

Azerbaijan: issues of increasing the efficiency of large state-owned enterprises

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FOREWORD

The book you are holding in your hands is a collection of brief studies on the effectiveness of a number of large state-owned and joint-stock companies in Azerbaijan. These studies were carried out by renowned local experts, including Professor Rasim Hasanov, Professor Ingilab Ahmadov, Professor Azer Mehtiyev, economists Samir Aliyev, Rovshan Agayev, Vahid Maharramov and lawyer Abil Bayramov. The studies cover such state enterprises and joint stock companies as: 1) State Oil Company SOCAR, 2) "AzeriGaz" Production Association, 3) "Azerbaijan Railways" Closed Joint-Stock Company, 4) "Azerbaijan Airlines" Closed Joint-Stock Company, 5) "AzerSu" Joint-Stock Company, 6) "AzInTelecom" LLC and "Baku Telephone Communication" LLC, which operate in the telecommunications sector, and 7) "Agricultural Procurement and Supply" Open Joint-Stock Company.

The problems of efficiency of state-owned and joint-stock companies are not new and have been the subject of constant debate among economists and the media. These problems were also in the spotlight of international financial institutions. In particular, the World Bank published a report "Republic of Azerbaijan: Corporate Governance and Ownership of State Owned Enterprises"¹ in 2017. In August 2020, the Asian Development Bank published a report "Azerbaijan: Transforming State-Owned Enterprises into Engines of Growth"².

The low efficiency and often inefficiency of state-owned and joint-stock companies has had an adverse impact on state budget revenues for many years. The country's economy could withstand this situation while oil revenues were at a high level and the incompetent activity of these agencies was compensated by various subsidies, state guarantees for credit resources and other preferences. But after the sharp drop in oil prices in 2014, the government found itself in a difficult situation and, in order to ensure budget revenues, was forced to devalue the national currency twice in 2015. At the same time, the government took a number of measures on structural reforms and development of roadmaps for 11 sectors of the country's economy. Among the decisions taken were those aimed at increasing the efficiency of state-owned and joint-stock companies. In the period between July 2016 and July 2020, the following decrees of President of Azerbaijan Ilham Aliyev was signed:

¹ <https://openknowledge.worldbank.org/bitstream/handle/10986/30207/AUS0000257-PUBLIC-2018-JUNE-ENG-Final-Technical-Note-AZ-SOEs-FINAL.pdf?sequence=1&isAllowed=y>

² <https://www.adb.org/publications/azerbaijan-diversified-resilient-inclusive-development>

- “On certain measures to speed up privatization of state property and enhance governance efficiency” dated 19 July 2016³, and
- “On additional measures to enhance the efficiency of legal entities the control stock (shares) of which is owned by the state” dated 5 September 2016⁴.

To implement these decrees, the Cabinet of Ministers adopted a number of decisions, of which I would like to note the following first of all:

- Dated 21 October 2016 “On ensuring the implementation of Clause 1.1.1 of Decree No. 1003 of the President of the Republic of Azerbaijan “On certain measures to speed up privatization of state property and enhance governance efficiency” dated 19 July 2016⁵,
- “On approving a number of regulatory acts related to enhancing the efficiency of legal entities the control stock (shares) of which is owned by the state” dated 4 June 2019⁶, and
- “On approving the Procedure for development and using a single database on major state-owned companies” dated 4 September 2019⁷.

I would like to specifically note the decision of the Cabinet of Ministers of 4 June 2019, which, albeit with a delay of 2.5 years (according to a presidential decree of 5 September 2016, only four months were given for the preparation of regulations to assess the effectiveness of activities and corporate governance standards) approved the following:

- “Procedure for assessing the effectiveness of the activities of legal entities whose shares (stock) are owned by the state”;
- “Procedure and Standards of Corporate Governance in State-Owned Joint-Stock Companies”;
- “Procedure for bonus payments to members of the governing bodies of legal entities on the basis of a payment system based on the results of the activities of legal entities in which the control stake (shares) is owned by the state”.

The first Procedure covers issues of performance appraisal of legal entities the control stock (shares) of which is owned by the state on the basis of 15 main and 8 additional economic indicators. It shows the formulas and rules for calculating these important

³ <http://e-qanun.az/framework/33346>

⁴ <http://e-qanun.az/framework/33613>

⁵ <http://www.e-qanun.az/framework/34470>

⁶ <http://e-qanun.az/framework/42596>

⁷ <http://e-qanun.az/framework/43243>

indicators. The coverage of the indicators is quite reasonable and their calculation is in accordance with the methodologies used in international practices. It is these calculations that enable determination of financial sustainability and attractiveness of a large state-owned enterprise for investors. According to this Procedure, efficiency is determined by comparing the actual values of indicators obtained in the current year with the prices forecast in the previous year (and approved by a higher institution). Of course, this approach is questionable, but it is better to use this method than not to assess effectiveness at all. Probably the most accurate would be the assessment of market players and investors. Unfortunately, very few large state-owned and joint-stock companies (mainly financial institutions) are reluctant to hold an IPO of their shares.

The second Procedure describes rules and standards of corporate governance in state-owned joint-stock companies. If we pay attention, we can see that the decision of the Cabinet of Ministers does not apply to state enterprises (non-joint stock companies such as SOCAR). Of course, this approach of the Cabinet of Ministers is regrettable. However, international organizations provide recommendations for state-owned enterprises.

The third Procedure regulates the issuance of bonus payments (to members of governing bodies) based on the performance of the state-owned legal entities ("Performance Based Remuneration System"). In particular, the Resolution of the Cabinet of Ministers dated 4 June 2019, unfortunately, does not specify the date on which the approved rules will come into force. This is why (at least this is the impression) the Ministry of Finance issued a letter on 29 June 2020 "To the attention of joint-stock companies, limited liability companies with 51 percent or more of their stock (shares) belong directly and indirectly to the state!" The letter states that the forecast (target) assessments of annual performance indicators must be submitted to the Secretariat of the Commission established by a decision of the Cabinet of Ministers dated 30 December 2016 by November 1 of the year preceding the reporting year after approval by the Supervisory Board (Board of Directors) (the function of the Secretariat of the Commission is assigned to the Ministry of Finance). Once a year before 31 March of the year following the reporting year, the Performance Indicators of the reporting year are compared with the forecast (target) assessments and the Performance Efficiency Ratio is calculated.

Thus, according to this letter, joint-stock and limited liability companies 51 percent or more of shares of which are directly and indirectly owned by the state must submit a forecast (target) performance assessment for 2021 to the Ministry of Finance by 1

November of this year. The first assessment of the efficiency of enterprises can be possible in 2022.

However, the Decree of the President of Azerbaijan dated 7 August 2020 “On the establishment of the Azerbaijan Investment Holding”⁸ introduced some changes to address these efficiency problems. The decree states that “... the deepening of structural reforms is required to improve the management system of state-owned enterprises, increase their efficiency and transparency, optimize their costs and risks, and fully revitalize them”. The decree states that the “Azerbaijan Investment Holding (AIH)” legal entity was being established, its Charter was being approved and determines that the activities of the AIH shall be managed by the Supervisory Board and the Board of Directors. Issues within the exclusive competence of the supreme governing body of state-owned companies and enterprises are to be resolved by AIH after approval by the President of the Republic of Azerbaijan. The Cabinet of Ministers has been instructed to prepare and submit to the President of the Republic of Azerbaijan within two months proposals on state-owned enterprises to be transferred into the AIH. The decree contains a number of other instructions.

The Charter of the AIH approved by the decree states that it is responsible for the management of state-owned companies and enterprises on the basis of common principles, improving their activities, including increasing the transparency and economic efficiency of their investment programs, ensuring their competitiveness, improving financial health and sustainability.

Interestingly, the areas of activity specified in the Charter of the AIH include monitoring the performance of state-owned enterprises in order to assess their efficiency. This raises certain questions because the Resolution of the Cabinet of Ministers dated 4 June 2019 already approved efficiency indicators.

At present, the governing bodies of the AIH have been formed and started operating. According to a decision of the President of Azerbaijan, the Supervisory Board of the AIH includes the Prime Minister (Chairman), Assistant to the President and Head of the Department of Economic Affairs and Innovative Development Policy of the Presidential Administration, Assistant to the President and Head of the Department of Economic Policy and Industry, and Ministers of Economy and Finance. A five-member Board has already been appointed.

The decisions made by the Azerbaijani government give hope that in the next three to five years, the efficiency of large state-owned and joint-stock companies will increase.

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Each of the research results included in this book is accompanied by an appropriate package of recommendations addressed to the government. Among these recommendations are those that are common to all sectors. In short, we would like to make general recommendations here:

1. The transformation of state-owned enterprises and companies with the status of Closed Joint-Stock Companies into Open Joint-Stock Companies and the gradual sale of the remaining shares on local and foreign stock exchanges, keeping only the controlling stake in state ownership. For this purpose, a special plan should be developed for each society. These plans should include a change in status as soon as possible, an assessment of the assets through an audit, the number of shares to be sold at appropriate stages and other important parameters. With the implementation of this reform, it is possible to achieve at least four positive results: 1) increase the efficiency of society; 2) attract local and foreign investors; 3) enliven the stock exchange in the country; 4) privatization revenues to the budget.

