed that the Contractor will need 36 trips to Azerbaijan to consult with Grantee and SOFAZ during the technical assistance program. The total project should represent approximately 536 person days of work, of which 360 days will be spent in-country by foreign-based consultants. Local subcontractors will be utilized for 138 person days. Virtually all of the work for this project will be completed in Baku, Azerbaijan or in the U.S. See Task Completion Schedule – Attachment II.

Each economy roundtrip airfare is assumed to be approximately \$3,000 refundable coach class from the U.S. to Baku. The Project Director and Project Manager are expected to take 10 round-trips and their airfare will be business class (assumed \$7,500 per trip). Ground transportation per day is assumed to be \$100 and the current State Department per diem for Baku is \$316 total for meals and lodging. Local interpretation for approx. 100 days and translation of documents is assumed to be \$50,000. Miscellaneous including courier costs and communication costs (including phone, fax, cellular, internet) are estimated at \$20,000.

L. Recommendations

Mayflower Partners recommends that USTDA provide a grant to the State Social Protection Fund of Azerbaijan of \$1,111,400 for a technical assistance program.

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TASK DESCRIPTIONS		LABOR IN PERSON DAYS					LABOR RECAP BY TASK					TRIP RECAP BY TASK					
TASK	DISCIPLINE	Project Director	Project Manager	Sr Consultant I	Sr Consultant II	Jr Consultant I	Jr Consultant II	Local Sub	Local Sub	Local Sub	TOTAL DAYS	LABOR COST	TRIPS	TRIP DAYS	LABOR COST	TRIPS	TRIP DAYS
A	Pension system framework (5%)	2	5	5	5	5	5	5	5	5	27	\$35,500	2	20	\$35,500	2	20
B	Incentive elements framework (5%)	2	5	5	5	5	5	5	5	5	27	\$35,500	2	20	\$35,500	2	20
C	Actuarial and insurance framework (5%)	2	5	5	5	5	5	5	5	5	27	\$35,500	2	20	\$35,500	2	20
D	Investment framework for funded pensions (5%)	2	5	5	5	5	5	5	5	5	27	\$35,500	2	20	\$35,500	2	20
E	Structure of individual funded pension accounts (15%)	6	15	15	15	9	9	9	9	9	78	\$111,000	5	50	\$111,000	5	50
F	Demographic modelling (10%)	4	10	20	20	20	20	20	20	20	54	\$76,000	4	40	\$76,000	4	40
G	Modelling impact of alternative benefits (10%)	4	10	20	20	20	20	20	20	20	54	\$76,000	4	40	\$76,000	4	40
H	Review & analysis of domestic capital markets (10%)	4	10	10	10	5	5	15	15	15	59	\$76,000	4	40	\$76,000	4	40
I	Analyze alternative investment strategies (10%)	4	10	10	10	10	10	4	4	4	48	\$76,000	3	30	\$76,000	3	30
J	Model alternative scenarios for awards (10%)	4	10	10	10	10	10	20	20	20	64	\$81,000	3	30	\$81,000	3	30
K	Pension program structure and implementation (10%)	4	10	10	10	10	10	20	20	20	64	\$81,000	3	30	\$81,000	3	30
L	Final report (5%)	2	5	5	5	5	5	5	5	5	27	\$35,500	2	20	\$35,500	2	20
LABOR IN PERSON DAYS		40	100	80	70	54	54	69	69	69	536	\$731,000	36	360	\$731,000	36	360
Total Labor Cost		\$80,000	\$180,000	\$120,000	\$105,000	\$54,000	\$54,000	\$69,000	\$69,000	\$69,000	\$536,000	\$731,000			\$731,000		
LABOR INCLUDING OVERHEAD & GENERAL ADMINISTRATIVE																	
Daily Rate		\$2,000	\$1,800	\$1,500	\$1,500	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$12,500	\$19,000			\$19,000		
TOTAL LABOR		\$80,000	\$180,000	\$120,000	\$105,000	\$54,000	\$54,000	\$69,000	\$69,000	\$69,000	\$536,000	\$731,000			\$731,000		
OTHER DIRECT COSTS (ODCs)																	
Air Fare (US-AZ) - non-director													26	R/T	\$3,000	10	R/T
Air Fare (US-AZ) - director																10	R/T
Per Diem Location																360	Per-Days
Travel & Expenses Report US																72	Per ride
Local Ground Transportation																360	Per ride
Misc. Inc. (Tel & Fax)																360	Per ride
TOTAL ODC's																	
Subtotal Other Direct Costs																	
% TOTAL LABOR																	
TOTAL ODC's																	
TOTAL PROJECT COST																	

Attachment II - Task Completion Schedule

WEEK	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26
Task Name																										
Pension system framework (5%)	█																									
Incentive elements framework (5%)		█																								
Actuarial and insurance framework (5%)			█																							
Investment framework for funded pensions (5%)				█																						
Structure of individual funded pension accounts (15%)							█																			
Demographic modelling (10%)								█																		
Modelling impact of alternative benefits (10%)									█																	
Review & analysis of domestic capital markets (10%)										█																
Analyze alternative investment strategies (10%)											█															
Model alternative scenarios for awards (10%)												█														
Pension program structure and implementation (10%)													█													
Final report (5%)																										

ANNEX 3



**U.S. TRADE AND DEVELOPMENT AGENCY
Arlington, VA 22209-2131**

NATIONALITY, SOURCE, AND ORIGIN REQUIREMENTS

The purpose of USTDA's nationality, source, and origin requirements is to assure the maximum practicable participation of American contractors, technology, equipment and materials in the prefeasibility, feasibility, and implementation stages of a project.

USTDA STANDARD RULE (GRANT AGREEMENT STANDARD LANGUAGE):

Except as USTDA may otherwise agree, each of the following provisions shall apply to the delivery of goods and services funded by USTDA under this Grant Agreement: (a) for professional services, the Contractor must be either a U.S. firm or U.S. individual; (b) the Contractor may use U.S. subcontractors without limitation, but the use of subcontractors from host country may not exceed twenty percent (20%) of the USTDA Grant amount and may only be used for specific services from the Terms of Reference identified in the subcontract; (c) employees of U.S. Contractor or U.S. subcontractor firms responsible for professional services shall be U.S. citizens or non-U.S. citizens lawfully admitted for permanent residence in the U.S.; (d) goods purchased for implementation of the Study and associated delivery services (e.g., international transportation and insurance) must have their nationality, source and origin in the United States; and (e) goods and services incidental to Study support (e.g., local lodging, food, and transportation) in host country are not subject to the above restrictions. USTDA will make available further details concerning these standards of eligibility upon request.

NATIONALITY:

1) Rule

Except as USTDA may otherwise agree, the Contractor for USTDA funded activities must be either a U.S. firm or a U.S. individual. Prime contractors may utilize U.S.

subcontractors without limitation, but the use of host country subcontractors is limited to 20% of the USTDA grant amount.

2) Application

Accordingly, only a U.S. firm or U.S. individual may submit proposals on USTDA funded activities. Although those proposals may include subcontracting arrangements with host country firms or individuals for up to 20% of the USTDA grant amount, they may not include subcontracts with third country entities. U.S. firms submitting proposals must ensure that the professional services funded by the USTDA grant, to the extent not subcontracted to host country entities, are supplied by employees of the firm or employees of U.S. subcontractor firms who are U.S. individuals.

