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Sabit Bagirov. OIL OF AZERBAIJAN: REVENUES, EXPENSES AND RISKS

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(view from 2007)

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AZERBAIJANI OIL: REVENUES, EXPENSES AND RISKS

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The book contains information about the oil contracts signed by the Azerbaijan Republic, describes sources of the country's oil revenues and their main beneficiaries, takes a look at the spending of oil revenues accumulating in the State Oil Fund of the Azerbaijan Republic, analyzes the risks of loss of some of the revenues and possible ways of mitigating them. The book also provides information about Azerbaijan's participation in the Extractive Industries transparency Initiative and proposes several possible directions for further development of the initiative.

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ABBREVIATIONS

ACG	– Azeri-Chirag-Guneshli oilfield
AIOC	– Azerbaijan International Operating Company
AZM	– Azerbaijan National Currency, Manat, before 2006
AZN	– Azerbaijan National Currency, Manat, from January 1, 2006
BP	– British Petroleum
BTC	– Baku-Tbilisi-Ceyhan oil pipeline
DFID	– Department for International Development
EBRD	– European Bank for Reconstruction and Development
EITI	– Extractive Industries Transparency Initiative
GC	– Government Committee
IMF	– International Monetary Fund
NGO	– Non-Government Organization
OSI	– Open Society Institute
PSA	– Production Sharing Agreement
PWYP	– Publish What You Pay
RA	– Republic of Azerbaijan
SB	– State Budget
SD	– Shah Deniz gas field

SOCAR – State Oil Company of the Azerbaijan Republic

SOFAZ – State Oil Fund of the Azerbaijan Republic

SSSF – The State Social Security Fund

TACIS – Technical Aid to the Commonwealth of Independent
States

WB – World Bank

UK – United Kingdom

INTRODUCTION

This book is dedicated to issues of drawing up an effective policy for managing revenues from the development of the oil and gas reserves of Azerbaijan (brief information on the country is given in Appendix 1), a country situated in the South Caucasus. The book contains the results of a survey carried out by the author in 2005-2006 on the project *“Azerbaijan: problems of good governance in extractive industries and mechanisms of effective public monitoring”* with support from the Central European University (Budapest) and Open Society Institute.

The relevance of the subject of this research is preconditioned by the fact that, as experience shows, natural resources often translate into a curse for the country. *“This ‘natural resource curse’ is the result of the interaction of two factors. The first is policy mismanagement, often a direct result of the easily available revenues that both lead to rent-seeking behavior and reduce pressures for necessary economic reforms. The second factor is the ‘Dutch disease’, which leads to a decline in other tradable sectors.”*¹

Azerbaijan has been noted for its oil and gas reserves since time immemorial. Industrial oil production began here in 1848. The country experienced the first oil boom in the last quarter of the 19th century, completing it with a level of production that equaled half of world production. The oil industry has been the leading sphere of the economy for more

¹ Managing Oil Wealth: The Case of Azerbaijan. John Wakeman-Linn, Chonira Aturupane, Stephan Danninger, Koba Gvenetadze, Niko Hobdari and Eric Le Borgne. International Monetary Fund, 2004

than a century (Appendix 2 contains brief information about this sector of the country's economy). Currently, the country is experiencing a second oil boom which is a result of the investment in oil production as part of the oil contracts signed by the country.

On the whole, the country's government signed 26 contracts in the period from 1994 to 2006. Two of them provide for the development of oil and gas reserves in the deposits Azeri-Chirag-Guneshli (ACG) and Shah Deniz (SD).

The production of first oil from ACG began in 1997. These were small volumes of oil because the Baku-Tbilisi-Ceyhan (BTC) main export pipeline had yet to be built in that period and the two oil pipelines Baku-Novorossiysk and Baku-Supsa that were available did not allow the country to considerably increase the volume of oil production. The large-scale development of the super-gigantic deposit ACG began in 2006. Natural gas production from the super-gigantic natural gas field Shah Deniz began in the same year.

The production of oil and gas reserves from these deposits promises the country enormous revenues. The analysis of the commercial terms of the contracts signed by Azerbaijan, given in the first chapter of the book, showed that the revenues gained by the country have different types and sizes. This chapter describes the causes and a brief history of the signing of the first oil contract. It provides a list of all Production Sharing Agreements (PSA) signed by the government and analyzes the main provisions of the contracts, including the provisions that agree on commercial terms. The chapter includes detailed examination of the following: 1) terms of repayment of operating and capital expenses, as well as financing charges, 2) formula for the sharing of profit oil between the State and the Contractor, 3)

pricing policies on hydrocarbons, 4) procedures for the payment of taxes, 5) terms of bonus payments, 6) project management solutions and other major clauses of the contracts. On the basis of the corresponding analysis of the above-mentioned provisions, there have been determined the items of revenues of Azerbaijan – profit oil, taxes, bonuses, etc. – and verified a number of beneficiary state establishments – oil fund, state social fund, etc.

Assessments of the expected revenues are given in the second part of the second chapter of the book. The calculations made by the author show that the ACG contract alone will fetch about 150 billion USD by 2025 with a price of \$45 per barrel. With a price of \$60 per barrel the country's cumulative revenues by 2025 may exceed 200 billion USD. In the peak years of development (2008-2012), the country's revenues may stand at 15-20 billion USD a year. In 2005, the country's state budget was about 4.3 billion USD.

Calculations of the revenues expected from ACG in the period up to 2025 were carried out on the basis of a number of presumptions concerning the schedule of investment and production of hydrocarbon reserves, the volume of exploitation expenses on one barrel of extracted oil, the cost of oil transit and others. The calculations were carried out in two rows of different values of oil prices from 18 to 60 dollars. The revenues of the Oil Fund, the state budget and SOCAR till the expiry of the contract, i.e. including 2024, are calculated for these values.

An analysis of the contracts and legal acts that were signed, concerning the State Oil Fund, showed that it is this agency that is the main recipient of the oil revenues. SOFAZ was established in late 1999 to prevent an adverse impact of immense oil revenues on the country's economy and to reduce the risk of

the Dutch disease. Another important function of SOFAZ is to accumulate currency reserves for future generations.

The third chapter provides a scrutiny into spending orientations with respect to oil revenues. Azerbaijan started to collect revenues from production-sharing agreements before the production of the first oil in November 1997. These were the bonuses which foreign oil companies paid in return for the signing of oil contracts and obtaining of pre-emptive rights at different stage of negotiations. Bonuses were payable since 1992 and became a valuable response to the needs of the economy of Azerbaijan through 1999; in particular, these transfers were essential to fill in the budget gap, as well as solve emergency social projects, and afford monetary interventions in maintaining the exchange rate of the national currency. The State Oil Fund of the Azerbaijan Republic (SOFAZ) realized its first spending in 2001. The analysis of expenditure orientations reveals a number of state structures involved in the entire process, thereby making competent officials responsible for the effective use of the rental income at their disposal. In particular, the transfers from SOFAZ into the state budget and extra allocations for the social needs of refugees and internally displaced persons eventually fetch up at the hands of different public agencies – this is the final destination where the money is often exposed to misuse and mismanagement.

The spending of money from the Oil Fund in 2001 totaled 4,059 million AZM (0.82 million US dollars)². In 2006 a total of 998950.9 million AZN (1105.4 million USD) was spent³. Over 2001-2006 years, Oil Fund money was spent on: 1) improving the

² Annual report of SOFAR, 2001, page 34.

http://www.oilfund.az/download/az/2001_az.pdf

³ Annual report of SOFAR, 2006, page 8.

http://www.oilfund.az/download/OilfundAz_2006.pdf

social status of refugees; 2) SOCAR share in BTC oil pipeline project; 3) 2006 state budget (transfers); 4) construction of Oguz-Gabala water pipeline; 5) reconstruction of the irrigation system Samur-Absheron; 6) charter capital of the State Investment Company; 7) SOFAZ operations and staff. The program of spending from SOFAZ funds in 2007 provides for the financing of the same expenses as in 2006 except for the BTC project and the State Investment Company.

Most of the spending of oil money from SOFAZ in 2004-2006 was channeled straight into the state budget. A similar measure is planned in 2007 as well. We should observe that the oil revenues of the country are not limited to these transfers. The state budget is also receiving taxes on contractors' revenues and income tax from the personnel. Moreover, the country's budget is traditionally supplemented by taxes paid by SOCAR. Owing to oil money, state budget spending in 2006 exceeded the level of 2005 by 77 per cent⁴. It is thanks to the oil money that state budget expenditure this year will exceed last year's by 67 %⁵. Analysis shows that because of the oil revenues, state budget expenditure has been on the increase of late and has mainly been channeled into: 1) management (increase in the number of public workers, their wages and pensions); 2) state investment, 3) social needs; and 4) army.

All these expenses are explained by the government by the need for meeting the objectives of economic development, development of the non-oil sector and the countryside,

⁴ http://www.azstat.org/publications/azfigures/2007/az/020.shtml#t20_1

⁵ In 2006, the budget expenses totaled 3,790,123,600 manats, http://www.maliyye.gov.az/download/news/01.06.2007_GANUN-2006.pdf
The plan of budget spending for 2007 is 6,314,900,000 manats, http://www.maliyye.gov.az/download/news/01.06.2007_Qanun-2007%20-%20MM.pdf

improvement of the social conditions of the population and boosting the defense capability of the country in its conflict with neighboring Armenia. However, the expenditure is rising at such a pace that the economy is experiencing overheat which manifests itself in the following:

- strengthening of the national currency;
- growth of inflation.

It is clear that the management of oil revenues in different countries has its own specificity. At the same time, it is also clear that the management of oil revenues in all countries consists of such phases as planning and execution of expenditure. And it is possible for losses to be incurred at both phases, which may take place for different reasons. The list of these reasons and associated risks is quite long. The most considerable risks of loss in Azerbaijan are considered in the fourth chapter of the book. The analysis of legal acts and government decisions, discussions with local, foreign experts and government officials, focus groups, as well as the study of other countries' experience, have helped the author create the following list of the main reasons for possible losses or ineffective use of some of the oil revenues:

- lack of government experience in managing revenue windfalls;
- imperfect laws;
- dependency of the judiciary on the executive branch;
- dependency of the legislature on the executive branch;
- weak democratic institutions;
- weak civil society;
- weak independent media;

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- conflict of interests at SOCAR participating in PSA.

Each of these factors is considered in this study. The provisions of a number of laws and legal acts, which directly or indirectly create a risk of losing part of oil revenues, are analyzed especially carefully. Specifically, the fifth chapter of the book discusses the legal acts that regulate the activities of SOFAZ, the laws regulating public service, state procurement and the activities of the country's Chamber of Accounts, anti-corruption legal acts and laws on access to government information and state secrets. The importance of analyzing the aforesaid laws along with the legal acts that regulate the activities of SOFAZ is due to the fact that part of oil revenues is coming into the state's budget and then being spent by various government agencies. The research also has tried to answer is whether there are any available reserves for improving laws in order to reduce the risks of ineffective use of oil revenues. The survey showed that such reserves do exist.

In June 2003, at an EITI conference in London, Azerbaijan joined the initiative and became one of the pilot countries. The sixth chapter of the book tries to answer what prospects participation in the EITI opens in terms of reducing the risk of losing part of oil revenues. The analysis of the EITI progress in the country has revealed the following:

- thanks to this initiative, society is better informed of the resource revenues, in particular, oil revenues of the country;
- civil society can monitor resource revenues and the way they are spent;
- civil society receives the incentive for development.

Chapter 6 also addresses the possibility of developing the Azerbaijani version of the EITI. It shows the importance of expanding the accountability of companies and the government, since a number of questions of interest to civil society have yet to be answered.

Finally, the last seventh chapter of the book examines a number of recommendations to reduce the risk of losing part of oil revenues, including the improvement of the legal field, increasing the interest of civil society in monitoring processes of managing oil revenues and increasing the potential of civil associations and the media in monitoring oil revenues and expenses.

Improvement of the legal framework in which oil revenues are managed can be achieved by replacing the current isolated legal acts by a special new law on the Oil Fund and management of oil revenues. This law can be built on the basis of the following principles:

- exclusive right of parliament to decision-making on spending SOFAZ resources;
- exclusive right of parliament to impose limitations on storage and placement of SOFAZ resources;
- rejecting the concept of a SOFAZ budget which, in addition to expenses on itself, also includes expenditure on different state projects and programs;
- distribution of some oil revenues among citizens;
- targeted use of SOFAZ resources;
- establishing a parliamentary commission to watch SOFAZ investment policy;

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- appointing SOFAZ executive director by parliament on president's motion;
 - possibility of attracting foreign managers to run SOFAZ portfolio investment and place its resources.

Increasing the interest of civil society in monitoring processes of managing oil revenues is an important factor for the good management of oil and gas revenues. A government that looks at civil society will be more responsible in the process of decision-making. Today many citizens of the country have yet to realize their co-participation in oil and gas revenues. Opinion polls show that many people treat these revenues as something alien that belongs not to them, but to officials. Only comprehensive campaigns that affect many strata of the population and have a cyclic nature for at least several years can change the situation. Citizens may have an increasing interest in monitoring oil revenues also if they are partly and directly distributed among the country's population.

The recommendations drawn up during the study can be used not only by the country's government, but also by international organizations, including financial institutions and donor organizations.

The book is not intended to cover all challenges that emerge in connection with oil revenues. For example, it does not touch on the possible macroeconomic consequences, Dutch disease precedents, delays in the process of democratization and institutional reforms and other issues that are quite interesting and certainly deserve more careful study. Unfortunately, the author was limited to the framework of the survey and this book.

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the survey reflected in this book, as well as to Professor Alan Doig for his valuable advice regarding the methodology of research.

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1. AZERBAIJAN OIL CONTRACTS

This chapter analyzes oil contracts signed by Azerbaijan. The purpose is to answer the questions of which types of revenues the country is getting from contracts and where these revenues are going (including government and private organizations). The author of this research had a chance to analyze 24 of the 26⁶ contracts that were signed. Access to the texts of the 24 contracts was granted thanks to members of parliament. After being signed, contracts are ratified by the parliament, which is why members of parliament have those texts. Although after being ratified, the contracts become a law and have to be available to citizens of the country, in fact only contracts on two deposits are available: ACG and Shah Deniz. They have been posted on the website of the BP⁷. We should observe that government websites do not provide texts of contracts. The disclosure of these aforesaid two contracts was a condition for allocating funds to contractors for the construction of the Baku-Tbilisi-Ceyhan oil pipeline. International non-government organizations also played an important role here.

During the surveys presented in this book, a number of documents⁸ regulating the activities of the national company

⁶ Two PSA's have yet to be handed over to Parliament for ratification

⁷ <http://subsites.bp.com/caspian/ACG/Eng/agmt1/agmt1.pdf>

http://subsites.bp.com/caspian/SHA/Eng/agmt1/SD%20PSA_final.pdf

⁸ Regulations. <http://www.socar.gov.az/regulation-en.html>

Decree of the President of Azerbaijan Republic.

<http://www.socar.gov.az/decree-en.html>

SOCAR and protocols⁹ on taxation signed between the government and the ACG contractor were analyzed as well.

This chapter contains a description of:

- The reasons for signing the oil contracts?
- The main conditions of the contracts;
- Types of Azerbaijan's revenues stipulated in the contracts;
- Recipients of oil revenues.

1.1. Reasons for the signing of contracts and their history

Liberalization which began in the USSR in the 1980s created certain opportunities for foreign investment. The policy of perestroika declared by the Soviet leadership and in general, the transfer of relations with other countries from the Cold War atmosphere to a normal level, the increase in the number of invitations to foreign investors and the richness of the Soviet Union's natural resources could not but attract the attention of transnational oil companies. After a 70-year break, representatives of these companies started visiting the Soviet Union's oil-rich regions, including Azerbaijan.

The interest in Azerbaijan was above all caused by the Chirag and Azeri deposits that were discovered in 1985-87 and by the existence of a developed oil industry infrastructure in Azerbaijan. Since a major part of these deposits are located in the

⁹ <http://www.taxes.gov.az/eng/psa/index.shtml>

depths of the Caspian Sea, a great amount of investment, new technologies and equipment were required for its exploitation. None of these were available in a country with a difficult economic situation. For this reason and taking account of the interest of foreign companies, the Soviet government announced a tender on the Azeri deposit in January 1991¹⁰. Such well-known companies as *BP* (in association with *Statoil*), *Amoco* and *Unocal* participated in that tender. The results of the tender were announced in summer 1991. According to these results, the US company *Amoco* won the tender. However, the Azerbaijani government decided to bring in other companies as well. Thus, under the leadership of *Amoco*, the foundations of a consortium that includes companies like *Unocal*, *BP/Statoil*, *McDermott* and *Ramco* were laid. This consortium was to prepare the technical feasibility study and draft contracts.

The state independence of the Azerbaijani Republic was restored in October 1991. The government of independent Azerbaijan decided to continue negotiations with foreign companies on the joint exploitation of oil fields, because oil was a major resource that newly-independent Azerbaijan could deliver to the world market on a large scale and make high profits. The high oil profits could be the main means of ensuring macroeconomic stability in the country and lead the economy out of the decline. On the other hand, the importance of financial possibilities for a country that was at war was one of the leading natural factors.

Cooperation with foreign companies also promised political dividends to the young and independent state: the

¹⁰ Resolution No 2525, dated 18 January 1991, was adopted jointly by the Cabinet of Ministers of the Azerbaijan Republic and the Ministry of Oil and Gas Industry of the USSR.

ensuring of economic interests of the world's developed countries in Azerbaijan could guarantee the independence of our country in some way and play a considerable role in supporting Azerbaijan's fair position on the settlement of the Nagorno Karabakh problem.

The first government of independent Azerbaijan could not complete the negotiations with foreign oil companies, because political development resulted in power change in the country in May 1992. However, taking account of the country's political and economic interests, the new government decided to continue the negotiations with foreign companies and went even further on this issue, trying to involve more companies in the exploitation of Azerbaijan's oil and gas reserves. An impetus was given to the preparation of the contract on the Azeri deposit while the possibility of signing contracts on other deposits was discussed. On 7 September 1992, an agreement was signed with the *BP/Statoil* alliance on the Chirag deposit and the Shah Deniz promising structure, while another agreement was signed with the *Pennzoil/Ramco* alliance on 1 October on the preparation of the technical feasibility studies and draft contracts on the Gunsheli deposit. The oil companies made a number of commitments in these contracts. For example, immediately after the signing of the agreement with *BP/Statoil*, this alliance committed itself to paying a bonus of 30m dollars to the Azerbaijani government. *Pennzoil/Ramco* promised to implement a project to collect 1 bn cu. m. of gas that was discharged into the atmosphere during the exploitation of the Oil Rocks and Guneshli deposits and transport it to the coast.

The *BP/Statoil* alliance was to prepare its proposals on the Chirag deposit and Shah Deniz promising structure in six months, while *Pennzoil/Ramco* was to prepare its proposals on the

rehabilitation and further development of the Guneshli deposit in 90 days.

Taking into account that the Guneshli, Azeri and Chirag deposits belong to a single structure and in order to save investment and operating costs in the process of developing them, SOCAR made a decision in October 1992 to study prospects for the establishment of a general infrastructure in connection with these deposits. Five memorandums of understanding were signed with foreign companies in November on the establishment of a general supply base, a common network of underwater pipelines and terminals, a common fleet and a common export pipeline. Within the framework of these memorandums, working groups of specialists were set up to carry out the necessary research and prepare technical proposals in three months. Thus, the process of merging those deposits came to an end.

In May 1993, the sixth memorandum of understanding was signed on the single working program on the Azeri, Chirag and Guneshli deposits in May 1993. Finally, on 4 June 1993, the SOCAR board of directors adopted a declaration on the joint development of these deposits. Some of the main conditions indicated in the declaration are the following:

- the main purpose is the effective development of oil and gas deposits, the effectiveness of investment, the minimization of exploitation costs, to increase Azerbaijan's profits to a maximum, to strengthen local production and to make maximum use of scientific potential and personnel;
- the share of SOCAR is 30 per cent. SOCAR is given two years to find financial resources for this share;

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- foreign companies should pay a bonus of 3m dollars for every per cent of their participation. The company that accepts the conditions of the declaration should pay one third of this bonus in 10 days, while the remaining two thirds should be paid in 30 days after the oil contract that will be signed takes effect;
 - the chairman of the joint management committee that will be set up will be a representative of SOCAR;
 - SOCAR will have the right to select the operator in the contractual area;
 - a fund that will finance the preliminary work plan will be set up in a very short period of time;
 - all previous agreements that run counter to the declaration are invalid.

All companies that participated in the future contract accepted the conditions of the declaration in one week and officially informed SOCAR about that.

According to agreements reached with foreign companies, at the end of June SOCAR and foreign companies were to start the process of agreeing the commercial conditions of the contract to be signed. It was expected that this process would take one or two months, after which the contract would be ready to be signed.

However, political power changed in the country again in June 1993. The new government decided to suspend this process in order to familiarize itself with the course of work.

The negotiations resumed afterwards, and on 20 September 1994, Azerbaijan signed its international oil contract – “the Contract of the Century” – with a consortium of foreign oil

companies on the joint development of the deep water part of the Azeri, Chirag and Guneshli deposits. The following foreign companies signed the contract: *BP* (Britain), *Amoco* (USA), *Lukoil* (Russia), *Pennzoil* (USA), *Unocal* (USA), *Statoil* (Norway), *McDermott* (USA), *Ramco* (Britain), *TPAO* (Turkey) and *Delta Nimir* (Saudi Arabia). The Azerbaijani government is represented by SOCAR in the agreement. We should also point out that the current list of companies and production sharing are different now because some companies sold their shares in the contract afterwards.

In the following years, Azerbaijan signed new production sharing agreements with foreign companies. Table 1.1 shows all contracts signed by Azerbaijan.

Table 1.1

N	Dates when the contracts were signed and took effect	Names of deposits	Shares of SOCAR and foreign companies*, %
1	20.09.94 02.12.94	Azeri-Chirag-Guneshli	SOCAR(10); BP (34.1367); ChevronTexaco(10.2814); Lukoil(10.0000); Statoil(8.5633); ExxonMobil(8.0006); TPAO(6.7500); Devon Energy(5.6262); Itochu(3.9205); Amerada Hess (2.7213)
2	10.11.95 13.02.96	Garabag	SOCAR(7.5); Lukoil (12.5); Devon Energy (30.0); Agip-Lukoil(45); Agip(5)
3	04.06.96 04.10.96	Shah-Deniz	SOCAR(10); BP(25.5); Statoil (25.5); LukAgip(10); TotalFinaElf(10); OIEC(10); TPAO(9)
4	14.12.96 25.02.97	Dan Ulduzu, Ashrafi	SOCAR(20); BP(30); Unocal(25.5); Itochu(20); Delta(4.5)
5	13.01.97 13.06.97	Lankaran-Deniz, Talysh-Deniz	SOCAR(25); Elf(40); Total(10); DEMINEX(10); OIEC(10); PETROFINA(5)

N	Dates when the contracts were signed and took effect	Names of deposits	Shares of SOCAR and foreign companies*, %
6	03.07.97 05.12.97	Yalama	SOCAR(40); LUKOIL(32.4); ARCO(27.6)
7	01.08.97 05.12.97	Absheron	SOCAR(50); Chevron(30); Total(20)
8	01.08.97 05.12.97	Nakhchivan	SOCAR(50); ExxonMobil(50)
9	01.08.97 05.12.97	Oguz	SOCAR(50); ExxonMobil(50)
10	02.06.98 07.07.98	Kurdashi, Araz-Deniz, Kirgani-Deniz	SOCAR(50); Agip(25); MITSUI (15); TPAO (5); REPSOL (5)
11	20.07.98 01.12.98	Inam	SOCAR(50);); LASMO (12.5); BP (25); CTK (12.5)
12	20.07.98 18.12.98	Araz, Alov, Sharg	SOCAR(40); BP(15); Statoil (15); TPAO(10); Alberta Energy(5); ExxonMobil(15)
13	25.12.98 11.06.99	Atashgah, Yanan Tava, Mugan-Deniz	SOCAR(50); Japex(22.5); Inpex(12.5); Itochu(7.5); Telkoku(7.5)
14	02.06.98 13.11.98	Janub-Garb Gobustan	SOCAR(20); CNPC(50.26); Commonwealth Oil & Gas(29.74)
15	21.07.98 20.11.98	Muradkhanli, Zardab, Jafarli	SOCAR(50); Ramco(50)
16	02.06.98 16.04.99	Kursangi, Garabagli	SOCAR(50); Frontera Resousers(30); Delta-Hess(20)
17	27.04.99	Savalan, Dalga, Lerik-Deniz, Jenub	SOCAR(50); ExxonMobil(30) ?(20)
18	27.04.99 21.04.00	Zafar, Mashal	SOCAR(50); ExxonMobil(30); Conoco(20)

N	Dates when the contracts were signed and took effect	Names of deposits	Shares of SOCAR and foreign companies*, %
19	27.04.99 09.06.00	Padar blok	SOCAR(20); Moncrief Oil(80)
20	12.09.00 25.10.00	Mishovdag Kamaledin	SOCAR(15); Moncrief Oil(49.7); Petoil(35.3)
21	09.01.01 12.06.01	Zig, Hovsan	SOCAR(50); Lukoil(50)
22	04.06.03 02.12.03	Pirsaat	SOCAR(20); Shengli (50); Intersun(30)
23	29.09.04 29.04.05	Binagadi group of fields	SOCAR(25); AZEN(75)
24	18.06.04 29.04.05	Garachu- khur	SOCAR(25); Noble Sky(75)
25	05.11.04 29.04.05	Kurovdag	SOCAR(50); Caspian Energi Group(50)
26	16.08.05	Surakhani blok	SOCAR(25); Rafi Oil FZE (UAE)(75)

**The companies and their shares are the same as when the contract was signed. Afterwards, some companies in a number of contracts sold their shares to other companies fully or partly.*

Exploration-drilling work in some of these contracts did not yield any results. No commercially profitable hydrocarbon reserves were discovered in the following promising structures: Garabag, Dan-Ulduzu, Ahsrafi, Lankaran-Deniz, Talysh-Deniz, Absheron, Nakhchivan, Oguz, Kurdashi block, Atashgah, Yanan Tava, Mugan-Deniz, Zafar and Mashal. However, these negative results do not mean that there is no oil at all in those structures. Maybe SOCAR itself will decide to develop these deposits one day. This is especially likely because of the growing oil prices.

1.2. The main conditions of the contracts

The contracts that have been signed belong to the type of Production Sharing Agreements (PSA). This type of the contracts was selected because PSAs can provide a better guarantee than concessions¹¹ for the state's right to own natural resources. On the other hand, the selection of "service" contracts, which are used in world practice (it is known that such contracts allow a country to make more revenues), was very difficult for Azerbaijan because the financial possibilities of the country were very limited at the time. The low credit rating of Azerbaijan, which had just gained its independence, made it impossible to get loans from foreign credit institutions.