Of course, this is a reform that requires years (maybe 2-5 years, depending on the size of the company). However, it is important to start this process as soon as possible. The efficiency and competitiveness of state-owned companies and societies can be ensured through these reforms;

2. The structure of state enterprises and joint stock companies should be reconsidered. It is against market principles to carry out extraction/production (in the extractive industry - Upstream) and distribution (Downstream) activities in one company at the same time. Their separation will increase the competitive environment in the relevant sector, make it possible to create and develop new private companies. This, in turn, serves to make the quality and price of services substantial. In general, assets to be held in state ownership and monopoly (dominant position) must be substantiated. Non-profile enterprises and institutions should be excluded from state-owned companies and societies and privatized. The role of private companies in the sectors should be increased;

3. Identification of the main "harm" links of companies and societies through an in-depth analysis of the value chain, analysis of damage risks, implementation of appropriate measures to ensure the profitability of companies and societies;

4. Adoption of accurate and clear-cut norms and rules governing the financial relations of state-owned enterprises and joint-stock companies with the state and relevant financial flows. Today, there are almost serious gaps in this area. One of the problems is that state-owned companies are burdened with quasi-fiscal costs;

5. According to the 4 June 2019 Resolution of the Cabinet of Ministers, the application of Corporate Governance Regulations and Standards in state-owned joint stock companies is intended only for joint stock companies. It seems expedient to expand the scope of this decision to apply it to state enterprises. According to the decision, it is extremely important to establish Boards of Directors (Supervisors) in all large state-owned enterprises and societies as soon as possible (within a few months) and to provide real control (influence) over their activities and executive bodies. At the same time, the company's management, control, risk analysis and other bodies/committees should be established;

6. Ensuring accountability and transparency. To this end, amendments to legislation should establish clear and transparent frameworks for companies' accountability and transparency obligations. Quarterly and annual performance and financial statements of companies should be open to the public. Information of public importance should be available on a regularly updated working website. Existing legislation in this direction can be improved in a very short time. Ensuring accountability and transparency will bear fruit immediately. The responsibility of the company's governing bodies will increase, and as a result, efficiency indicators will gradually improve;

7. Taking into account the transformation of information into an important value-creating factor in modern times, to strengthen special activities in the studied organizations in order to study public opinion and provide flexible, reasonable and authoritative reactions to relevant information in the information area.

In conclusion, we would like to note that the research was made possible with the support of the Centre for International Private Enterprise (CIPE). We would like to thank this organization on behalf of our group of experts.

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Sabit Bagirov,

President of Entrepreneurship Development Foundation

TRANSPARENCY AND ACCOUNTABILITY IN THE ACTIVITIES OF THE STATE OIL COMPANY OF THE REPUBLIC OF AZERBAIJAN

Samir Aliyev

State participation in the oil and gas industry in Azerbaijan is carried out through the State Oil Company of the Republic of Azerbaijan (SOCAR). SOCAR is not only a state-owned company, but also the largest company in Azerbaijan and the biggest taxpayer. In 2019 alone, the company paid 1.409 billion manats in taxes to the state budget and 173.6 million manats to the State Social Protection Fund. As a rule, 6-8 percent of budget revenues and 15-17 percent of tax revenues are usually contributed by the State Oil Company. In 2019, SOCAR accounted for 76.4 percent of taxes and other mandatory payments paid by state-owned taxpayers. In 2018, the number of employees in the company was 51,125 people. Last year, the company's assets amounted to 65.4 billion manats and its total revenues amounted to 83.8 billion manats. 61 percent of revenues were generated from the sale of crude oil, 26.5 percent of petroleum products, 4.7 percent of petrochemical products and 4.9 percent of natural gas. The company received most of its revenue (76 percent) from operations in Switzerland. Only 7.3 percent of total revenues were generated in Azerbaijan. In this regard, it is important to disclose SOCAR's financial activities to the public, and this study also examines the issues of transparency and openness of the state company, the level of compliance of its governance with modern standards.

SOCAR owns all the hydrocarbons produced, as well as oil, petrochemicals and gas products obtained from their refining. Azerbaijan produces an average of 40 million tons of oil and 29 million cubic meters of gas every year. The refined products produced by SOCAR over the past 10 years are mostly intended for the domestic market. In 2009, it exported 56.6 percent of oil products, while in 2018 the share of exports fell to 18 percent.

Legal status and governance principles

SOCAR is a state-owned company and 100 percent of its shares belong to the Republic of Azerbaijan. The organizational legal form of the company is special and it is registered as a state enterprise. As a fully state-owned enterprise, SOCAR always

receives state support. The government has historically provided financial and strategic support to SOCAR, helping SOCAR to expand its operations, resources, production levels, transportation and processing networks.

Decree No. 844 of the President of the Republic of Azerbaijan “On Improving the Structure of the State Oil Company of the Republic of Azerbaijan” dated 24 January 2003 approved a new management structure of SOCAR based on the current legislation, including a new Charter. According to the charter, SOCAR's structure includes the Management, the Company's Board and five Committees. The company's management includes 13 people, including the company's president, first vice president and 11 vice presidents.

According to Clause 5.3 of the Charter, the president, first vice president and all vice presidents are appointed and dismissed by the President of the Republic of Azerbaijan, who is the head of state and government. Of the 13 people in the company's management, 11 are members of the ruling New Azerbaijan Party.

The charter does not provide for any criteria for the knowledge and skills of senior executives, including age and work experience. At the same time, there is no limit to time in office for the company's executives.

According to SOCAR's reports⁹, the company implements a centralized management system based on the principles of corporate governance, and it consists of the company's Board, management and committees. However, our research shows that SOCAR's management does not meet corporate governance standards. The organizational and legal form of the company is not clear. All these issues are reflected in international standards, including the Guide to Corporate Governance in State-Owned Companies adopted by the Economic Cooperation and Development Countries in 2015¹⁰.

The organizational and legal form of SOCAR as a commercial entity contradicts the requirements of the current Civil Code. According to Article 64 of the Code, a commercial organization means a business partnership and company. Such organizations are considered to be commercial organizations with authorized (joint) capital divided into shares of their founders (participants). According to the Code,

⁹ <http://www.socar.az/socar/assets/documents/az/socar-annual-reports/davamli-inkisaf2014.pdf>

¹⁰ OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition
https://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015-edition_9789264263680-ru

when establishing business partnerships and companies, the words "limited liability company" and "joint stock company" must be indicated in the company's name.

SOCAR's organizational and legal status is stated in the company's name as a "state company". The state registration of the company was carried out in 1992 on the basis of the legislation in force at that time. The current Civil Code was adopted in 2000. Unfortunately, although the company's charter was updated in 2003, this factor was not taken into account. It is not clear to which category the company belongs – a business company or a partnership. At the very least, the law requires that the name of the firm be categorized.

Another problem is the non-application of corporate governance standards in SOCAR. The prospectus posted by the company as an issuer on the Baku Stock Exchange¹¹ states that due to the lack of specific corporate governance standards in the Republic of Azerbaijan, the form of management of companies is generally determined by the Civil Code and it is claimed that SOCAR's current corporate governance bodies are established in accordance with relevant legislation. Most of the company's reports repeatedly emphasize the application of corporate governance standards. However, our research shows that governance principles do not fully comply not only with corporate governance standards, but also with the requirements of the Code to which the company refers. Although the code describes important elements of corporate governance, they are not applied to SOCAR's management structure.

According to the Charter, SOCAR's structure includes the management, the Company Board, five Committees (*Audit, Risk Management, Procurement, Personnel Management, Information Security Committees*), the Head Office, branches, representative offices and non-legal entities (Departments), joint oil companies and institutions established by the Company. SOCAR does not have *a general meeting* and *a supervisory board* elected by it. There is only Company Board, which acts as the *Board of Directors*. In essence, the functions of the general meeting and supervisory board are performed by the President of the country. The company does not have mutual control mechanisms, control is only one-sided and applies to the structures at the disposal of the president of the company.

Azerbaijan has adopted only two documents on corporate governance standards for banks and businesses. "Corporate governance standards in banks" were approved by Decision No. 1951100027 of the Chamber of Control over Financial Markets in the

¹¹ http://bfb.az/teqdimat/?s_issuer=5083

Republic of Azerbaijan dated 27 June 2019¹². These standards have been developed in accordance with the Basel Committee on Banking Supervision's "Principles for Improving Corporate Governance" and taking into account international corporate governance practices. The other document is the "Azerbaijan Corporate Governance Standards" adopted by the Ministry of Economic Development of the Republic of Azerbaijan (now the Ministry of Economy) in 2011¹³. By its Resolution No. 257 of 4 June 2019, the Cabinet of Ministers approved the "Rules and Standards of Corporate Governance in State-Owned Joint Stock Companies"¹⁴. Since the organizational and legal form of SOCAR is not a joint-stock company, it is impossible for these Rules and Standards to fall within its scope because these Rules and Standards are intended only for state-owned joint stock companies.

SOCAR's financial relations with the state

The state allocates funds to SOCAR mostly through authorized capital or loans. The Central Bank of the Republic of Azerbaijan, acting as a Lender, provides loans to Azerbaijani banks and SOCAR acts as a re-borrower with a state guarantee. An agreement on the issuance of a state guarantee is signed by the Ministry of Finance of the Republic of Azerbaijan, the Central Bank of the Republic of Azerbaijan, SOCAR and Azerbaijani banks acting as guarantors on behalf of the Government of the Republic of Azerbaijan.

Financial flows between SOCAR and the state can be systematized as follows:

Financial transfers from the state to SOCAR:

Support for capital growth. SOCAR's authorized capital increased fourfold in 2011-2019, from 1.059 billion manats to 4.323 billion manats. The main source of growth was state budget assistance to the company. The purpose of this assistance was to increase the authorized capital of "AzeriGaz" PA, to establish a urea plant, to provide state support for the drilling of some oil fields (Umid, Karabakh and Babek fields).