Interested U.S. firms and consultants who submit proposals must meet USTDA nationality requirements as of the due date for the submission of proposals and, if selected, must continue to meet such requirements throughout the duration of the USTDA-financed activity. These nationality provisions apply to whatever portion of the Terms of Reference is funded with the USTDA grant.

3) Definitions

A "U.S. individual" is (a) a U.S. citizen, or (b) a non-U.S. citizen lawfully admitted for permanent residence in the U.S. (a green card holder).

A "U.S. firm" is a privately owned firm which is incorporated in the U.S., with its principal place of business in the U.S., and which is either (a) more than 50% owned by U.S. individuals, or (b) has been incorporated in the U.S. for more than three (3) years prior to the issuance date of the request for proposals; has performed similar services in the U.S. for that three (3) year period; employs U.S. citizens in more than half of its permanent full-time positions in the U.S.; and has the existing capability in the U.S. to perform the work in question.

A partnership, organized in the U.S. with its principal place of business in the U.S., may also qualify as a "U.S. firm" as would a joint venture organized or incorporated in the United States consisting entirely of U.S. firms and/or U.S. individuals.

A nonprofit organization, such as an educational institution, foundation, or association may also qualify as a "U.S. firm" if it is incorporated in the United States and managed by a governing body, a majority of whose members are U.S. individuals.

SOURCE AND ORIGIN:

1) Rule

In addition to the nationality requirement stated above, any goods (e.g., equipment and materials) and services related to their shipment (e.g., international transportation and insurance) funded under the USTDA Grant Agreement must have their source and origin in the United States, unless USTDA otherwise agrees. However, necessary purchases of goods and project support services which are unavailable from a U.S. source (e.g., local food, housing and transportation) are eligible without specific USTDA approval.

2) Application

Accordingly, the prime contractor must be able to demonstrate that all goods and services purchased in the host country to carry out the Terms of Reference for a USTDA Grant Agreement that were not of U.S. source and origin were unavailable in the United States.

3) Definitions

“Source” means the country from which shipment is made.

“Origin” means the place of production, through manufacturing, assembly or otherwise.

Questions regarding these nationality, source and origin requirements may be addressed to the USTDA Office of General Counsel.

ANNEX 4

USD 07.81011B

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U.S. TRADE AND DEVELOPMENT AGENCY

MAR - 4 2008

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Grant Agreement on Technical Assistance for Pension Reforms Project

between

1 - English + Azer
copy

The State Social Protection Fund of Azerbaijan Republic

and

The United States Trade and Development Agency

USTDA # 07-81011B

RECEIVED	DATE	TIME
DEVELOPMENT AGENCY	MAR - 4 2008	
<i>SM. DS. ... ER. ...</i>		

GRANT AGREEMENT

This Grant Agreement is entered into between the Government of the United States of America, acting through the U.S. Trade and Development Agency ("USTDA") and the State Social Protection Fund of Azerbaijan Republic ("Grantee"). USTDA agrees to provide the Grantee under the terms of this Agreement US\$600,000 ("USTDA Grant") to partially fund the cost of goods and services required for Technical Assistance ("TA") on the proposed Pensions Project ("Project") in Azerbaijan ("Host Country").

1. USTDA Funding

J. Engle ...

The funding to be provided under this Grant Agreement shall be used to partially fund the costs of a contract between the Grantee and the U.S. firm selected by the Grantee ("Contractor") under which the Contractor will perform the TA ("Contract"). Payment to the Contractor will be made directly by USTDA on behalf of the Grantee with the USTDA Grant funds provided under this Grant Agreement.

2. Terms of Reference

The Terms of Reference for the TA ("Terms of Reference") are attached as Annex I and are hereby made a part of this Grant Agreement. The TA will examine the technical, financial, environmental, and all other critical aspects of the proposed Project. The Terms of Reference for the TA shall also be included in the Contract.

3. Standards of Conduct

USTDA and the Grantee recognize the existence of standards of conduct for public officials, and commercial entities, in their respective countries. The parties to this Grant Agreement and the Contractor shall observe these standards, which include not accepting payment of money or anything of value, directly or indirectly, from any person for the purpose of illegally or improperly inducing anyone to take any action favorable to any party in connection with the TA.

4. Grantee Responsibilities

- (A) The Grantee shall undertake its best efforts to provide reasonable support for the Contractor, such as local transportation, office space, and secretarial support.
- (B) In addition to the support provided for by Article 4(A) above and the USTDA funding provided under this Agreement, the Grantee shall be responsible for covering US\$ 511,400 of costs to complete the full Terms of Reference.

5. USTDA as Financier

(A) USTDA Approval of Competitive Selection Procedures

Selection of the U.S. Contractor shall be carried out by the Grantee according to its established procedures for the competitive selection of contractors with advance notice of the procurement published online through *Federal Business Opportunities* (www.fedbizopps.gov). Upon request, the Grantee will submit these contracting procedures and related documents to USTDA for information and/or approval.

(B) USTDA Approval of Contractor Selection

The Grantee shall notify USTDA at the address of record set forth in Article 17 below upon selection of the Contractor to perform the TA. Upon approval of this selection by USTDA, the Grantee and the Contractor shall then enter into a contract for performance of the TA. The Grantee shall notify in writing the U.S. firms that submitted unsuccessful proposals to perform the TA that they were not selected.

(C) USTDA Approval of Contract Between Grantee and Contractor

The Grantee and the Contractor shall enter into a contract for performance of the TA. This Contract, and any amendments thereto, including assignments and changes in the Terms of Reference, must be approved by USTDA in writing. To expedite this approval, the Grantee (or the Contractor on the Grantee's behalf) shall transmit to USTDA, at the address set forth in Article 17 below, a photocopy of an English language version of the signed contract or a final negotiated draft version of the contract.

(D) USTDA Not a Party to the Contract

It is understood by the parties that USTDA has reserved certain rights such as, but not limited to, the right to approve the terms of the contract and any amendments thereto, including assignments, the selection of all contractors, the Terms of Reference, the Final Report, and any and all documents related to any contract funded under the Grant Agreement. The parties hereto further understand and agree that USTDA, in reserving any or all of the foregoing approval rights, has acted solely as a financing entity to assure the proper use of United States Government funds, and that any decision by USTDA to exercise or refrain from exercising these approval rights shall be made as a financier in the course of funding the TA and shall not be construed as making USTDA a party to the contract. The parties hereto understand and agree that USTDA may, from time to time, exercise the foregoing approval rights, or discuss matters related to these rights and the Project with the parties to the contract or any subcontract, jointly or separately, without thereby incurring any responsibility or liability to such parties. Any approval or failure to approve by USTDA shall not bar the Grantee or USTDA from asserting any right they might have against the

Contractor, or relieve the Contractor of any liability which the Contractor might otherwise have to the Grantee or USTDA.

(E) Grant Agreement Controlling

Regardless of USTDA approval, the rights and obligations of any party to the contract or subcontract thereunder must be consistent with this Grant Agreement. In the event of any inconsistency between the Grant Agreement and any contract or subcontract funded by the Grant Agreement, the Grant Agreement shall be controlling.

6. Disbursement Procedures

(A) USTDA Approval of Contract Required

USTDA will make disbursements of Grant funds directly to the Contractor only after USTDA approves the Grantee's contract with the Contractor.

(B) Contractor Invoice Requirements

The Grantee should request disbursement of funds by USTDA to the Contractor for performance of the TA by submitting invoices in accordance with the procedures set forth in the USTDA Mandatory Clauses in Annex II.