Any international oil contract, including "the Contract of the Century", is a consensus of the interests of the customer and executor. It was not easy to reach a consensus on this matter. Although Azerbaijan tried to sign contracts with more beneficial conditions, it was forced to take account of the interests of the opposite side.

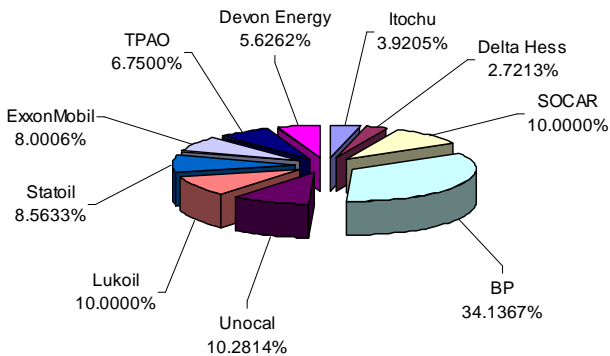
The subject of the contract. Agreements on this show the name(s) of oil and gas reserves where the contractor company (a

¹¹ **Concessions.** This type of contract was used as the first type in world experience. The difference between concessions and other oil contracts is that a company extracting hydrocarbon reserves in the area of a concession owns all reserves. In return, the company pays the country "royalties" (mining tax) or income tax. The "royalties" usually account for a certain percentage of the volume of extraction. Depending on the size of a deposit and other specific features, this percentage is between 5 and 20 per cent. Usually, its volume is 12.5 per cent. The practice of concessions has been used in Azerbaijan for a very long time. This type of contract was called *Iltizam* in Azerbaijan and was quite common in the early 19th century.

group of companies) are working, the geographical coordinates of the territory of the contract and the size of the relevant area.

The parties to the contract. The relevant section of every contract shows the executor (contractors) and the customer in the contract. The degree of each company's participation in the contract is characterized by the "interest share" that is given per cent. The interest share shows how much of profit oil belongs to that company. Picture 1.1 shows the shares of companies in the "Contract of the Century"¹². As we can see (See Table 1.1), there have been changes in the composition of participating companies since the contract was signed. All Azerbaijani contracts allow such changes (on certain conditions).

The interest share also shows the level of participation in and the responsibility of the party to the contract, which owns it, for the financing of the project.



Picture 1.1

¹² <http://www.bp.com/genericarticle.do?categoryId=9006615&contentId=7037409>

The term of the contract. Except for the “Contract of the Century”, Azerbaijan’s contracts on deposits in the Caspian Sea agree on three terms: 1) the period of exploration; 2) the additional period of exploration; 3) the period of development and production.

As a rule, the period of exploration is about three years and starts when the contract takes effect.

The possibility of extending the period of exploration is reflected in contracts, and relevant conditions are determined at this moment. The additional period of exploration ranges from one year to three years in contracts that have been signed.

The period of development and production is, as a rule, 25 years in contracts signed by Azerbaijan (on offshore deposits). Only three contracts have different periods: ACG and SD deposits – 30 years and the Nakhchivan deposit – 35 years.

In the ACG contract, the period of development and production is called the main period. A period of exploration is also shown in this agreement. The reason is that the ACG deposits were discovered before the signing of the contract. The main period of the contract starts when it takes effect and lasts for 30 years, however, according to the contract, the parties can extend the term of the contract if they are interested. The need to extend the term of the contract can emerge if new oil reserves are discovered in the contractual area.

Per acre payments. During the period of exploration, the contractor carries out per acre payments. Three production sharing agreements provide for an annual per acre payment to the tune of 1,200 dollars for each square kilometer of the contractual territory. In the remaining contracts, the size of the per acre payment is 2,000 dollars per year. A maximum

contractual territory has been allocated for exploration work at the block of the promising structures Alov-Araz-Sharg. It equals 1,400 sq. m. here. The size of the annual per acre payment is 2,800,000 dollars per year.

The rights and responsibilities of the parties. Contracts indicate the rights and responsibilities of the parties. For example, the contractor has exclusive rights to carry out oil and gas operations in the contractual area within the framework of conditions established by the contract. The contractor has the right to have his expenses reimbursed (repaid) and make a profit. The contracts also define some prohibitions for the contractor. For example, the contractor cannot carry out work that has nothing to do with oil and gas operations in the contractual area.

SOCAR takes the following main commitments:

- To provide the contractor with all the necessary geological, geophysical, geochemical, and technical information regarding the contractual area and wells;
- To create the necessary conditions for the contractor to carry out oil and gas operations (licenses, customs documents, visas, licenses for export-import operations, means of communications, the right of residence for foreign staff, land plots, etc.)

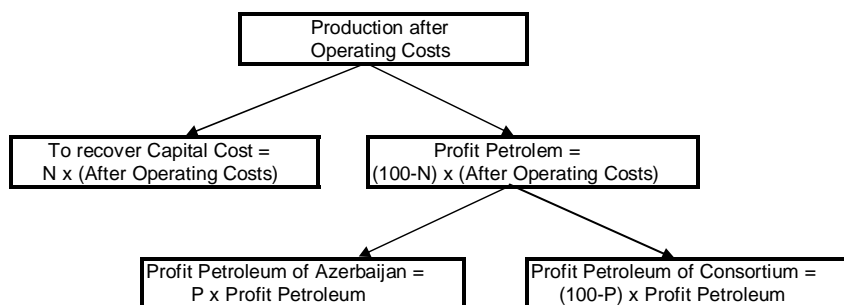
The contractor has the following commitments:

- To provide the necessary funding for all programs agreed on oil and gas operations;
- To carry out oil and gas operations according to the principles of safety and effectiveness accepted in international experience;

- To make minimum use of extracted hydrocarbons for oil and gas operations.

The rule of paying expenses and sharing profit oil.

Picture 1.2 shows the scheme of production sharing common for all oil contracts of Azerbaijan.



Picture 1.2

In the picture: N is the part of extracted oil that is used for covering the investment expenses of the contractor (per cent). This indicator is agreed between participants in the project; P is the share of profit oil that is due to Azerbaijan as the country that owns it (per cent).

As we can see from the picture, before extracted oil, a relevant amount of oil is separated for covering exploitation expenses (the expenses of the period of exploration can be added here depending on the agreement).

According to the agreements, the contractor can use part of the production free of charge in order to maintain pressure in the stratum.

All calculations are made on a quarterly basis.

The N indicator cannot exceed 50 per cent in contracts signed by Azerbaijan. Oil projects require a great amount of investment and it is impossible to recoup those expenses in the first year of the project, and this process might take several years. Companies are interested in keeping this period as short as possible, which might require a great amount of the production to be used for covering expenses. On the other hand, the country that owns the reserves wants to take over as much production as possible from the very beginning of the production (this can be explained by financial difficulties or a shortage of energy in the country). International experience shows that 25-70 per cent of the production is used for covering expenses every year. As we said, in Azerbaijani oil contracts this should not exceed 50 per cent.

After a relevant volume is separated from the production first for covering exploitation and then capital expenses, the remaining oil is called profit oil. This oil is divided between Azerbaijan and the contractor.

The volume of P shown in Picture 1.2, i.e. the share of the profit oil that is due to Azerbaijan (per cent) is determined on the basis of special methodology. That methodology is based on the consensus of the interests of both Azerbaijan and companies. Of course, during negotiations every party is trying to ensure its interests to a maximum extent in sharing the profit oil, however, because of the conflict of interests, each party is forced to agree not with what it wants, but with what is possible. A contract can be signed only when there is a consensus. At this moment, the interests of one party can be better ensured. The reason for such a result stems from the parties' ability to negotiate, to make more accurate calculations and to make predictions. In general,

agreeing on the issue of dividing profit oil is the most tense and responsible work during negotiations on an oil contract.

The oil contracts signed by Azerbaijan can be divided into two groups in terms of dividing profit oil:

- The contracts in which the parties' shares in profit oil are determined depending on the meaning of one of the main financial indicators of the foreign company that is directly named in the text of the agreement;
- The contracts in which the parties' shares in profit oil are made dependent on the meaning of some factor *R* (see below).

The first type of contracts includes contracts signed on the ACG and Atashgah-Yanan Tava-Mugan Deniz deposits. All other contracts belong to the second group.

It must be noted that in essence, there is no big difference between these two groups, because in the end, in both cases profit oil is divided so that the company's indicator of profitability is not lower than some limit (restrictions from company shareholders).

In the contract signed on the ACG deposits, the sharing of profit oil depends on the following factors:

- whether or not the Early Oil Production scheme is being implemented¹³;
- the level of expenses on the transportation of extracted oil;

¹³ According to the contract, the amount of crude oil that is received by the contractor for 30 days non-stop while exploiting the Chirag-1 platform corresponds to this period.

- the degree of reimbursement for the capital expenses of the contractor.

Calculations on covering expenses (exploitation and capital) and sharing profit oil are carried out on a quarterly basis. After the volume of profit oil is determined, the financial indicator that was of importance to the contractor at the end of the previous quarter – Real Rate of Return (RROR) – is calculated¹⁴. If the preliminary oil scheme becomes a reality and the overall transportation expenses are not higher than three dollars per barrel, in this case profit oil is divided on the basis of Tables 1.2 below, depending on the RROR:

Table 1.2

	Azerbaijan's share in profit oil	Contractor's share in profit oil
RROR < 16,75%	30	70
16,75% <= RROR < 22,75%	55	45
22,75% <= RROR	80	20

Profit oil is divided on the basis of this table if the preliminary oil scheme is not implemented, but overall transportation expenses are not higher than three dollars per barrel. The sharing of profit oil under the contract is explained in detail in other combinations of the aforesaid factors. In the worst case scenario, the share of profit oil due to Azerbaijan can be less than indicated in the aforesaid table by up to 5 per cent.

¹⁴ The relevant method of calculating is shown in the contract.

In other contracts signed by Azerbaijan, profit oil is divided on the basis of the R factor indicator. That factor is calculated with the help of the following formula:

$$R(n+1) = \frac{A(n)+B(n)+C(n)}{D(n)}$$

Here: A (n) – is the paid volume of the contractor's cumulative (overall) capital expenses at the end of quarter N; B (n) – is the paid volume of the contractor's cumulative (overall) financial (credit interest rates) at the end of quarter N; C (n) – is the cumulative (overall) value of profit oil due to the contractor at the end of quarter N; D (n) – is the volume of cumulative (overall) capital investment at the end of quarter N.

Conditions for dividing profit oil depending on the price of the R factor are very similar in Azerbaijani contracts. Table 1.3 shows conditions for dividing profit oil on the basis of the R factor in contracts signed on offshore deposits.

Another special feature of the contracts signed by Azerbaijan is that there is neither a minimum or maximum restriction on the revenues of the contractor in the terms on the division of revenues. This means that during the contractual period, the contractor can gain a high *Net Present Value* (NPV), and the *Profitability Index* (PI) can be very high in comparison with other spheres of international business. We should point out that such terms are very frequent in world oil business.

Table 1.3

R		The share of Azerbaijan in profit oil, %											
>=	<	Gara-bag	Shah Deniz	Dan Uldu-zu, Ashra-fi	Lan-karan-Deniz, Talysh-Deniz	Yala-ma	Ab-sheron	Nakh-chivan	Oguz	Kur-dashi, Araz-Deniz, Kir-gani-Deniz	İnam	Araz, Alov, Sharg	Zafar, Mash-al
0	1.00	50.0	45.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0
1.00	1.25	50.0	55.0	50.0	50.0	50.0	50.0	50.0	50.0	52.5	60.0	52.5	52.5
1.25	1.50	50.0	55.0	50.0	52.5	55.0	55.0	55.0	52.5	52.5	60.0	55.0	55.0
1.50	1.75	60.0	55.0	60.0	57.5	60.0	60.0	60.0	57.5	57.5	70.0	57.5	57.5
1.75	2.00	60.0	55.0	60.0	57.5	65.0	60.0	65.0	57.5	57.5	70.0	60.0	60.0
2.00	2.25	62.5	70.0	62.5	65.0	65.0	67.0	65.0	65.0	65.0	80.0	65.0	65.0
2.25	2.50	65.0	70.0	65.0	65.0	70.0	67.0	70.0	65.0	65.0	85.0	70.0	70.0
2.50	2.75	70.0	70.0	70.0	75.0	70.0	77.0	70.0	75.0	75.0	85.0	70.0	70.0
2.75	3.00	75.0	70.0	75.0	75.0	85.0	77.0	75.0	75.0	75.0	87.5	80.0	80.0
3.00	3.25	80.0	80.0	80.0	80.0	90.0	82.5	85.0	80.0	90.0	90.0	90.0	90.0
3.25	3.50	85.0	80.0	85.0	85.0	90.0	87.5	90.0	85.0	90.0	90.0	90.0	90.0
3.50	3.75	90.0	80.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0
3.75	4.00	90.0	80.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0
4.00		90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0

Financial expenses. A great deal of financial resources used for implementing the contracts that have been signed has been borrowed from financial institutions. Borrowing them entails certain expenses, i.e. this or other oil company takes credits from banks in order to carry out work on the project it is implementing and pays certain annual interest rates on the credit. Of course, the contractor company adds financial means relevant to this interest rate to the funds it spends under the contract and it is repaid at the expense of extracted oil. For this reason, Azerbaijan not want the loans taken by contractor companies from banks to be too expensive, i.e. it does not want interest rates that will be paid at the expense of Azerbaijan's national resources to be too high. As an example, let's have a look at the agreement in the ACG Contract on financial expenses. It (Paragraph 11.4 of the contract) says that "expenses on financing main (capital) expenses that have not been paid for each calendar quarter are combined with the balance of main expenses that were not paid until that day after every calendar quarter and then are paid as main expenses", i.e. when a new quarter starts financial expenses are added to main expenses that were not paid by its first day. Financial expenses equal to the production of the remaining main expenses that have not been paid by the beginning of a quarter in one fourth of the annual interest rate of the main capital. The same scheme is applied in covering exploitation expenses.

The aforesaid scheme of calculating is the same in most of the contracts signed by Azerbaijan. The difference is the annual interest rate that is agreed.

Annual interest rates in the ACG contract have been agreed in the volume of Libor +4 per cent, i.e. even if the interest is more expensive or cheaper, financial expenses are counted and

used in this volume from the interest rate. The same interest rate is applied in a number of other agreements, for example, the agreements on the SD and Garabag deposits.

Management of project implementation. According to Azerbaijani contracts, a managing committee (MC) is set up in order to implement relevant projects within 30 days after the beginning of work on the deposit. The following are the main functions of this committee:

- Oversight over oil and gas operations;
- The approval of annual budgets and programs;
- Oversight over expenses;
- Setting up of auxiliary subcommittees and oversight over their work;
- The approval of programs on personnel training;
- The approval of plans on abolition work.

As a rule, the MC consists of an equal number of representatives from SOCAR and the contractor. When the MC makes a decision, SOCAR and the contractor both have one vote. The chairman of the MC is appointed from SOCAR representatives in the MC. The MC should hold meetings no less than twice a year. Annual programs should be approved three months before the beginning of the new year.

The MC on the ACG Contract was set up in early 1995. It included 10 people from SOCAR and 10 representatives from foreign companies (one representative from each company). Later on, the Azerbaijan International Operating Company (AIOC) was set up and BP became project operator on 1 June 1999.

The operating company. The contractors of the contract set up an Operating Company (OC) to implement the project. This company does not aim to make a profit and is only responsible for the daily management, coordination and implementation of oil and gas operations. As a rule, the OC is set up after the approval of the program on the development of a hydrocarbon deposit. The supreme managing body of the company is the council of directors. The contractor companies have their representatives in the council. Operating companies can be set up (registered) in Azerbaijan or other countries. Agreements in contracts related to operating companies usually cover the following issues:

- The responsibility of the company;
- Structural principle;
- Decision-making;
- Working rules;
- Personnel;
- Educational measures to increase professionalism.

The Azerbaijan International Operating Company (AIOC) has been set up in connection with the ACG Contract and this company carries out all work on the development of the ACG deposits.

Agreements on bonuses. Bonus means a “money award” in English. As a rule, bonuses are a certain amount of money and their sum is agreed during talks between the negotiating parties and is reflected in the contract. The payment of bonuses is common in world experience. Two types of bonuses are used in contracts signed by Azerbaijan: 1) signing bonus; 2) successful

Table 1.4

million USD

Conditions for paying a bonus	Number of the contract*											
	1	2	3	4	5	7	8	9	10	11	12	13
Within 30 days after a contract takes effect	135	8	37	8	37	30	10	10	32	32	100	10
Within 30 days after the beginning of the drilling of the first exploration well												
Within 30 days after the approval of the exploitation program											20	
Within 30 days after daily oil production totals 40,000 barrels per day		25		25								
Within 30 days after stable production of 40,000 barrels of oil a day for a period of 60 days	67.5											
Within 30 days after stable production of 12,000 barrels of oil a day for a period of 60 days		42		42								25
For every 100m barrels that have been extracted			1		2.5	1	1					2.5
Since the exploitation program envisages every 100m barrels of oil or oil equivalent, within 30 days after the approval of that program								2.5	2.5	2.5	1	
Within 30 days of an events that happens at a later date, 1) When 12,000 barrels of oil or oil equivalent are extracted for 60 days; 2) Stable production from two wells for 60 days			50		10	25	30	10	10		50	
Within 30 days after the main export oil is pumped into the pipeline for 60 days	67.5											
Within 30 days after beginning of industrial oil production										10		

* The number of the contract is in the same order as in Table 1.

project implementation bonus. The signing bonus is paid soon after the signing of a contract.

On the whole, the first bonus was paid to the Azerbaijani government under the contract with BP/Statoil on the Chirag and Shah Deniz deposits in September 1992. The sum of that bonus was 30m US dollars. According to the ACG Contract, foreign companies should pay a bonus of 3m US dollars to the Azerbaijani government for each per cent of their interest shares. The contractor should pay half of this sum within 30 days after the ratification of the contract and the rest of the sum after the daily production level reaches 40,000 barrels and within 60 days after the commissioning of the main export pipeline. Up till now, Azerbaijan has received bonuses of 202.5m US dollars. As we can see, the ACG Contract envisages both types of bonuses.

Table 1.4 shows the sums and terms of bonuses under some contracts signed by Azerbaijan.

Contracts on natural gas. According to the contract, accompanying gas is handed over to SOCAR free of charge. Before the beginning of 2003, the AIOC had already given Azerbaijan 9.9 bcm of accompanying gas.

Tax payment. The contracts that have been signed contain relevant agreements on the following types of taxes:

- Taxes from the profit of the contractor;
- Taxes from the income of foreign contractors;
- Taxes from foreign legal entities;
- Taxes from the income of local and foreign staff;
- Value Added Tax.

Table 1.5 reflects degrees of taxes agreed in Azerbaijan's oil contracts.

Table 1.5

Contract	Profit tax of the contractor, %	The income tax of the contractor, %
Azeri-Chirag-Guneshli	25	5
Garabag	25	6.25
Shah Deniz	25	6.25
Dan Ulduzu, Ashrafi	25	6.25
Lankaran-Deniz, Talysh-Deniz	32	8
Yalama	32	8
Absheron	32	8
Nakhchivan	32	8
Oguz	32	8
Kurdashi, Araz-Deniz, Kirgani-Deniz	32	8
Inam	32	8
Araz, Alov, Sharg	32	8
Zafar, Mashal	30	7.5
Atashgah, Yanan Tava, Mugan-Deniz	32	8

All contracts provide for zero VAT.

On the whole, the following can be said with regard to contracts signed by Azerbaijan:

- The contractor has to pay only taxes envisaged by the contract;

-
- Agreements between governments on avoiding dual taxation make it possible to apply tax concessions;
 - Every contractor is responsible for paying only its own taxes;
 - The points of the contract related to taxes prevail over other tax-related legislative acts of the country;
 - Tax payments by the contractor are carried out through SOCAR, i.e. the contractor does not have direct relations with the Tax Ministry;
 - The contractor has the right to ask SOCAR for a relevant document confirming that it has paid taxes. The contractor can even hire an audit company to check the payment of its taxes by SOCAR;
 - The Tax Ministry solves all issues related to the contracts with SOCAR;
 - If SOCAR does not pay the contractor's taxes on a permanent basis, the contractor has the right to decide to pay its taxes on its own.

As can be seen, the Tax Ministry cannot have direct relations with the contractor. In this case, SOCAR is a mediator and at the same time, is responsible for calculating taxes correctly and paying them in time.

In addition to oil contracts on tax payment mechanisms, a number of special protocols¹⁵ have been signed between the Working Commission set up by the Cabinet of Ministers and the contractors: "On the payment of taxes by employees and private individuals", "On the payment of taxes by foreign contractors",

¹⁵ <http://www.taxes.gov.az/qanun/psa.shtml>

“On the export-import duties and taxes of the Azerbaijan Republic” and “On the Value Added Tax”.

Customs procedures. Equipment, materials, means of transport, as well as food for staff imported into Azerbaijan in order to implement oil and gas operations are exempted from customs duties.

Hydrocarbon resources that have been extracted can be freely exported at any time without paying taxes.

Export-import operations are carried out according to relevant customs rules and instructions and certain duties are paid for customs services.

The inspection of oil and gas operations. SOCAR’s authorized representatives can inspect the course of work related to oil and gas operations, facilities, equipment and materials. Taking a decision in this regard, SOCAR should notify the contractor at least three days in advance.

The definition of the cost of oil. As was noted above, the specific feature of production sharing agreements is that in these contracts, the operating and main costs of the contractor are paid by separating a relevant share of the production. In order to establish this relevant share, the price of oil (gas) is used. How is the price established? Relevant agreements that answer this question are one of the most important parts of all contracts.

The price of this or other oil on the world market depends on the API¹⁶ gravity, which is its main quality indicator. As we know, the price of oil is determined on the world market. However, according to Azerbaijan’s PSAs, the extracted oil is divided before it is placed on the market and on Azerbaijani

¹⁶ The American Petroleum Institute gravity, or **API gravity**, is a measure of how heavy or light a petroleum liquid is compared to water.

territory. To be more specific, the extracted oil is divided at the Points of Delivery shown in the contracts. The contract on the ACG deposits signed on this Point says that after the main oil export pipeline (BTC) is put into operation, the metering device installed at its point of entry is regarded as the Point of Delivery. We should point out that BTC starts at the Sangachal terminal and the Point of Delivery is also situated here. According to the contract on ACG, before the BTC is put into operation, the place where the Point of Delivery is located is determined by the Steering Committee.

Thus, in order to divide extracted oil, it is necessary to define its price at the Point of Delivery. Of course, this price cannot be the same as the price on the world market, because certain expenses (transit expenses, expenses for carrying, insuring, keeping, loading and unloading oil, and other operations and services) are required for delivering oil from the Point of Delivery near Baku to its buyers. Oil buyers operating on the market can be divided into two categories: 1) intermediate buyers and 2) last hand buyers. The first group includes various companies that aim to buy and sell oil and make a profit on it. The second group includes companies that use oil (refining and other types of consumption). Most of them are oil refineries.

Let's have a look at one specific feature of the ACG contract. In this contract, the contractor consists of a number of companies. Each of them gains the right to use its oil after getting its share in the profit oil. The company can sell it to other contractors in bulk, independently and refine it at its own refineries (if they exist).

The ACG contract also uses an idea like the *Point of Sale*. It says: The Point of Sale is such a geographic point where the right to own crude oil is transferred from a seller to a buyer regardless

of whether the operation is carried out under FOB, CIF, C and F conditions or other conditions generally-accepted in the oil industry. Of course, the volume of oil at these points is measured with the help of metering devices.

After every quarter, all the parties¹⁷ to the ACG contract should provide within 30 days information about the independent sale of their oil in the previous quarter. This information includes the retail price of oil, its volume, date and the name of the Point of Sale. The cost of oil is defined on the basis of these, and SOCAR is given information about it. If any of the parties does not agree to this cost, SOCAR and the contractor address an expert known internationally. If his opinion does not satisfy the party, the expert is appointed by the Stockholm Chamber of Commerce and his decision is mandatory for the parties.

The ACG contract notes two rules of defining the cost of oil¹⁸. The first rule is used when the overall volume of sale operations carried out by the parties exceeds the overall volume of oil sales¹⁹ by 33.3 per cent. At this moment, the cost of oil is taken (of course, taking account of all sale volumes) as equal to the average figure (the “weight” of the price, i.e. taking account of the volume of goods sold for that price) of all sale prices (at relevant Points of Sale) and expenses related to the delivery of oil to the Points of Sale (pipeline tariffs, transit fees, transport losses²⁰,

¹⁷ All companies involved, including SOCAR

¹⁸ Article 13 of the contract

¹⁹ It is a sale for convertible currency between a buyer and seller who want to conclude a contract on “commercially independent sale”, but are not partners

²⁰ Transport losses in the Azeri-Chirag-Guneshli contract are losses caused by the Baku-Tbilisi-Ceyhan project. Transport losses are deducted from the overall extraction. In international practice, the volume of transport losses should not be higher than 0.1 per cent of the overall volume of oil transported by pipelines

payment for using terminals, tanker rent, taxes on the use of pipelines) are deducted while making calculations. If the overall volume of the parties' sales on the basis of commercially independent acts does not exceed 33.3 per cent of the overall volume of all sales, the cost of oil equals its sale price on the basis of commercially independent acts (calculated on the basis of the aforesaid rules) and the average figure of prices in acts that are not independent from a commercial point of view (the "weight" of the price, i.e. taking account of the volume of goods sold for that price). The price shown in the Platt's Oilgram journal is used for sales that are not commercially independent. If this journal does not indicate the price of that oil, the average denominator of the price of three close types of oil agreed on by the parties is calculated.

Immediately after the quarter ends, it is impossible to define the cost of oil. This becomes possible only after a certain period of time. The reports made in that period take the price of oil in the previous quarter on the basis of the ACG project. Amendments should definitely be made within 30 days after the price of oil in the last quarter is calculated.

Other agreements. Apart from what we said above, there are also agreements on oil prices, measuring the volume of extracted oil, use of accompanying gas, currency and financial operations, ways of solving disputed issues, ensuring the security of oil operations, etc.

The approval of contracts by the Milli Majlis. The ratification of the contracts by the parliament was due to the lack of an oil law in the country and the fact that a number of provisions in the contracts ran counter to some Azerbaijani laws. We should point out that there is still no appropriate law on the development of Azerbaijan's oil and gas reserves by local and

foreign companies (including the issue of licensing and so on). The approval of oil contracts by the Milli Majlis is just a formality. If the country's president agrees to sign this or that contract, that contract does not meet with any serious resistance in the Milli Majlis. The Milli Majlis has not made the slightest change to any of the 24 approved contracts.

1.3. The types of revenues the country will make according to Azerbaijani contracts

Summarizing the aforesaid results, we can say that the Azerbaijani oil contracts provide for the following types of revenues due to the state:

- A certain part of the profit oil;
- Bonuses;
- Per acre payments;
- Tax on the contractor's profit;
- Tax on the subcontractor's profits;
- SOCAR's share in the profit oil (for example, 10 per cent of the contractor's profit oil in the ACG project);
- Social taxes;
- Accompanying gas;

1.4. Addresses of the revenues

The specific addresses of the aforesaid revenues are determined by the government. Table 1.6 shown below indicates both addresses and relevant decisions concerning types of revenues.