Investment. Projects in which SOCAR participates are fully or partially financed from the state budget or investment-oriented funds allocated from the State Oil Fund. By Order No. 287 of the President of the Republic of Azerbaijan dated 25 February 2014,

¹² <http://www.e-qanun.az/framework/43056>

¹³ <http://economy.gov.az/article/korporativ-idar%C9%99etm%C9%99/21348>

¹⁴ <http://www.e-qanun.az/framework/42596>

the SOCAR-owned Southern Gas Corridor CJSC with a charter capital of \$100 million was established, 51 percent of which is state-owned and 49 percent is owned by SOCAR, in order to implement the second stage of the Shah Deniz gas condensate field project, expand the South Caucasus Pipeline, and ensure the management of the Trans-Anatolian (TANAP) and Trans-Adriatic Pipeline (TAP) projects¹⁵. In 2017, 142.8 million manats was spent to finance Azerbaijan's participation in the Southern Gas Corridor project through SOCAR¹⁶. In 2014-2016, the State Oil Fund transferred a total of 1,232.1 million US dollars (1530.3 million manats) to the Ministry of Economy to increase the authorized capital of the Southern Gas Corridor OJSC¹⁷.

Lending. In 2015, as part of the Public Investment Program, the Central Bank opened a credit line in the amount of 3,141.5 million manats to 16 customer organizations to implement a number of projects under the state guarantee within the implementation of the. 60.2 percent of these funds, or 1891.5 million manats, fell to SOCAR¹⁸.

The Opinion of the Chamber of Accounts on the draft state budget for 2020¹⁹ states that 9.4 million manats remaining in the single treasury account of the state budget for 2018 has been paid to SOCAR's Oil Refinery as a loan through the Ministry of Finance in 2019 subject to repayment within one year.

In March 2018, SOCAR received a short-term loan of 102 million manats (USD 60 million) and a long-term loan of 98 million manats from the Ministry of Finance²⁰.

Tax breaks. Another tax break provided to SOCAR is related to VAT. Pursuant to the provisions of the ACG, Shah Deniz and Absheron PSAs, "Azerbaijan (ACG) Limited" (AzACG), "Azerbaijan (Shah Deniz) Limited" (AzSD) and "SOCAR Absheron LLC" have zero-rate VAT certificates from tax authorities that are valid until 19 September 2019, 3 June 2026 and 22 May 2034 respectively on the basis of relevant PSAs²¹.

¹⁵ Report on the activities of the Cabinet of Ministers of the Republic of Azerbaijan in 2016, Baku, 2017

¹⁶ Report on the activities of the Cabinet of Ministers of the Republic of Azerbaijan in 2017, Baku, 2018

¹⁷ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law "On the execution of the 2017 state budget of the Republic of Azerbaijan" and the annual report on the execution of the state budget. Page 212. http://sai.gov.az/upload/files/REY_ICRA2017_final.pdf

¹⁸ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law "On the execution of the 2016 state budget of the Republic of Azerbaijan" and the annual report on the execution of the state budget. Baku, 2017, page 92

<http://sai.gov.az/upload/files/HP%202016%20fealiyyet.pdf>

¹⁹ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law "On the execution of the 2020 state budget of the Republic of Azerbaijan" <http://sai.gov.az/1/rej/71/>

²⁰ SOCAR, "Financial report for 2017", Fundamentals of financial reports and important accounting principles, page 95

²¹ SOCAR, "Financial report for 2017", Fundamentals of financial reports and important accounting principles, page 21

Budget assistance. According to a decision of the Milli Majlis dated 30 June 2017, 250 million manats was allocated to SOCAR in 2017 to make up for the damage caused by the sale of natural gas produced by the State Oil Company of the Republic of Azerbaijan in the domestic market below cost (from the funds provided for in the "Social Security" subsection)²².

The depreciation that took place in 2015 significantly increased "AzerEnerji"'s foreign debt obligations, making it difficult for the state-owned company to meet a number of its obligations, including payments to the State Oil Company. In order to settle the problem of mutual payments between "AzerEnerji" OJSC and the State Oil Company of the Republic of Azerbaijan and in accordance with a relevant order of the Cabinet of Ministers, "AzerEnerji" OJSC was provided with a long-term low-interest loan to repay its arrears to SOCAR as of 1 October 2015.

SOCAR payments to the state

Budget payments. Revenues from the sale of crude oil are reflected in the price margin between the international market price of crude oil and the domestic price regulated by the state minus the relevant tax of the Republic of Azerbaijan. The difference between the market price and the domestic price regulated by the state is taxed at the rate of 30 percent and the tax amount is transferred into the state budget.

In the state budget for 2019, SOCAR's budget revenues amounted to 1,448.6 million manats. This includes consolidated taxes and other payments through the State Oil Company together with the state enterprises of "AzeriGaz" and "AzerKimya" (excluding personal income tax). Last year, SOCAR accounted for 5.8 percent of total state budget revenues, 10.4 percent of state budget revenues from oil sectors (AZN 13,604.6 million) and 62.9% of tax revenues from the oil sector (2,240 million manats). The share of SOCAR in the budget payments of state-owned taxpayers has grown significantly in recent years. In 2019, the share of SOCAR in the budget payments of these taxpayers increased to 76.4 percent²³.

Investment. In accordance with special government decisions, SOCAR makes cash investments and finances (including asset transfers) into the state budget, state agencies and government-implemented projects, including those on construction and

²² Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law "On the execution of the 2019 state budget of the Republic of Azerbaijan", Baku, 2019

²³ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law "On the execution of the 2020 state budget of the Republic of Azerbaijan" and the annual report on the execution of the state budget http://sai.gov.az/upload/files/2019-REY_%C4%B0CRA.pdf

repair. The amount of such investments and financing (in the form of payments to subcontractors of government agencies) in 2018 amounted to 675 million and 5 million manats. These funds were mainly channeled into the repair and reconstruction of existing and new recreation, transport, education and medical infrastructure in the Republic of Azerbaijan. In 2013-2018, SOCAR's investments and financing of state projects amounted to 2,570 million manats.

There is no clear system of rules governing SOCAR's financial relations with the state. The existing rules do not reflect a special approach to relationship between an institution with a special role in the country's economy and the state, and are almost indistinguishable from the relationship between the state and an ordinary enterprise. The only document that reflects the special relationship between SOCAR and the state on financial transfers is Resolution No. 534 of the Cabinet of Ministers dated 30 December 2016 "**On income and expenditure estimates of large state-owned companies**"²⁴. This decision does not regulate the rules of fiscal transfer, but the procedures for the preparation, approval and state control of SOCAR's revenue and expenditure estimates with the participation of the state.

Another document, approved by Resolution No. 504 of the Cabinet of Ministers dated 26 November 2018, is the "**Procedure for state budget organizations, public legal entities established on behalf of the state, extra-budgetary state funds owned by the state by 30 percent or more to disclose their annual financial activities, information on the use of funds provided to them from the state budget or property allocated to them on their Internet information resources**". According to this Procedure, since SOCAR is a state-owned business entity, it should disclose its financial activities, including information on the use of funds allocated to it from the state budget or property allocated to it, through its Internet information resources no later than 30 April of each year, at the end of the reporting period.

The organization of the budget system in the Republic of Azerbaijan, the organization of the preparation, approval, execution and control over budgets, as well as inter-budgetary relations, are regulated by the Law "**On the Budget System**" adopted in 2002. Although the law regulates the interaction between the state budget and the budget of the Nakhchivan Autonomous Republic and local budgets, as well as extra-budgetary state funds, it does not regulate the relationships between the state budget and state-owned companies. The law only mentions state-owned enterprises in the list of organizations involved in the budgeting process.

²⁴ <http://www.e-qanun.az/framework/34668>

The Tax Code²⁵ does not define a different tax regime for state-owned companies. Issues related to taxation and tax control, tax exemptions and breaks for parties to Production Sharing Agreements (PSAs) and those operating in the Alat Economic Zone are not covered in this Code. For example, revenues from the sale of crude oil produced under the ACG PSA and condensate produced under the Shah Deniz PSA are not subject to excise and price margin taxes.

Transparency and accountability

As a result of amendments made to SOCAR's Charter in 2014, the publication of an annual report was included as a mandatory obligation. Pursuant to Clause 6.1-1 of the Charter, the Company publishes consolidated financial statements together with the auditor's report on its website and periodicals no later than 30 June of the year following the reporting period. According to this clause, if SOCAR or its subsidiaries receive state-guaranteed loans or participate in public borrowing projects during the reporting period, or receive subsidies, subventions, grants or budget funds allocated for the implementation of certain powers, they shall also submit the report to the Ministry of Finance of the Republic of Azerbaijan.

SOCAR has switched to international financial reporting standards on 1 January 2008. Since 2009, the Company has annually posted financial statements (*Consolidated Financial Statements in accordance with International Financial Reporting Standards*) on its official website²⁶.

Along with the financial statements, the Company regularly publishes the Annual Report (2004-2018) and the Sustainable Development Report (2011-2018) on its official website²⁷.