(C) Order of Disbursement

USTDA will proceed to disburse USTDA Grant funds only after the Grantee has disbursed its full share of costs covering the Terms of Reference, per article 4B of this Grant Agreement.

7. Effective Date

The effective date of this Grant Agreement ("Effective Date") shall be the date of signature by both parties or, if the parties sign on different dates, the date of the last signature.

8. TA Schedule

(A) TA Completion Date

The completion date for the TA, which is March 1, 2009, is the date by which the parties estimate that the TA will have been completed.

(B) Time Limitation on Disbursement of USTDA Grant Funds

Except as USTDA may otherwise agree, (a) no USTDA funds may be disbursed under this Grant Agreement for goods and services which are provided prior to the Effective Date of the Grant Agreement; and (b) all funds made available under the Grant Agreement must be disbursed within four (4) years from the Effective Date of the Grant Agreement.

9. USTDA Mandatory Clauses

All contracts funded under this Grant Agreement shall include the USTDA mandatory clauses set forth in Annex II to this Grant Agreement. All subcontracts funded or partially funded with USTDA Grant funds shall include the USTDA mandatory clauses, except for clauses B(1), G, H, I, and J.

10. Use of U.S. Carriers

(A) Air

Transportation by air of persons or property funded by the USTDA Grant shall be on U.S. flag carriers in accordance with the Fly America Act, 49 U.S.C. 40118, to the extent service by such carriers is available, as provided under applicable U.S. Government regulations.

(B) Marine

Transportation by sea of property funded by the USTDA Grant shall be on U.S. carriers in accordance with U.S. cargo preference law.

11. Nationality, Source and Origin

Except as USTDA may otherwise agree, the following provisions shall govern the delivery of goods and services funded by USTDA under the Grant Agreement: (a) for professional services, the Contractor must be either a U.S. firm or U.S. individual; (b) the Contractor may use U.S. subcontractors without limitation, but the use of subcontractors from Host Country may not exceed twenty percent (20%) of the USTDA Grant amount and may only be used for specific services from the Terms of Reference identified in the subcontract; (c) employees of U.S. Contractor or U.S. subcontractor firms responsible for professional services shall be U.S. citizens or non-U.S. citizens lawfully admitted for permanent residence in the U.S.; (d) goods purchased for performance of the TA and associated delivery services (e.g., international transportation and insurance) must have their nationality, source and origin in the United States; and (e) goods and services incidental to TA support (e.g., local lodging, food, and transportation) in Host Country are not subject to the above restrictions. USTDA will make available further details concerning these provisions upon request.

12. Taxes

USTDA funds provided under the Grant Agreement shall not be used to pay any taxes, tariffs, duties, fees or other levies imposed under laws in effect in Host Country. Neither the Grantee nor the Contractor will seek reimbursement from USTDA for such taxes, tariffs, duties, fees or other levies.

13. Cooperation Between Parties and Follow-Up

The parties will cooperate to assure that the purposes of the Grant Agreement are accomplished. For five (5) years following receipt by USTDA of the Final Report (as defined in Clause I of Annex II), the Grantee agrees to respond to any reasonable inquiries from USTDA about the status of the Project.

14. Implementation Letters

To assist the Grantee in the implementation of the TA, USTDA may, from time to time, issue implementation letters that will provide additional information about matters covered by the Grant Agreement. The parties may also use jointly agreed upon implementation letters to confirm and record their mutual understanding of matters covered by the Grant Agreement.

15. Recordkeeping and Audit

The Grantee agrees to maintain books, records, and other documents relating to the TA and the Grant Agreement adequate to demonstrate implementation of its responsibilities under the Grant Agreement, including the selection of contractors, receipt and approval of contract deliverables, and approval or disapproval of contractor invoices for payment by USTDA. Such books, records, and other documents shall be separately maintained for five (5) years after the date of the final disbursement by USTDA. The Grantee shall afford USTDA or its authorized representatives the opportunity at reasonable times to review books, records, and other documents relating to the TA and the Grant Agreement.

16. Representation of Parties

For all purposes relevant to the Grant Agreement, the Government of the United States of America will be represented by the U.S. Ambassador to Host Country or USTDA and Grantee will be represented by its Chairman. The parties hereto may, by written notice, designate additional representatives for all purposes under the Grant Agreement.

17. Addresses of Record for Parties

Any notice, request, document, or other communication submitted by either party to the other under the Grant Agreement shall be in writing or through a wire or electronic medium which produces a tangible record of the transmission, such as a telegram, cable or facsimile, and will be deemed duly given or sent when delivered to such party at the following:

To: Chairman
State Social Protection Fund of Azerbaijan Republic
Zardabi Str. 80
Baku
Azerbaijan

Phone: +994 12 434-38-62

Fax: +994 12 434-38-62

To: Director	Commercial Section
U.S. Trade and Development Agency	U.S. Embassy
1000 Wilson Boulevard, Suite 1600	83 Azadlyg Prospect
Arlington, Virginia 22209-3901	Baku
U.S.A.	Azerbaijan

Phone: (703) 875-4357

Fax: (703) 875-4009

Phone: 994-12-4980-335

Fax: 994-12-4656-671

All such communications shall be in English, unless the parties otherwise agree in writing. In addition, the Grantee shall provide the Commercial Section of the U.S. Embassy in Host Country with a copy of each communication sent to USTDA.

Any communication relating to this Grant Agreement shall include the following fiscal data:

Appropriation No.: 117/81001

Activity No.: 2007-81011B

Reservation No.: 2008-81006

Grant No.: GH2008810004

18. Termination Clause

Either party may terminate the Grant Agreement by giving the other party thirty (30) days advance written notice. The termination of the Grant Agreement will end any obligations of the parties to provide financial or other resources for the TA, except for payments which they are committed to make pursuant to noncancellable commitments entered into with third parties prior to the written notice of termination.

19. Non-waiver of Rights and Remedies

No delay in exercising any right or remedy accruing to either party in connection with the Grant Agreement shall be construed as a waiver of such right or remedy.

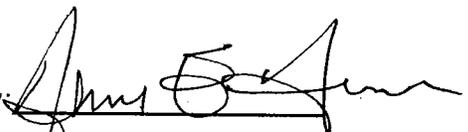
20. U.S. Technology and Equipment

By funding this TA, USTDA seeks to promote the project objectives of the Host Country through the use of U.S. technology, goods, and services. In recognition of this purpose, the Grantee agrees that it will allow U.S. suppliers to compete in the procurement of technology, goods and services needed for Project implementation.

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IN WITNESS WHEREOF, the Government of the United States of America and the State Social Protection Fund of Azerbaijan Republic, each acting through its duly authorized representative, have caused this Agreement to be signed in the English language in their names and delivered as of the day and year written below. In the event that this Grant Agreement is signed in more than one language, the English language version shall govern.

**For the Government of the
United States of America**

By: 

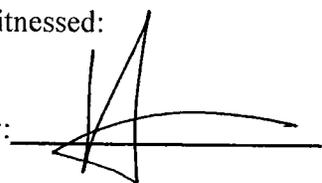
Date: February 25, 2008

**For the State Social Protection Fund
of Azerbaijan Republic**

By: 

Date: 25.02.2008.