Table 1.6

Types of revenues	Addre-sses of reve-nues	Name of the law
State share in the profit oil	SOFAZ	Presidential decree dated 29 Dec. 1999 establishing the SOFAR (including amendments and changes made on the basis of Decree 849 of 7 Feb. 2003 and Decree 652 of 1 March 2005 issued by the president of the RA) ²¹
Bonuses	SOFAZ	The same
Per acre payments	SOFAZ	The same
Tax on the contractor's profit	SB	Tax Code and ACG contract
Tax on the subcontractor's profit	SB	Tax Code and ACG contract
The share of SOCAR in the profit oil	SOCAR	ACG contract and the presidential decree dated 29 Dec.1999 establishing the SOFAR (including amendments and changes made on the basis of Decree 849 of 7 February 2003 and Decree 652 of 1 March 2005 issued by the president of the RA)
Social taxes	SSSF	The protocol concerning taxation on employees and physical persons
Accompanying gas	SOCAR	ACG contract

²¹ <http://www.oilfund.az/index.php?n=164>

Analysis shows that most of the revenues were received by the Oil Fund in 2001-2006. In 2006, State Budget revenues increased significantly and reached the revenues of the State Fund. If in 2006 the revenues of the Oil Fund totaled 1,165.6 million dollars²², the taxes paid by foreign contractors into the State Budget totaled 1,100 million dollars²³. According to the author's calculations, in the next few years, the revenues of the Oil Fund are expected to be much higher than those of the State Budget. The amount of social taxes paid into the SSSF is not being disclosed. Along with that, we can say that this sum is much lower than the tax paid from the contractor's revenues.

²² Annual report of SOFAZ, 2006, page 8.

http://www.oilfund.az/download/OilfundAz_2006.pdf

²³ http://www.eiti-az.org/ts_gen/download/EITI_report_2006_eng.pdf

2. COUNTRY REVENUES

2.1. Previous revenues

The full-field development of the super-gigantic oil field ACG began in Azerbaijan in 2006. Natural gas production from the super-gigantic natural gas field SD began in the same year. According to the latest statements of SOCAR management, ACG has recoverable oil reserves of about 6.5 billion barrels²⁴ and about 100 billion cubic meters of associated gas. Shah Deniz has²⁵ about 850 trillion cubic meters of natural gas and about 200 million tons of gas condensate. However, according to BP information the extractable reserves of this deposit equal 5.4 billion barrels²⁶. According to BP information, the SD deposit contains about 22,100 billion cubic feet of natural gas and 750 million barrels of gas condensate²⁷. BP does not rule out that there are additional reserves in the lower layers of the deposit²⁸.

The production of these hydrocarbons will pave the way for huge revenues. What kind of revenues in particular? This chapter makes an attempt to assess the expected results. Before assessing anticipated revenues, here is some information about the revenues already made.

²⁴ The Bulletin of “Turan” Information Agency, 27.10.06

²⁵ The Bulletin of “Turan” Information Agency, 02.08.06

²⁶ <http://www.bp.com/genericarticle.do?categoryId=9006667&contentId=7014330>

²⁷ <http://www.bp.com/genericarticle.do?categoryId=9006668&contentId=7014342>

²⁸ Ibid

Before the signing of the first oil contract, foreign companies engaged in negotiations with the Azerbaijan government had made significant bonuses. Payment of bonuses accompanied the signing of all offshore contracts. The total amount of all bonuses by late 1997 was \$700 million.

Bonuses played an important role in stabilizing the macroeconomic situation and tackling problems related to the budget deficit. Calculations show that in 1995-2000, 62 per cent of the budget deficit was financed by bonuses.

In November 1997, production of early oil started from the ACG contract area. This marked the commencement of profit oil, some of which was to go to the government of Azerbaijan. The Azerbaijan share in the profit oil was being sold by SOCAR, and the proceeds accumulated in bank accounts of SOCAR until 2001, i.e. the time when the State Oil Fund of Azerbaijan Republic (SOFAZ) started functioning. After the establishment of SOFAZ, it received²⁹ the remainder of the money (\$270,964,700.00) earned from oil contracts signed in previous years (remnant bonuses – \$100 million, money earned from the sale of profit oil – \$162,346,200, revenues from the lease of facilities - \$360,000, transit fees for the transportation of oil via the Baku-Supsa pipeline – \$8,258,600) and the SOCAR money kept in the International Bank of Azerbaijan. In 2002, \$52.6 million were transferred into the account of SOFAZ from the National Bank. This money came from previous revenues from oil contracts that had been signed. In 2003, another \$124 million from oil contracts signed in previous years were transferred \$65.4

²⁹ Presidential decree dated 4 January 2001

million kept at the country's National Bank, \$48.6 million from Lukoil and \$10 million from ExxonMobil).³⁰

According to the existing legal act (See Chapter 5.2), SOFAZ is receiving the following revenues from the oil contracts:

- Azerbaijan's share from profit oil extracted as part of PSA;
- Bonuses paid on conditions of PSA;
- Per-acre payments paid on conditions of PSA;
- Dividends due to Azerbaijan and revenues from the division of the profit linked to oil and gas projects;
- Transit revenues from export and gas pipelines;
- Revenues from the handover of assets.

Table 2.1 provides data on SOFAZ revenues³¹ between 2001 and 2006. While compiling the table, most of the data was taken from annual SOFAZ reports³². Only the data in the brackets were calculated by the author. This was done in the following way. For example, the indicator of revenues in US dollars from the management of SOFAZ revenues, which was not mentioned in the 2002 SOFAZ report, was determined in the following way:

$$\begin{array}{r} 124273 \\ 24.3 = \text{-----} \times 289.5 \\ 1474499 \end{array}$$

Here: 124273 are revenues from the management of SOFAZ assets in 2002, in AZN; 1474499 are total revenues for 2002 in AZN; 289.5 are total revenues for 2002 in US dollars.

³⁰ Annual SOFAZ report for 2003

http://www.oilfund.az/download/az/2003_az.pdf

³¹ SOFAZ annual reports. www.oilfund.az

³² <http://www.oilfund.az/az/account>

Table 2.1. SOFAZ revenues

Source of revenues	2001, Million AZM/ Million USD	2002, Million AZM/ Million USD	2003, Million AZM/ Million USD	2004, Million AZM/ Million USD	2005, Million AZM/ Million USD	2006, tousands.AZN/ Million USD
SOCAR funds for 1 January	1241018.0/ 270.9	2346951.1/ 491.5	3387278.1/ (692.2)	4015033.8/ 815.6	4726257.4/ 964.0	1280457.0/ 1394.3
Sale of profit oil	826 601.7/ 177.8	975 882/ 200.6	869 008.3/ 176.9	1 294 834.7/ 263.8	2 713 094.8/ 579.9	896 258.0/ 1005.4
Bonuses	29 927.4/ 6.4	257 630*/ 52.6*	608 945.8*/ 124.0*	105 991.1/ 21.6	4 592.1/ 1.0	1 797.7/ 2.0
Transit fees	54 797.0/ 11.7	61681.0/ 12.7	63 588.9/ 12.9	59 712.3/ 12.1	78 217.6/ 16.5	12 716.3/ 14.2
Acreage payments	50 064.1/ 10.7	52 704/ 10.8	94 555.3/ 19.3	43 261.0/ 8.8	40 756.0/ 8.8	7 570.9/ 8.6
Lease payments	2 225.3/ 0.5	2 329/ 0.5	586.4/ 0.1	-	-	-
Assets handed over to the government	-	-	24.4/ (0.005)	2984.3/ (0.607)	7612.9/ (1.625)	669.8/
Difference in the price of oil	-	-	-	-	316474.2/	10 972.7/ 12.5
Revenues from the management of SOFAZ assets	146 378/ 14.2	124 273.0/ (24.3)	183 784.1/ (37.4)	75 623.2/ (15.4)	139 576.3/ (29.8)	55 953.3/
The total of revenues per year:	2 351 011.5/ 492.4	1 474 499/ 289.5	1 820 493.2/ (370.7)	1 582 406.6/ (322.1)	3 300 323.9/ 704.6	985 938.7/ 1 165.6
SOCAR funds for 31 December	2 351 011.5/ 492.4	3 821 450.1/ 781.0	4 015 033.8/ (815.6)	4 726 257.4/ 964.0	6 402 284.4/ 1 394.3	1 267 444.8/ 1 454.5

* The bonuses received before the establishment of SOFAZ and kept at the National Bank before being handed over to SOFAZ in 2002 and 2003

Revenue from difference in the price of oil. Pursuant to the Law “On 2006 State Budget” of the Republic of Azerbaijan as well as under the Memorandum of Agreement signed between the Ministry of Finance, Ministry of Economic Development, SOFAZ and SOCAR, payments made to the SOFAZ from the differences between the contract price and domestic wholesale price of crude oil produced and exported from the Republic of Azerbaijan constituted another source of the Fund’s revenues.

All revenues from the management of SOFAZ assets include: revenues from the investment of the Fund’s money (assets), dividends, revenues from the sale of assets, revenues from the re-estimation of the Fund’s currency reserves and so on

It is interesting that revenues from the management of SOFAZ assets are absent not just in the 2002 report, but also in the 2003, 2004, 2005 and 2006 reports. Only the report for 2001 contains a relevant indicator of revenues. It is difficult to explain this absence because revenues from the management of SOFAZ assets are given in foreign currency. What is more, it is impossible to count the 2003 and 2004 revenues from the management of SOFAZ assets on the basis of the aforesaid scheme because the SOFAZ reports for these years also lack information about the total revenues of SOFAZ of all types in 2003 and 2004. In order to overcome this situation, we estimated SOFAZ revenues of all types in 2003 and 2004 using the average annual rate of AZN from the International Monetary Fund³³.

The SOFAZ reports also lack information about revenues from the sale of assets handed over to the country’s government, expressed in US dollars. For this reason, we had to calculate them using the aforesaid calculation scheme.

³³ <http://www.imf.org/external/pubs/ft/scr/2008/cr08216.pdf>

In the previous chapter we pointed out the mechanism of distributing profit oil between Azerbaijan and the contractor in the ACG contract. Table 1.3 describes three possible schemes of sharing the revenues. By the middle of 2007, profit oil between the consortium and the country was distributed on the basis of the first scheme for the time being, i.e. Azerbaijan gets 30 per cent of profit oil and the contractor – 70 per cent.

The bonuses paid by foreign companies are carried out on the basis of conditions given in Table 1.3, according to contracts signed with the government of Azerbaijan (Table 1.1).

We should observe that SOFAZ is receiving transit tariffs for pumping oil and gas by the pipelines Baku-Tbilisi-Ceyhan, Baku-Supsa and Baku-Tbilisi-Erzurum³⁴.

The average annual profitability (in basic currency – US dollars) of the management of SOFAZ assets is given in Table 2.2.

Table 2.2.

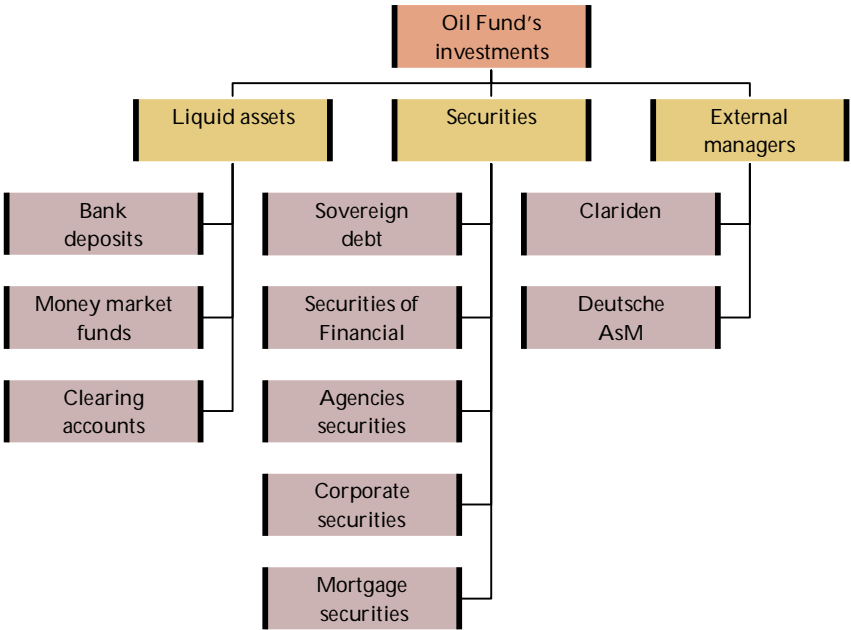
	2001	2002	2003	2004	2005	2006
SOFAZ revenues from investing financial resources ³⁵	3.87	2.15	4.42	1.88	2.79	8.5

The significant increase in the profitability of the investment of SOFAZ assets in 2006 is probably explained by the inflation of the dollar as well. In any case, according to the annual SOFAZ report, the profitability of investment in manats (AZN) in 2006 totaled 2.9 per cent.

³⁴ <http://www.oilfund.az/az/content/13/9>

³⁵ ARDNF-nin illik hesabatları. <http://www.oilfund.az/index.php?n=19>

The scheme on the investment of SOFAZ assets in 2006 is given in picture 2.1³⁶. In 2006, most of the SOFAZ assets (51.6 per cent) were kept in a liquid position for a period of one year, 33.9 per cent for a period of one to three years, 8.2 per cent for a period of three to five years, 2.8 per cent for a period of five to seven years and 3.5 per cent for a period of more than seven years.



Picture 2.1.

Table 2.3 presents the composition of SOFAZ currency assets on 31 December 2006.

³⁶ SOFAZ's annual report, 2006

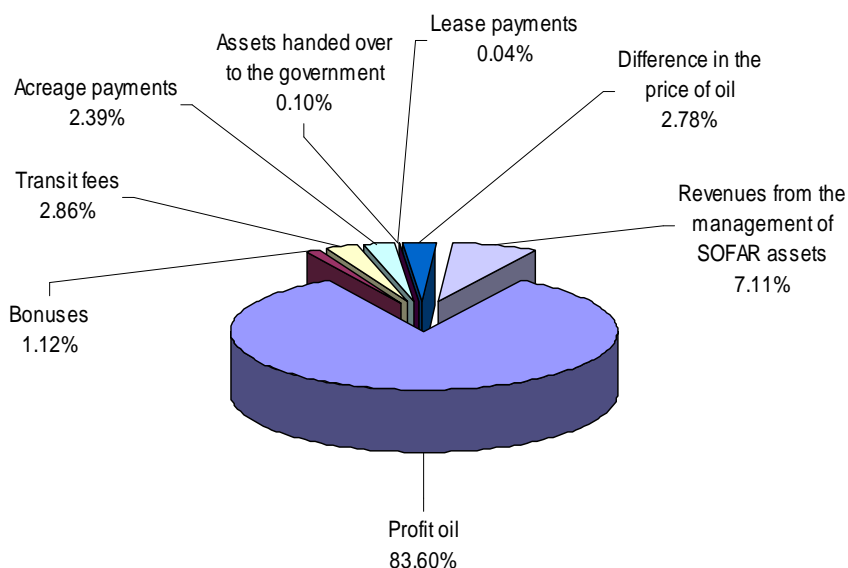
Table 2.3.

	SOFAZ	Clariden	Deutsche AsM	Total	%
Securities:	1 260.5	34.9	74.8	1 370.2	94.2
Sovereign debt	-		45.4	45.4	3.1
Securities of Financial institutions	834.3	8.6	28.4	871.3	59.9
Agencies securities	163.8	9.3	-	173.1	11.9
Corporate securities	192.2	2.0	1.0	195.2	13.4
Mortgage securities	70.2	15.0	-	85.2	5.9
Equities	-	4.6	-	4.6	0.3
Liquid assets:	69.1	7.5	3.7	80.3	5.5
Bank deposits	-	7.4	-	7.4	0.5
Money market funds	0.8	-	2.5	3.3	0.2
Clearing accounts	68.3	0.1	1.2	69.6	4.8
TOTAL:	1329.6	47.0	78.5	1 455.1	100

As we can see, at the end of 2006, foreign managers managed only 8.6 per cent of the overall volume of SOFAZ assets. Profitability from the management of SOFAZ assets by Clariden (a member of the Credit Suisse Group) in 2006 totaled 6.28 per cent, while by Deutsche Asset Management – 5.25 per cent.

According to a decree issued by the country's president on 28 December 2005, in 2006 55 per cent of SOFAZ assets were kept in dollars, 35 per cent in euros and five per cent in pounds. Another five per cent of SOFAZ assets were kept in the currencies of high rating countries.

Picture 2.2 gives the composition of the general basket of SOFAZ revenues in 2001-2006 (excluding the currency reserves handed over to SOFAZ in 2001-2003 from accounts at the National Bank and SOCAR).



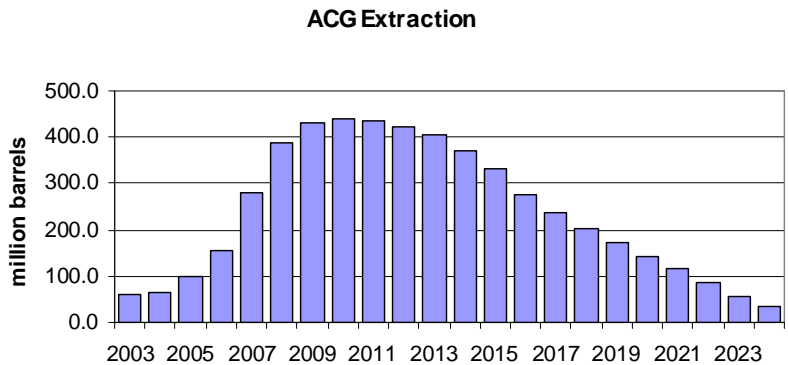
Picture 2.2.

As we can see, the lion's share of revenues comes from the sale of profit oil. Since it is planned to switch to the second scheme of sharing profit oil beginning from 2008 (See table 1.3), we can predict that the share of profit oil in the general basket of SOFAZ revenues will increase.

2.2. Expected revenues

Predictions in this paragraph are based on certain pre-conditions. The list of these pre-conditions includes the dynamics of production and investment, exploitation costs, oil transportation costs and oil prices on the world market.

Expected production in the ACG Contract is shown in Picture 2.3. When this table was drawn, the latest materials of the AIOC and SOCAR were used. Of course, the dynamics of production can be different every year in the future. The differences are unlikely to be serious. In any case, making predictions about revenues today, we have to use this histogram.



Picture 2.3

Production in the aforesaid deposits will rapidly grow and reach it peak in 2010. The volume of oil to be extracted in that year is expected to be about 440m barrels. At the next stage that will last until 2024, the production will gradually come to naught.

Based on various print materials and press releases of the AIOC, we have determined relevant predictions regarding investment. Thus, based on those statements, we can draw the conclusion that capital costs on ACG will continue until 2008 and will total about 18 bn US dollars. Such a volume of investment costs will be recouped in installments in the future. The year when the recoupment of capital costs is completed will depend on oil prices on the world market. To be more precise, the price of oil at the Delivery Point of is taken as a basis in calculations to recoup capital costs. The word "Delivery Point" is used in all oil contracts. This word shows the point where oil is shared. Under the contract on ACG, the Delivery Point is the point where oil extracted from the deposit enters the BTC pipeline. This point is on the territory of the Sangachal terminal. Delivering oil to points of sale from here requires expenses: BTC transit costs, insurance, tanker transportation costs, etc. Thus, the price of oil at the Delivery Point is determined by deducting these costs from its price at the point of sale.

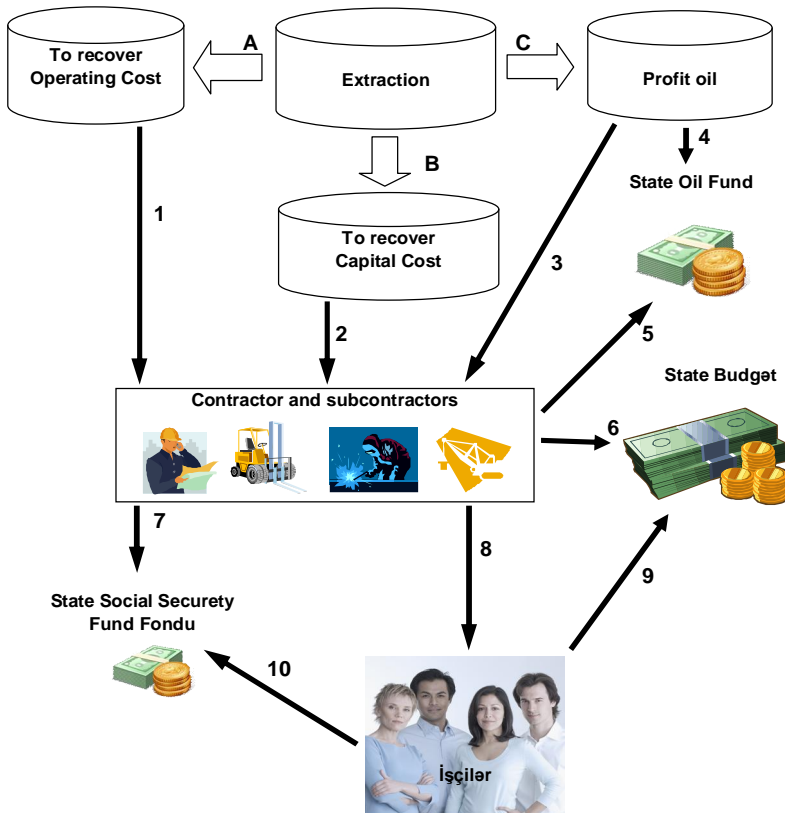
Another pre-condition that we used while making a prediction of future revenues was related to oil transportation costs. In our calculations, we took the price of three dollars per barrel as a basis. It is important to determine the pre-conditions because in the contract on ACG the sharing of the profit oil between Azerbaijan and the contractor depends on the level of transit costs.

Finally, the most difficult thing is to predict the price of oil on the world market. The term of the contract expires in 2024 and no-one probably knows how oil prices will change in 20 years. As a way out, we made our calculations for five price options for one barrel of oil at the Delivery Point: 18, 25, 35, 45 and 60 dollars.

Another pre-condition is related to operating costs. In our calculation, we accepted these costs as two dollars per barrel.

Thus, after determining all the main pre-conditions, we can start making predictions about revenues. However, we have to make one note here. There are several types of revenues expected from the ACG Contract.

Picture 2.4 shows directions of sharing the production.



Picture 2.4

Arrows here show financial flows. Their essence is as follows:

- 1 - Payments for services and goods;
- 2 - Payments for services and goods;
- 3 - The share of the contractor in profit oil;
- 4 - The share of the state in profit oil;
- 5 - Rent and transit costs;
- 6 - Taxes from the profit of the contractor and incomes of subcontractors;
- 7 - 22 per cent of the salary fund of the staff;
- 8 - Salaries of the staff;
- 9 - Income tax of the staff;
- 10 - The payments of the staff to the pension fund.

This scheme has been drawn on the basis of the terms of the ACG Contract.

The operating and investment costs recouped using Azerbaijani oil become a profit for other subjects. Among these subjects are companies and other organizations providing various services (banks, insurance companies, etc.) and companies that sell and rent their products. According to the terms of the contract, subcontractors pay a 5-per-cent tax to the budget from their incomes (i.e. from the price of the contract). This is what Direction 6 on the slide reflects.

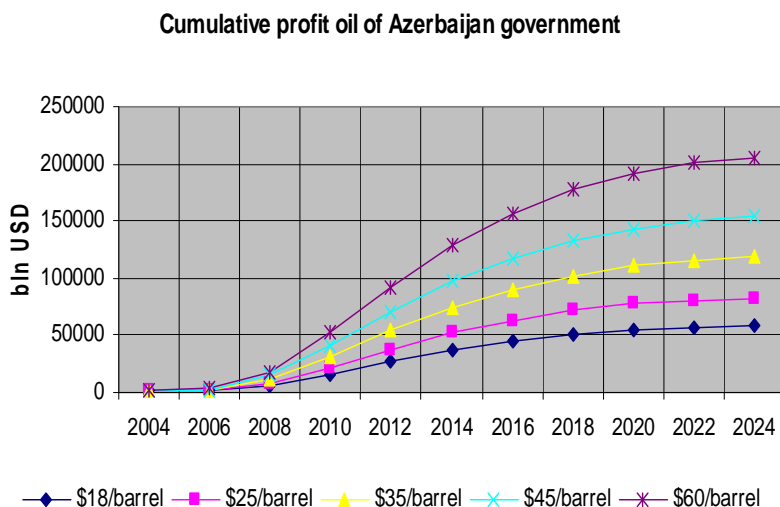
Payments that equal 22 per cent of the salary fund of people working in contractor and subcontractor companies are made to the SSSF, and this is shown in Direction 7 on the second slide. Those who work in these companies are getting salaries

(Direction 8) and pay income tax to the budget (Direction 9) and pension fees (Direction 10) to the SSSF.

This scheme does not show the bonuses and per acre profits received by the SOFAZ from oil contracts, because although they are company expenses, there is a different scheme for them (payments).

Analyses show that the biggest types of revenues are the shares of the state and SOCAR in profit oil and incomes of the state budget and the SSSF. Our predictions cover exactly these types of revenues.

Picture 2.5 shows predictions on the cumulative profit oil that will be due to Azerbaijan.

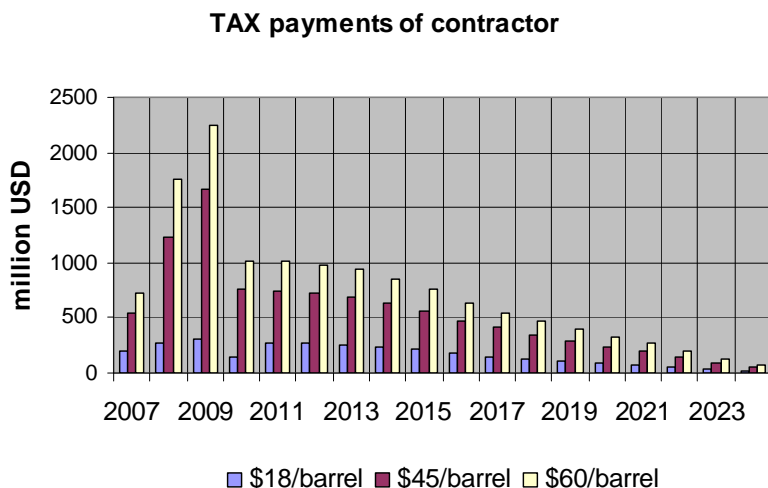


Picture 2.5

As we can see, by the end of 2024, i.e. by the time the contract expires, the volume of the cumulative profit oil that will be due to Azerbaijan can be between 50 bn and 210 bn US dollars depending on prices.