The powers of the Milli Majlis, the legislature, to inspect and monitor SOCAR's activities are limited. The only instance SOCAR depends on is the President of the Republic of Azerbaijan. Therefore, the company does not report on its activities to other bodies, including parliament. In terms of legislation, parliament has the right to request certain information. According to Article 11 of the Law of the Republic of Azerbaijan "*On the status of a deputy of the Milli Majlis of the Republic of Azerbaijan*", *members of parliament may apply to state enterprises, departments and organizations to obtain the necessary materials and documents related to their activities*. These bodies shall

²⁵ <http://www.e-qanun.az/code/12>

²⁶ <http://www.socar.az/socar/az/economics-and-statistics/economics-and-statistics/socar-reports>

²⁷ <http://www.socar.az/socar/az/economics-and-statistics/economics-and-statistics/socar-reports>

submit the requested materials and documents to MPs within 10 days, subject to the requirements of the legislation of the Republic of Azerbaijan on state secrets. In addition, Article 39 of the *Internal Regulations of the Milli Majlis of the Republic of Azerbaijan* states that *the Committees established by parliament shall have the right to request documents and materials necessary for the preparation of draft laws and resolutions from state and non-state institutions.*

The Chamber of Accounts, a parliamentary body, has limited powers to inspect SOCAR. Article 2.1 of the *Law on the Chamber of Accounts* states that the scope of the Chamber's activities includes control over the use of funds allocated from the state budget to legal entities and municipalities. However, so far there is no information on the inspection of SOCAR, a company that receives extensive funds from the state each year.

Financial statements have been posted on the company's website since 2009. The documents have been posted on the site and audited cover the 2009-2019 time period. During this period, only one company, *Ernst and Young Holding*, has been the auditor. Based in central London, EY operates in more than 150 countries around the world. For information, the State Oil Fund has worked with three audit companies in the 2002-2015 time period. These are *Ernst and Young Holding* (2002-2006, 2010-2012), *Deloitte and Touche* (2007-2009) and *PWC* (2013-2019).

In general, long-term cooperation with one audit company was widespread in state-owned companies in the former USSR. For example, Kazakhstan's "*KazMunayGas*"²⁸ also worked only with *Ernst and Young Holding* in the 2005-2019 time period. The Russian giant "*Gasprom*"²⁹ cooperated with PWC in 1998-20014 and with "*FBK LLC*" in 2015-2019. Ukrainian "*Naftogaz*"³⁰ has worked with three companies. In the early years of its activities, it used the services of world-class companies such as local "*BDO LLC*" (2001-2003, 2010-2011), then "*Ernst and Young Holding*" (2004-2009) and then "*Deloitte and Touche USC*" (2012-2019) as external auditors. "*KazMunayGas*"³¹ has posted an audit report for the first quarter of 2020, while "*Gasprom*"³² and "*Naftogaz*"³³ have posted financial statements that have not been independently audited.

²⁸ http://www.kmg.kz/rus/investoram/finansovye_i_godovye_otchety/

²⁹ <http://www.gazprom.ru/investors/disclosure/reports/2018/>

³⁰

<http://www.naftogaz.com/www/3/nakweben.nsf/0/C4775D2495121A4AC2257107003B5C8D?OpenDocument&Expand=1&>

³¹ http://ir.kmg.kz/storage/files/73946358b6204e69/KZT_FS_3m2020_ENG.PDF

³² <https://www.gazprom.ru/press/news/2020/july/article508573/>

Forward-looking strategy

SOCAR's goal is to become the world's major vertically integrated international oil and gas company with operational efficiency, social and environmental responsibility in line with best industry practices. In return for such an ambitious goal, the Company does not have a development strategy that would set out its goals for the short and medium term.

SOCAR's mission has been limited to playing a role and contributing to the strategies adopted by the government. For example, the *State Program on the Development of the Fuel and Energy Complex of the Republic of Azerbaijan (2005-2015)* states that the main tasks for SOCAR are to intensify the development of existing fields and accelerate the introduction of modern production, geophysical and oilfield equipment.

However, in the absence of a document setting out medium- and long-term goals and objectives it is difficult to see what role SOCAR will play in the global energy sector in the future and determine whether it intends to enter other sectors. The President of SOCAR has once again announced on the company's official website that a new Strategy³⁴ is being developed. He said that SOCAR had started working with McKinsey on the development of a new strategy for the period up to 2035 and plans to submit it to the government in the near future.

For comparison, in 2018, Russia's "Gazprom" adopted a Strategy in the field of power engineering for 2018-2027³⁵. Kazakhstan's "KazMunayGas" has a development strategy until 2025³⁶.

At a time when the share of renewable energy in world markets is growing rapidly, BP, which specializes in oil and gas production, has announced the main goals of its strategy until 2030³⁷. The essence of the strategy is to gradually replace traditional energy with green energy. To this end, it plans to increase investment in low-carbon technologies and reduce oil and gas production.

³³

<http://www.naftogaz.com/www/3/nakweben.nsf/0/C4775D2495121A4AC2257107003B5C8D?OpenDocument&Expand=1&>

³⁴ <http://www.socar.az/socar/az/news-and-media/news-archives/news-archives>

³⁵ <http://www.gazprom.ru/press/news/2018/june/article436680/>

³⁶ http://www.kmg.kz/rus/kompaniya/strategiya_kompanii/

³⁷ <https://www.bp.com/en/global/corporate/news-and-insights/press-releases/from-international-oil-company-to-integrated-energy-company-bp-sets-out-strategy-for-decade-of-delivery-towards-net-zero-ambition.html>

Conclusions and suggestions

The activities of SOCAR, a state-owned company engaged in the exploration development of oil and gas fields in Azerbaijan, production, processing and transportation of oil, gas and gas condensate, the sale of oil, petrochemical products and gas in domestic and foreign markets, has always been at the center of public attention and opened the way for various discussions. Civil society, including the media, has difficulty obtaining the necessary information from this organization. The company does not appear interested in being open to the public, despite posting financial and performance reports. The official website has recently seen a reduction in news, especially related to sales. There are no reports on the financial and program activities of the company's joint ventures and subsidiaries.

In addition to being the largest company in Azerbaijan in terms of its assets, SOCAR is the biggest taxpayer and the biggest employer. The company has fairly large social responsibility.

When preparing this study, the following trends were observed in SOCAR's activities over the past 10 years:

- *SOCAR is growing rapidly, entering the non-oil sector along with the oil sector and becoming a major risk for the country's economy*
- *Debt obligations exceeding the country's foreign debt continue to grow and their repayment threatens the stability of the country's foreign exchange market*
- *Against the background of rapid changes in the world's energy segment, increasing share of renewable energy, there is no single medium-term and long-term Strategy document that would define the Company's vision and goals for the future and envisage its development*
- *The company, which always emphasizes in its reports that it applies corporate governance systems, has management that does not meet corporate governance standards.*
- *There is no mechanism to control the company's activities by the legislature*
- *There are no clear regulations governing financial flows between the company and the state*

Despite leaving the EITI international initiative, Azerbaijan has stated that international principles of transparency and accountability standards will be applied to the extractive industry, and in this regard, the President signed a Decree on 5 April 2017 "On additional measures to increase transparency and accountability in the extractive industry". According to the decree, a number of international principles for the application of transparency and accountability standards in the extractive industry, including reporting to citizens on the management of revenues from the extractive industry, transparency and accountability in the activities of government agencies and the private sector, as well as strengthening public financial management and accountability, etc. should be referred to in order to ensure transparency and accountability. The decree established a Extractive Industries Transparency Commission to ensure transparency and accountability in the extractive industry of the Republic of Azerbaijan.

Taking all this into account, it would be expedient to take the following steps to increase the efficiency of SOCAR's management, to achieve transparency and accountability:

1. Defining the company's future goals and clarifying the scope of its activities

1.1. *Develop a unified Development Strategy of the company aimed at medium- (5 years) and long-term (15-20 years).* It would be expedient for the new Strategy to define a policy on renewable energy production observed in the world in recent years.

1.2. Eliminate its horizontal and vertical monopoly position in order to prevent SOCAR from growing into a company with the status of "Too big to fail" and create a competitive environment in the market.

1.3. *Limiting the company's horizontal integration goals.* For this purpose, it would be expedient to separate "AzerKimya" Production Association from the company and turn it into an independent company.

1.4. *Limiting the company's vertical integration goals.* In order to strengthen mutual control and ensure transparency between production and sales entities, withdraw "AzeriGaz" PA from SOCAR and transform it into an independent entity selling natural gas to the population and non-population groups within the country.

2. Clarification of the organizational legal form of the company and application of corporate governance standards in management

2.1. Ensure a transition of the organizational and legal form of the company from the current status of a “state enterprise” to the status of a joint-stock company with shares belonging to the state

2.2. *Apply corporate governance standards.* To do this, the Charter must be amended to change the management structure and the current Company Board must be abolished. Instead, a Supervisory Board (or Board of Directors) must be appointed by the president, responsible for strategic management. The Supervisory Board (or Board of Directors) appoints the heads and members of the executive body – the Leadership Team and the Control and Audit Committee.