Witnessed:

By: 

Witnessed:

By: _____

Annex I -- Terms of Reference

Annex II -- USTDA Mandatory Clauses

Annex I

Terms of Reference

The Azerbaijan State Social Protection Fund (“SSPF”) seeks to reform and build up the pension system for the citizens of Azerbaijan. This is to be done via two component programs: the Insurance Accumulation Project, which sets up individually insured, funded pension accounts; and the Financial Accumulation Project, which allocates a portion of the strategic financial resources of the Government of Azerbaijan to SSPF for disbursement through funds held by the pension system. This technical assistance program will provide direct and valuable input to SSPF to implement its planned pension reform program. With funding from oil revenues to be allocated by the Azerbaijan government in the future, it is expected that SSPF will have sufficient government funding and support to implement the recommendations of the Contractor. SSPF has already shared the cost of over \$5 million of upgrades to SSPF’s operating systems through the United Nations Development Programme Technical Assistance program (“UNDP TA”). Set forth below are distinct tasks to analyze, model and assist in the implementation of this TA.

Task A – Pension system framework

The Contractor shall provide an analytical framework, based on the experience of other countries, for the assessment of the desirable features of the pension system in the Republic of Azerbaijan.

The responsibilities of the Contractor are:

1. Analysis of pension reform experiences in other countries, including but not limited to Kazakhstan, Sweden, Norway, Chile, Latvia, Estonia, Lithuania, and other countries, especially those with significant revenues from natural resources;
2. Analysis of defined benefit, defined contribution, forced savings, non-forced savings, public and private pension schemes;
3. Analysis of the relationship between funded and Pay-As-You-Go (PAYG) schemes;
4. Analysis of the specific asset management arrangements of each of the countries analyzed, with extensive details on asset managers, how they are engaged and managed by the state pension authorities, and their fees; an analysis of returns to investors; and information on the government oversight and regulations of each of these pension systems.

Task B – Incentive elements framework

1. In coordination with the Grantee, the Contractor shall set out the advantages and disadvantages of alternative fiscal regimes for encouraging individually insured funded pensions, including, for example, tying in health insurance and programs in the hope that workers will pay the combined contribution in order to be eligible for health benefits.

2. The Contractor shall describe in detail how other countries have created the incentives for individuals to save under individually insured funded pension accounts.
3. The Contractor shall analyze the impact on the State budget and the financial operating environment of the Grantee.

Task C – Actuarial and insurance framework

1. The Contractor shall set out the advantages and disadvantages of requiring individuals to purchase whole life annuities with their accumulated pension funds.
2. The Contractor shall report on the desirability of encouraging the development of a market for life insurance and annuities, and the preconditions for achieving this.
3. The Contractor shall discuss appropriate role of the Government of Azerbaijan in supporting the provision of these insurance services.

Task D – Investment framework for individually insured funded pensions

1. The Contractor shall discuss the advantages and disadvantages of a simple national default age-based lifestyle investment strategy sponsored by the Grantee for participants in the funded pension scheme arrangement.
2. The Contractor shall set out the options for domestic and foreign currency investments in Azeri funded pension funds, make recommendations for target ranges of domestic versus foreign currency investments, and explain the advantages and disadvantages of these investment choices with respect to inflation, liquidity and returns.
3. The Contractor shall discuss the advantages and disadvantages of alternative options for domestic Azeri investments within funded pensions.

Task E – Structure of individually insured funded pension accounts

1. The Contractor shall review the advantages, disadvantages and practicalities of using the Grantee's modernized individual accounting system for funded personal pension accounts.
2. The Contractor shall consider alternative possibilities, including account administration by international service providers.
3. The Contractor shall make recommendations for funded personal pension accounting and administration systems.
4. The Contractor shall analyze the options for implementing funded personal pension accounts alongside the existing PAYG system.
5. The Contractor shall make recommendations for how the funded personal pension accounts will be financed, how they will be allocated to individual accounts, how pensioners could choose a non-state Pension Accumulation Fund (AF) to manage their pension savings, how many AFs should be allowed by Grantee and whether there should be a default state fund for all who fail to designate an AF manager. If so, the contractor shall explain how this state fund would function and interact with the Grantee.

6. The Contractor shall make recommendations to the Grantee on whether Asset Management Companies (“AMCs”) should be chosen for the AFs, or the State Oil Fund of Azerbaijan and its agents should take on the asset management of the AFs.
7. The Contractor shall make recommendations for timing of a phase-in of AFs and expected budget consequences to the Grantee.

Task F – Demographic modeling

- a) In coordination with the Grantee, the Contractor shall identify “pools” of entitlement among current and future Azeri citizens and residents, and establish a demographic basis for modeling the cost of allocating deferred individual benefits under the pension program; this task should take into account various high/medium/low scenarios for Azeri population growth rate, which was 0.8% p.a. as of August 2006¹, and make high/medium/low assumptions regarding the refugee population.
- b) The Contractor shall model different options for benefit structures and present implications under varying assumptions on the State’s financial resources, size of the individual benefit entitlements, frequency of benefit contributions, and vesting of ownership to the participant and limitations thereof.
- c) The Contractor shall analyze the implications on participation in the formal economy based on entitlement rates, estimated “drawdown schedules” and participant demographics.
- d) The Contractor shall identify and recommend the guidelines and requirements for individuals to participate in the pension program.
- e) The Contractor shall illustrate the potential valuation impact of different qualification rules for entitlement on the budget of the Grantee, State budgets and State resources.
- f) The Contractor shall discuss and make explicit assumptions about the eligibility of expatriate workers in Azerbaijan and Azeris abroad, and returning emigrants.

Task G – Modeling impact of alternative benefit program design

The Contractor shall consider alternative benefit program designs and include them in the Base Model; in particular, the Contractor shall analyze the following:

- a) Likely cumulative real value (and as a percentage of basic State pension) of individual entitlements for twelve years after retirement for beneficiaries of differing ages;
- b) Macroeconomic balance and individual standard of living implications of a term pension benefit ending after 144 months;
- c) Standard of living implications in retirement for contributors in younger population cohorts who may not benefit from the dividend compared with those who do (implications of dividend no longer being offered after given number of years); and
- d) Hypothetical “permanent” dividend that could be distributed as pension contribution supplement in “perpetuity”.

¹ International Finance Corporation, Azerbaijan at a Glance, August 12, 2006.

The Contractor shall provide one or more working simulation models to illustrate the hypothetical costs and benefits of a range of alternative assumptions for the deferred individual dividend on the above mentioned variables.

Task H – Review and analysis of domestic capital markets and their inclusion in the funded pension scheme

The Contractor shall discuss Azerbaijan’s domestic capital markets (including short- and long-term debt, equity, foreign exchange, and hybrid securities such as convertible debt) by providing the following information:

1. Review the current stage of development of the domestic capital markets in Azerbaijan;
2. Discuss which types of domestic investments should be made available to the funded pension scheme;
3. Discuss the potential role of domestic pension investments to foster the development of the domestic financial markets and the economy of Azerbaijan;
4. Discuss the issues which may constrain the ability of domestic markets and the domestic economy to absorb pension investments and recommend how these constraints may be alleviated;
5. Discuss the advantages and disadvantages of holding different allocations between domestic and international currency investments in the Azeri funded pension scheme; and
6. Recommend guidelines for managing risks taken by or on behalf of individual participants in the Azeri funded pension scheme. The guidelines should provide targets for domestic and international investment allocations for each individual pension investor’s aggregate investments as well as domestic versus international investment target allocations for the fund itself.

Task I – Analyze alternative investment strategies and their implementation

The Contractor shall analyze the following and make recommendations to the Grantee regarding the following issues.