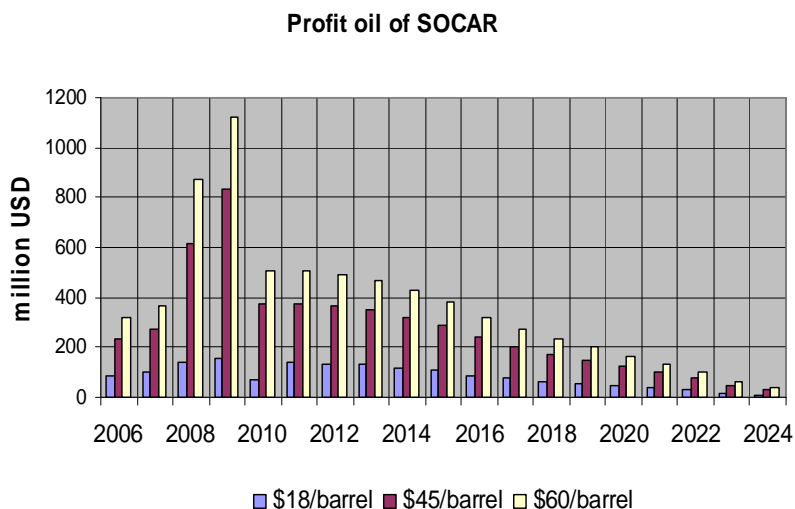
As we said above, the contractor pays taxes to the state budget from its profit oil. This is not the only type of income that the budget obtains in the sphere of oil contracts. Other types of incomes are taxes on the profits of subcontractors and the income taxes of employees working on relevant oil contracts. In ACG, taxes with a 25-per-cent tax rate from the contractor's taxed profit and a 5-per-cent tax rate from subcontractors' incomes are paid. Here, we will only look through predictions on the incomes of the state budget from taxes on the contractor's profit oil. I should point out that rules of calculating the contractor's taxed profit are shown in the contract, and according to these rules, some expenses should be deducted from the value of the profit oil. It is very difficult to predict these expenses. For this reason, we have accepted the expenses I mentioned at the level of 5 per cent in order to roughly assess budget incomes and have calculated the taxes with a 20-per-cent degree. Of course, this, as a precondition, causes certain mistakes, however, in the end we can have some idea about budget incomes. Thus, the prediction of budget incomes is shown in Picture 2.6.

As we can see, the state budget will also get high incomes. If the price of one barrel of oil is 60 US dollars at the Delivery Point, in the peak year of production from ACG the state budget can be 2.3 bn US dollars from taxes on the profit of the contractor alone.



Picture 2.6

SOCAR is one of the contractors in the ACG contract and has a 10-per-cent share. This means having a relevant share in the part of the profit oil that belongs to the contractor. However, when SOFAZ was set up, on the basis of an appropriate decision, the share of SOCAR in ACG was mentioned among the sources of forming SOFAZ assets. Thus, SOCAR was deprived of its share. However, according to the 7 February 2003 resolution of the country's president, SOCAR's right to own its share was reinstated. According to the presidential resolution issued on 16 May 2007, SOCAR assets accumulated in SOFAZ before 2003 (about 102.3 US dollars) were transferred from SOFAZ accounts to SOCAR accounts. Taking this into account, it is possible to calculate the incomes that SOCAR will get in the future. The results of these calculations are given in Picture 2.7.



Picture 2.7

The Azerbaijani SSSF also gets some incomes from the ACG project and if our legislation on this sphere does not change, it will continue getting incomes in the future. In order to predict these incomes, it is necessary to know the number of employees in the years to come and their salary fund. Our assumptions about this are not quite reliable. Despite that, we decided to make assumptions here as well. According to our predictions, the incomes of the aforesaid fund during the implementation of the contract might be about 20-30 million US dollars.

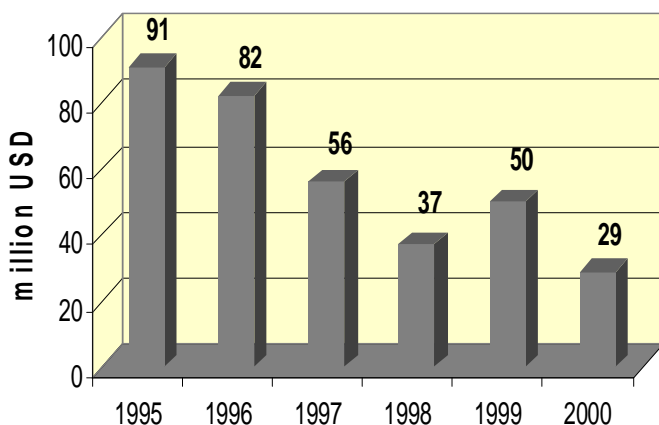
Thus, if the price of oil is 60 dollars per barrel at the Delivery Point in 2007-2024, the total income of the SOFAZ, the state budget, the SSSF, and SOCAR might be more than 230 bn US dollars in 2024. Of course, oil prices will not remain stable in these years and will change. However, the country's revenues are likely to be much higher, because the tendency of growing prices

and their approach to the 100 dollar level are quite realistic, according to experts. Taking into account the revenues expected from the contract on Shah Deniz, as well as the tendency of growing oil and gas prices, we can predict even higher revenues for the country.

In conclusion, I would like to stress once again that the calculations given in this chapter are demonstrative and cannot be regarded as being completely accurate. Along with that, we should point out that these approximate calculations show that Azerbaijan is most likely to get large revenues in the next two decades. Considering that the proved hydrocarbon reserves will significantly shrink in the same decades, which might turn Azerbaijan into an energy importer again, the spending of oil revenues with minimum losses and high effectiveness is a serious issue for the country.

3. GOVERNMENT EXPENDITURE

As indicated in Chapter 1, the first oil contract was signed in September 1994. However, before the contracts were signed, at the stage of negotiations, Azerbaijan received considerable bonuses in 1992 and 1993 which the government started using to cover its expenses. Afterwards, the signing of each new contract was accompanied by the payment of bonuses to the government. Picture 3.1 shows how oil bonuses were used to cover budget deficit between 1995 and 2000³⁷.



Picture 3.1

³⁷ Economic overview of Azerbaijan. Quarterly bulletin of TACIS. 2001, April-June

As we have already indicated, the oil fund was established in the last days of 1999. International financial institutions have played an important role in this as they recommended that the government sterilize oil revenues in order to reduce the risk of “Dutch disease”. The fund started functioning in 2001, when SOFAZ resources were allocated, following presidential decrees, to finance different projects (investment, social, etc.). They were also transferred into the state budget and spent on managing the fund (keeping a staff, paying for the services of foreign consultants, etc.). Table 3.1 below provides data³⁸ on SOFAZ expenditure between 2001 and 2006.

Over these years, financing of projects consisted of two entries: expenditure on improving the social plight of refugees and IDPs and on financing the share of the Azerbaijan state company in the BTC oil pipeline project, as well as financing of two water projects and the establishment of the State Investment Company. A total of 297,9 mln. AZN³⁹ million manats was spent on financing the pipeline over the three-year period.

2006 also saw non-budgetary expenses to the tune of 17,575 AZN (on the re-assessment of SOFAZ’s currency assets and taxes).

Table 3.2 contains data allowing a comparison to be made between the expenditure of oil money and of the state budget.

³⁸ Annual reports of SOFAZ, www.oilfund.az

³⁹ <http://www.oilfund.az/index.php?n=23>.

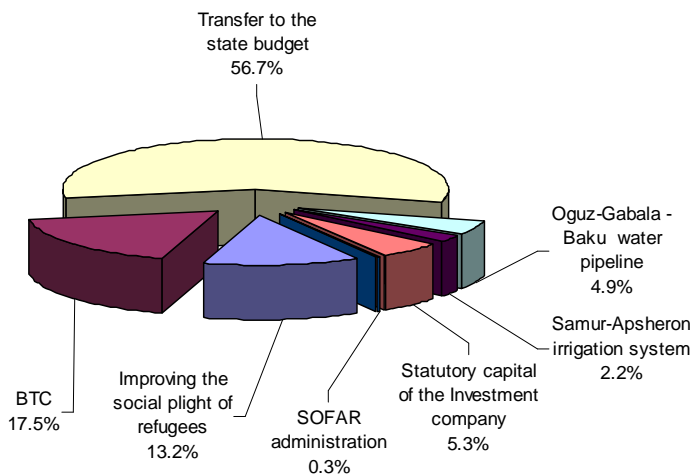
Table 3.1

Structure of SOFAZ expenditure	2001, million AZM	2002, million AZM	2003, million AZM	2004, million AZM	2005, million AZM	2006, thousand AZN/ million AZM	Total, million AZM/ thousand AZN
Improving the social plight of refugees	3583.3	188839.0	99812.9	74952.3	201948.2	110031.5/ 550157.5	1119293.2/ 223858.64
BTC project	-	242298.7	576000.0	89000.0	205000	75409/ 377045.0	1489343.7/ 297868.74
Transfer to the state budget	-	-	500000.0	650000	750000	585000/ 2925000.0	4825000.0/ 965000
Oguz-Gabala-Baku water pipeline	-	-	-	-	-	82748.7/ 413743.5	413743.5/ 82748.7
Samur-Apscheron irrigation system	-	-	-	-	-	37000.0/ 185000.0	185000/ 37000
Formation of the statutory capital of the Investment company	-	-	-	-	-	90000/ 450000.0	450000.0/ 90000
SOFAZ administration costs	476.6	3034.0	4307.3	3555.6	7838.3	1186.6/ 5933.0	25144.8/ 5028.96
TOTAL:	4059.9	434171.7	1180120.2	817507.9	1164786.5	981375.9/ 4906879.0	8507525.2/ 1701505.04

Table 3.2

Year	SOFAZ expenditure ⁴⁰ , Million manats	State budget ⁴¹ , Million manats	The share of the transfer from SOFAZ in the state budget, %
2001	0,8	806.6	0
2002	86,8	931.7	0
2003	236,0	1 234.0	8.1
2004	163,5	1 501.0	8.6
2005	232,9	2 140.7	7.0
2006	981.3	3 789.7	15.4

Picture 3.2 shows the structure of the spending of SOFAZ assets in 2001-2006.

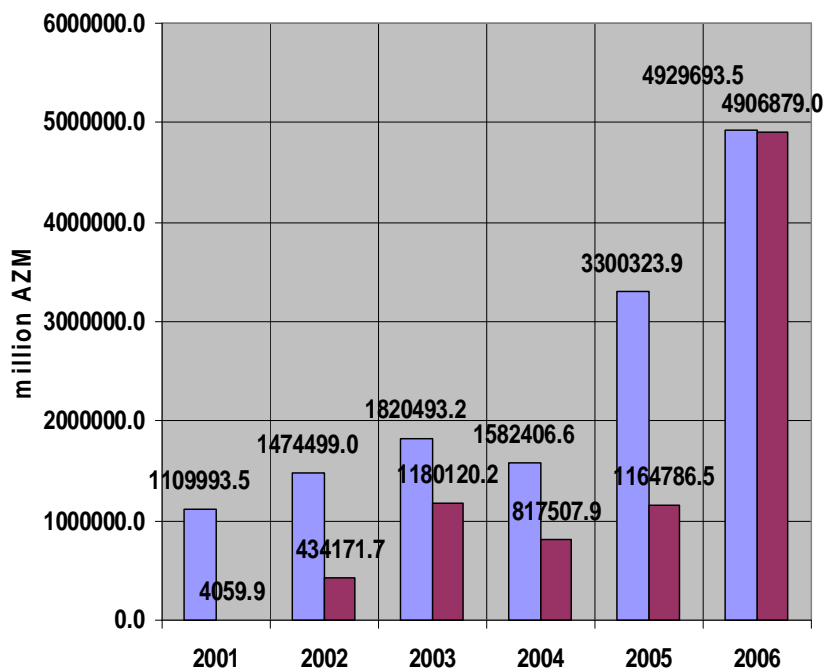


Picture 3.2.

⁴⁰ SOFAZ annual reports, www.oilfund.az

⁴¹ http://www.azstat.org/publications/azfigures/2007/az/020.shtml#t20_1

Picture 3.3 shows a comparison of annual SOFAZ revenues and expenses for the same years.



Picture 3.3.

The following SOFAZ expenditure is planned for 2007⁴²:

⁴² www.oilfund.az

Table 3.3

N	Expenditure direction	Volume of expenditure, thousand manats
1.	Financing social needs of refugees and IDPs	124 161,0
2.	Transfers into the state budget	585 000,0
3.	Construction of a water pipeline from Oguz-Gabala region to Baku	183 620,0
4.	Reconstruction of the Samur-Absheron canal	76 900,0
5.	Management of SOFAZ	7 385,9
	Total	977 066,9

Transfers from SOFAZ into the state budget and the money allocated for refugees and IDPs pass through different state bodies where there is a risk of partial and ineffective expenditure, which may take place, among other things, due to loopholes in legislative acts mentioned in Chapter 5.

Is there a reason to fear that some of the oil money might be lost (misappropriated by officials or used irrationally) as it is spent on various government projects and programs? Although there has not any court hearings on any cases of corruption or misappropriation of oil money, the existing risks that are examined in the next chapter allow us to suppose that there will be losses.

4. RISK FACTORS ASSOCIATED WITH INEFFECTIVE MANAGEMENT OF RESOURCES

This chapter describes the main risk factors from the ineffective management of oil revenues:

- government is inexperienced in managing major revenues;
- laws are imperfect;
- the judiciary is dependent on the executive branch;
- legislature is dependent on the executive branch;
- there are no effective tools to fight corruption;
- democratic institutions are too weak;
- civil society is too weak;
- independent media are too weak;
- SOCAR's conflict of interests in PSAs;
- others.

These factors were revealed by means of analyzing existing legal acts and decisions made by the government, conversations with local and foreign experts and government officials and learning the experience of other countries.

4.1. The government's lack of experience

The government's lack of experience in governing major revenues is explained by the fact that everything was decided by Moscow in Soviet times. The local government could not dispose of the oil and other products on its own. For instance, it had no right to sell the national resources in foreign markets, had no right to form its own hard currency reserves and, consequently, did not need to govern these reserves. All this was taken care of by the central (Moscow) government. On the other hand, the closeness of the Soviet economy, its isolation from global economic processes, stock and commodity exchanges did nothing to foster local specialists in transactions involving securities, financial analysis of investment processes, etc. Today, Azerbaijan is trying to solve these problems by training its own specialists and attracting foreign managers to manage the assets of the State Oil Fund and hard currency reserves of the National Bank.

According to annual SOFAZ⁴³ reports for 2001-2005, the fund was attaching special importance to the development of human resources. Starting from 2001, the fund employees were attending special workshops on managing investment portfolios organized by a number of German and French banks. In 2002, the fund employees received special trainings on international accounting standards organized by auditing companies Ernst&Young, PriceWaterhouseCoopers and Deloitte & Touche. In the same year, SOFAZ introduced a computerized system of accounting. The fund's employees had the opportunity to improve their qualifications through online paid educational

⁴³ http://www.oilfund.az/index_en.php?n=19

programs on issues of financial and dealing transactions. Trainings for the fund employees were continued in subsequent years. The trainings were organized with the assistance of a number of investment banks with which the fund is cooperating, as well as international financial institutions.

In 2004 the US Trade and Development Agency (TDA) allocated SOFAZ a grant for institutional development in the amount of \$1,091,000⁴⁴. The grant was utilized for developing strategic asset allocation options for the Fund, enhancements of asset management and risk management practices and external manager selection guidelines, selection and implementation of portfolio management software and support in investment specific legal areas. The assistance was also directed towards enhancing the organizational structure of the Fund, strengthening internal controls and cross-reporting between the Fund's departments, as well as improving and developing human capital of the Fund. In the same year, TDA held a tender to select a consulting company for SOFAZ. The winning bidder was Overture Managed Solutions (OMS). The New-York based OMS is specialized in providing "turn-key", state-of-the-art investment management platforms for financial institutions. OMS also provides advisory services to fund management firms, pension funds and other institutional funds regarding application of such systems. The parent company of Overture Managed Solutions (OMS), Overture Financial Services signed an agreement with the Oil Fund for implementation of the Institutional Capacity Building project on January 18, 2005. Completion of the project is scheduled within 2005.

⁴⁴ Annual Report, 2004. State Oil Fund of the Azerbaijan Republic
http://www.oilfund.az/index_en.php?n=19

In 2005 the Oil Fund also established ties with various financial institutions. The Oil Fund conducted a tender, in order to select a financial and banking institution to provide the Oil Fund with depository services. The primary objective of the tender was to select a financial institution capable of providing international custodial services to SOFAZ. The Bank of New York was selected as a result of competitive bidding⁴⁵.

4.2. Imperfect laws

The laws of the country, which gained independence 14 years ago, has practically been formed anew. This process was complicated also because the country changed its development course from a socialist and centrally managed Soviet system to a market liberal-democratic one. Another difficulty was posed by the fact that in parallel with that, a whole school of lawyers and law-makers was being formed in the country. In the Soviet times, laws were written in Moscow and of course it was not an easy task to create, over a short period of time, a system of perfect laws based on a completely different attitude towards private property and other relations between economic players. Such a situation was characteristic of all post-Soviet republics. Ambiguous and unclear definitions of certain provisions of laws precondition their arbitrary interpretation on the part of government officials and eventually lay the foundation for bribery. Quite often laws do not meet the requirements of

⁴⁵ Annual Report, 2004. State Oil Fund of the Azerbaijan Republic
http://www.oilfund.az/index_en.php?n=19

international organizations in terms of transparency, accountability and other good governance criteria.

In next chapter we looked at a number of drawbacks in the existing laws:

- on public service;
- on state procurement;
- on the Chamber of Accounts;
- on access to information;
- on fight corruption;
- on declaration of incomes for public officers.

4.3. Dependence of the judiciary on the executive branch.

So far, Azerbaijani laws and governance traditions do not ensure the independence of the judiciary. Under article 99 of the Azerbaijani Constitution, the executive power in the Azerbaijani Republic belongs to the president. On the other hand, under article 109 of the Constitution, judges of the Constitutional Court, Supreme Court and Appeal Courts are appointed by the parliament on a presidential motion. Judges of all other courts are appointed by the president who also appoints the country's prosecutor-general with the consent of parliament. In other words, the legislative realities are such that judges effectively operate under direct control of the presidential administration. The main criterion in appointing judges is their loyalty to the presidential authority.

4.4. Dependence of the legislative branch on the executive one

In the period of Azerbaijan's independent, i.e. over the past 15 years, three parliamentary elections have been held: in 1995, in 2000 and 2005. All these elections were marred by major irregularities and described by international organizations as being not free and undemocratic. Many politicians and political analysts are convinced that the executive branch was conducting these elections after having initially prepared the lists of future members of parliament. The opposition managed to get about 5 per cent of seats in the parliament. The process of voting was accompanied by numerous irregularities, as a result of which the country ended up with a parliament obeying to the executive branch. For all these years, the parliament was easily adopting laws the drafts of which had earlier been prepared either by the presidential administration or different cabinet ministries. Very rarely were drafts of new laws initiated by the parliament proper.

4.5. Weak mechanisms for fighting corruption

Azerbaijan cannot boast of good governance indicators today. In fact, in 2005 Transparency International ranked Azerbaijan 137th-143th (together with Cameroon, Ethiopia, Indonesia, Iraq, Liberia and Uzbekistan) out of 159 countries of the world for corruption perception index, which is one of the good governance indicators. A high level of corruption in the country is confirmed by a sociological survey recently (May

2004) commissioned by Transparency Azerbaijan among 1,000 respondents⁴⁶. According to the survey, more than 86.9 per cent of those polled see the level of corruption in the country as quite high (52.2 per cent) or very high (34.7 per cent).

Over the past two years, the government has taken a number of measures to lower corruption in the country:

- law on fighting corruption has been adopted;
- the state program to fight corruption has been adopted;
- the law on declaration of incomes for public workers has been adopted;
- the state commission to fight corruption has been set up;
- a department to fight corruption has been established within the Prosecutor-General's Office;
- other measures have been taken.

The number of punishment for corruption-related crime has increased. However, the fight against corruption has not become a priority state policy yet.

The World Bank report⁴⁷ "Governance Matters, 2007" dated 10 July 2007 presents assessments of management quality on Azerbaijan as well (all in all, this document presents an assessment on 212 countries and territories). The quality of state management is assessed on the basis of the following six indicators in this report:

⁴⁶ <http://www.alac-az.org/transpfiles/25.pdf>

⁴⁷ www.govindicators.org

- 1) Voice and Accountability;
- 2) Political Stability and Absence of Violence;
- 3) Government Effectiveness;
- 4) Regulatory Quality;
- 5) Rule of Law;
- 6) Control of Corruption.

The assessment of these indicators in Azerbaijan is given in Table 4.1:

Table 4.1.

Dimensions of governance	% (0-100)							
	1996	1998	2000	2002	2003	2004	2005	2006
Voice and Accountability	16.7	19.2	19.2	25.5	23.1	23.1	17.8	14.9
Political Stability and Absence of Violence	24.5	24.5	18.8	15.4	11.1	10.1	12.0	15.9
Government Effectiveness	16.6	17.5	19.4	19.4	22.3	18.5	30.8	27.5
Regulatory Quality	15.6	19.0	22.4	23.9	28.3	30.2	32.2	34.1
Rule of Law	17.6	14.8	14.8	21.9	24.3	22.4	23.8	22.4
Control of Corruption	13.1	9.7	7.3	11.2	12.1	9.2	16.0	15.0

As we can see from Table 4.1, Azerbaijan still has to do a lot to increase the quality of management.

4.6. Weak democratic institutions

Democratic traditions in Azerbaijan date back to 1918, when, after a revolution in Russia, the Azerbaijani Democratic

Republic was formed. It existed for only two years. Then Soviet Russia annexed Azerbaijan again and established Bolshevik dictatorship here. The new era of democratic transformation started after Azerbaijan gained independence in 1991. The first election, which was quite close to democratic standards, was held in June 1992 when Abulfaz Elchibay was elected as president of the Azerbaijani Republic. The fact that the election broke the Soviet tradition of supervised voting and falsified vote count is confirmed at least by the information that the president received about 59 per cent of the votes, while the runner-up got about 35 per cent. All subsequent elections in the country were marred with major irregularities which were registered by international organizations. The CoE Secretary General Terry Davis said while commenting on the 2005 parliamentary election in Azerbaijan: "All elections held in Azerbaijan after restoration of the independence were criticized by the international community. Unfortunately, the 2003 presidential and the 2005 local government elections followed suit. Therefore, the forthcoming parliamentary election should be better than the previous ones."⁴⁸

The country's parliament, elections to which were held in 1995, 2000 and 2005, was actually formed, not elected. The process was managed by the presidential administration. The presidential election held in 1993 (early election), 1998 and 2003 were marred with certain irregularities which were reflected in the reports of international organizations. At the same time, it has to be acknowledged that Heydar Aliyev really had the highest popularity rating in the country which was also confirmed by numerous sociological surveys. Thus, there was no

⁴⁸ The information bulletin of Information Agency "TURAN", 06.09.05

need to overstate the number of citizens who voted for him. But the old Soviet mentality and traditions took over.

There are more than 50 political parties in the country, but the vast majority of them are midget parties.

The conditions of political struggle in the country are too far away from being described as democratic.

4.7. Weak civil society organizations

There are about 2,000 nongovernmental organizations in Azerbaijan. Most of them are not registered. Until several years ago, registration of NGOs was extremely complicated. The situation has slightly improved over the past two years.

The existing NGOs operate in different spheres: human rights, ecology, legal awareness, social support, etc. The weakness of civil organizations is mainly explained by the fact that they are very still very young and their financial status is not stable.

As part of the research, the author conducted a focus group involving renowned leaders⁴⁹ of public associations. The first question members of the focus group had to answer was the

⁴⁹ Ahmed Hashimoglu – president of “Progress and Democracy” organisation, Arastun Orujev – representative of the Fridrich Nauman Foundation in Azerbaijan, Avaz Hasanov - president of the Society of Humanitarian Research, Chingiz Mammadov – representative of “Counterpart” organisation, Eldar Namazov – president of the Public Forum In the name of Azerbaijan, Mais Gulaliyev – president of the Center for Citizens’ Initiatives, Sahib Mammadov - chairman of the League of Protection of Labor Rights, Vahid Gaziyeu – president of “INAM” Pluralism Center

question whether there was a need for strengthening civil society and if so, what were the reasons for its weakness. According to focus group members, the weakness of civil society organizations is mainly explained by the following:

- lack of experience in public activity;
- poor financial support of civil society organization; absence of local donors and limited nature of foreign donor resources;
- difficulties in registration of public associations;
- absence of state support for civil society development.

The other three questions asked of members of the focus group concerned the importance and role of the NGO Coalition and the model of its development. All members confirmed the importance of the Coalition. They indicated that in the conditions of weak civil society organizations their unity in coalitions will not only mean collective effort of different organizations. This will also make their efforts more effective.

4.8. Weakness of the independent media

There are independent print media in the country represented by a handful of newspapers. There are many more newspapers expressing the opinion of the authorities or the opposition. The daily print-run of independent newspapers is negligible and accounts for about 0.5 per cent of the capital city with the population of 3m people. The print-run of the opposition press is slightly bigger – about 2 per cent of the

population of Baku. Such low print-run figures are explained by the poor purchasing power of the population. Therefore, the main source of information for the country's population is the six television channels, two of which are state-owned, three are owned by people close to the authorities and one other private channel is owned by people who are less affiliated to the government but are prone to their influence nonetheless. The channel expresses the opinion of the government much more frequently than that of the opposition in politically active periods.

According to article 57 of the Constitution, Azerbaijani citizens have the right to criticize the work and activities of state bodies and their officials, political parties, trade unions, other public organizations, and individual citizens. At the same time, according to the same article, insult and slander cannot be considered as criticism. Legal norms providing for an explanation of insult and slander are contained in articles 148 and 147 respectively. But these norms do not meet international requirements and the adoption of a new law on defamation is on the agenda.

Censorship in the country is legally banned. According to article 6 of the Law on freedom of information adopted by the Azerbaijani parliament on June 19, 1998, state censorship in the media is unacceptable. The unacceptability of censorship in the media is confirmed by article 7 of the Law on the mass media. In practice, however, the presidential administration enforces unofficial censorship on pro-government and independent media. The presidential administration is monitoring all mass media and if there are publications which they think are undesirable, they express their regret about such articles, reports, interviews and so on to the heads of the relevant media

(independent and pro-government) and recommend that they avoid publishing such materials in the media. The heads of the media who get such recommendations often censor their own media.

Opposition newspapers criticize the government systematically. Independent newspapers do that quite often too. However, no matter what scathing articles they may publish, this does not perturb the authorities too much. There is practically no reaction to critical articles, and this significantly weakens the role of the media in the fight against corruption.

Opposition and independent newspapers publish articles about corruption quite often. But in many cases these articles are not a product of an in-depth journalistic investigation. Besides that, their coverage of the electorate is very insignificant. Television channels broadcast programs about corruption very rarely and even those few that are televised are very selective.