2.3. The Charter should include requirements for the competencies of the management and members of the structures governing the Company (Supervisory Board, Leadership Team, Control and Audit Committee)

3. Amendments to relevant legislation to establish clear and unambiguous frameworks for transparency and accountability obligations

3.1. Increase the accountability of SOCAR to the legislature, the Milli Majlis

3.2. Disclose the company's quarterly and semi-annual financial statements to the public in accordance with the principles of the Open Government Partnership

3.3. Amend the Law “On Access to Information” to include SOCAR in the category of information owners (Article 9) and the list of information required to disclose financial and operational information related to the company's activities (Article 29)

3.4. Disclose financial statements of SOCAR's subsidiaries, including subsidiaries in which the company has a majority stake

4. Adoption of relevant norms and rules regulating financial flows between SOCAR and the state

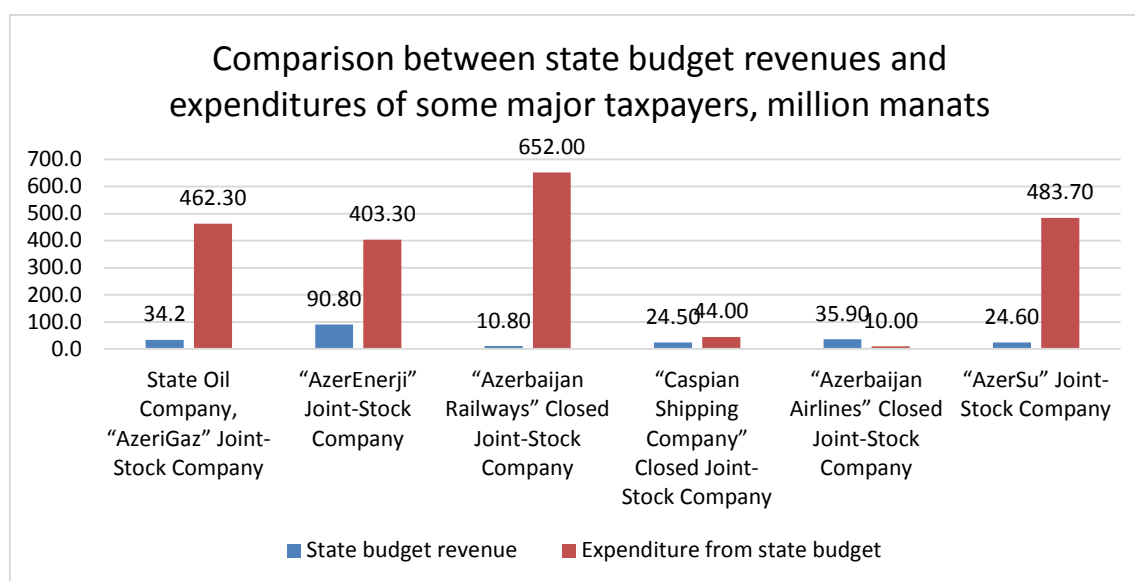
5. Improving the Company's procurement standards and ensuring the transparency of the selection procedures for an independent external auditor to inspect its operations.

“AZERIGAZ” PRODUCTION ASSOCIATION IN THE SHADOW OF THE STATE OIL COMPANY

Ingilab Ahmadov

Introduction

The border between Azerbaijani public finance and state-owned companies is very subtle. Taking advantage of this uncertainty, large monopolistic state-owned companies see public finance as their hope, preferring to capitalize on public finance opportunities instead of strengthening their corporate status. Unfortunately, instead of declining, the dependence of state-owned companies on public finance continues to grow with every passing in the 28 years of post-Soviet market relations.



http://sai.gov.az/upload/files/2019-REY_%C4%B0CRA.pdf

The chart has been prepared by Chamber of Accounts on the basis of various reports on state budget execution.

Of course, barriers to entrepreneurship and a market economy consist not only of state-owned companies being the burden on the budget. However, the solution of this problem can make a tangible contribution to the development of entrepreneurship and play an exceptional role in laying the foundation for sustainable economic development.

“AzeriGaz” Production Association

“AzeriGaz” currently operates as a production association under the SOCAR umbrella.

“AzeriGaz” is engaged in production, processing, storage, transportation, distribution of gas, as well as construction, use, control, testing and certification of industrial and consumer facilities, transportation of gas between producers, distributors, consumers and gas reservoirs, long-distance transportation of gas along pipelines for import-export and transit purposes, etc.³⁸

“AzeriGaz” is a state-owned company that plays an important role for several reasons:

1. Natural gas production in Azerbaijan is gradually becoming the key and most promising type of energy, displacing crude oil.
2. In the near future, natural gas is expected to become Azerbaijan's most stable and promising product supplied to world markets.
3. Consumption in the domestic market, heating system supply, as well as electricity production, are mainly fuelled by natural gas.
4. Despite all this, “AzeriGaz” doesn’t operate an independent entity but as a production association within SOCAR.

The above suggests that although the country’s gas industry is an important sector in terms of export potential, transportation and supply of the domestic market, it does not operate as a standalone, which raises serious questions in relation to governance within the State Oil Company and requires a separate research.

Legal framework

“AzeriGaz” Production Association was established on the material and technical basis of “AzeriGaz” Closed Joint-Stock Company by Order No. 366 of the President of the Republic of Azerbaijan dated 1 July 2009 “On improving the management mechanisms in the oil and gas industry”³⁹.

The activities of “AzeriGaz” are governed by SOCAR's Charter.

³⁸ https://www.azerbaijans.com/content_543_az.html

³⁹ <http://www.socar.az/socar/az/company/organization/azerigas-production-union>

The Charter of the State Oil Company of the Republic of Azerbaijan was approved by Decree No. 844 of the President of the Republic of Azerbaijan dated 24 January 2003 as amended by Decree No. 127 dated 18 September 2004.

Management

As mentioned above, “AzeriGaz” is managed by SOCAR. The company's annual report for 2018 lists a separate natural gas export department, the Oil and Gas Scientific Research and Design Institute (NeftGazElmTadgigatLayihə), the “AzeriGaz” PA, the Gas Processing Plant, and the Oil and Gas Construction Trust (NeftGazTikinti)⁴⁰.

Board

The SOCAR Board is an advisory body under the President of the Company. Meetings of the Company's Board are chaired by the President of the Company. The Board of the Company also includes Vice-Presidents of the Company and other officials of the Company appointed by the President of the Company.

Even the organization of the Board in accordance with the principles of corporate governance in the current environment does not mean that it is fulfilling its function. In particular, in the circumstances of a fragile institutional framework, the very existence of the Board (BoD) does not in itself indicate that management's responsibilities, accountability and, finally, the division of powers are reflected in practice. If the general legislative and institutional framework does not meet the desired “check and balance” principle, the attributes of corporate governance, including the Board, are formal in nature and do not allow for good governance.

Finance: Financial indicators of “AzeriGaz”

The financial performance of “AzeriGaz” is usually not fully reflected in the reports. At best, general information may include limited statistical data on gas facilities, production figures that are of no importance for analysis, and sometimes financial information.

⁴⁰ <http://socar.az/socar/assets/documents/az/socar-annual-reports/illik-hesabat-2018.pdf>

SOCAR's annual financial statements do not publish statistics on "AzeriGaz" as a separate production unit, except for some statistical figures on gas sales. Therefore, it is difficult to analyze the financial situation in the gas industry and how effective "AzeriGaz" is.

Back in 2011, in the context of increasing the authorized capital of SOCAR by 190 million manats, it was noted that 150 million manats of this increase was due to the government's increase in the authorized capital of "AzeriGaz" PA and 40 million manats was intended for the establishment of a urea plant⁴¹. The increase in the company's authorized capital by 230 million manats in 2012 was due to the increase in the authorized capital of SOCAR's subsidiary "AzeriGaz" PA, a company dealing with the sale and distribution of natural gas in the Republic of Azerbaijan⁴². The state invested 178 million manats to increase the authorized capital of SOCAR in 2014⁴³, 581 million manats in 2015⁴⁴, 172 million manats in 2016⁴⁵, 243 million manats in 2017⁴⁶ and 1.190 million manats in 2018⁴⁷. Last year, 959.5 million manats of budget funds were allocated to provide state support for drilling operations on some oil fields (Umid, Karabakh and Babek)⁴⁸. In accordance with the decision of the Cabinet of Ministers in 2018, SOCAR's debt to the Ministry of Finance in the amount of 680 million manats was transferred into the company's authorized capital⁴⁹.

In 2018, state budget revenues from SOCAR amounted to 1,425.1 million manats, which is 8.2 percent more than in 2017. These are consolidated taxes and other

⁴¹ SOCAR, "Financial statement 2012", "Note 28, Authorized capital, added capital and undivided profit", page 54

⁴² SOCAR, "Financial statement 2013", "Note 28, Authorized capital, added capital and undivided profit", page 59

⁴³ SOCAR, "Financial statement 2014", "Note 26, Authorized capital, added capital and undivided profit", page 67

⁴⁴ SOCAR, "Financial statement 2015", "Note 27, Authorized capital, added capital and undivided profit", page 69

⁴⁵ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law of the Republic of Azerbaijan "On execution of the state budget of the Republic of Azerbaijan for 2016" and on the annual report on the execution of the state budget, page 255. http://sai.gov.az/upload/files/ICRA-2016-SON_FINAL.pdf

⁴⁶ SOCAR, "Financial statement 2017", "Note 28, Authorized capital, added capital and undivided profit"

⁴⁷ SOCAR, "Financial statement 2018", "Note 27, Authorized capital, added capital and undivided profit", page 80

⁴⁸ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law of the Republic of Azerbaijan "On introducing amendments to the Law of the Republic of Azerbaijan on the state budget of the Republic of Azerbaijan for 2018", <http://sai.gov.az/upload/files/2018-DURUSTLESME-REY-FINAL.pdf>

⁴⁹ SOCAR, "Financial statement 2018", "Note 27, Authorized capital, added capital and undivided profit", page 80

payments made through the State Oil Company, including the state enterprises of “AzeriGaz” and “AzerKimya” (excluding personal income tax). Last year, SOCAR accounted for 6.3 percent of total state budget revenues, 15.1 percent of state budget revenues from the oil sector (7,884 million manats) and 58.4 percent of tax revenues from the oil sector (2,441.5 million manats)⁵⁰.