- a) The Contractor shall analyze risk and return implications of alternative investment strategies; the preferences of the sponsoring entities will be analyzed and presented. The financial and behavioral aspects of risk taking, and expected financial rewards for individuals as well as the fiduciary responsibilities of the plan sponsors will be presented to the sponsoring entities. Issues surrounding the framework for investment risks taken for the management of portfolios will be recommended and discussed.
- b) Advice on foreign exchange and macroeconomic balance management implications of conversion of funds and also virtual accounts from foreign currency into Manat term payments shall be provided.
- c) Recommendations on legal obligations of Grantee in respect of individuals’ virtual accounts shall be provided.

Several alternatives for the investment management will be presented. This presentation would include but not be limited to:

- 1) The use of a so-called “lifestyle” model of asset allocation which would provide a mechanism for the automatic switching of the risk profiles of individual virtual accounts at a set number of years before normal retirement dates to reduce uncertainty of dividend benefit as retirement approaches.
- 2) The use of a minimum risk, low return investment strategy pursued throughout the length of the period for which the virtual accounts existed.

Task J – Model alternative scenarios for awards to existing pensioners

The Contractor shall consider alternative scenarios for awards to existing pensioners and include them in the base model:

- a) analyze cost (in relation to GNP, in US\$) of granting same nominal value awards to existing pensioners as to contributors;
- b) suggest framework for analyzing impact on macro economy of alternative policy choices for the dividends for both contributors and pensioners; policy alternatives would include both variations in monetary value and phasing of 144 month term awards;
- c) using official projections and demographic projections for participation in the formal economy over the years ahead, model implications of alternative policy choices for the dividends for both contributors and pensioners;
- d) prepare a technical report summarizing issues that may arise from giving beneficiaries the right to choose between accepting a 144 month term award or purchasing a whole life annuity from an insurance company.

Task K – Pension program structural and implementation issues

The Contractor shall provide:

- a) advice on the legal framework for individual account structure, ownership rights and transfer of rights; this will include legal issues surrounding the transfer of ownership to the Grantee and then to individuals;
- b) advice on technical implementation issues with respect to virtual personal accounts;
- c) advice on operational issues such as communication, funding, drawdown procedures and foreign exchange conversion issues;
- d) an analysis of the current collections process for transfer of contributions to the Grantee and the various future collections options available to the Grantee as pension reforms are implemented (including using the Azeri banking system to receive contributions from employers and individuals directly).

Task L – Final report (including development impact analysis).

The Contractor shall prepare and provide to the Grantee and to USTDA a Final Report in accordance with Clause I of Annex II of the Grant Agreement. The work performed pursuant to each of the above tasks in the Terms of Reference must be distinctly set forth in the Final Report in a substantive and comprehensive manner, and shall include all corresponding deliverables. The Final Report shall contain an executive summary. In addition to any other required deliverables in accordance with Annex II of the Grant Agreement, the Contractor shall provide both the Grantee and USTDA with 6 copies each of the Final Report on CD-ROM. The CD-ROM version of the Final Report will include:

- Adobe Acrobat readable copies of all documents;
- Source files for all drawings in AutoCAD or Visio format; and
- Source files for all documents in MS Office 2000 or later formats.

All reports will be produced in both English and Azeri.

- The Final Report will include a section titled “Expected Host Country Developmental Outcomes”. This section will describe the benefits that the Host Country can expect to receive by implementing the recommendations of the TA. The discussion should be divided into “direct outcomes” and “final outcomes”.
- The Final Report will also include a section identifying prospective U.S. Sources of Supply. Direct U.S. exports which could arise as a result of this TA are primarily in the information and communications technologies (“ICT”) and financial services sectors. Azerbaijan is a potential growth market for U.S. information technology firms, asset management firms, banks, pension funds, insurance companies and other non-bank financial institutions.

Notes:

- (1) The Contractor is responsible for compliance with U.S. export licensing requirements, if applicable, in the performance of the Terms of Reference.
- (2) The Contractor and the Grantee shall be careful to ensure that the public version of the Final Report contains no security or confidential information.
- (3) The Grantee and USTDA shall have an irrevocable, worldwide, royalty-free, non-exclusive right to use and distribute the Final Report and all work product that is developed under these Terms of Reference.

Annex II

USTDA Mandatory Contract Clauses

A. USTDA Mandatory Clauses Controlling

The parties to this contract acknowledge that this contract is funded in whole or in part by the U.S. Trade and Development Agency ("USTDA") under the Grant Agreement between the Government of the United States of America acting through USTDA and the State Social Protection Fund of Azerbaijan Republic ("Client"), dated _____ ("Grant Agreement"). The Client has selected _____ ("Contractor") to perform Technical Assistance ("TA") on the Pensions project ("Project") in Azerbaijan ("Host Country"). Notwithstanding any other provisions of this contract, the following USTDA mandatory contract clauses shall govern. All subcontracts entered into by Contractor funded or partially funded with USTDA Grant funds shall include these USTDA mandatory contract clauses, except for clauses B(1), G, H, I, and J. In addition, in the event of any inconsistency between the Grant Agreement and any contract or subcontract thereunder, the Grant Agreement shall be controlling.

B. USTDA as Financier

(1) USTDA Approval of Contract

All contracts funded under the Grant Agreement, and any amendments thereto, including assignments and changes in the Terms of Reference, must be approved by USTDA in writing in order to be effective with respect to the expenditure of USTDA Grant funds. USTDA will not authorize the disbursement of USTDA Grant funds until the contract has been formally approved by USTDA or until the contract conforms to modifications required by USTDA during the contract review process.

(2) USTDA Not a Party to the Contract

It is understood by the parties that USTDA has reserved certain rights such as, but not limited to, the right to approve the terms of this contract and amendments thereto, including assignments, the selection of all contractors, the Terms of Reference, the Final Report, and any and all documents related to any contract funded under the Grant Agreement. The parties hereto further understand and agree that USTDA, in reserving any or all of the foregoing approval rights, has acted solely as a financing entity to assure the proper use of United States Government funds, and that any decision by USTDA to exercise or refrain from exercising these approval rights shall be made as a financier in the course of financing the TA and shall not be construed as making USTDA a party to the contract. The parties hereto understand and agree that USTDA may, from time to time, exercise the foregoing approval rights, or discuss matters related to these rights and the Project with the parties to the contract or any subcontract, jointly or separately, without thereby incurring any responsibility or liability to such parties. Any approval or failure to approve by USTDA shall not bar the Client or USTDA from asserting any right they might have against the Contractor, or relieve the Contractor of any liability which the Contractor might otherwise have to the Client or USTDA.

C. Nationality, Source and Origin

Except as USTDA may otherwise agree, the following provisions shall govern the delivery of goods and services funded by USTDA under the Grant Agreement: (a) for professional services, the Contractor must be either a U.S. firm or U.S. individual; (b) the Contractor may use U.S. subcontractors without limitation, but the use of subcontractors from Host Country may not exceed twenty percent (20%) of the USTDA Grant amount and may only be used for specific services from the Terms of Reference identified in the subcontract; (c) employees of U.S. Contractor or U.S. subcontractor firms responsible for professional services shall be U.S. citizens or non-U.S. citizens lawfully admitted for permanent residence in the U.S.; (d) goods purchased for performance of the TA and associated delivery services (e.g., international transportation and insurance) must have their nationality, source and origin in the United States; and (e) goods and services incidental to TA support (e.g., local lodging, food, and transportation) in Host Country are not subject to the above restrictions. USTDA will make available further details concerning these provisions upon request.