There are extremely many cases when journalists were punished on charges of slander.

On the whole, the situation surrounding freedom of the press in the country leaves something to be desired. According to a study by the international organization "Reporters without Borders" in 2006 Azerbaijan took 135th place among 168 countries. Among the former Soviet republics, Estonia (6th place), Latvia (10th place), Lithuania (27th place), Moldova (85th place), Georgia (89th place), Armenia (101st place), Ukraine (105th place), Tajikistan (117th place), Kyrgyzstan (123rd place) and Kazakhstan (128th place) hold a higher position than Azerbaijan in the rating table. Russia (147th place), Belarus (151st place) and Turkmenistan (167th place) hold a lower position in the rating table.

Within the framework of the present research, the author conducted a focus group to find out the opinions of leaders of some media outlets and political analysts⁵⁰ regarding the possibility of using the media for supporting the activity of the NGO Coalition. Members of the focus group were asked the following questions:

- Is it possible for the media to join NGO coalitions? Is it realistic to expect media to support the activity of NGO coalitions? How can the media be involved in advocacy activities of coalitions?
- Can the media anticipate any problems for supporting certain campaigns of NGO coalitions if such campaigns cause annoyance of the authorities?
- Can the establishment of coalitions of public associations be an effective tool for promoting public interests?

Here are the generalized results of opinions expressed by participants:

- there is no need for the media to take part in coalitions of public associations. But in some case mass media can be members of coalitions. Civil responsibility must overlap with professional interests. Mass media can take part in coalitions by delegating their editors or journalists. By and large, mass media must be independent. Mass media can be interested in supporting coalition initiatives if different events

⁵⁰ Arif Aliyev – Chairman of “New Generation” Journalist Union and Chief Editor of “Gun” newspaper, Hikmet Hadjizade - political scientist, former Chief Editor of “Svoboda” newspaper, Mehman Aliyev – director of “Turan” Information Agency, Rasim Musabekov - political scientist, Rashid Hajili – director of Media Right Institute

initiated by the coalition are innovative and actual. It is also important for the coalition to attract a representative of the government and other stakeholders to its activities. A more active and well thought-out participation of the media can be ensured in the even of prior training for journalists. Work with the media must be planned by the coalition;

- the fall in the advertising revenues of such media (the advertising market in Azerbaijan is under the control of the executive authorities), indirect pressure on them, denial of access to government information and accreditation, and revocation of their licenses (if it is a TV channel);
- establishment of coalitions of public associations is certainly an effective way of promoting public interests. It is very important to use the capacity of the mass media to the maximum extent possible.

4.9. SOCAR's conflict of interests in PSAs

SOCAR has its own share (See Table 1) in all contracts and thus, is one of the contactors. At the same time, SOCAR represents the government in these contracts. As a contractor, SOCAR is interested in increasing the revenues of the subcontractor in the contract. But as a result, this might reduce the revenues of the government. This situation has come about because of the lack of a law on oil on the one hand, and on the other, because there was no Ministry of Energy (which was

subsequently reorganized into the Ministry of Industry and Energy – MIE) until 2001 and SOCAR was in charge of negotiations with foreign oil companies.

Over the last one or two years, the role of the MIE in negotiations with foreign investors in the oil and gas sector has been increasing. However, this does not have an absolute nature yet. In order to fully eliminate the conflict of interests, it is necessary to make changes to the contracts that have been signed and hand over the function of representing the government from SOCAR to the MIE. The government still hesitates to correct the contracts, although we can hardly doubt that these changes will not cause protests from foreign companies involved in PSAs.

Conclusion

The factors described above might cause a loss of some of oil revenues. Both the government and the civil society have to make efforts to weaken the impact of these factors.

5. IS THERE ROOM FOR IMPROVING LAWS?

Regardless of who is the source of revenues – the national company or foreign companies, the management of these revenues is regulated by a single system of legal norms.

Below we examine a number of legal norms that SOFAZ and other government agencies in charge of oil revenues are using. The main attention will be paid to requirements for transparency and accountability in them.

There is no special law on the management of oil and gas revenues. But there is a number of laws that regulate general issues of managing revenues. Oil and gas revenues are a private case in this management. Also, there are legal acts regulating the activities of public officials and the operation of the State Oil Fund. All these legal acts are interesting from the standpoint of analyzing their conformity with good governance requirements in general and good governance of oil and gas revenues in particular. Therefore, this section will analyze a number of the most important legal acts and provisions which may precondition the risk of ineffective governance of hydrocarbon revenues. This group includes the following laws and legal acts:

- public service;
- activity of SOFAZ;
- state budget expenditure;

expenditure of out-of-budget funds.

In this section, we will also look at a group of laws regulating the activities of the bodies capable of lowering the risk of ineffective management of revenues. These include laws:

- Regulating the activities of civic organizations;
- Ensuring free access to information.

5.1. Legal norms regulating public service

This paragraph analyzes a number of key laws pertaining to the activities of state agencies and public workers. The analysis is intended to reveal the provisions affecting the quality of governance of state revenues. The following legal acts will be analyzed:

- Law on public service;
- Law on state procurement;
- Law on the Chamber of Accounts;
- Law on fighting corruption;
- Legal norms defining punishment for corruption;
- Rules of financial accountability for public workers.

The analysis of the aforementioned laws was carried out using the methodology of Professor Allan Doig⁵¹.

⁵¹ Alan Doig and Stephanie McIvor. The National Integrity System. National Integrity systems Country Studies Terms of Reference. Commonwealth countries project

Law on public service. It was adopted by parliament on December 29, 2000. Subsequently, on February 13, 2001, on July 2, 2002 and on December 3, 2002, the parliament adopted a number of amendments to the law.

This law regulates many important issues related to public service. The law:

- Gives a definition of public service and government agencies;
- Establishes the main tasks of public service (ensuring citizens' rights and freedoms in accordance with the country's constitution and laws is described as the first duty here) and principles of public service;
- Gives a classification of state bodies, as well as administrative and auxiliary posts;
- Establishes professional requirements to administrative and auxiliary posts;
- Gives the text of a public servant's oath;
- Regulates the main duties and rights of a public servant;
- Establishes the main restrictions related to public service (for example, those related to additional revenues);
- Establishes the procedure of employment for public service and career growth;
- Establishes the procedure of appraising public servants;
- Regulates conditions for relieving people from their posts;

-
- Other provisions.

Who is affected by the law? According to article 2, the law affects public officials working in executive bodies as well as those on staff in legislative and judicial bodies.

According to article 4, the law does not affect the country's president, MPs, the prime minister, the ombudsman, heads of central executive bodies and their deputies, the chairman and members of the Central Electoral Commission, the chairman and employees of the Chamber of Accounts, heads of local executive authorities, servicemen and the administration of the Naxcivan Autonomous Republic, which is part of Azerbaijan. The existence of this list causes a lot of suspicion because all these people are in state service and their activities must undoubtedly be affected by the law on public service.

Political independence of a public officer. Article 4 provides a number of public service principles pertaining to issues of political independence:

- *provision 4.1.9.* Equality of rights of public officers regardless of race, nationality, language, sex, social, family, proprietary status and position, area of residence, religious affiliation, conviction, membership in public organizations and other factors not associated with professional qualities;
- *provision 4.2.* Subdivisions of political parties and public associations cannot be established in state bodies;
- *provision 4.3.* While performing their duties, public officers are governed by the Constitution of the Azerbaijan Republic, laws and other legislative acts.

They are not affected by the decisions of political parties and public associations.

Therefore, a public officer can be a member of a political party because the above-mentioned principles and other legal norms do not prohibit that. In reality, many public officers (from a minister to a rank-and-file clerk) are members of the ruling party or parties close to it. Interestingly enough, equality of rights guaranteed by provision 4.1.9 does not concern the factor of political affiliation, and this is rather widespread.

Under provision 4.2, subdivisions of political parties must not be established in state bodies. However, many state bodies use the principle of solidarity and shared interest of ruling party members. Cases when medium and even high level managers coerce their subordinates to join the ruling party are quite frequent.

At the same time, research (surveys, media content analyzes) show that provision 4.3 of the law is being fulfilled, i.e. political parties do not adopt official decisions aiming to affect a certain state body. But corporate interests of the ruling party can be promoted by its members working in state bodies.

Article 20 prohibits public officers to engage in political activity (20.1.6). However, this provision is flagrantly breached by representatives of the ruling party holding senior positions in the government.

Recruitment and career growth: Article 4 provides a number of principles for recruitment for public service:

- transparency of recruitment procedures;
- recruitment for public service through a competition;

-
- equality of applicants' right to take any position in line with their skills, achievements and professional aptitude.

Article 28 of the law establishes the order of recruitment for public service. It says that recruitment for public service is based on a competition or interview. It is curious that the initial version of the law indicated only competition. The recruitment possibility was introduced as an amendment on 3 December 2002. Article 28 says that a competition is held for administrative positions of the 6th to 9th categories. These are the lowest level position. Recruitment for positions of the 1st to 5th categories is conducted through an interview (Article 29). Articles 28 and 29 describe several principles of conducting a competition (in two stages: test and interview. A more detailed description of the competition is provided in the rules⁵²), but nothing is mentioned about how the interview is conducted. However, in the competition too the final word is said by the manager. Several successful candidates are introduced to him/her, and he/she chooses one of them.

The law says nothing about how the principle of transparency is observed in the process of recruitment for public service.

The law allows a public officer the opportunity to take a higher position. However, a public officer can mainly be promoted on recommendation of his manager.

Nepotism. According to article 27, it is forbidden to hire family members as a subordinate in public service. The article lists types of relationships regarded as being intimate: spouses, their parents, sisters, brothers and children. However, in

⁵² <http://www.csc.gov.az/?por=1&kr=65&id=144>

Azerbaijani mentality, relatives go far beyond this circle. Therefore, a minister or a department manager is likely to help, say, their nephew find a public service job and promote his career. In this case, law will not be breached, but nepotism will be obvious.

Is it possible to accept gifts? The law does not regulate ethical issues pertaining to a public officer's conduct. There are no norms pertaining to the acceptance of gifts. There is only a brief statement in Article 18 which says: "a public officer must observe norms of business ethics". However, another law, namely "On fighting corruption", does dwell upon gifts. We will touch upon those issues below, when considering the said law. It is also worth indicating that draft laws "On conflict of interests" and "On the code of ethics for public officers".

What is more important: obedience to law or manager? An analysis of the provisions of the law shows that one of the main principles on which the law is based is the principle of a public servant's unconditional subordination to his superior. For example, Article 18 (the main duties of a public servant), i.e. its first two points (18.0.1 and 18.0.2) note the importance of abiding by the law and following the superior. But at the same time, there are two more provisions that actually consolidate and increase a subordinate's dependence on his superior. Point 18.0.6 says that if necessary, a public servant must do extra work on an instruction from his superior. Point 18.0.9 says that a public servant must provide the head of the government agency with information about his incomes and property situation every year. On the other hand, Article 19 related to the rights of a public servant does not specify that a public servant has the right to complain about his superior to a higher instance. Thus, as we can

see, Article 18 and 19 in fact put a public servant in a situation when in his work he has to follow his superior, not the law.

Can a public officer appeal against a manager's decision? There are no norms in the law which would regulate the order of appeal. However, since there is no direct prohibition on that, a public officer can, if he wants to, appeal against the decision with a more senior body or court. If a public officer has doubts over legitimacy of the manager's decision, according to provision 19.0.11 he can ask the manager to issue the instruction in writing.

Control over execution of the law. According to article 5, control over the application of the Law on public service, the statutory and methodological definition of public service, and the determination of the list of people attributed to the category of public workers is exercised by the public service council of the Azerbaijani Republic. The council includes 18 members. Six members of the council are appointed by the Azerbaijani president, six by the chairman of the Milli Majlis of the Azerbaijani Republic and six by the chairman of the Constitutional Court of the Azerbaijani Republic. The authority of the Council is established by the above-mentioned Regulations. The Council is not a state body and its members, independent in their activity, work on pro-bono basis. The activity of the council and the organization of its work are supervised by the chairman of the council. The chairman is elected from amongst its members by an ordinary majority of votes. At present, its chairman is the head of the Azerbaijani presidential staff.

Certain conclusions on the law. The law is pretty good from the standpoint of barring "accidental" people, may be even educated and talented, from public service. In other words, if the current management does not want to see someone in public

service, it can easily achieve that by using certain provisions of the law. As a result, state bodies tend to be increasingly made up of “related” people. These include relatives, people from the same area, friends, neighbors, etc. In other words, these people are known very well to the management of a state body (or higher) and are reliable. Therefore, the main and the most claimed requirement of a public officer under current circumstances is reliability. Of course, it would also be good if he was educated and experienced, but this is less important.

Thus, the main condition for retaining the status of a public worker is implicit obedience to the supervisor, not a conscientious performance of professional duties in line with the law. In other words, law becomes a factor of secondary importance in comparison with the factor of obedience to the boss. Those hired for service consider themselves to be the protégés of a particular boss, not of the state.

If a boss at a certain stage in the hierarchy is corrupt, all his subordinates are most likely to commit corrupt acts and will hardly fight against their corrupt boss. According to the results of a number of surveys conducted by international institutions, corruption in Azerbaijan’s decision-making circles is quite high.

Another peculiarity of public service in Azerbaijan is the fact that there is little rotation of senior officials.

According to a sociological survey commissioned by Transparency Azerbaijan⁵³, people have faced corruption when retiring and having their pensions calculated:

- Very often - 20,8 per cent of those polled;
- Quite often – 29,1 per cent of those polled;

⁵³ <http://www.transparency-az.org/files/25.pdf>

-
- Occasionally – 26,3 per cent of those polled;
 - Rarely – 14,0 % per cent of those polled;
 - Have not encountered corruption – 7,0 per cent of those polled.

According to the survey, people have faced corruption when acquiring a plot of land:

- Very often - 22,1 per cent of those polled;
- Quite often – 28,9 per cent of those polled;
- Occasionally – 19,2 per cent of those polled;
- Rarely – 14,2 per cent of those polled;
- Have not encountered corruption – 6,3 per cent of those polled.

Thus, the law on public service largely depends on the personality factor. It is necessary to reconsider a number of provisions in the law and the legal acts pertaining to the formation and operation of the public service council. For example, if all six representatives of the parliament or most of them in the council on the management of public service were from opposition parties, this would definitely help increase officials' subordination to the law, not to their superiors. To this end, it is necessary to make a relevant amendment to Article 5 of the law on public service. Moreover, it is necessary to make relevant amendments to Articles 18 and 19 of the law in order to eliminate the problems indicated above.

But first of all, it is necessary to provide for the independence of the legislative and judicial branches of the executive one.

The law on State Procurement . It was adopted by parliament on January 29, 2002. Subsequently (on November 22, 2002 and October 21, 2005), a number of amendments to it were also adopted.

Along with this law, the procedure of state procurement is also regulated by the following important documents:

- Presidential decree No 668 of 29 January 2002 “On the application of the law on state procurement”;
- Presidential decree No 855 of 20 February 2003 “On the approval of the statute on the State Agency for State Procurement”;
- The statute on the State Agency for State Procurement;
- The decision of the country’s government No 124 of 2 August 2002 “On the approval of the sample of the final protocol of the tender commission of the results of a tender”;
- The decision of the country’s government No 165 of 28 October 2002 “On the approval of rules of using and the volume of concessions, as well as the method of calculating the influence of price changes on goods (work and services) and on the purchase agreement”;
- The decision of the country’s government No 34 of 28 February 2003 “On the approval of the sample of the agreement on the purchase of goods (work and services)”.

According to the well-known methods⁵⁴, the compliance of the state system of state procurement with good management

⁵⁴ Alan Doig and Stephanie McIvor. National Integrity systems. Country Studies Terms of Reference

criteria can be estimated on the basis of analyzing the following main issues:

- Do rules for public procurement require competitive bidding for all major procurements with limited exceptions?
- Are the rules laid down in documents publicly accessible?
- Are there strict formal requirements that limit the extent of sole sourcing?
- Are all major public procurements widely advertised to the private sector?
- Are procurement decisions made public?
- Is there a procedure to request review of procurement decisions?
- Can an unfavorable decision be reviewed in a court of law?
- Are there provisions for blacklisting of companies proved to have bribed in a procurement process?
- Are there rules and procedures to prevent nepotism/conflict of interest in public procurement?
- Are assets, incomes and life styles of public procurement officers monitored?

The analysis of existing legal documents (including the law on state procurement) was carried out by the author of this research taking account of the aforesaid issues. But before that, we would like to point out that the law is too detailed. This is proved by the volume of the law which consists of 10,925 words. The amount of details seems to be too high for such a legal act as

the law. In our view, many details could be removed from the law and included in subordinate legislation. Now let's talk about the compliance of existing legal documents with good management requirements.

Do rules for public procurement require competitive bidding for all major procurements with limited exception? Yes, according to the law and Presidential decree No 688 of 29 January 2002 "On the application of the law on state procurement", all procurements that cost more than 250m in non-redenominated⁵⁵ manats (about 55,000 dollars) should be carried out on the basis of an open tender. According to article 16 of the law, state purchases of goods and services in the Azerbaijani Republic, depending on the conditions stipulated by the law, are implemented by an open tender, a two-stage tender, a tender with a limited number of participants, invitation of bids, invitation of quotations from one source.

Are the rules laid down in documents publicly accessible? Yes, all the existing legal documents are accessible to citizens. They are all published in the government press and moreover, they have been posted on the government's website⁵⁶.

Are there strict formal requirements that limit the extent of sole sourcing? There are no such provisions in legal acts.

Are all major public procurements widely advertised to the private sector? According to Article 22 of the law, an organization that carried out procurements publishes an announcement about the holding of a tender. According to Article 25, while holding an open tender, the announcement on

⁵⁵ Starting from 1 January 2006, the Azerbaijan national currency unit, the Manat, was denominated to the following proportion: 1 new manat = 5000 old manats.

⁵⁶ <http://www.tender.gov.az/LawAz.html>

its holding should be published for the first time in state newspapers and in international media at least within 30 banking days before the opening of packages of tender proposals and for the second time, within 20 banking days. If the tender is held in two stages, these terms will equal to 60 and 40 days respectively. Article 26 establishes the composition of the information published on the holding of the tender. According to conversations held by the author with a number of experts and businessmen, there have been violations of the law in practice when no announcement was published on the holding of the tender. In most cases, according to interviewed experts and businessmen, announcements are published.

Are procurement decisions made public? Yes, this is required by the law (According to Article 5.3, the results of a tender are published within five banking days in the same media where the announcement on the holding of the tender was published), and as a rule, it is done.

Is there a procedure to request review of procurement decisions? Can an unfavorable decision be reviewed in a court of law? According to Article 38.2, a participant in a tender can appeal to a higher government agency or a court against the decision of the tender commission.

Are there provisions for blacklisting companies proved to have given bribes in a procurement process? The law does not contain provisions that would stipulate "black lists" of companies accused of attempts to pay bribes.

Are there rules and procedures to prevent nepotism/conflict of interest in public procurement? Yes, the law has provisions (Article 13) on preventing a conflict of interests. However, in the opinion of a number of interviewed experts and businessmen, there are many facts that testify to violations. Quite

often, tenders are won by companies that are closely related to the leadership of government agencies that hold the tender. This is done through figureheads, but Azerbaijan is a small country and information about the owner of this or that well-known local company is usually known to many.

Are assets, incomes and life styles of public procurement officers monitored? It is expected that the law on the declaration of the incomes of state officials will take effect on 1 January 2007. But even after that, the public will have no opportunity to monitor officials' incomes because the aforesaid law, which was adopted in 2005, does not provide for the disclosure of information about officials' incomes.

Thus, the Law generally meets international requirements. In reality, however, according to independent experts, businessmen and journalists, provisions of the law are often violated, and there are two reasons for that: 1) lack of public monitoring of state purchases; 2) reluctance of unsuccessful tender participants to go public with certain violations (mainly due to the lack of the independent judiciary, and also the fact that unsuccessful tender participants hope to win it next time and don't want to be confrontational with state bodies). Although the law does describe norms to regulate the right and order of filing a complaint with purchasing organization or the state body approving a purchase, as well as the procedure for suspending a purchase, almost no-one is taking advantage of these rights. The author of the present research does not know of any legal proceeding following tender results.

Law on the Chamber of Accounts. It was adopted on July 2, 1999. Subsequently (on October 5, 2001, December 7, 2001, March

9 2004, September 1, 2004 and December 30, 2004), the parliament adopted a number of amendments to the law.

Status and role of the Chamber of Accounts (CA). The Chamber of Accounts (CA) plays the role of the highest auditing body in Azerbaijan. The Chamber of Accounts, in line with the Azerbaijani Constitution (article 92), is formed by parliament. According to article 1 of the law, the Chamber of Accounts is subordinated to the parliament and is a permanently operating body of budgetary and financial control. The Chamber of Accounts is headed by the chairman whose status is considerably lower than that of the general auditor in a number of countries. The chairman of the Chamber of Accounts, according to article 8 of the law: presides over meetings of the Chamber of Accounts; assigns work among his deputy and auditors, organizes work of the chamber's auditors, twice a year (during the parliament's spring session no later than April 15 and during the fall session no later than October 15), reports to the parliament on the work of the chamber.

According to the law in question, all state expenditures can become subject to audit.

According to article 2 of the Law, the Chamber of Accounts:

- issues conclusions on draft state budgets and out-of-budget state funds;
- provides a conclusion on the annual budget execution report;
- exercises control over the execution of revenue and expenditure items of the state budget and out-of-budget funds;

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- informs the parliament, on a quarterly basis, of the execution of state budget revenues and expenditures;
 - exercises control over management of state property and proceeds from the privatization of state property;
 - on parliament's instruction, conducts financial expertise of draft laws on state budget and out-of-budget funds, as well as international agreements signed by the country;
 - analyzes the earnings of the treasury;
 - analyzes the movement of state budget and out-of-budget funds into bank accounts;
 - audits state budget and combined budget revenues and expenditure, including out-of-budget state funds;
 - other functions.

On the other hand, according to article 14, "the Chamber of Accounts operates on the basis of an activity plan. The activity plan is based on queries and suggestions filed by the president of the Azerbaijani Republic, the Milli Majlis of the Azerbaijani Republic, and standing commissions of the Milli Majlis of the Azerbaijani Republic. The activity plan of the Chamber of Accounts is approved by the Chamber of Accounts." According to article 16, "... without the instruction of the president of the Azerbaijani Republic or the Milli Majlis of the Azerbaijani Republic, financial and budgetary expertise in excess of the chamber's activity plan is prohibited."

Requirements for professional qualities of CA managers
According to article 7 of the law, people having commitments to other states and those convicted of serious or particularly serious crimes cannot become chairmen, deputy chairmen and auditors

of the chamber. *"Citizens of Azerbaijan with an educational degree, with at least five years of experience in state administration, state control, economic and financial spheres can become chairmen, deputy chairmen and auditors of the chamber."*

As is evident, the law does not rule out the appointment of someone not meeting the requirements of control over state expenditures.

Interference in CA activity. Article 19 of the law says that interference in the work of the Chamber of Accounts is unacceptable. It says that a person might be brought to account for creating obstacles to the work of the chairman of the Chamber of Accounts, his deputy or auditors and for putting pressure on them. Moreover, this article points out that the chairman of the Chamber of Accounts, his deputy and auditors cannot be detained, arrested, held criminally liable and so on without the consent of the country's parliament. The article ends with the provision: "The state guarantees the independence of professional activities."

Nepotism. According to article 7 of the law: "Candidates for chairmanship and deputy chairmanship of the Chamber of Accounts cannot be directly related to the chairman of the Milli Majlis of Azerbaijan, the prime minister of Azerbaijan, the finance minister of Azerbaijan, the prosecutor-general of Azerbaijan, the chairman of the Supreme Court of Azerbaijan, and the chairman of the board of the National Bank." As we can see, the law does not rule out the appointment of a relative of the president to the position of the chairman of the Chamber of Accounts.

Additional sources of income of CA members. According to article 7 of the law, employees of the Chamber of Accounts, including its chairman, cannot engage in other payable work

except for scientific, pedagogical and creative work. As is evident, the limitations concern salaries from other sources. As for incomes in general, e.g. dividends from securities, the law contains no limitations to that effect. And this too can be a source of the conflict of interests.

Protection of CA members. The law contains a number of norms protecting supervisors and employees of the Chamber of Accounts from an early dismissal from their posts. In practice, the chairman of the Chamber of Accounts is subjected to strong influence from the presidential administration. The president of the country can at any time initiate the procedure of dismissing the chairman of the chamber from his position by using his clout over the parliament.

The examination of the Chamber of Accounts is hampered by the still functioning Regulations on treasury under the Finance Ministry. According to the Regulations, the Finance Ministry has the right to conduct financial examination of government agencies. Quite often, as experience of the past two years shows, government agencies prefer to be examined by the Finance Ministry, not by the Chamber of Accounts.

Law on fighting corruption. It was adopted by parliament in late 2003 and became effective on January 1, 2005. The initial version of the law contained a number of loopholes, especially with regard to the financial accountability of public officers. Therefore, considerable changes and additions were subsequently introduced. Also, the parliament adopted special rules for submitting financial reports by government officials. These rules are dwelt upon in a special section below. However, it is worth indicating that a number of drawbacks from the corruption law are now observed in the said rules.

Concept of corruption. The law provides a definition of corruption which meets the international definition.

Top anti-corruption body. According to the law at issue (article 4), the anti-corruption commission under the public service council is the highest state agency on fighting corruption.

A special department to fight corruption has recently been established under the prosecutor-general's office.

Financial accountability of public officers. According to Article 5 of the law, public officers are required to indicate the following in their financial reports⁵⁷: 1) annual income (including information on types, volume and sources of incomes), 2) taxable property, 3) deposits in banks, securities and other financial resources, 4) participation in joint stock companies and their own interest, 5) arrears exceeding a conditional financial unit (about \$1.2) by 5,000 times, 6) other proprietary and financial commitments exceeding the conditional financial unit by 5,000 times. The definitions of norms provided in Article 5 are worthy of note. Provision 5.1 says that people occupying senior posts must provide information (as described above), while provision 5.2 says that the financial information described in provision 5.1 can be requested in an order established by law. In other words, according to provision 5.2, this information does not have to be requested. But then how should the requirement of provision 5.1 be understood? These contradictions create a situation of unpredictability and impunity. At first sight, Article 6, Responsibility for breaching financial requirements, is supposed to introduce clarity to this contradiction. However, the analysis of Article 6 shows that the norms are connected with provision

⁵⁷ Apparently this concerns rules of financial accountability approved by parliament and president on 24 June 2005

5.2 and concerns cases when financial information was requested but the public officer failed to provide it.

Nepotism. Article 7 of the law says that with the exception of elected positions and a number of special cases regulated by law, close relatives cannot hold subordinate positions. However, we have a similar situation here as well (see above) due to the notion of a close relative.