Table 1. Tax payments of the State Oil Company (consolidated with companies subordinated to it) (except for personal income tax), thousand manats

Major state taxpayers	2013	2014	2015	2016	2017	2018
State Oil Company	1469741.3	1684587.7	1389231.5	1244764.9	1297234.6	No information
“AzeriGaz” Production Association	23834.5	27590.4	19370.5	2810.6	7275.7	No information
“AzerKimya” Production Association	643.9	8.4	844.8	4817.1	13009.4	No information
Total through State Oil Company	1494219.7	1712186.5	1409446.8	1252392.6	1317519.7	1425069.4

Source: Chamber of Accounts

SOCAR's 2018 financial report shows oil and gas production together. It shows sales and distribution together for oil and gas together too⁵¹. Thus, it is not clear from the report what the financial situation on gas is, what the cost and benefit ratio is, etc.

Only the analysis of revenues by categories shows natural gas as a separate item and it is noted that whereas in 2017 this item fetched 2,670 million manats, in 2018 this figure reached 3,191 million manats (page 81).

⁵⁰ Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft law of the Republic of Azerbaijan “On execution of the state budget of the Republic of Azerbaijan for 2017” and on the annual report on the execution of the state budget,
http://sai.gov.az/upload/files/REY_ICRA2017_final.pdf

⁵¹ <http://socar.az/socar/assets/documents/az/socar-financial-reports/Maliyye.hesabat.2018.pdf> s.42

At the same time, SOCAR's financial report for 2019 shows the liabilities of "AzeriGaz" PA separately (p. 93).

Interestingly, the 2018 report notes the following regarding gasification of the regions. "As of 31 December 2018, gasification was 95.7 percent complete and the management estimates that the rest will be completed by the end of the year." The next financial report for 2019 states the following: "As of 31 December 2019, gasification in the country was 96.01 percent complete and the management believes that the state will continue to finance the remaining gasification costs through capital investments"⁵² (page 92).

On 6 August 2020, the head of state strongly criticized the inefficient operation of state-owned enterprises, saying that it was unacceptable for gasification to be carried out at the expense of the state and for SOCAR and other state-owned enterprises to receive assistance from the state budget⁵³.

This example demonstrates that the company has serious shortcomings in financial management and overall performance and is in need of reform.

Financial relations between "AzeriGaz" and the state

Very little is known about "AzeriGaz"'s relationship with the state budget, as well as the role of the state in financing the PA's development projects. Open source data is also not sufficient for analysis because it is not systematic.

The difficulty in analyzing the financial performance of "AzeriGaz" is mainly due to the fact that the Production Association sells gas to the domestic market at a much lower price than the gas it exports to foreign markets. In particular, in 2016, the PA's wholesale price in the domestic market was \$28/mcm, the final price for the consumer was \$66.67/mcm, the export price to Georgia was \$165/mcm and to Turkey \$180/mcm⁵⁴.

On the other hand, it should be noted that these prices, especially the export price, are variable, and therefore the proportion changes compared to domestic prices. For this

⁵² <http://www.socar.az/socar/assets/documents/az/socar-financial-reports/Maliyy%C9%99%20hesabatlar%C4%B1%202019.pdf>

⁵³

[://azertag.az/xeber/Prezident Ilham Aliyev koronavirusla mubarize sahesinde gorulen tedbirler ve sosial iqtisadi veziyyetle bagli videoformatda musavire kechirib YENILANIB 2 VIDEO-1554479](http://azertag.az/xeber/Prezident_Ilham_Aliyev_koronavirusla_mubarize_sahesinde_gorulen_tedbirler_ve_sosial_iqtisadi_veziyyetle_bagli_videoformatda_musavire_kechirib_YENILANIB_2_VIDEO-1554479)

⁵⁴ <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/07/Azerbaijans-gas-supply-squeeze-and-the-consequences-for-the-Southern-Corridor-NG-110.pdf>

reason, the statistics on gas sales are mostly confidential but also mixed. Taking all this into consideration, it is very difficult to calculate the profitability of “AzeriGaz” in the current situation.

Information on the losses of “AzeriGaz” is occasionally published in the media⁵⁵.

International experience

The practice of gas liberalization in the 3rd energy package of the European Union can be considered as one of the best examples in the world in this area. The 3rd directive envisages the adaptation of management in the gas industry to the maximum market principles of natural monopolies in three alternative directions. 1) complete ownership unbundling), 2) independent system operator, 3) independent transmission operator.

Kazakhstan's “Law on Gas and Gas Supply” looks rather interesting. In contrast to the legislation of Azerbaijan, the Kazakhstan law on gas supply details the competences and responsibilities of the body responsible for gas and gas supply (authorized body)⁵⁶.

Another important document is the government decree approving the concept of the fuel and energy complex of the Republic of Kazakhstan until 2030 (On approving the Concept for the development of the fuel and energy complex of the Republic of Kazakhstan until 2030, Resolution No. 724 of the Government of the Republic of Kazakhstan dated 28 June 2014)⁵⁷.

This document reflects the main priorities of the country's gas industry. In particular, it is noted that the geography of Kazakhstan does not create the basis for efficient gas supply, some parts of the country are supplied with imported gas (Uzbekistan, Russia) and only about 50 percent of the country's population provided supplied with gas⁵⁸.

For comparison, in Azerbaijan this figure is 98 percent.

⁵⁵ <http://sozcu.info/manet/manshet-3/2227-azeriqazda-shok-faktlar-ashkarlandi-ilde-700-milyon-kubmetr-itki-korrupsiya-daha-neler.html>

⁵⁶ https://online.zakon.kz/document/?doc_id=31107618#pos=155;-37

⁵⁷

<https://policy.asiapacificenergy.org/sites/default/files/Concept%20for%20the%20Development%20of%20the%20Fuel%20and%20Energy%20Sector%20until%202030%20%28RU%29.pdf>

⁵⁸ <http://today.kz/news/ekonomika/2017-02-16/736396-uroven-gazifikatsii-v-kazahstana-dostig-pochti-46-protstentov/>

As is the case in Azerbaijan, Kazakhstan's national oil company, Kazmunaygaz, is the sole operator for the management and transportation of gas. The company's 2018 report also outlines its development prospects in the gas industry, as well as areas for improving the company's corporate status⁵⁹.

“AzeriGaz” efficiency

The Order of the President of the Republic of Azerbaijan “On additional measures to increase the efficiency of the activities of state-owned legal entities” dated 5 September 2016 (No. 2300) highlights the importance of a phased transition to international accounting standards in the management of companies the control stock of which is owned by the state. In addition, the Cabinet of Ministers approved a special procedure in its Decision No. 534 dated 30 December 2016 on the estimates of revenues and expenditures of large state-owned companies⁶⁰. The Procedure mainly deals with cash flow from operating activities, cash flow from financing activities, cash flow from investment activities, cash flow from other operations and other indicators. The problem is that there has been no real progress in this direction since then. The President's speech in August this year criticizing the inefficiency of state-owned enterprises is clear evidence of that⁶¹.

A recent report by the Asian Development Bank on Azerbaijan⁶² identifies the following four steps in terms of assessing the financial performance of public enterprises:

(i) set an international benchmark in emerging market economies. This benchmark may be the pre-tax profitability of private companies operating in the field;

(ii) determine the profitability rate of a relevant sector relative to the benchmark (for example, if the average annual profitability of state-owned companies is 8 percent, this should be the target compared to the benchmark);

⁵⁹ http://annual-report2018.kmg.kz/documents/KMG_ANNUAL_REPORT_2018_RU.pdf

⁶⁰ <http://www.e-qanun.az/framework/42596>

⁶¹

https://azertag.az/xeber/Prezident_Ilham_Aliyev_koronavirusla_mubarize_sahesinde_gorulen_tedbirler_ve_sosial_iqtisadi_veziyyetle_bagli_videoformatda_musavire_kechirib_YENILANIB_2_VIDEO-1554479

⁶² <https://www.adb.org/sites/default/files/publication/624476/aze-diversified-resilient-inclusive-development.pdf>

(iii) The difference between the benchmark and the profitability of a relevant public enterprise is the efficiency loss;

(iii) Potential efficiency losses are adjusted in advance for the return on investment.

ADB experts conclude that the worst efficiency losses of Azerbaijan's state-owned companies were recorded in 2015 (7.6 percent of GDP). For comparison, in 2013-2017 this figure averaged around 4.2 percent of GDP⁶³.

Since no such calculations have been made for "AzeriGaz", there is no exact figure on the exact amount of losses for this company. Using this approach, however, the government could identify more meaningful goals and try to achieve them.

Conclusion

The biggest problem in the activity of "AzeriGaz" is its information secrecy. In particular, the company's website⁶⁴ consists mainly of "slogans" and advertisements for the safe use of gas by subscribers. There is no specific information on gas production, export and supply on SOCAR's website either. In such circumstances, it is impossible to systematically monitor the activities of the PA, analyze the dynamics of its statistical data or have complete and accurate information on the management of the company.

The country's gas sector has always been more problematic than other utilities, and this is still the case now. In particular, there are problems with sustainable and quality supply of natural gas, especially for the population. SOCAR's corporate responsibility to address the problems is not at the desired level. Occasional conflicts of the PA with subscribers are related to gas metering, illegal interference with gas pipelines and interruptions in gas supply. Against this background, the weakness of the company's database, as well as a lack of a functional and useful website, hinders the integrity of its activities.

Another problem of "AzeriGaz" is related to its status. The fact that the company operates as a production association within SOCAR puts all its commitments on management and profitability on SOCAR's shoulders. If SOCAR had a proper corporate governance status as a company, this could be positive for the production

⁶³ <https://www.adb.org/sites/default/files/publication/624476/aze-diversified-resilient-inclusive-development.pdf>

⁶⁴ <http://azeriqaz104.az/az/news/964>

association. However, since it has its own problems, the gas sector is faced with incomplete management. In this context, the issue of corporate responsibility, especially in the domestic market, goes to the back burner and the Company focuses more on its gas export obligations.