D. Recordkeeping and Audit

The Contractor and subcontractors funded under the Grant Agreement shall maintain, in accordance with generally accepted accounting procedures, books, records, and other documents, sufficient to reflect properly all transactions under or in connection with the contract. These books, records, and other documents shall clearly identify and track the use and expenditure of USTDA funds, separately from other funding sources. Such books, records, and documents shall be maintained during the contract term and for a period of five (5) years after final disbursement by USTDA. The Contractor and subcontractors shall afford USTDA, or its authorized representatives, the opportunity at reasonable times for inspection and audit of such books, records, and other documentation.

E. U.S. Carriers

(1) Air

Transportation by air of persons or property funded by the USTDA Grant shall be on U.S. flag carriers in accordance with the Fly America Act, 49 U.S.C. 40118, to the extent service by such carriers is available, as provided under applicable U.S. Government regulations.

(2) Marine

Transportation by sea of property funded by the USTDA Grant shall be on U.S. carriers in accordance with U.S. cargo preference law.

F. Workman's Compensation Insurance

The Contractor shall provide adequate Workman's Compensation Insurance coverage for work performed under this Contract.

G. Reporting Requirements

The Contractor shall advise USTDA by letter as to the status of the Project on March 1st annually for a period of two (2) years after completion of the TA. In addition, if at any time the Contractor receives follow-on work from the Client, the Contractor shall so notify USTDA and designate the Contractor's contact point including name, telephone, and fax number. Since this information may be made publicly available by USTDA, any information which is confidential shall be designated as such by the Contractor and provided separately to USTDA. USTDA will maintain the confidentiality of such information in accordance with applicable law.

H. Disbursement Procedures

(1) USTDA Approval of Contract

Disbursement of Grant funds will be made only after USTDA approval of this contract. To make this review in a timely fashion, USTDA must receive from either the Client or the Contractor a photocopy of an English language version of a signed contract or a final negotiated draft version to the attention of the General Counsel's office at USTDA's address listed in Clause M below.

(2) Payment Schedule Requirements

A payment schedule for disbursement of Grant funds to the Contractor shall be included in this Contract. Such payment schedule must conform to the following USTDA requirements: (1) up to twenty percent (20%) of the total USTDA Grant amount may be used as an advance payment; (2) all other payments, with the exception of the final payment, shall be based upon contract performance milestones; and (3) the final payment may be no less than fifteen percent (15%) of the total USTDA Grant amount, payable upon receipt by USTDA of an approved Final Report in accordance with the specifications and quantities set forth in Clause I below. Invoicing procedures for all payments are described below.

(3) Contractor Invoice Requirements

USTDA will make all disbursements of USTDA Grant funds directly to the Contractor. The Contractor must provide USTDA with an ACH Vendor Enrollment Form (available from USTDA) with the first invoice. The Client shall request disbursement of funds by USTDA to the Contractor for performance of the contract by submitting the following to USTDA:

(a) Contractor's Invoice

The Contractor's invoice shall include reference to an item listed in the Contract payment schedule, the requested payment amount, and an appropriate certification by the Contractor, as follows:

- (i) For an advance payment (if any):

"As a condition for this advance payment, which is an advance against future TA costs, the Contractor certifies that it will perform all work in accordance with the terms of its Contract with the Client. To the extent that the Contractor does not comply with the terms and conditions of the Contract, including the USTDA mandatory provisions contained therein, it will, upon USTDA's request, make an appropriate refund to USTDA. "

(ii) For contract performance milestone payments:

"The Contractor has performed the work described in this invoice in accordance with the terms of its contract with the Client and is entitled to payment thereunder. To the extent the Contractor has not complied with the terms and conditions of the Contract, including the USTDA mandatory provisions contained therein, it will, upon USTDA's request, make an appropriate refund to USTDA."

(iii) For final payment:

"The Contractor has performed the work described in this invoice in accordance with the terms of its contract with the Client and is entitled to payment thereunder. Specifically, the Contractor has submitted the Final Report to the Client, as required by the Contract, and received the Client's approval of the Final Report. To the extent the Contractor has not complied with the terms and conditions of the Contract, including the USTDA mandatory provisions contained therein, it will, upon USTDA's request, make an appropriate refund to USTDA."

(b) Client's Approval of the Contractor's Invoice

(i) The invoice for an advance payment must be approved in writing by the Client.

(ii) For contract performance milestone payments, the following certification by the Client must be provided on the invoice or separately:

"The services for which disbursement is requested by the Contractor have been performed satisfactorily, in accordance with applicable Contract provisions and the terms and conditions of the USTDA Grant Agreement."

(iii) For final payment, the following certification by the Client must be provided on the invoice or separately:

"The services for which disbursement is requested by the Contractor have been performed satisfactorily, in accordance with applicable Contract provisions and terms and conditions of the USTDA Grant Agreement. The Final Report submitted by the Contractor has been reviewed and approved by the Client. "

(c) USTDA Address for Disbursement Requests

Requests for disbursement shall be submitted by courier or mail to the attention of the Finance Department at USTDA's address listed in Clause M below.

(4) Termination

In the event that the Contract is terminated prior to completion, the Contractor will be eligible, subject to USTDA approval, for reasonable and documented costs which have been incurred in performing the Terms of Reference prior to termination, as well as reasonable wind down expenses. Reimbursement for such costs shall not exceed the total amount of undisbursed Grant funds. Likewise, in the event of such termination, USTDA is entitled to receive from the Contractor all USTDA Grant funds previously disbursed to the Contractor (including but not limited to advance payments) which exceed the reasonable and documented costs incurred in performing the Terms of Reference prior to termination.

I. USTDA Final Report

(1) Definition

"Final Report" shall mean the Final Report described in the attached Annex I Terms of Reference or, if no such "Final Report" is described therein, "Final Report" shall mean a substantive and comprehensive report of work performed in accordance with the attached Annex I Terms of Reference, including any documents delivered to the Client.

(2) Final Report Submission Requirements

The Contractor shall provide the following to USTDA:

(a) One (1) complete version of the Final Report for USTDA's records. This version shall have been approved by the Client in writing and must be in the English language. It is the responsibility of the Contractor to ensure that confidential information, if any, contained in this version be clearly marked. USTDA will maintain the confidentiality of such information in accordance with applicable law.

and

(b) Three (3) copies of the Final Report suitable for public distribution ("Public Version"). The Public Version shall have been approved by the Client in writing and must be in the English language. As this version will be available for public distribution, it must not contain any confidential information. If the report in (a) above contains no confidential information, it may be used as the Public Version (provided USTDA receives a total of four (4) copies). In any event, the Public Version must be informative and contain sufficient Project detail to be useful to prospective equipment and service providers.

The Contractor shall also provide one (1) copy of the Public Version of the Final Report to the Foreign Commercial Service Officer or the Economic Section of the U.S. Embassy in Host Country for informational purposes.

(3) Final Report Presentation

All Final Reports submitted to USTDA must be paginated and include the following:

(a) The front cover of every Final Report shall contain the name of the Client, the name of the Contractor who prepared the report, a report title, USTDA's logo, USTDA's mailing and delivery addresses, and the following disclaimer:

"This report was funded by the U.S. Trade and Development Agency (USTDA), an agency of the U.S. Government. The opinions, findings, conclusions or recommendations expressed in this document are those of the author(s) and do not necessarily represent the official position or policies of USTDA. USTDA makes no representation about, nor does it accept responsibility for, the accuracy or completeness of the information contained in this report."