Gifts, hospitality and gifts register. Article 8 of the law allows public officers to accept gifts the value of which does not exceed the conditional financial unit by 50 times. This is about \$60. The gifts exceeding this amount are considered to be property of the state body. The public officer may keep the gift by paying the balance of the gift value to the treasury. Please note that the value of acceptable gifts for members of the US Congress and government employees is about the same. It is interesting though that according to the law, the acceptable value of a gift is close to that of the USA even though there is a huge difference in the salaries of public officers of the two countries. There are no restrictions in the law on the acceptance of invitations to restaurants or other forms of hospitality. Neither are there any provisions requiring compilation and keeping a register of such invitations.

Legal norms envisioning punishment for corruption. The acceptance of a bribe is punishable under article 311 of the Criminal Code, while the giving of a bribe is punishable under article 312.

According to article 311, a bribe-taker can be sentenced to three to 12 years' imprisonment depending on the nature and circumstances of the crime.

According to article 312, a bribe-giver can be penalized by a fine in the amount of 1,000 to 2,000 minimal wages or in the amount of 500 to 1,000 minimal wages and/or three to eight years' imprisonment. If a bribe-giver commits this act under pressure from a public official and informs a relevant state agency of this, he is exempt from criminal prosecution.

Corrupt activities may also be punishable under article 308, Abuse of Power, of the Criminal Code. Such deeds are punished by a fine in the amount of 1,000 to 2,000 minimal wages, by the deprivation of the right to occupy certain posts or engage in certain types of activity for a period of up to three years, or by correctional work for a period of up to two years, or by imprisonment for up to three years. Corrupt activities envisioned under article 308 which have brought about unpleasant consequences are punished by imprisonment for three to seven years and the deprivation of the right to occupy certain posts or engage in certain types of activity for a period of up to three years.

Abuse of power includes three key features: abuse of power contrary to public interests; arising of consequences in the form of breach of rights and legitimate interests of citizens or organizations or the interests of the public or the state protected by law; causal relationship between a deed and its consequences.

The new law On fighting corruption also contains norms (article 10) on disciplinary, civil, administrative and criminal liability for corruption.

In practice, despite Azerbaijan's high corruption perception index, the number of people convicted of corruption-related offences over the past several years was not very big.

According to statistical reports contained in the government's report⁵⁸:

- For acts punishable under Article 308 of the Criminal Code of the Azerbaijan Republic (abuse of official powers), nine individuals were convicted in 2000, 22 – in 2001, 24 – in 2002, and 15 – in 2003;
- For acts punishable under Article 309 of the Criminal Code (excess of official powers), no one was convicted in 2000, but four individuals were convicted in 2001, 11 – in 2002, and 8 – in 2003;
- For acts punishable under Article 311 of the Criminal Code (bribe-taking), one individual was convicted in 2000, 6 – in 2001, 7 – in 2002, and 6 – in 2003;
- For acts punishable under Article 312 of the Criminal Code (bribery), four individuals were convicted in 2000, 7 – in 2001, 5 – in 2002, and 5 – in 2003.

Rules of financial accountability for public officials. They were adopted by parliament on June 24, 2005 with immediate effect. The rules aim to eliminate certain loopholes in the law on fighting corruption relating to the accountability of public officials. The rules indicate the terms for submitting such reports (January of every year), list of public positions (including the president of the country) subject to reporting, the addresses to which representatives of the executive and legislative branches of power should submit their reports. However, the Rules have so far failed to solve the issue of transparency of such reports. The

⁵⁸ Istanbul Anti-Corruption Action Plan. Azerbaijan. Status Report, submitted by the Government of Azerbaijan for the review at the 2nd Review Meeting, 16-18 June 2004, Paris

Rules indicate that financial reports of public officials are a private issue and are not subject to disclosure.

5.2. Legal norms regulating the activity of SOFAZ

The main legal acts regulating the activity of SOFAZ are:

- Presidential decree⁵⁹ dated December 29, 1999 establishing the State Oil Fund;
- Regulations of SOFAZ⁶⁰ approved by a presidential decree dated December 29, 2000;
- Rules of storing, placing and managing hard currency reserves of the State Oil Fund⁶¹. The Rules were approved by a presidential decree dated June 19, 2001.

Presidential decree establishing the State Oil Fund. The decree was issued on December 29, 1999. It lists the sources of the fund's resources and issues instructions:

- SOCAR is to ensure the sale of Azerbaijan's share of the profit oil according to the terms of contracts signed with foreign companies;
- The Cabinet of Ministers is to prepare, within two months, and submit for presidential approval the

⁵⁹ http://www.oilfund.az/inside_az.php?zid=2&nID=125

⁶⁰ http://www.oilfund.az/inside_az.php?zid=2&nID=128

⁶¹ http://www.oilfund.az/inside_az.php?zid=2&nID=127

Regulations of SOFAZ and suggestions on the fund's managerial structure;

- The National Bank is to ensure, prior to the launch of SOFAZ's operation, the accumulation of its resources on a special bank account.

The Decree lists the following as SOFAZ funding sources:

- Azerbaijan's share in the profit oil produced under PSA;
- bonuses paid under PSA;
- per-acre payments under PSAs;
- Azerbaijan's dividends and revenues from production sharing on oil and gas projects;
- transit fees from export oil and gas pipelines;
- revenues from reassignment of assets under PSAs;
- revenues from management (placement, investment, etc.);
- grants and other assistance.

Regulations of SOFAZ. The SOFAZ Regulations entered into force following a presidential decree dated December 29, 2000. The decree also issues certain instructions:

- SOCAR is to transfer hard currency resources belonging to SOFAZ into the fund's account before January 5, 2001;
- The National Bank is to prepare and submit, within 15 days, suggestions on keeping SOFAZ funds in highly rated foreign banks.

The Regulations of SOFAZ were subsequently amended on two occasions⁶².

In its current version, the Regulations include the following sections:

- General provisions;
- Main functions of the fund;
- Sources of the fund's resources;
- Use of the fund's resources;
- Management of the fund.

Under Paragraph 1.2 of the SOFAZ Regulations, the fund reports to the president and is subordinated only to him. There is no requirement on responsibility and accountability to parliament in the SOFAZ Regulations. Considering the fact that the fund accumulates financial resources of the state (in fact, the resources are expected to exceed the state budget by many times in the near future), it is difficult to explain why SOFAZ is not subordinated to parliament which exercises control over the state budget.

According to Paragraph 1.4, overall control over formation and expenditure of SOFAZ funds is exercised by the Watchdog Council of the fund. This runs counter to the law on the Chamber of Accounts (see above) whereby the CA is to control the execution of income and expenditure of the state budget and out-of-budget funds (Article 2).

According to Paragraph 4.1, the use of the fund's resources is carried out in accordance with main expenditure directions approved by the president of the country.

⁶² Presidential decrees dated February 7, 2003 and March 1, 2005

Under Paragraph 4.2, these resources can be spent on resolving socioeconomic and pressing nationwide problems, as well as construction and reconstruction of strategically important infrastructure facilities. But who is to determine the nature of problems and importance of infrastructure facilities and how will this be done is not elaborated by the Regulations. According to the author's own observations and a poll conducted among experts, decisions about the priority of this or that project are often based on the relationship between this or that minister or government official and the president. Proposals from the member of the presidential team who has easier access to the head of state are accepted more easily.

Members of the Watchdog Council of the fund are appointed by the president (Paragraph 5.5). We believe that if this right had been entrusted to the parliament, this would have led to greater independence of the Council, which is important given the fund's accountability to the president only.

The Regulations contain norms pertaining to the inspection of the fund's financial activity on the part of an auditor appointed by the president. However, the Regulations say nothing about inspection of the fund by the Chamber of Accounts. For the time being, CA has not inspected SOFAZ yet. The fund is annually audited by an internationally-recognized audit company. Up to date, this has been done by Ernst & Young. This company has managed to win the relevant tender every year, which raises certain questions. Yes, this is one of the leading audit companies in the world. But we think that a regular change of auditors would secure more trust in this process on the part of civil society, and what is more, it would probably allow the SOFAZ management to get more interesting recommendations and cast a new look at their activities.

The auditor's view is posted on the SOFAZ website⁶³ (we should notice that the relevant file is becoming bigger and bigger. The last report for 2006 is more than six megabytes in size. There is no need for that. It is impossible to look at this file in the Internet). Information is also contained in the annual reports of the fund posted on the website.

Thus, the analysis of the Regulations shows that the needs to be improved. Besides that, even though the Regulations say that the fund's watchdog council must include representatives of public organizations (paragraph 5.4.), this is not the case. Therefore, it might be worth reconsidering the composition of the council. The issue of including a representative of the NGO sector in the Observation Council has been repeatedly raised in the last few years at various public discussions dedicated to the oil revenues. There has also been a relevant appeal to the country's president from the NGO Coalition to Increase Transparency in Extractive Industries. But the situation is still the same.

The Regulations contain norms pertaining to transparency in the fund's operations. For instance, paragraph 5.3. says that the auditor's report (statement) reflecting the results of the fund's yearly activities must be published in the media. In practice, this information is posted on SOFAZ's website, while the executive director of the fund occasionally conducts news conferences. However, we have to observe that the information posted on the website contains a general idea of the work of SOFAZ, but this information is enough for a comprehensive analysis of the effectiveness of the work of the fund, i.e. many representatives of civil society can in principle find interesting information about the revenues and expenses of the fund. But the

⁶³ <http://www.oilfund.az/index.php?n=20>

expert community and financial analysts may not be happy with the annual reports of the fund posted on the website.

At the same time, we have to point out that SOFAZ is the most transparent state institution (maybe only the National Bank can compete with it).

Rules for storing, placing and managing hard currency reserves of the State Oil Fund. These rules were approved by a presidential decree of June 19, 2001. The rules include the following sections:

- General issues;
- Storage of the Oil Fund's hard currency reserves;
- Managing the Oil Fund's hard currency reserves;
- Report on management of the Oil Fund's hard currency reserves.

The General issues section specifies the legal framework on the basis of which the Regulations and their objectives were prepared, and provides definitions to such notions as "the fund's hard currency reserves" and other definitions relating to recalculation of the fund's reserves into the balance currency unit, i.e. the Azerbaijani manta.

The Storage of the Oil Fund's hard currency reserves section provides: a) the required ratings of foreign banks in which the fund's resources can be kept; b) rating demands for the fund's partners in international stock markets; c) rating demands for commercial banks and other financial institutions providing the fund with the service of a securities depository; and d) the fund's actions when the rating of its partners lowers. The section

also provides rating demands for the countries whose currency unit is used for storing the fund's investment portfolio.

The management of the SOFAZ's hard currency reserves section describes general principles and directions in which the fund's resources shall be managed, risk management issues and the fund's key investment directions.

The Report on management of the Oil Fund's hard currency reserves section says that quarterly information and an annual report are submitted to the watchdog council and the president.

Therefore, the analysis of the Regulations shows that the fund's activity is a rather closed area. Under such circumstances, it is difficult to assess the fund's activities towards managing its resources. As mentioned above, the Regulations of SOFAZ envision an examination of its financial activities on the part of an internationally recognized auditor. However, such an audit will not provide an answer to questions about management efficiency of the fund's resources.

The aforesaid rules are not the only document that the staff of the fund use in their everyday work. There is also the internal instruction⁶⁴ of SOFAZ approved by the executive director of the fund. However, this document has yet to be posted on the SOFAZ website.

⁶⁴The instruction on internal procedures to manage the currency assets of the Oil Fund
http://www.oilfund.az/download/az/2001_az.pdf page 43

5.3. Legal acts regulating the expenditure of budget funds

Issues of managing the state budget are regulated by the Law on the budget system⁶⁵. The law contains a number of norms aimed at ensuring transparency of the budgetary process. For instance, article 14 of the law says that a draft budget must be published in the media within 10 days of reaching parliament. Paragraph 20.7 says that quarterly and yearly reports on the execution of the consolidated budget are published in the media. Paragraph 25.6 says that a relevant executive body keeps record of state arrears and publishes them in the media on a quarterly basis. Paragraph 27.1 says that coordination of activities towards creation, execution and control over the execution of the state budget and extra-budgetary funds is implemented in line with an approved action plan jointly prepared by executive bodies and extra-budgetary funds. The action plan is published in the media.

All these norms create the impression about a high level of transparency of budget and extra-budgetary expenditures. However, the information being published is of a general nature and does not allow for an in-depth analysis. Also, the law does not contain norms allowing citizens and public organizations to inquire about budget and extra-budgetary expenditures.

The list of recommendations by the Entrepreneurship Development Foundation⁶⁶ in the budget sphere also contains the following: «...4) public hearings on the budget must be held. Openness, accessibility, completeness (in detail) and clearness, which are the main principles of budget transparency, must be

⁶⁵ http://www.maliyye.gov.az/law1_2_07_02_en.shtml

⁶⁶

ensured. The IMF transparency code in budget and tax policy (Adopted at the 50th session of the provisional committee of the IMF board of directors on 16 April 1998) and the OECD recommendations on budget transparency must be taken into account.

5.4. Legal acts regulating extra-budgetary expenditures

We have already looked at the legal acts regulating the activity of one such extra-budgetary fund, namely SOFAZ. Another extra-budgetary fund which accumulates oil revenues is, as mentioned in section 1.2 above, the State Social Security Fund. Of course, the proportions of the fund's revenues are considerably smaller than those of SOFAZ. At the same time, it is interesting to find out how protected the State Social Security Fund's resources are from the risk of loss.

The annual budget of the SSSF is approved by parliament and assumes legal effect. The budget is published and posted on the SSSF's website⁶⁷. Revenue items of the fund's budget are very generalized and do not specify allocations from state companies.

5.5. Legal acts pertaining to the activity of civic organizations

The activity of civic organizations is regulated by the Law on public associations and funds, and other general laws (the

⁶⁷ <http://www.sspf.gov.az/qanuvericilik/qanunlar/0790-2q.htm>

Law on state registration of legal entities⁶⁸, the Law on grants, the Law on accounting⁶⁹, the Tax Code⁷⁰, etc). The establishment of public organizations mainly involved two difficulties:

- Complicated procedures of state registration (but this problem is also characteristic of companies). In other words, the law on state registration of legal entities and other relevant acts of the Justice Ministry are rather complicated and the process of registration can drag out for months if the attitude to a new NGO is not friendly;
- Unofficial coordination of registration of a certain NGO between the Justice Ministry and the Presidential Administration.

It is for these two reasons that the number of registered NGOs in Georgia and Armenia is two to three times bigger than in Azerbaijan.

In all fairness, however, we have to say that the situation surrounding the registration of NGOs tends to improve. Also, the activities of unregistered NGOs are not banned and many NGOs actually operate without official registration. But it does create certain problems for them in the process of receiving grants (not many donors are ready to provide grants to unregistered NGOs) and payment of taxes.

⁶⁸ http://www.justice.gov.az/leg_az6.htm

⁶⁹ <http://www.taxes.gov.az/qanun/index.shtml>

⁷⁰ <http://www.taxes.gov.az/eng/qanun/>

5.6. Legal acts ensuring free access to information

There are two main laws that regulate access to government information: “On access to information”⁷¹ and “On the state secret”. The law “On access to information” was adopted on 19 June 1998. The law was drawn up on the basis of recommendations from the Council of Europe. NGOs, especially the Institute for Media Rights took an active part in drawing up the draft law. Experts have recognized the law as meeting international requirements. But this is what monitoring of the implementation of the law, carried out by the Institute for Media Rights, shows. According to the Institute’s first report⁷² on the results of the monitoring (for the period from 1 October 2006 to 30 June 2007), which was presented to the public on 30 July 2007, the provisions of the law have often not been fulfilled over the last two years since it came into force. Although many government agencies have their own websites now, information liable to disclosure is posted only partially here. Special information services, envisaged by the law, have yet to be established in government agencies. The establishment of websites by municipalities is being delayed. A representative for information affairs has still not been appointed by the president though it is required by the law. Queries to ministries for this or that type of information are satisfied partially (during the period of the monitoring, government agencies replied only to 125 of the 441 queries). A number of government agencies refuse to provide information at all. Judiciary bodies use various pretexts to avoid examining complaints related to the implementation of the law.

⁷¹ <http://www.ngo-az.org/contents.php?cid=441>

⁷² <http://www.mediarights.az/index.php?lngs=aze&id=129>

The other law which provides government officials with ammunition to refuse to divulge information to citizens is the law on state secrets which was adopted on November 16, 2004.

6. TRANSPARENCY INITIATIVE AND ITS ROLE IN REDUCING THE RISK OF LOSS

6.1. Beginning

Azerbaijan joined this initiative on 17 June 2003. On that day, the head of the Azerbaijani delegation to the London conference⁷³ on the Extractive Industries Transparency Initiative (EITI), the first vice-president of the State Oil Company of the Azerbaijan Republic, Ilham Aliyev made a speech⁷⁴ and stated that Azerbaijan was joining this initiative⁷⁵. Azerbaijan was declared a pilot country along with other three countries. At present, the list of countries that have joined the EITI is as follows: Azerbaijan, Kazakhstan, Kyrgyzstan, Ghana, Nigeria, Congo, East Timor, Sao Tome and Principe and others.

After that, the Azerbaijani cabinet of ministers issued Decree No 224 on 13 November 2003 and set up a government commission on the transparency initiative in industries engaged in the production of mineral reserves, chaired by the executive director of the State Oil Fund⁷⁶. The commission also included members like the Azerbaijani ambassador to Britain and

⁷³ <http://www2.dfid.gov.uk/news/files/eitireportconference17june03.asp>

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⁷⁵ <http://www2.dfid.gov.uk/pubs/files/eitidraftreportazerbiajan.pdf>

⁷⁶ http://www.oilfund.az/inside_az.php?nID=24

representatives of the State Statistics Committee, the State Oil Company, the Tax Ministry, the Ministry of Economic Development, the Ministry of Ecology and Natural Resources, the Finance Ministry, the Ministry of Fuel and Energy and the Foreign Ministry. The commission was instructed to determine the form and deadline for submitting reports about the incomes of government agencies, state companies and other state-owned organizations from the exploitation of mineral resources in the country, to collect those reports, to compile a single report on the country and publish it in the press on a permanent basis. The decree on the collection of reports gave the commission relevant authorities.

As a result of several meetings of the commission, the report forms were defined and a decision was made to present them to the public.

6.2. The participation of the civil society

The presentation of the report forms prepared by the government commission was held at the Amirov conference hall of the Park Hyatt Hotel on 5 April 2004. The roundtable was attended by representatives of oil companies and about 20 well-known national NGOs. The meeting also discussed who could represent the civil society in the EITI. An opinion was expressed that Azerbaijani NGOs should discuss this issue and set up a representative institute that would fulfill the functions of a third party in the EITI.

The proposals of the government commission were subsequently presented to public organizations. This presentation was held at the Azerbaijani embassy in London on 20 April 2004.

Finally, at the initiative of the Open Society Institute (Azerbaijani branch), a round table attended by more than 30 well-known Azerbaijani NGOs was held at the conference hall of the ISR Plaza Hotel on 13 May. The first part of the round table gave NGOs information about the EITI, explained the purpose of the initiative and discussed the participation of the civil society.

The second part of the round table decided to set up a coalition of Azerbaijani NGOs to support the EITI. 30 NGOs and two private individuals decided to join the coalition and signed a Memorandum⁷⁷ on the establishment of the coalition to increase transparency in the extractive industry and adopted a statute (regulations)⁷⁸ on the coalition. The members of the newly-established coalition elected a managing body of seven people - the Council of the Coalition (Himayat Rizvanqizi, Ingilab Ahmadov, Mayis Gulaliyev, Mirvari Qahramanli, Qubad Ibadoglu, Sabit Bagirov and Sevgim Rahmanov).

The memorandum of the coalition notes the following aims:

- to ensure that revenues from the exploitation of natural resources that are due to Azerbaijan are handed over to the state in full and to organize and carry out public oversight over their reliable preservation and effective use;

⁷⁷ http://www.eiti-az.org/ts_gen/eng/koalisiya/eng_k2.htm

⁷⁸ http://www.eiti-az.org/ts_gen/eng/koalisiya/eng_k4.htm

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- to take relevant measures to fully inform Azerbaijani citizens about the exploitation of natural resources and revenues and to organize and carry out public oversight over the activities of government agencies and companies in this sphere;
 - to ensure the joint implementation of the transparency efforts of civil society institutes and to increase public activity in this sphere;
 - to represent Azerbaijan's public organizations in the Extractive Industries Transparency Initiative announced by the British government and joined by the Azerbaijani government.

The memorandum also notes the guiding principles of the coalition:

- Openness to cooperation. The coalition is ready to cooperate with any state, NGO, media, international NGOs, public figures, scientists, experts and so on;
- Unlimited membership. Any NGO and private individual can become a member of the coalition;
- Transparency. The activities of the coalition will be totally transparent and open to society;
- Accuracy. The coalition will try to ensure maximum accuracy in all its opinions and decisions and to make sure that opinions, statements and assessments are based on accurate information and deep analysis;
- Absence of political aims. The coalition will not participate in any activity pursuing political aims;
- Lawfulness. The activities of the coalition are carried out within the framework of Azerbaijani legislation.

The council of the coalition held several meetings from 14 May 2004 to 11 June. These meetings discussed the working plan and adopted it for implementation. The council also set up a working group on financial accountability forms drawn up by the government commission (Sabit Bagirov, Ingilab Ahmadov and Gubad Ibadoglu). The working group analyzed the financial accountability forms of the government and prepared its proposals on financial accountability forms⁷⁹. On 11 June 2004, the council approved the proposals of the working group. The proposals were submitted to the chairman of the government commission, Mr Samir Sharifov, as well as to the DFID and oil companies on 14 June 2004.

The suggestions of the Coalition are based on the following principles:

- Report forms should comply with the philosophy and conditions of contracts signed by Azerbaijan;
- Report forms should comply with ideas used in Azerbaijani legislation and financial accountability;
- At the beginning of the EITI initiative, results achieved in the sphere of contracts in previous years should be reflected in a single report in a systemic way;
- Reports on the EITI should reflect all the main indicators that are not a commercial secret for companies and at the same time, create a fuller idea about financial indicators of contracts;
- Taking into account that SOCAR is working both with independent and other companies in the extractive

⁷⁹ <http://www.eiti-az.org/gen/feal/suranin-teklifleri-14062004.pdf>

industry, its financial results should be reflected in separate report forms;

- Report forms should indicate which government agency will get Azerbaijani oil in the end and how much oil will be channeled into the private sector and local workers;
- It is necessary to identify a trial period for EITI accountability and prepare reports only on PSAs and on the independent activities of SOCAR during that period (several quarters). At the second stage, it is necessary to involve in accountability contracts based on the joint company form in the oil sphere and other extractive spheres;
- An audit company should be asked to carry out an inspection only if there are doubts about any indicators in report forms.

Let us review the essence of some of these principles.

Reporting forms are to be in line with the philosophy and conditions of the contracts signed by Azerbaijan. Considering the fact that the agreement Azerbaijan has signed with foreign companies on joint development of its hydrocarbon resources are production sharing agreements, it would be wrong to describe the portion of the production owned by Azerbaijan as payment by a foreign company. Therefore, the reports should contain two individual sections: 1) a section that would be reflect the sharing of profit between the host country and contractors; 2) a section that would reflect payments by companies to the host country (for example, bonuses, taxes, dividends, etc.). On the other hand, the fact that royalty and license fee payments by foreign companies are indicated in reporting forms as none is expected

to raise public discontent. These indicators are not envisioned in Azeri contracts, therefore, it would be inappropriate to include them in reporting forms either.

Reporting forms are to be in line with Azerbaijani laws and principles used in financial reporting. For example, the notion of “government” is not used in the Azerbaijani Constitution and other legislative acts. For this reason, reporting forms shouldn’t use notions such as “government share”.

Results of all contract-related activities as of the EITI initiative commencement date have to be summed up in the form of a one-time report. Considering the great public interest in the EITI, in addition to regular reports by companies and state bodies, it would be appropriate to prepare a one-time report that would reflect any progress or achievements made in the pre-EITI period as a result of the implementation of agreements signed with foreign investors. Such a report would be of interest because for certain reasons the Azerbaijani public is still largely unaware of the general economic indicators of the agreements signed with foreign companies. The fact that this information (volume of oil production starting from the contract commencement date, total volume of profit oil and its division between parties to the contract, bonuses paid by companies since the contract commencement date, etc.) is often provided by different sources and at times is not available at all leads to the appearance of various rumors, which, in its turn, undermines public confidence in the work of foreign companies and causes public suspicion as to the information being released on payments in favor of Azerbaijan.

The EITI reports are to contain information that does not represent a commercial secret for companies and at the same time fully discloses the contract’s financial results. In order to

create a clear picture of the financial outcomes of the agreements signed and of the progress of cost recovery, and to have the opportunity of making substantiated prognoses of anticipated revenues, it would be appropriate to expand the reporting scope of regular reports to reflect, in addition to company payments, the capital expenditure that has not been recovered as of the reporting date, the outstanding SOCAR arrears and financing expenses (credit interest). The current situation is not transparent and the public is unaware of the cost recovery process, of the way SOCAR is repaying its debt to foreign companies and of how the profit oil is shared between the state and foreign companies. The disclosure of such information will contribute to making the work of SOCAR and the government in general more efficient.

Reporting forms are to reflect which state institution and in what proportion will benefit from the produced oil and whether it will be channeled towards the private sector and local workers. In other words, contractor payments in Azerbaijan is shared among several institutions. These include:

- State budget;
- Oil Fund;
- Social Fund;
- Local companies;
- Citizens.

Thus, the Coalition believes that the following institutions have to provide reports within the EITI framework:

- Operating Company;
- Foreign company that is part of the contractor side;
- State Oil Company that is part of the contractor side;
- Finance or Tax Ministry (state budget revenues);
- State Oil Fund;

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- State Social Security Fund;
 - State Oil Company on independent activities.

Auditing companies be invited only in the event of discovery of irregularities in any reporting indicators. The Coalition sees its mission in facilitating the participation of all interested sides in the exploration and development of Azerbaijan's natural resources and contributing to fruitful cooperation among them. The Coalition sees its role in the EITI initiative in monitoring the reporting activities of the government and companies that have joined the initiative. The Coalition intends to conduct this monitoring by comparing reporting forms and summing up all indicators. And to do that, the Coalition possesses sufficient potential. The Coalition believes that it would be in line with the EITI philosophy if the Coalition could invite an auditing company if necessary (to examine an oil company's or state agency's reporting procedures).

On the basis of these principles, the Coalition initiated a number of amendments to the reporting forms proposed by the government commission.

It is worth mentioning that the Coalition suggested that a larger number of indicators be disclosed and this beyond the EITI philosophy. On the other hand, before the suggestions were developed, the government commission had already adopted the reporting forms and agreed them with companies. For this reason, as a result of the subsequent trilateral (the government commission, companies and the coalition) negotiations (these negotiations continued for about four months), only a little number of the proposals were accepted.