Another problem of “AzeriGaz” is that it does not have an advanced financial accounting system. SOCAR'S financial statements contain limited financial information on the gas industry. The report does not have a "value chain" approach based on gas production, exports and supply to the domestic market.

Statistical data on gas production and supply are imperfect, and against this background, major losses in the gas industry are in some ways overshadowed by a higher profitability of crude oil. Although the majority of gas supply companies operate at a loss, their continued operation is due not only to their social function, but also to the weak financial accounting in this area as a whole.

Recommendations

1. “AzeriGaz” should restructure its information disclosure policy, an information system covering its entire activity should be created, and it is expedient that information of public importance be reflected on a regularly updated working website;
2. Since the legislation on the gas industry is very outdated, a new legal framework should be created in accordance with modern requirements, the mechanisms for regulating gas supply should be improved and clearly reflected in it, which may be one of the first steps in the context of reforms;
3. It would be expedient to review and change the current status of “AzeriGaz”;
4. In parallel, it seems logical to separate and evaluate the financial flows of the Upstream and Downstream segments of the Production Association;
5. Since SOCAR's corporate governance as a whole requires serious improvement, an appropriate strategy and plan should be developed to improve the corporate governance of “AzeriGaz” in this context;
6. The social burden of “AzeriGaz” should be assessed and appropriate subsidies and tariff policies should be implemented for more effective implementation so that this burden does not become an obstacle to the effective functioning of the PA;

7. The issue of privatization of “AzeriGaz” should be reconsidered, at least its procurement activities may be transferred to private management or privatized.

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ASSESSING ECONOMIC ACTIVITIES OF “AZERBAIJAN RAILWAYS” CJSC

Azer Mehtiyev

Objective of the study

The objective of this study is to assess the effectiveness of the activities of “Azerbaijan Railways” CJSC, currently the only "player" in the railway transport sector of the country, and to develop recommendations for its improvement.

Place and role of railway transport in the transport sector of the country

The transport system in the Republic of Azerbaijan consists of land transport (road and rail transport), water transport, air transport and pipeline transport. According to the State Statistics Committee (SSC), in 2019, 6.0 percent of the new value (GDP) created in the country, 6.0 percent of net profit fell to the share of transport and warehousing. This sector accounts for 8 percent of hired employees and 7.4 percent of fixed assets in the country's economy⁶⁵.

Cargo transportation. In 2019, 235.3 million tons of cargo were transported, of which 155.3 million tons (66.0 percent) by automobiles, 58.6 million tons (25 percent) by pipelines, 15.2 million by railways (6.5 percent), 6.0 million tons by sea, 0.18 million tons by air. The share of railways in freight transportation in the country's transport sector decreased from 20.7 percent in 2005 to 6.5 percent in 2019. Despite the 1.8-fold increase in the annual volume of freight transportation (in thousands of tons) in the country's transport sector from 2005 to 2019, there was a 42.6 percent decrease in rail freight.

Freight turnover. In 2019, the total freight turnover in the country's transport sector amounted to 89.7 billion ton-km, of which 5.15 billion ton-km, or 5.7 percent, fell to the share of railways.

Passenger transportation. According to the State Statistics Committee, 2.06 billion passengers were transported in the country's transport sector in 2019: 1.8 billion (88.2

⁶⁵ Transport in Azerbaijan. SSC bulletin. Official report. Baku, 2020, page 9

percent) by road, 236.7 million (11.5 percent) by subway, and 3.85 million (0.19 percent) by rail. In other words, the share of railway transport in total passenger traffic in the country is less than 0.2 percent. There was a sharp decline in rail passenger transport in Azerbaijan in 2005-2015: during this period, the number of railway passengers decreased 2.9 times.

Revenue and expenditure. According to the State Statistics Committee, in 2019, revenues from freight and passenger transportation by rail amounted to 299.8 million manata (up to 4.2 percent of total revenues in the sector) and expenditure amounted to 340.7 million manats (up to 8.5 percent of total expenditures in the sector). According to the State Statistics Committee, the country's railway transport services were carried out at a loss for four years after 2015. Research conducted on the basis of data of the State Statistics Committee shows that the loss of general transport in railway transport is due to the transportation of passengers.

Railway infrastructure. The operating length of railway tracks in Azerbaijan is 2,140 km. Of these, 54.8 percent (1,170 km) are electrified and 38 percent are two-way tracks. According to the SSC, in 2010-2019, the number of passenger cars decreased by more than 2.5 times, the number of containers by 3.3 times and the number of containers by 7.8 times.

Key players in the railway transport sector. At present, the Azerbaijani railway transport sector is almost entirely state-owned and the main “player” in the sector is the state-owned “Azerbaijan Railways” Closed Joint-Stock Company.

“Azerbaijan railways” CJSC: status, activity directions and management features

Status and goals of the company. “Azerbaijan Railways” CJSC was established by reorganization of the Azerbaijan State Railway on the basis of the Order of the President of the Republic of Azerbaijan dated 20 July 2009 (No. 383). In accordance with the order, “Azerbaijan Railways” CJSC was established as a body subordinated to the Ministry of Transport. However, later, by a presidential decree dated 18 September 2015⁶⁶, the Company was removed from the subordination of the Ministry and began to operate as an independent state company.

By Decision of the Cabinet of Ministers of the Republic of Azerbaijan No. 36 dated 15 February 2010⁶⁷, the Charter and structure of “Azerbaijan Railways” CJSC were approved. According to the charter, the Company is a legal entity, has an independent balance sheet, bank accounts and other accounts. The state is not liable

⁶⁶ <https://president.az/articles/16210>

⁶⁷ <http://www.e-qanun.az/framework/19253>

for the Company's liabilities and bears the risk of losses related to the Company's activities to the extent of the value of state-owned shares. The charter specifies 53 activities of the Company.

Management of "Azerbaijan Railways" CJSC. According to the charter, the supreme governing body of the Company is the general assembly of its shareholders. The exclusive powers of the general assembly have been delegated to the Cabinet of Ministers and the State Committee for Property Affairs in accordance with the known presidential decree on the establishment of "Azerbaijan Railways" CJSC.

According to the Charter, the executive body of the Company is the Board of Directors operating in a collegial manner. According to the charter, the Board of Directors consists of seven people – the chairman of the Company, the first deputy chairman and four other deputies, as well as the director of "Nakhchivan Railways" LLC. The Board of Directors is headed by the Chairman of the Company, who is appointed and dismissed by the President of the Republic of Azerbaijan. The first deputy chairman and deputy chairmen of the Company are appointed and dismissed by the President of the Republic of Azerbaijan.

The current Charter of the Company does not provide for the existence of a Supervisory Board.

Company structure. The structure of "Azerbaijan Railways" CJSC consists of its Executive Office, subsidiaries, non-legal entities (departments) subordinated to the Company and branches and representative offices of the Company. Along with "Nakhchivan Railways" LLC, the company's website contains information about two other subsidiaries – "Azerbaijan Railways Container" LLC and "Azerbaijan Railways Express" LLC. According to the consolidated financial statement of "Azerbaijan Railways" CJSC for 2017, the structure of the Company includes a total of 17 institutions: four of them deal with sport, five with construction, the rest with logistics and other activities. 15 of these enterprises are fully owned by "Azerbaijan Railways" CJSC, while in the other two it has a certain share: 51 percent of the shares of "AzRus Trans" CJSC and 50 percent of "Astara Grain Terminal".

3. Company's performance indicators: efficiency, transparency and accountability

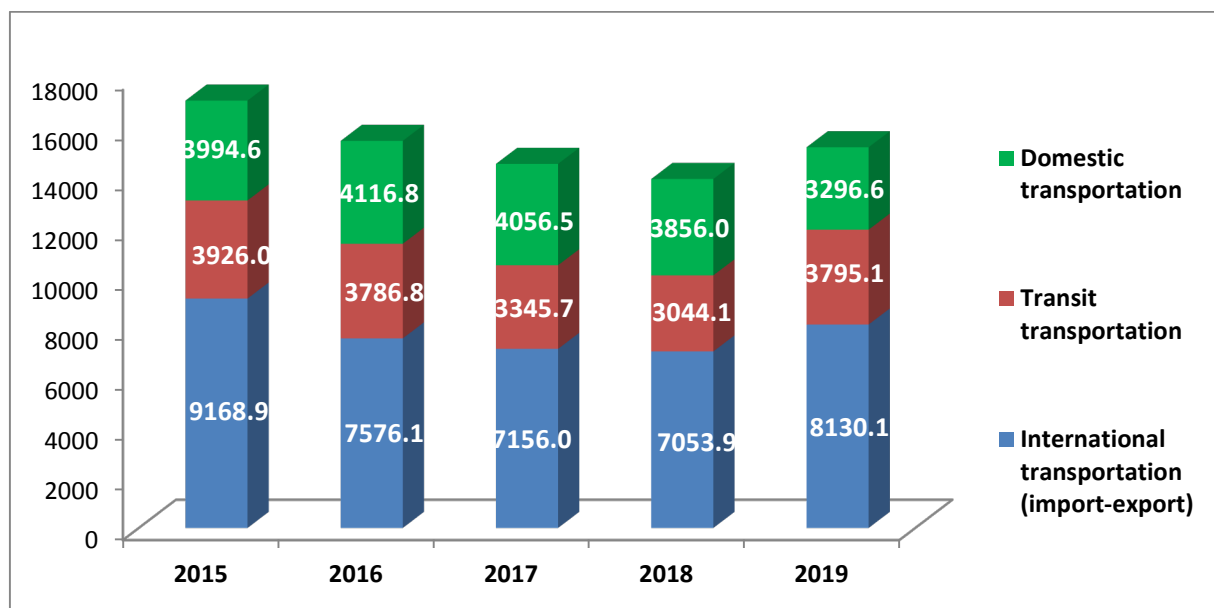
Access to information and restrictions. Article 5.4 of the Company's Charter states that "in order to ensure transparency, the Company is obliged to publish the annual financial report with the auditor's report in the press and post it on the Company's website no later than four months after the end of the financial year". However, despite this requirement of the Charter, the Company's consolidated financial

statements are not available on its website. Only consolidated reports on the Medical-Sanitary Service of “Azerbaijan Railways” CJSC are posted on the website. The consolidated financial report of the Company for 2018 was partially published in the October 2019 issue of the “Azerbaijan Railways” newspaper. During the study, we were able to find the Company's consolidated financial statements for 2015, 2016 and 2017 (in English) on the World Bank's website.