(b) The inside front cover of every Final Report shall contain USTDA's logo, USTDA's mailing and delivery addresses, and USTDA's mission statement. Camera-ready copy of USTDA Final Report specifications will be available from USTDA upon request.

(c) The Contractor and any subcontractor that performs work pursuant to the Grant Agreement must be clearly identified in the Final Report. Business name, point of contact, address, telephone and fax numbers shall be included for Contractor and each subcontractor.

(d) The Final Report, while aiming at optimum specifications and characteristics for the Project, shall identify the availability of prospective U.S. sources of supply. Business name, point of contact, address, telephone and fax numbers shall be included for each commercial source.

(e) The Final Report shall be accompanied by a letter or other notation by the Client which states that the Client approves the Final Report. A certification by the Client to this effect provided on or with the invoice for final payment will meet this requirement.

J. Modifications

All changes, modifications, assignments or amendments to this contract, including the appendices, shall be made only by written agreement by the parties hereto, subject to written USTDA approval.

K. TA Schedule

(1) TA Completion Date

The completion date for the TA, which is March 1, 2009, is the date by which the parties estimate that the TA will have been completed.

(2) Time Limitation on Disbursement of USTDA Grant Funds

Except as USTDA may otherwise agree, (a) no USTDA funds may be disbursed under this contract for goods and services which are provided prior to the Effective Date of the Grant Agreement; and (b) all funds made available under the Grant Agreement must be disbursed within four (4) years from the Effective Date of the Grant Agreement.

L. Business Practices

The Contractor agrees not to pay, promise to pay, or authorize the payment of any money or anything of value, directly or indirectly, to any person (whether a governmental official or private individual) for the purpose of illegally or improperly inducing anyone to take any action favorable to any party in connection with the TA. The Client agrees not to receive any such payment. The Contractor and the Client agree that each will require that any agent or representative hired to represent them in connection with the TA will comply with this paragraph and all laws which apply to activities and obligations of each party under this Contract, including but not limited to those laws and obligations dealing with improper payments as described above.

M. USTDA Address and Fiscal Data

Any communication with USTDA regarding this Contract shall be sent to the following address and include the fiscal data listed below:

U.S. Trade and Development Agency
1000 Wilson Boulevard, Suite 1600
Arlington, Virginia 22209-3901
U.S.A

Phone: (703) 875-4357
Fax: (703) 875-4009

Fiscal Data:

Appropriation No.: 117/81001
Activity No.: 2007-81011B
Reservation No.: 2008-81006
Grant No.: GH2008810004

N. Definitions

All capitalized terms not otherwise defined herein shall have the meaning set forth in the Grant Agreement.

O. Taxes

USTDA funds provided under the Grant Agreement shall not be used to pay any taxes, tariffs, duties, fees or other levies imposed under laws in effect in Host Country. Neither the Client nor the Contractor will seek reimbursement from USTDA for such taxes, tariffs, duties, fees or other levies.

ANNEX 5

Annex I

Terms of Reference

The Azerbaijan State Social Protection Fund (“SSPF”) seeks to reform and build up the pension system for the citizens of Azerbaijan. This is to be done via two component programs: the Insurance Accumulation Project, which sets up individually insured, funded pension accounts; and the Financial Accumulation Project, which allocates a portion of the strategic financial resources of the Government of Azerbaijan to SSPF for disbursement through funds held by the pension system. This technical assistance program will provide direct and valuable input to SSPF to implement its planned pension reform program. With funding from oil revenues to be allocated by the Azerbaijan government in the future, it is expected that SSPF will have sufficient government funding and support to implement the recommendations of the Contractor. SSPF has already shared the cost of over \$5 million of upgrades to SSPF’s operating systems through the United Nations Development Programme Technical Assistance program (“UNDP TA”). Set forth below are distinct tasks to analyze, model and assist in the implementation of this TA.

Task A – Pension system framework

The Contractor shall provide an analytical framework, based on the experience of other countries, for the assessment of the desirable features of the pension system in the Republic of Azerbaijan.

The responsibilities of the Contractor are:

1. Analysis of pension reform experiences in other countries, including but not limited to Kazakhstan, Sweden, Norway, Chile, Latvia, Estonia, Lithuania, and other countries, especially those with significant revenues from natural resources;
2. Analysis of defined benefit, defined contribution, forced savings, non-forced savings, public and private pension schemes;
3. Analysis of the relationship between funded and Pay-As-You-Go (PAYG) schemes;
4. Analysis of the specific asset management arrangements of each of the countries analyzed, with extensive details on asset managers, how they are engaged and managed by the state pension authorities, and their fees; an analysis of returns to investors; and information on the government oversight and regulations of each of these pension systems.

Task B – Incentive elements framework

1. In coordination with the Grantee, the Contractor shall set out the advantages and disadvantages of alternative fiscal regimes for encouraging individually insured funded pensions, including, for example, tying in health insurance and programs in the hope that workers will pay the combined contribution in order to be eligible for health benefits.

2. The Contractor shall describe in detail how other countries have created the incentives for individuals to save under individually insured funded pension accounts.
3. The Contractor shall analyze the impact on the State budget and the financial operating environment of the Grantee.

Task C – Actuarial and insurance framework

1. The Contractor shall set out the advantages and disadvantages of requiring individuals to purchase whole life annuities with their accumulated pension funds.
2. The Contractor shall report on the desirability of encouraging the development of a market for life insurance and annuities, and the preconditions for achieving this.
3. The Contractor shall discuss appropriate role of the Government of Azerbaijan in supporting the provision of these insurance services.

Task D – Investment framework for individually insured funded pensions

1. The Contractor shall discuss the advantages and disadvantages of a simple national default age-based lifestyle investment strategy sponsored by the Grantee for participants in the funded pension scheme arrangement.
2. The Contractor shall set out the options for domestic and foreign currency investments in Azeri funded pension funds, make recommendations for target ranges of domestic versus foreign currency investments, and explain the advantages and disadvantages of these investment choices with respect to inflation, liquidity and returns.
3. The Contractor shall discuss the advantages and disadvantages of alternative options for domestic Azeri investments within funded pensions.

Task E – Structure of individually insured funded pension accounts

1. The Contractor shall review the advantages, disadvantages and practicalities of using the Grantee's modernized individual accounting system for funded personal pension accounts.
2. The Contractor shall consider alternative possibilities, including account administration by international service providers.
3. The Contractor shall make recommendations for funded personal pension accounting and administration systems.
4. The Contractor shall analyze the options for implementing funded personal pension accounts alongside the existing PAYG system.
5. The Contractor shall make recommendations for how the funded personal pension accounts will be financed, how they will be allocated to individual accounts, how pensioners could choose a non-state Pension Accumulation Fund (AF) to manage their pension savings, how many AFs should be allowed by Grantee and whether there should be a default state fund for all who fail to designate an AF manager. If so, the contractor shall explain how this state fund would function and interact with the Grantee.

6. The Contractor shall make recommendations to the Grantee on whether Asset Management Companies (“AMCs”) should be chosen for the AFs, or the State Oil Fund of Azerbaijan and its agents should take on the asset management of the AFs.
7. The Contractor shall make recommendations for timing of a phase-in of AFs and expected budget consequences to the Grantee.