A round table that was held at the initiative of the British embassy in Azerbaijan on 6 July 2004 discussed issues related to the EITI. Participants were the council of the coalition (full

composition), the director of the Baku office of the Open Society Institute, a representative of the DFID, a representative of the embassy, and a representative of the World Bank. The participants were welcomed by the British ambassador. During the conference, representatives of the coalition explained their proposals and answered questions. It is interesting that the representative of the World Bank said during the conference that the coalition's proposals had been prepared at a professional level.

The next discussion of the Initiative's progress in Azerbaijan was held at SOFAZ on 8 July 2004. It was attended by the director of the Oil Fund, representatives of the Coalition Council, director of the OSI Baku branch office, DFID, the UK Embassy and the World Bank.

The meetings held on 6 and 8 July gave an impetus to discussions between the council of the coalition and the government commission. The first bilateral meeting of the sort was held at SOFAZ on 16 July 2004. This meeting discussed possible forms of cooperation between all interested sides and adopted a resolution to prepare special memorandum on understanding. After that, discussions on the draft memorandum were carried out with the participation of all interested sides (the government commission, companies and the coalition) and its text was completely agreed in early November. During the discussions on the draft memorandum, some proposals of the council of the coalition were accepted by the government commission and companies.

The attitude to the signing of the memorandum within the coalition was not unambiguous. As we said above, members of the coalition were in favor of wide explanations and this is reflected in its proposal made on 11 June. However, in order to

implement the EITI in Azerbaijan as soon as possible and on the other hand, to avoid being sidelined from this process and to preserve the possibility of influencing developments in the future, the general meeting of the members of the coalition on 15 October 2004 adopted a decision that the coalition should join the memorandum.

6.3. The memorandum on understanding⁸⁰

This memorandum was signed during a ceremony that was held at the Quba hall of the Hyatt Regency Hotel in Baku on 24 November 2004. The ceremony was attended by representatives of the Azerbaijani government, almost all local and foreign oil companies operating in Azerbaijan, joint ventures engaged in oil and gas production, civil society and media, the ambassadors of countries that the oil companies represent, heads of the representative offices of the World Bank, the European Bank for Reconstruction and Development and the International Monetary Fund in Azerbaijan and other agencies. The ceremony was addressed by the chairman of the government commission, the president of AIOC, the president of the State Oil Company of the Azerbaijan Republic, the coordinator of the coalition of NGOs, the British ambassador to Azerbaijan, and the heads of the representative offices of the World Bank, EBRD and IMF in Azerbaijan.

It is planned to make the following reports along with the memorandum:

⁸⁰ <http://www.eiti-az.org/gen/feal/memorandum.pdf>

1. Payments/allocations that the government of the Azerbaijan Republic receives from foreign and national extracting companies;
2. Payments made by foreign extracting companies to the government of the host country;
3. Reports about payments made by local extracting companies to the government of the host country (Azerbaijan Republic).

According to the memorandum, these reports should be submitted twice a year: on 15 March on the previous year and 15 August on the first half of the current year. However, compliance with deadlines stipulated under the Memorandum has not been ensured. The table below provides real time for the submission of reports.

	Reporting period	Auditor	Disclosure of auditor's opinion on the report
1 st report ⁸¹	2003	Deloitte & Touche	15.03.2005
2 nd report ⁸²	First half of 2004	Deloitte & Touche	15.03.2005
3 rd report ⁸³	2004	Deloitte & Touche	03.08.2005
4 th report ⁸⁴	First half of 2005	AGN Mak Azerbaijan LTD	27.01.2006
5 th report ⁸⁵	2005	Deloitte & Touche	18.08.2006
6 th report ⁸⁶	First half of 2006	Deloitte & Touche	31.01.2007
7 th report ⁸⁷	2006	Moore Stephens	24.08.2007

⁸¹ <http://www.oilfund.az/download2/EITI2003.pdf>

⁸² <http://www.oilfund.az/download2/EITI2004.pdf>

⁸³ <http://www.oilfund.az/download2/eng2303.pdf>

⁸⁴ http://www.oilfund.az/download/sofaz_report.pdf

⁸⁵ http://www.oilfund.az/download2/eiti_report_31122005_en.pdf

⁸⁶ <http://www.oilfund.az/?news=97>

⁸⁷ <http://www.oilfund.az/pub/uploads/amw40Dkk.pdf>

As we can see, delays are still continuing. According to the explanation provided by the government commission, reasons for the delay include the fact that some companies joined the initiative later than others, that it is impossible to force them to disclose information, lack of experience of those preparing the reports, etc. This is evidence of the need for a special law. If submission of reports is made a requirement, companies will treat the initiative more seriously.

At the proposal of the coalition, the memorandum also makes it possible to make changes to report forms and the terms of presenting them with the mutual agreement of the parties. Each party to the memorandum can put forward such proposals and other parties should discuss these proposals together.

In 2005, the NGO Coalition submitted a number of suggestions towards improving the reporting forms and the Memorandum, but although they were discussed, they were not accepted.

According to the memorandum, the proposals are submitted directly to an audit company with an international reputation. The auditor puts together information on the same indicators from foreign and local companies and compares it with the government's information and presents its opinion to the parties to the memorandum after analyzing the reports of companies. The work done by the auditor is not an audit. This is only verification. This verification does not require professional accountancy. If any difference is discovered in government and company reports, then the auditor puts questions to those submitting the reports and tries to establish reasons for the difference. The final opinion disclosed by the auditor provides information about both the differences proper and explanation of

reasons. In some cases explanations are backed by bank documents and this is sufficient for the auditor.

The opinion of the auditor is presented at a broad meeting attended by parties to the Memorandum (members of the government commission, companies and representatives of the Coalition). After this presentation, the government's report and the auditor's opinion is posted on the SOFAZ website⁸⁸. The Coalition also publishes this information on its website⁸⁹. The auditor's report is then analyzed by the NGO Coalition and an opinion is provided to the public⁹⁰. It is worth mentioning that some suggestions expressed in the Coalition's conclusion (towards improving the process) were later accepted by the government commission. Attachments 8-13 present the opinion of the coalition on six government and company reports within the framework of the EITI.

According to the memorandum, the auditor is selected by a special selection group. This selection group of six members is defined by the parties to the memorandum. Each party to the memorandum nominates two people to the selection group. The persons representing a party to the memorandum have one vote each. The auditor is selected in a competition. The auditor is selected again for every period. The auditor is paid for its services by other parties to the memorandum in turns, except for the coalition. The relevant agreement is open to all parties to the memorandum.

According to the terms of the memorandum, the auditor and the commission are responsible for the confidentiality of reports presented by foreign and local companies. They cannot

⁸⁸ <http://www.oilfund.az/>

⁸⁹ http://www.eiti-az.org/ts_gen/eng/index.htm

⁹⁰ http://www.eiti-az.org/ts_gen/eng/feal/CoalitionOpinionSept2006.pdf

disclose these reports, whether in full or partly, to parties to the memorandum or to any third party. The inclusion of this requirement into the Memorandum is explained by the fact that most companies do not agree to the disclosure of their reports.

As we can see, the individual reports of companies are not disclosed to the coalition – a party to the memorandum. Only government reports can be disclosed. The point on the confidentiality of company reports was adopted at their insistence. The companies explained it by the fact that the disclosure of some indicators in their reports (other payments and taxes) might affect their competitiveness. It must be noted that some companies were ready for individual disclosure at the end of 2004 and especially at the second international conference on the EITI on 17 March 2005 (for example, BP, Shell and Statoil), which means that the situation might change in the future. BP and Statoil are currently publishing their individual reports as part of the annual reports, albeit rather late. The adoption of the above-mentioned law could compel all companies to disclose their reports. There is no information in these reports which would represent a commercial secret. This is confirmed by the reports of BP and Statoil.

The council of the coalition, which feels that the situation might change in the future, proposed indicating in the text of the memorandum that all reports should be archived and stored, and this proposal was accepted and included in the memorandum (last paragraph). Thus, when the issue of personal disclosure is solved in the future, Azerbaijani citizens will probably be able to familiarize themselves with company reports on previous periods.

The Memo also contains legally unclear provisions. For instance, Article 11 says: “each party shall be responsible for

ensuring complete confidentiality of all material acquired as part of the present Memorandum until the information is disclosed with the consent of all parties thereof". What does 'responsibility' mean here? The Memo does not provide an answer to this question. In addition to that, the Coalition does not have access to any information until the auditor's report is revealed and therefore cannot disclose anything.

Thus, the memorandum on understanding was an important step for the implementation of the EITI in Azerbaijan. However, it is very likely that changes will be made to this document in the future in order to increase transparency in the extractive industries.

The EITI has yielded the following benefits in its initial stage in Azerbaijan:

- 1) The public constantly (twice a year) receives information about revenues coming into the State Oil Fund of the Republic of Azerbaijan (Azerbaijan's share in profit oil and company payments) and into the state budget;
- 2) Representatives of the civil society (the coalition) participate in the EITI process and have the opportunity to influence this process;
- 3) Civil society organizations unite in the coalition and develop their ability to work together.

According to the current philosophy of the EITI, it serves only to disclose the revenues of the state, however, making effective use of these revenues is a more important issue. For this reason, civil society organizations should increase oversight not only over revenues, but also expenses.

6.4. Role of EITI in reducing the risk of losing oil revenues

The numerous round table discussions held by the NGO Coalition with representatives of civil organizations, the media, teachers and university students in attendance showed that participants in such meetings and discussions are more interested in the following questions:

- 1) What revenues did the country have in a certain period?
- 2) What types of revenues is the country getting and how much has the country made on each of these types?
- 3) Is the country fully getting revenues envisaged by the terms of the contract?
- 4) What is the companies' separate contribution to the overall revenues of the country?
- 5) What government agencies are receiving oil revenues?
- 6) What are oil revenues being spent on, why and how much?
- 7) How effective is the spending of oil revenues?
- 8) Is part of revenues misappropriated?
- 9) Do the revenues make up for the damage inflicted on the environment?
- 10) What are the revenues from oil contracts separately?

Analysis shows that the Azerbaijani version of the EITI answers the first question. The EITI does not fully answer the second question. Company and government reports do not cover

the revenues of the State Social Security Fund, the revenues of the budget from subcontractors' taxes on oil contracts and from the income tax paid by the staff of the companies participating in oil projects. We should observe that these revenues of the country, which are not covered by the Azerbaijani version of the EITI, account for 1-2 per cent of the overall revenues, according to experts. But we should also point out that for example, in ACG, 1-2 per cent of the overall volume of revenues, as long as the contract is valid, total 2-5 billion dollars and this significant amount of money should probably not remain closed to civil society as this will increase the risk of their ineffective spending.

As for the third question, though it is rarely asked by participants in the round table discussions, it is still topical because world practice is aware of Alaska's experience in the dishonest implementation of contracts by individual company managers⁹¹, which led to the loss of billions for the budget of the state. If this has happened in Alaska, is there any guarantee that this will not happen in Azerbaijan?

The Azerbaijani version of the EITI does not oblige companies that work in Azerbaijan and have joined the EITI to disclose individual reports. Only two of the 22 companies participating in the EITI in Azerbaijan publish individual reports. These are BP and Statoil. For this reason, the fourth question has yet to be answered by most of the companies. Incidentally, we should observe that the government commission has a positive attitude to companies disclosing their reports individually. The chairman of the government commission has repeatedly said this at trilateral (government, companies and the NGO Coalition) and bilateral (government and the NGO coalition) meetings which were attended by the author.

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The forms of reports that are used in the Azerbaijani version of the EITI do not indicate the government agencies into the accounts of which companies are making payments. But the answer to this question can be found in the following legal acts (See Chapter 5.3). Thus, although the Azerbaijani version of the EITI does not answer the fifth question, citizens can still get it from other sources.

Questions 6-9 are frequently asked by participants in the meetings. In response to these questions, we have to answer that the philosophy of the EITI does not cover questions related to the spending of oil revenues, although it is this sphere of spending that entails the highest risk in terms of possible losses, misappropriations, corruption and simply ineffective use of revenues.

Question 10 is also unanswered because reports within the framework of the Azerbaijani version of the EITI contain aggregated information.

Thus, a number of questions of interest to civil society related to oil revenues and their spending are not answered within the EITI.

At the same time, the EITI creates conditions for informing citizens about the overwhelming majority of the country's revenues from the development of natural reserves. Civil organizations receiving information about the country's revenues as a result of introduction of EITI can monitor the process of accumulation and spending of the country's revenues. Without the EITI civil society organizations monitoring budget expenditure could not be sure that their control covers all revenues. However, such total control is not available in Azerbaijan yet. Is civil society capable of doing that now? We will try to answer this question in the next paragraph.

6.5. Is it possible to improve the Azerbaijani version of the EITI?

An analysis of EITI principles⁹² shows that there are no restrictions on the volume of information that is disclosed. It is only important to ensure that the requirements for the disclosure of information do not run counter to the country's law and contracts signed with foreign companies (the sixth principle of the EITI).

Thus, the improvement of the Azerbaijani version of the EITI is possible if the government and companies have a positive attitude to this. We think there are no serious grounds for them to object to the expansion of accountability in order to ensure the disclosure of information regarding at least the fourth and 10th questions and the full answer to the second of the questions listed in Point 6.4.

7. NOTES FOR THE ROAD MAP

The analysis of proposed risks of ineffective management of oil revenues, conducted in Paragraph 4, has confirmed their importance. Indeed, the following factors heighten the risk of losing some of the country's revenues: a) absence of the necessary governmental experience in managing revenue windfalls; b) imperfection of laws, dependence of the judiciary on the executive power; c) dependence of legislature on executive power; d) ineffective anti-corruption mechanisms; e) weak democratic institutions; f) weak civil society organizations; g) weak independent media; h) conflict of interest of SOCAR in PSAs.

The lack of governmental experience is explained by the country's Soviet past. The government has been taking measures of late to reduce the risk of ineffective management of the country's financial resources accumulating in the National Bank and SOFAZ. This is not an easy task and is likely to take time before the country gains the necessary experience and develops intellectual potential for handling the financial resources independently. The country will most likely continue using the services of different foreign consulting companies and financial managers. In principle, there is nothing negative in this. Many governments in the world are using the services of different consulting services. For example, even the Norwegian Pension Fund is making wide use of the services of a number of financial companies.

Another issue is slightly worrying – are the opportunities of foreign consultants being used to the maximum extent? The author of the research has determined during private discussions with a number of well-informed government officials that public officers responsible for managing the country's financial resources are very cautious not only in decision-making on the basis of recommendations from consultants but also in seeking the country leadership's go-ahead for a certain course of action. In the conditions of high dynamism in modern capital and securities markets such caution and sluggishness in decision-making leads not only to the loss of potential gains but even losses as a consequence of inflation of currency units in which SOFAZ and National Bank reserves are kept. It is extremely difficult to analyze the effectiveness of management of SOFAZ funds because information about transactions on placement and investment of financial resources is kept confidential.

The analysis of a number of laws (Paragraph 5) regulating public service has shown that there is room for their improvement. Namely, it would be advisable to ensure that the Law on Public Service covers all public officers without any exceptions. It is also advisable to tighten the provision of the law limiting the influence of political parties on a state body. It is important to categorically ban the widespread practice when leaders of state bodies lobby (and at times even force) their subordinates to join the ranks of their party. Unfortunately, the law does not have any limitations to that effect. It is very important to tighten the provision of the law limiting nepotism. By and large, the law allows state bodies to be made up of their own people. "Own" people are relatives, fellow countrymen, friends, neighbors, members of the same party as the head of the state body, etc. As a result, national laws become less important for public officers than the orders and opinions of their chief.

The analysis carried out in Paragraph 5 has shown that there is also room for improvement in the laws On State Purchases, On the Chamber of Accounts, On the fight against corruption, and the Rules of financial accountability approved by parliament.

The same Paragraph 5 analyzes legal documents regulating the activity of SOFAZ and points to provisions in these documents creating risks of ineffective management of oil revenues. There is room for developing the legal framework here as well.

The presence of perfect laws is, of course, a key precondition for good management of revenues. But this is not enough. It also requires the presence of a judiciary which would be independent of the executive branch. Unfortunately, as Paragraph 4 shows, Azerbaijan cannot boast of independent and fair courts yet.

It is proposed that the package of individual standard acts that regulate the activities of SOFAZ should be improved by replacing them with a special new law on the Oil Fund and the management of oil revenues.

It would be appropriate to take the following principles into account in this law:

- decision-making on SOFAZ expenditure by parliament;
- decision-making on limitations on storage and placement of SOFAZ resources by parliament.
- rejection of the current SOFAZ budget concept whereby the fund's assets can also be used to finance different state projects and programs;

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- distributing a portion of oil revenues among citizens. In doing so, it is necessary to ensure that citizens are entitled to a fair share in the oil revenues;
 - targeted use of SOFAZ resources;
 - establishing a parliamentary commission to observe SOFAZ's investment policy;
 - having the SOFAZ executive director appointed by parliament on a presidential motion;
 - attracting foreign managers for SOFAZ portfolio investment and placing its assets.

The parliament practically has right of influencing the process of decision-making on spending oil revenues. The parliament is the body which is supposed to be the main opponent of the executive branch. It is ludicrous when parliament, which has the right (at least) to approve the state budget, cannot take part in the discussion pertaining to how SOFAZ resources are spent which are expected in the next two years to exceed the government's annual budget by several budget.

The use of first principle in the new law would mean the transfer of the decision-making right on spending SOFAZ resources from the president to parliament. According to the existing Regulations of SOFAZ, the spending of oil revenues is effected by annual presidential decrees on priority expenditure directions (paragraph 4.1.). The transfer of this right to parliament would enable decision-making by a broader spectrum of stakeholders because parliament represents not only different political forces but also many other sectors (business, education, health, etc.), regions, ethnic groups, etc.

Today, decisions on storage and placement of SOFAZ resources are made by the SOFAZ executive director on the basis of the Rules for keeping, placing and managing the hard currency resources of the State Oil Fund, which have been approved by the president. In view of the adoption of the new law, it must reflect norms pertaining to these rules.

According to the abovementioned Rules for developing and executing the annual program (budget) of the State Oil Fund, the fund's expenditure, in addition to expenses associated with the fund's current activities, also envisions expenditure on the implementation of various state projects and programs. Prognostication of the fund's expenditure, according to the said Rules, is performed jointly with the Finance Ministry. It might be appropriate to exempt SOFAZ from having to make a prognosis of its expenses on the said projects and programs. This work must be carried out within the framework of a single budgetary process.

The high level of oil revenues for a number of years during peak levels of hydrocarbon production will make it possible to distribute a portion of them among citizens. In doing so, it is necessary to ensure that all citizens are entitled to a share of the revenues. By allocating funds for the solution of social problems of refugees and IDPs, the government is actually violating the right of other citizens to natural wealth which is considered to be common. This policy also leads to the growing discontent of other citizens and conflicts. Such conflicts are not widespread, but the level of discontent has been on the increase lately. Calculations show that with a world market price of oil at \$60 per barrel, the country's revenues could reach \$20 billion in 2009. If \$8 billion is divided among citizens, this would mean that each of them will receive \$1,000. This is good money for a

country in which almost 40% of the population lives beyond the poverty line. The annual income of these people does not exceed \$600 and it is not too difficult to understand how glad these people will be. Also, the attitude of many people toward oil contracts will also change profoundly. Sociological surveys show that many see them as a means of self-enrichment for the government elite.

Targeted use of SOFAZ resources. The implementation of this principle would mean the rejection of meaningless transfers from the fund to the state budget. Such transfers become negligible in total budget expenditure and it is impossible to keep track of them afterwards. Targeted use of the resources for specific projects would enable us to monitor how this money has been spent.

According to the Regulations on the SOFAZ, there is an Observation Council which is formed by the president. This council must be made up of representatives of the government, parliament and public organizations. Although three years have passed, representatives of the civil society have yet to be included. Under the said Regulations, the fund is not accountable to parliament, which means that the discussion of the fund's work is rather limited. When forming the parliamentary commission to monitor the fund's investment activities, the experience of Norway could be used. In Norway, this commission consists of MPs representing an opposition party. But even if the commission has a mixed composition, it will have a positive effect.

Although a number of important anti-corruption measures of institutional nature have been taken over the past three years, the fight against corruption has not become a priority task for the government. Under such circumstances, the threat of

embezzlement of some oil revenues by some officials is quite tangible.

The actual dependence of the judiciary and the legislature on the executive branch and the ineffective anti-corruption struggle are mainly the result of poor democratic development in the country. Soviet traditions of forming the parliament are still continuing. As a result, many institutions which are intended to ensure good governance turn out to be of little or no effect.

Paragraph 4 also analyzes risks connected with a weak civil society and independent media.

Measures towards both quantitative and qualitative growth of NGOs would be appropriate in the country today. The existing procedures for the registration of NGOs are too complicated and need to be simplified. Namely, it is very important to amend the current law on public associations and funds or to adopt a new law on non-commercial organizations. The existing law does not provide for the establishment of any non-commercial organizations than NGOs and foundations. For instance, an attempt to establish a non-profit Think Tank would not be materialized, which is why such institutes are established in Azerbaijan in the form of Ltd. It does not make sense to set up an NGO because of a membership issue involved.

Even if the existing law is left unchanged, then at least the legal acts of the Justice Ministry pertaining to registration have to be reconsidered. They make the registration procedure extremely complicated and leave room for the ministry officials to deny or delay the registration of an NGO. There are numerous provisions in these acts which are completely meaningless and unfounded.

There are still cases when ministry officials consult those of the presidential administration on whether to register NGOs

which take a critical stance towards the incumbent authorities. For example, Transparency International – Azerbaijan was registered only in late December 2005, i.e. registration was granted only five years after the organization was set up. And this too happened with assistance of the US ambassador.

The focus groups and in-depth interviews with heads of a number of media outlets and journalistic associations held by the author of the research have revealed some important directions of improving journalists' awareness of oil contracts, anticipated revenues, legal acts pertaining to the management of oil revenues and government expenditure of the revenues. Besides, the focus groups and interviews have shown that it is also important to make journalists more interested in monitoring the spending of oil revenues and carrying out journalistic investigations. Therefore, the following measures could be instrumental in improving the effectiveness of the media in the area of monitoring oil revenues:

- training journalists;
- providing a series of lectures at journalistic faculties;
- conducting a special roundtable for the editors of the leading mass media;
- arranging competitions for the best journalistic investigation about how oil revenues are spent;
- arranging competitions for the best short film;
- creating special clips and broadcasting them on television channels.

All these measures will certainly boost the potential of the more active part of Azerbaijani society. The main problem in this area is financial. The cost of activities listed in paragraph 4.2 and

4.3 depends on the number and nature of the activities (roundtables, training sessions, journalistic competitions, short films, special editions, TV programs, etc.) and the number of areas they cover. The more money is spent, the higher the effect. However, we have to keep in mind that starting from a certain amount the effectiveness will start declining despite the growing expenditure.

International financial institutions such as WB, IMF, EBRD, ADB, as well as the European commission and development agencies of a number of leading countries (such as USAID, DFID, etc) have been playing an important role in facilitating the country's shift to democratic society and liberal economy. By providing technical and financial assistance, they actually act as partners of the government in many reforms. Although this relationship is not always smooth and at times even tense, the country is undergoing reform, slowly but steadily.

The role of international institutions and different international and national NGOs in developing the civil society in Azerbaijan is also quite important.

All this leaves hope that international institutions will help both the government and civil society organizations ensure good governance of oil revenues.

The role of international institutions is facilitating the above-mentioned good governance of oil revenues can be quite extensive. Such assistance on the part of international institutions could be in the form of:

- technical assistance to the government and civil society organizations;
- financial assistance to civil society organizations.

The significance of the risks of ineffective management of oil revenues, listed at the beginning of this chapter, requires immediate measures to improve the situation. Otherwise, losses are inevitable.

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APPENDICES

A brief note about the Republic of Azerbaijan

The Republic of Azerbaijan gained independence on 18 October 1991. Prior to that, the country was part of the former USSR.

The Republic of Azerbaijan is located in the eastern part of the South Caucasus (Appendix 1). Its territory covers 86,600 square kilometers and is located between 44° and 52° East longitude, and 38° and 42° North latitude.

Azerbaijan borders on Russia in the north (390 km), Georgia in the north-east (480 km), Armenia in the west (1007 km), Iran in the south (765 km), Turkey in the south-west (15 km), while in the east it is washed by the Caspian Sea.

The country's population as of early 2006 was 8.4 million people.

More than half of the country's territory is occupied by mountains (the highest mountain top is Bazarduzu – 4466 m), which are made up of the Greater Caucasus in the north and the Lesser Caucasus in the west and south-west.

There are more than 1000 rivers on the territory of Azerbaijan but only 21 of them are more than 100 km long. The Kur, the biggest river in the South Caucasus, crosses the territory of Azerbaijan from north-west to south-east and flows into the Caspian Sea.

The greater part of the country's territory is located in a subtropical climate zone.

The state language is Azeri, which belongs to the Turkic family of languages.

The main religion is Islam. About 70% of all Muslims are Shiites, while 30% Sunnis. There are also Orthodox, Judaic and Catholic communities in Azerbaijan.

According to the 1995 Constitution, Azerbaijan is a presidential republic. The head of state is the president who is elected through nationwide vote for five years (Ilham Aliyev has been president since 15 October 2003). The head of state has extensive legislative and executive authority.

The legislature is one-chamber National Assembly (the Milli Mejlis) elected for five years. All 125 MPs are elected on single-mandate constituencies. Citizens above the age of 18 have the right to vote.

The highest body of executive power is the Cabinet of Ministers appointed by the president and approved by the Milli Mejlis. The head of the Cabinet of Ministers is Artur Rasizade who was appointed prime minister in 2003.

Administratively, the country consists of 59 districts, 11 cities and the Autonomous Republic of Nakhchivan which has its own Constitution, parliament and government.

Azerbaijan is a member of the UN, Council of Europe, CIS, International Bank for Reconstruction and Development (IBRD), European Bank for Reconstruction and Development (EBRD), Organization of Islamic Conference, OSCE, NATO's Partnership for Peace program, World Trade Organization with the status of an observer, etc.

Azerbaijan is an agro-industrial country. The leading sector of the economy is production and refining of hydrocarbon resources. In 2006 the share of the oil sector in the GDP reached 40 %, in budget revenues 55 % and in exports 85 %.

According to many ancient historians and travelers, oil production on the Absheron Peninsula and its export to Iran, Iraq, India and other countries began in ancient times. According to well-known Italian traveler Marco Polo, back in the 13th century there were many oil wells on the Absheron Peninsula and oil produced from them was exported to many countries. The mud oil production method existed in Absheron until 1872. The reducing reserves of oil located at small depths, as well as the growing demand for oil, necessitated the technology of bore-hole oil production. The first industrial well was drilled on Absheron in 1848 near Baku.

Drilling of wells became widespread in Azerbaijan in the early 1870s. In 1873, Azerbaijan started the exploration and development of the world's largest fields of Ramani, Sabunchu, Balakhani and Bibiheybat. 12 years later, in 1884, they produced 6.2 million tons of oil.