Task F – Demographic modeling

- a) In coordination with the Grantee, the Contractor shall identify “pools” of entitlement among current and future Azeri citizens and residents, and establish a demographic basis for modeling the cost of allocating deferred individual benefits under the pension program; this task should take into account various high/medium/low scenarios for Azeri population growth rate, which was 0.8% p.a. as of August 2006¹, and make high/medium/low assumptions regarding the refugee population.
- b) The Contractor shall model different options for benefit structures and present implications under varying assumptions on the State’s financial resources, size of the individual benefit entitlements, frequency of benefit contributions, and vesting of ownership to the participant and limitations thereof.
- c) The Contractor shall analyze the implications on participation in the formal economy based on entitlement rates, estimated “drawdown schedules” and participant demographics.
- d) The Contractor shall identify and recommend the guidelines and requirements for individuals to participate in the pension program.
- e) The Contractor shall illustrate the potential valuation impact of different qualification rules for entitlement on the budget of the Grantee, State budgets and State resources.
- f) The Contractor shall discuss and make explicit assumptions about the eligibility of expatriate workers in Azerbaijan and Azeris abroad, and returning emigrants.

Task G – Modeling impact of alternative benefit program design

The Contractor shall consider alternative benefit program designs and include them in the Base Model; in particular, the Contractor shall analyze the following:

- a) Likely cumulative real value (and as a percentage of basic State pension) of individual entitlements for twelve years after retirement for beneficiaries of differing ages;
- b) Macroeconomic balance and individual standard of living implications of a term pension benefit ending after 144 months;
- c) Standard of living implications in retirement for contributors in younger population cohorts who may not benefit from the dividend compared with those who do (implications of dividend no longer being offered after given number of years); and
- d) Hypothetical “permanent” dividend that could be distributed as pension contribution supplement in “perpetuity”.

¹ International Finance Corporation, Azerbaijan at a Glance, August 12, 2006.

The Contractor shall provide one or more working simulation models to illustrate the hypothetical costs and benefits of a range of alternative assumptions for the deferred individual dividend on the above mentioned variables.

Task H – Review and analysis of domestic capital markets and their inclusion in the funded pension scheme

The Contractor shall discuss Azerbaijan’s domestic capital markets (including short- and long-term debt, equity, foreign exchange, and hybrid securities such as convertible debt) by providing the following information:

1. Review the current stage of development of the domestic capital markets in Azerbaijan;
2. Discuss which types of domestic investments should be made available to the funded pension scheme;
3. Discuss the potential role of domestic pension investments to foster the development of the domestic financial markets and the economy of Azerbaijan;
4. Discuss the issues which may constrain the ability of domestic markets and the domestic economy to absorb pension investments and recommend how these constraints may be alleviated;
5. Discuss the advantages and disadvantages of holding different allocations between domestic and international currency investments in the Azeri funded pension scheme; and
6. Recommend guidelines for managing risks taken by or on behalf of individual participants in the Azeri funded pension scheme. The guidelines should provide targets for domestic and international investment allocations for each individual pension investor’s aggregate investments as well as domestic versus international investment target allocations for the fund itself.

Task I – Analyze alternative investment strategies and their implementation

The Contractor shall analyze the following and make recommendations to the Grantee regarding the following issues.

- a) The Contractor shall analyze risk and return implications of alternative investment strategies; the preferences of the sponsoring entities will be analyzed and presented. The financial and behavioral aspects of risk taking, and expected financial rewards for individuals as well as the fiduciary responsibilities of the plan sponsors will be presented to the sponsoring entities. Issues surrounding the framework for investment risks taken for the management of portfolios will be recommended and discussed.
- b) Advice on foreign exchange and macroeconomic balance management implications of conversion of funds and also virtual accounts from foreign currency into Manat term payments shall be provided.
- c) Recommendations on legal obligations of Grantee in respect of individuals’ virtual accounts shall be provided.

Several alternatives for the investment management will be presented. This presentation would include but not be limited to:

- 1) The use of a so-called “lifestyle” model of asset allocation which would provide a mechanism for the automatic switching of the risk profiles of individual virtual accounts at a set number of years before normal retirement dates to reduce uncertainty of dividend benefit as retirement approaches.
- 2) The use of a minimum risk, low return investment strategy pursued throughout the length of the period for which the virtual accounts existed.

Task J – Model alternative scenarios for awards to existing pensioners

The Contractor shall consider alternative scenarios for awards to existing pensioners and include them in the base model:

- a) analyze cost (in relation to GNP, in US\$) of granting same nominal value awards to existing pensioners as to contributors;
- b) suggest framework for analyzing impact on macro economy of alternative policy choices for the dividends for both contributors and pensioners; policy alternatives would include both variations in monetary value and phasing of 144 month term awards;
- c) using official projections and demographic projections for participation in the formal economy over the years ahead, model implications of alternative policy choices for the dividends for both contributors and pensioners;
- d) prepare a technical report summarizing issues that may arise from giving beneficiaries the right to choose between accepting a 144 month term award or purchasing a whole life annuity from an insurance company.

Task K – Pension program structural and implementation issues

The Contractor shall provide:

- a) advice on the legal framework for individual account structure, ownership rights and transfer of rights; this will include legal issues surrounding the transfer of ownership to the Grantee and then to individuals;
- b) advice on technical implementation issues with respect to virtual personal accounts;
- c) advice on operational issues such as communication, funding, drawdown procedures and foreign exchange conversion issues;
- d) an analysis of the current collections process for transfer of contributions to the Grantee and the various future collections options available to the Grantee as pension reforms are implemented (including using the Azeri banking system to receive contributions from employers and individuals directly).

Task L – Final report (including development impact analysis).

The Contractor shall prepare and provide to the Grantee and to USTDA a Final Report in accordance with Clause I of Annex II of the Grant Agreement. The work performed pursuant to each of the above tasks in the Terms of Reference must be distinctly set forth in the Final Report in a substantive and comprehensive manner, and shall include all corresponding deliverables. The Final Report shall contain an executive summary. In addition to any other required deliverables in accordance with Annex II of the Grant Agreement, the Contractor shall provide both the Grantee and USTDA with 6 copies each of the Final Report on CD-ROM. The CD-ROM version of the Final Report will include:

- Adobe Acrobat readable copies of all documents;
- Source files for all drawings in AutoCAD or Visio format; and
- Source files for all documents in MS Office 2000 or later formats.

All reports will be produced in both English and Azeri.

- The Final Report will include a section titled “Expected Host Country Developmental Outcomes”. This section will describe the benefits that the Host Country can expect to receive by implementing the recommendations of the TA. The discussion should be divided into “direct outcomes” and “final outcomes”.
- The Final Report will also include a section identifying prospective U.S. Sources of Supply. Direct U.S. exports which could arise as a result of this TA are primarily in the information and communications technologies (“ICT”) and financial services sectors. Azerbaijan is a potential growth market for U.S. information technology firms, asset management firms, banks, pension funds, insurance companies and other non-bank financial institutions.

Notes:

- (1) The Contractor is responsible for compliance with U.S. export licensing requirements, if applicable, in the performance of the Terms of Reference.
- (2) The Contractor and the Grantee shall be careful to ensure that the public version of the Final Report contains no security or confidential information.
- (3) The Grantee and USTDA shall have an irrevocable, worldwide, royalty-free, non-exclusive right to use and distribute the Final Report and all work product that is developed under these Terms of Reference.