In 1901, Azerbaijan produced 10.979 million tons of the world's total production of 22.5 million tons. Later on, oil production declined due to the depletion of oil-fields. Particularly sharp was the decline in production during World War I and the subsequent revolution in Russia. Starting from 1922, there has been a stable increase in oil production which reached a record 23.482 million tons a year in 1941. In those years, Azerbaijan turned into one of the world's centers of petroleum science, technical and technological development.

In 1940, Azerbaijan contributed 71.5% of the USSR oil production. In 1941-1945, 63.2% of the USSR total oil production was contributed by Azerbaijan.

By the end of World War II, oil production in Azerbaijan started dropping. Subsequently, measures were taken to stabilize it. And although it was impossible to reach the pre-war level of production, between 1947 and 1963 there was stable production at about 21 million tons a year. In 1969, oil production level started declining and this recession lasted until 1985. It was followed by a five-year period of stable production of about 13 million tons. In 1990, production started falling again (slightly) until production from the Azeri-Chirag-Guneshli contract area commenced in 1997. Azerbaijan signed the first oil contract on this group of fields in 1994. Subsequently, the government signed 25 other PSAs with foreign companies.

Along with hydrocarbon resources the country is developing the reserves of iron, zinc and molybdenum ores, mineral salt, drill water containing iodine and bromide, gypsum, lime, bitumen, clay, marble and other natural resources.

Some of the produced oil is refined at two oil refineries which is part of the state oil company. There are enterprises producing oil-field equipment, chemical and electro-technical products, aluminum, construction materials, processing agricultural and food products.

Agriculture specializes in cultivation of vegetable, fruit, cotton plant, tobacco and subtropical crops, as well as mulberry silkworm and sheep.

The main economic sectors are oil production and refining industries and agriculture. In the 196-1980s, mechanical

engineering, chemical, textile, food and other sectors were developing in the republic as well.

The key sector of the economy is the oil and gas sector (40% of the GDP). In 1997, a total of 9 million tons of oil (99.2% of the 1996 level) and 6 billion cubic meters of gas (95% of the 1996 level) were produced. Production of petrol and diesel, and their exports to CIS, increased by 20%.

The second biggest sector in terms of contribution to GDP is agriculture. Agricultural lands occupy 46% (about 4 million hectares) of the country's territory, and half of them is used as pastures. This sector produces grains, technical (cotton and tobacco), subtropical (pomegranate, tea, citrus, persimmon) crops and grapes. Natural silk is also produced.

The national currency unit is the Manat. In late 2006, 1 Manat was equal to 1.147 USD.

The table below provides main macroeconomic indices for the last two years.

Key macroeconomic indices ⁹³	2005, million AZN	2006 million AZN
Gross Domestic Product (GDP)	12522.5	17735.8
GDP per capita (million manats)	1484.3	2078.5
GDP per capita (USD)	1613.4	2389.1
Industrial production	9290.5	14454.7
Agricultural products	1752.1	1915.6

⁹³ http://www.azstat.org/publications/azfigures/2007/en/001.shtml#t1_5

Key macroeconomic indices ⁹⁴	2005, million AZN	2006 million AZN
Retail trade turnover circulation at all branches of sale total	4622.2	5760.3
Paid services for population by all kind of services	960.7	1400.7
Freight turnover in transport sector, mln.ton-km	26534	43137
Investment	5769.9	5985.7
Exports (\$ million.)	4347.2	6372.2
Imports (\$ million.)	4211.2	5267.6
Income of population	8063.6	9949.8
Income per capita, manat	974.9	1189.5
Number of registered unemployed, person	56343	53862
Consumer price indices of goods and services in comparison with the previous December, %	105.4	111.4
Wholesale index of industrial production (average annual, in comparison with to the previous year, percent)	118.9	117.7
Average monthly wage, AZN	123.6	141.3

⁹⁴ http://www.azstat.org/publications/azfigures/2007/en/001.shtml#t1_5

As is seen from this table, the growth in economy and population incomes is obvious. Analysis shows that this is mainly explained by three factors:

- Development of operations on oil contracts (mainly contracts on development of Azeri-Chirag-Guneshli oil and Shah Deniz gas field);
- Investment in the construction of residential and non-residential buildings;
- Growth in transport and communication sectors.

The main reason for inflation growth in the last two years, as many experts say, is the increase in state expenditure. Budget increase in 2006 was planned at 67%, while in 2007 at 58% in comparison with 2006.

Azerbaijan is strategically located on the way from Europe to Asia, on the so-called Great Silk Way. In 1993, a special program was adopted to establish a transport corridor from Europe through the Black Sea and the Caucasus to Central Asia.

A brief note about the oil industry of Azerbaijan

1. FROM THE HISTORY OF OIL PRODUCTION

According to many ancient historians and travelers: Abu Ishaq Istahri (8th century), Ahmad Balazuri (9th century), Al-Mas'udi (10th century), Yaqud Hamavi (13th century), Marco Polo (13th century), Hamdullah Qazvini (14th century), Katib Chelebi (14th century), Oleari (17th century), Campfer (17th century), oil production on the Absheron peninsula and its export to Iran, Iraq, India and other countries began from time immemorial. At that distant time, "the black gold" was used not just as fuel and for lighting, but also for military and medical purposes. For this reason, it is no surprise that oil extracted in Absheron was in great demand in many markets of the ancient east. According to the well-known Italian traveler, Marco Polo, there were a lot of oil wells in Absheron in the 13th century, from which oil was exported to many countries of the world. In order to extract oil, residents of this area dug wells similar to those used to extract water. In 1654, a local resident called Allahyar Mammad Nurioglu dug the first oil well with a depth of 35 meters in Absheron. Oil production by means of wells existed in Absheron until 1872. Shrinking oil reserves at small depths, as well as the growing demand for oil led to the development of the technology of oil production by means of drilling oil wells. The first well in Absheron was drilled near Baku in 1848.

The drilling of wells in Azerbaijan took on a large scale in the early 1870s. From 1873, the exploration and exploitation of the largest deposits in Ramana, Sabunchu, Balakhany and Bibi-Heybat began in Azerbaijan. Twelve years later, they yielded 6.2m tons of oil in 1884.

Figure 1 shows the schedule of oil production in Azerbaijan in the last quarter of the 19th century.

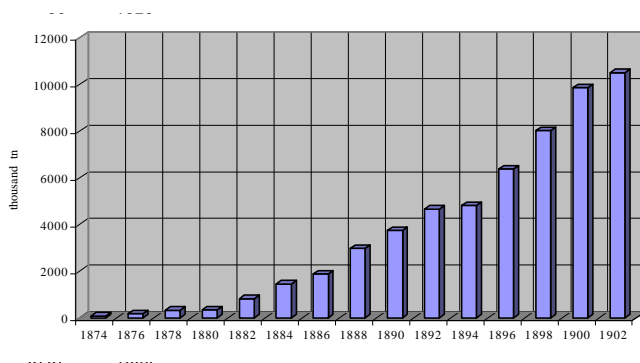


Figure 1

In 1901, 10.979m tons of the world's 22.5m tons of oil were extracted in Azerbaijan. Later, oil production fell as the existing deposits ran out. The fall in oil production was especially strong during World War I and the following revolution in Russia. However, the Bolsheviks who understood full well the importance of Azerbaijan's oil wealth, started taking active measures to restore oil production as soon as possible. A stable growth in oil production began in 1922 and reached the record amount of 23.482m tons in 1941. At that time, Azerbaijan turned into one of the world centers for the development of oil science, equipment and technology. Figure 2 shows the schedule of oil production in Azerbaijan in the Soviet period.

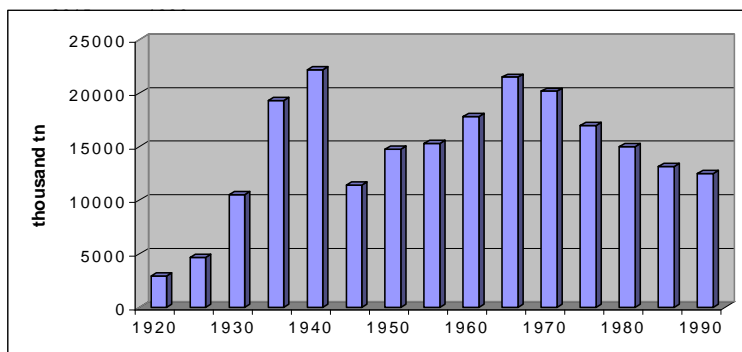


Figure 2

In 1940, Azerbaijan provided 71.5 per cent of oil production in the USSR. In 1941-45, 63.2 per cent of all Soviet oil was extracted in Azerbaijan. This oil played a decisive role in the Soviet victory over Germany.

By the end of the war, oil production in Azerbaijan started to fall. Later, a number of measures were taken to stabilize oil production. Although it was impossible to reach the level of the pre-war period, a stable growth in oil production was registered between 1947 and 1963. The level of stable production from 1964 to 1968 totaled about 21m tons per year. In 1969, an annual fall in oil production began and continued until 1985. Then there was a five-year period of stable production at the level of 13m tons. From 1990, oil production started falling again (insignificantly) up to the beginning of production work on the Azeri-Chirag-Guneshli contractual oil field. The first oil contract on this group of deposits was signed with the consortium of foreign oil companies in 1994.

Oil production from 1995 to 2005 is shown on Figure 3.

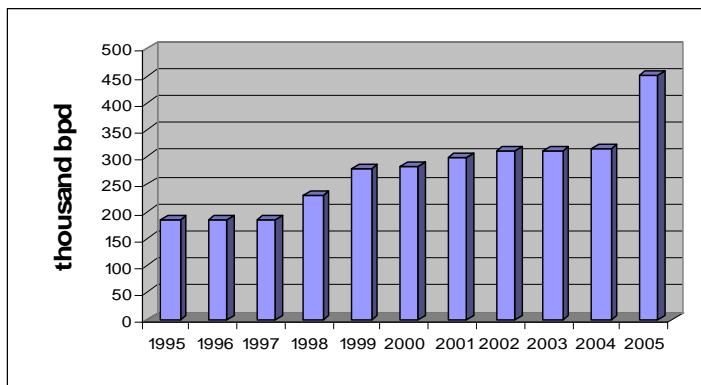


Figure 3

2. OIL AND GAS RESERVES

Industrial oil reserves in Azerbaijan were first discovered in 1848. This was the Bibi-Heybat deposit. Twenty-one years later, another super-gigantic deposit Balakhany-Sabunchu-Ramana was discovered. In general, 43 onshore deposits of hydrocarbons were explored. Thirty-seven of the 43 are currently in the industrial operating stock.

These deposits are geographically located in four oil and gas regions of Azerbaijan: Absheron peninsula, Kura cave, the Caspian-Quba and Shamakhy-Qobustan regions.

Industrial oil reserves in the Caspian Sea shelf were discovered in 1948. This was the Oil Rocks deposit. Later, another 23 offshore deposits of hydrocarbon reserves were explored, including such super-gigantic structures as Azeri-Chirag-Guneshli and Shah Deniz.

Of the 67 deposits, 37 are currently in the industrial operating stock onshore and 17 offshore.

A total of 1.450 bn tons of oil and more than 490 bn cu. m. of gas have been extracted so far.

The extent of the clarity of initial extractable oil and condensate reserves for onshore deposits is 92 per cent and for offshore deposits - 28 per cent.

Evaluations show that the volume of residual extractable reserves is:

- oil and condensate – 1,130 m tons;
- gas – 820 bn cu. m.

The main proven oil reserves are concentrated in the Azeri-Chirag-Guneshli deposit while natural gas reserves in the Shah Deniz deposit.

According to experts, oil reserves, including promising structures in the Azerbaijani sector of the Caspian, total 3 bn tons and gas – 3,000 bn cu. m.

3. OIL POLICY OF GOVERNMENT

The main elements of the government's energy policy are: 1) comprehensive encouragement of the development of oil and gas projects, including the participation of foreign capital; 2) the development of the transit infrastructure; 3) the reconstruction and development of the country's and gas transmission networks; 4) reconstruction and development of gas reservoirs 5) bringing domestic prices for energy resources closer to average European ones; 6) the preservation of the state regulation of prices for energy reserves; 7) keeping "blue chips" in state ownership.

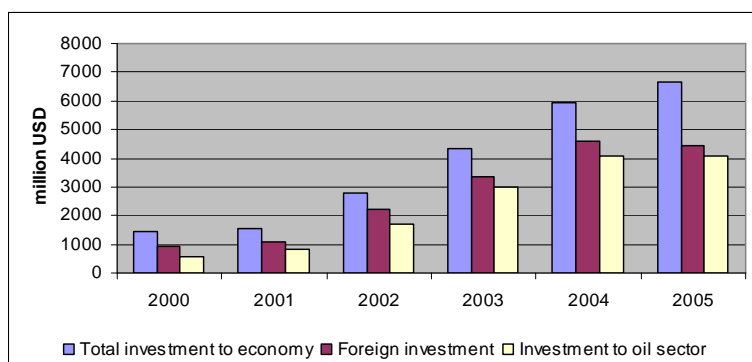
4. SWOT ANALYSIS

<p>Strengths</p> <ul style="list-style-type: none">▪ Existence of oil and gas reserves (availability for at least 25 years within current rate of development of reserves)▪ Common border with countries that possess considerable energy reserves: Russia, Iran, Kazakhstan and Turkmenistan▪ Location as a transit country▪ Availability of regional oil and gas pipeline▪ Established gas transmission network▪ Availability refining capacity	<p>Weaknesses</p> <ul style="list-style-type: none">▪ The physical depreciation of SOCAR equipment▪ A weak legislative and regulatory framework▪ Unresolved status of the Caspian with Iran and Turkmenistan▪ Domestic resources nor sufficient to fill existing pipelines during their lifetime
<p>Opportunities</p> <ul style="list-style-type: none">▪ Increased production of domestic resources (oil and gas)▪ Expanded transit activities and increased transit revenues▪ Transformation of SOCAR into a joint-stock company▪ Increasing volumes of the transit of Central Asian gas reserves	<p>Threats</p> <ul style="list-style-type: none">▪ Lack of new energy resource discoveries – possible transformation from an exporter of energy resources into an importer (in 25-30 years)▪ Proximity to conflict zones and terrorist threats▪ Dutch disease

5. FOREIGN INVESTMENT IN OIL PROJECTS

Beginning from 1994, Azerbaijan has signed 26 production sharing agreements with foreign oil companies.

The biggest amount of upstream investment has been made in the projects on the developments of the Azeri – Chirag – (deep[water] Guneshli oil fields and Shah Deniz gas field. Significant amount of investment has been channeled into the construction of the Baku-Ceyhan main export oil pipeline and Baku-Erzurum gas main. The volume of foreign investment in Azerbaijan's oil and gas projects in 2005 was 4.074 bn US dollars. Figure 11 7 shows the table of investments from 2000 to 2005.



Oil production is currently carried out in the fields: Azeri-Chirag-Guneshli, Janub-Garb, Gobustan, Muradkhanly, Zardab, Jafarli, Kyursangi, Garabagly, Padar and the adjoining structures Mishovdag, Kalamaddin, Zyk, Hovsan, Pirsaat, Binagadi, Kirmagi, Chakhnaglar, Sulutepe, Masazy, Fatmayi, Shabandag, Sianshor, Garachukhur, Kurovdag, and the Surakhan group. Natural gas production is starting from the super-gigantic field Shah Deniz.

6. OIL PRODUCTION, CONSUMPTION AND EXPORTS / IMPORTS

	1990	1995	2000	2006
Oil production (million tons)	12.5	9.2	14.0	32.3
Domestic oil consumption (million tons)	8.5	6.6	6.3	4.7
Oil exports (million tons)	0	0	5.5	23.4
Gas production (billion cubic meters)	9.9	6.6	5.6	6.8
Domestic gas consumption (billion cubic meters)	16.9	8.1	5.5	9.6
Gas exports (million cubic meters)	5.4	0	0	65.5
Gas imports(billion cubic meters)	13.4	0.6	0.3	4.4

Sources of information: State Committee on Statistics, SOCAR, BP

7. KEY PLAYERS IN THE OIL SECTOR

Oil and gas production and export:

- State Oil Company of the Azerbaijan Republic (SOCAR). The company is state property and is under the control of the country's president;
- British Petroleum (BP) and other foreign oil companies (Statoil, ExxonMobil, TotalFinaElf, Lukoil, Itochu and others) that are contractors in PSAs signed by the government;

Oil and gas processing:

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- State Oil Company of the Azerbaijan Republic (SOCAR);

The sale of oil products on the domestic market:

- State Oil Company of the Azerbaijan Republic (SOCAR);
- Azpetrol (private company);
- ABU Petrol (private company);
- Lukoil

Natural gas distribution:

- Azerigas JSC – a state-owned gas distributing company;

The companies listed above are key companies. Apart from them, many other local and foreign oil companies are represented in Azerbaijan's oil sector.

8. PRICES ON THE DOMESTIC MARKET

Energy prices on the domestic market are regulated by the state through the Tariff Council, which in fact is not an independent regulator because only government agencies are represented in it.

9. EXPORT ROUTES

If importing nations are distinguished by tendencies towards the diversification of supply sources, the exporting nations seem to diversify the markets for their products – crude oil, natural gas and petroleum products. In both cases, the ambitions are driven by the existing geopolitical paradigms.

OIL PIPELINES

Export pipelines in operation:

- Baku (Azerbaijan) – Tbilisi (Georgia) – Ceyhan (Turkey);
- Baku (Azerbaijan) – Novorossiysk (Russia);
- Baku (Azerbaijan) – Supsa (Georgia).

The table given below presents the information on the oil pipelines that were listed above.

	Shareholders	Throughput capacity, '000 bpd	Length, km
Baku – Tbilisi – Ceyhan	BP (30.1%); SOCAR (25.00%); Chevron (8.90%); Statoil (8.71%); TPAO (6.53%); ENI (5.00%); Total (5.00%), Itochu (3.40%); INPEX (2.50%), ConocoPhillips (2.50%) and Hess (2.36%)	1000	1768
Baku – Novorossiysk	SOCAR, Transneft	115	1475
Baku – Supsa	AIOC	145	837

The Baku-Tbilisi-Ceyhan oil pipeline

The oil pipeline was put into operation in May 2006. Oil from Azerbaijan's offshore fields Azeri-Chirag-Guneshli is exported by this pipeline. An agreement was signed in the city of Almaty

on 16 June 2006 envisaging the transportation of Kazakh oil via the Baku-Tbilisi-Ceyhan pipeline to the world markets. Under the agreement, the BTC will annually pump up to 10m tons (approximately 733m barrels) of Kazakh oil, which will be delivered to Baku by tankers from the port of Aktau.⁹⁵

Baku – Novorossiysk oil pipeline

After the collapse of the Soviet Union, it was repeatedly commissioned in November 1997 to supply the crude turnout from the Azeri – Chirag – (deepwater) Guneshli oil fields, offshore Azerbaijan. During the Soviet period the pipeline operated to pump crude oil from Siberian deposits to refineries in Baku. In recent years it exported the crude oil pumped on behalf of the State oil company of Azerbaijan. Whenever required, the pipeline is used by the Azerbaijan International Operating Company (AIOC).

Baku – Supsa oil pipeline

It was officially inaugurated on April 17th, 1999. The route mainly passes through the corridor of the old Baku-Batumi oil pipeline. AIOC operates Baku-Supsa line to supply the crude turnout from the Azeri – Chirag – deepwater (Guneshli) fields, offshore Azerbaijan.

⁹⁵ Экспертный доклад Фонда стратегических исследований Центрально-Азиатского региона, 13 ноября 2006. http://www.ia-centr.ru/public_details.php?id=214

Oil transportation by tankers

The delivery of oil and oil products by tankers from and into ports of Russia, Kazakhstan, Iran, Azerbaijan and Turkmenistan has long existed in the Caspian.

The main ports and terminals receiving oil and/or oil products are: the Baku port, the Dubendi terminal (near Baku), the Sangachal terminal (near Baku), the Makhachkala port (Russia), the Anzali port (Iran), the Noshahr port (Iran) and the Neka terminal (Iran).

The main ports and terminals from which oil and/or oil products are shipped out are: Aktau (Kazakhstan), Turkmenbashi (Turkmenistan), Okarem (Turkmenistan), the Sangachal terminal (near Baku), the Dubendi terminal (near Baku) and the Alaja terminal (Turkmenistan).

New ports are expected to be built to receive/ship out oil and oil products: the port of Hovsan near Baku and the port of Kuryk in Kazakhstan. Work to reconstruct and considerably increase the capacities is under way in all of the currently operating ports.

On January 24th, 2007, Kazmunaygaz, contractors for the development of Kashagan and Tengiz oil fields signed a Memorandum of Understanding in the framework of a project on the building up of the Kazakhstan Caspian Transportation System. According to a statement by Kazmunaygaz, the system has been destined to ensure the transportation of the growing amounts of oil exports, particularly from Kashagan and Tengiz (to world markets) through the Caspian Sea. Oil will be transported through the route known as Eskene – Kurik – Baku – Tbilisi – Ceyhan. The completion of this route also implies the

materialization of the Eskene – Kurik oil pipeline. The Trans-Caspian Transportation System will include oil discharge terminals along the Caspian coast of Kazakhstan, as well as tanker fleet, oil-loading terminals at the Caspian coast of Azerbaijan, and joining and communicating facilities for the Baku-Ceyhan pipeline infrastructure. It is planned that the Kazakh system will be capable of shipping 25 million tons per year of crude oil, with possible future expansion of up to 38 million tons. The project is expected to get materialized by 2010-2011.

Since the Caspian is a land-locked sea, oil delivered to the ports of Azerbaijan and Russia is then transported to the Black Sea ports of Batumi, Poti and Kulevi either by the existing oil pipelines Baku-Tbilisi-Ceyhan, Baku-Supsa, Baku-Novorossiysk and Makhachkala-Novorossiysk or by Azerbaijan's and Georgia's railway systems. Oil products from Kazakhstan and Turkmenistan are also transported to the same ports on the Black Sea by railway.

Thus, Georgia's Black Sea ports: Batumi, Poti and Kulevi are elements of the transport system of the Caspian region used for exports of oil and oil products.

Azerbaijan's state oil company (SOCAR) bought this port in early 2007 in order to develop alternative routes for exporting oil and oil products by railway. The total area of the terminal, which is located between the rivers of Tsiva and Khobbi, is 300 ha. This will make it possible to increase the capacity of the terminal from 10 to 15-20m t of hydrocarbons, and the volume of the reservoirs from 320,000 to 380,000 cu. m. For the time being, the terminal is capable of receiving 3m t of oil and 3m t of diesel fuel, as well as 4m t of fuel oil. Four railway branch lines allow 168 tanks to be serviced. The terminal is connected with the sea

by a canal and three oil loading racks. All of them will be reconstructed. SOCAR is also planning to equip the terminal with a rack for exporting liquefied gas. The work will be completed in the second half of 2007⁹⁶.

The tanker oil fleet

Today, operating on the Caspian are mainly tankers with a deadweight of 4-8,000 t, and new are being bought – with a deadweight of 12-13,000 t (a tanker with a deadweight of 12-14,000 t plying between Aktau and Baku can carry 1m t of oil a year, eight such tankers were bought in 2004-06)⁹⁷.

The main oil carrier in the Caspian today is perhaps Azerbaijan's state Caspian Shipping Company (Kaspar) which has 40 tankers and is continuing to beef up its fleet with new ships. Thus, the number of tankers has increased by five in the past few years. Tankers for Kaspar are made by the Russian factory Krasnoye Sormovo based in Nizhniy Novgorod. In 2006 alone, the tankers of the Caspian Shipping Company (Kaspar) took 9.4 million tons of crude oil and petroleum products across the Caspian Sea.

Two private companies are operating on the Caspian today:

- Mobilex Energy Ltd. (daughter of the western company Mobilex Europe, according to other information a Kazakh-Armenian company)⁹⁸;

⁹⁶ TURAN Information Agency, Energy bulletin, 24.01.07

⁹⁷ Транспортные перевозки на Каспии. И. Измоденов. 04 октября 2006
http://www.ia-centr.ru/public_details.php?id=140

⁹⁸ Транспортные перевозки на Каспии. И. Измоденов. 04 октября 2006
http://www.ia-centr.ru/public_details.php?id=140

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- Palmali (Azerbaijani company).

Mobilex Energy Ltd controls one of the terminals in the Kazakh port of Aktau and is currently creating its own tanker fleet for transportation on the Caspian. The company has already acquired three tankers with a displacement of 12,000 t. Mobilex has ordered at Vyborg ship-building factory a total of 10 tankers, five of which will be ready by 2007. By 2010, Mobilex promises to invest about 400m dollars in projects to develop transportation by tanker on the Caspian and the oil terminal in Aktau⁹⁹.

The company Palmali, the second largest river oil transporter in Russia, is becoming increasingly active on all main routes of the Caspian basin. Palmali is operating on all main routes of Caspian oil transportation (except for the Baku route). The shipping company Palmali operates ships with a load bearing capacity of 6-8,000 t on the Caspian.

Gas Pipelines

The Baku-Tbilisi-Erzurum (BTE) gas pipeline or the South Caucasus Pipeline (SCP) is designed to export natural gas extracted at the Shah Deniz deposit. The diameter of the gas pipeline is 106.6 cm with a throughput capacity is 20 bn cu. m. a year¹⁰⁰. The construction has now been completed. The length of the Azerbaijani section of the BTE is 442 km, the length of the Georgian section is 248 km, and the length of the Turkish section is 280 km. The gas pipeline is designed to transport natural gas from Azerbaijan's Shah Deniz offshore field.

⁹⁹ Транспортные перевозки на Каспии. И. Измоденов. 04 октября 2006
http://www.ia-centr.ru/public_details.php?id=140

¹⁰⁰ <http://www.oilcapital.ru/info/projects/63395/private/71213.shtml>

The SCP Co. funding shareholders are: BP (technical operator – 25.5%), Statoil (commercial operator - 25.5%), the State Oil Company of Azerbaijan Republic (SOCAR - 10%), LUKoil (10%), NICO (10%), Total (10%), and TPAO (9%).

Within the framework of the contract on the Shah Deniz project, four agreements have been signed on the distribution of gas from the field at the first stage (9.1 bn cu. m. a year). Under the agreement, Turkey is ready to buy 6.3 bn of cu. m. of gas a year, Azerbaijan - 1.5 bn cu .m., the BTC Co. - 0.5 bn cu. m. (for the operational needs of the pumping stations of the oil pipeline) and Georgia - 0.8 bn cu. m. (0.3 bn of them are the transit fee).

In accordance with a recent¹⁰¹ statement by the prime minister of the Republic of Kazakhstan, Danial Akhmetov, Kazakhstan is considering using the BTE for exporting natural gas to Europe.

It is planned that the BTE will be used to supply gas from the Shah Deniz field via Turkey to Greece. Moreover, prospects for the supply of the gas to the Nabucco pipeline are being studied.

¹⁰¹ <http://www.gazeta.kz/art.asp?aid=75024>