Freight structure. According to “Azerbaijan Railways” CJSC, the volume of cargo transportation by the Company in 2015 amounted to 17.1 million tons and in 2019 to 15.2 million tons. The Company's freight volume decreased by 18.4 percent in 2015-2018 and increased by 9 percent in 2019 compared to 2018. In 2019, the Company transported 8.1 million tons (53.3 percent) of international cargo (import-export operations), 3.8 million tons (25.0 percent) of transit cargo and the remaining 3.3 million tons (21.7 percent) were domestic (Figure 1).

Although there was a 9 percent increase in total freight traffic in 2019 compared to the previous year, international traffic (import-export) increased by 15.2 percent, transit traffic increased by 24.7 percent, while domestic traffic decreased by 14.7 percent.

Figure 1. “Azerbaijan Railways” CJSC freight structure in 2015-2019, thousand tons



Source: “Azerbaijan Railways” CJSC

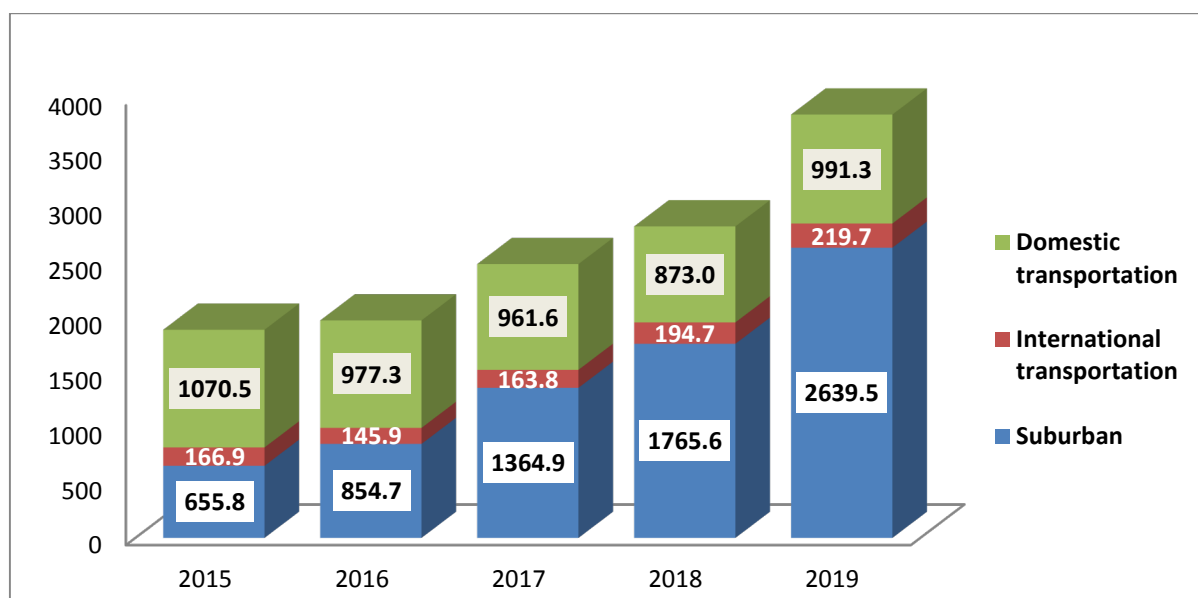
Despite Azerbaijan’s very favorable geographical location, as can be seen from Figure 1, the structure of “Azerbaijan Railways” CJSC's cargo transportation is dominated by import-export operations and domestic transportation, but the share of transit transportation varies between 20-25 percent. For comparison, 67 percent of “Georgian

Railway”’s freight consists of transit, 22 percent of import-export and 11 percent of domestic transportation⁶⁸.

According to the Company, the number of containers transported has been growing rapidly since 2017: the number of containers carried by the Company was 10,274 in 2016, 14,242 in 2017, 25,786 in 2018 and 42,114 in 2019. This rapid growth in container traffic is associated with the successful operation of “Azerbaijan Railways Container” LLC, which has been operating since August 2017.

Structure of passenger traffic. In the period from 2015 to 2019, there was a steady increase in passenger traffic by rail: the number of passengers carried increased from 1.9 million in 2015 to 3.85 million people in 2019 per person (doubled). However, this increase was due to suburban transport: the number of suburban passengers increased from 655,000 thousand to 2.6 million, growing four times (Figure 2). This increase in suburban passenger traffic is due to the operation of the Baku-Sumgayit high-speed train.

Figure 2. Structure of “Azerbaijan Railways” CJSC’s passenger traffic, thousand persons



Source: “Azerbaijan Railways” CJSC

In 2019, 68.6 percent of rail passenger traffic was suburban, 25.7 percent domestic and only 5.7 percent international.

Number of employees. According to “Azerbaijan Railways” CJSC, the number of employees of the Company decreased from 8,093 people in 2015 to 5,709 people in 2019, i.e. 2,384 people (about 30 percent) were laid off.

⁶⁸ <http://www.railway.ge/ru/>

Results of the financial activity. During 2014-2018, the Company's assets increased from 2.6 billion manats at the beginning of the period to 4.25 billion manats at the end of the period. In other words, they increased by 63.5 percent. In 2018, 3.9 billion manats of the total assets (91.8 percent) were long-term and the remaining 332 million manats (8.2 percent) were short-term assets.

During the 2014-2018 period, the Company's liabilities grew from 707 million manats to 3,037 million manats, i.e. increased 4.3 times, while its capital decreased from 1.9 billion to 1.2 billion manats (by 38.9 percent). The majority of liabilities are long-term liabilities: in 2018, 83.1 percent of total liabilities were long-term liabilities. The rapid growth in the Company's liabilities was due to long-term liabilities: their amount in 2018 was 4.8 times higher than in 2014 (Table 1).

98.4 percent of the Company's long-term liabilities consist of long-term debts. During 2014-2018, the Company's long-term debts increased more than 10 times: from 245.8 million to 2.5 billion manats.

Table 1. "Azerbaijan Railways" CJSC's liabilities and capital in 2014-2018 period (million manats)

	2014	2015	2016	2017	2018
Long-term liabilities	531.2	1068.24	1624.3	2390.1	2523.33
Current liabilities	175.73	594.78	922.7	510.63	514.16
Total liabilities	706.97	1663.02	2547.0	2900.73	3037.49
Total capital	1900.3	1262.05	1102.58	856.84	1216.36
Total liabilities and capital	2607.3	2925.07	3649.58	3757.57	4253.86

(Source: *Consolidated financial report of "Azerbaijan Railways" CJSC*)

Of particular interest are the changes in the capital structure of the Company. As already mentioned above, according to relevant decisions of the Cabinet of Ministers, the authorized capital of the Company in 2010 was increased from 599.0 million manats in 2010 to 806.1 million manats in 2017. In addition, during 2014-2018, the amount of state investment in the Company increased 3.6 times: from 523 million manats to 1.9 billion manats. However, the Company's capital not only did not increase but even decreased from 1.9 billion manats in 2014 to 848 million manats in 2017, and then slightly increased to 1.2 billion manats in 2018 (Table 2).

Table 2. Changes to “Azerbaijan Railways” CJSC’s capital structure in 2014-2018 (million manats)

	2014	2015	2016	2017	2018
Authorized capital	726.15	726.15	726.15	806.06	806.06
State investments	523.06	607.1	946.21	1174.51	1905.46
Accumulated losses/undivided profit	651.1	-42.27	-539.57	-1103.38	-1475.81
Total exchange rate difference		-12.9	-14.87	-13.28	-12.86
Other reserves		-16.03	-16.03	-16.03	-16.03
Shareholder capital	1900.3	1262.05	1101.89	847.88	1206.83
Non-control share			0.69	8.96	9.53
Total capital	1900.3	1262.05	1102.58	856.84	1216.36

(Source: *Consolidated financial report of “Azerbaijan Railways” CJSC*)

These reductions in the Company's capital are due to the Company's loss-making operations. Thus, although 2014 ended as a loss year, by the end of the year the Company made undivided profit of 651.1 million manats. In the following years the losses increased and the accumulated losses at the end of 2018 amounted to 1.48 billion manats.

“Azerbaijan Railways” CJSC's consolidated profit or loss report shows that in 2014-2018, the amount of the Company's annual income was less than its operating expenses for the relevant years (Table 3). Taking into account the non-operating losses of the company, its losses increased and, as can be seen from Table 4, the Company ended the entire five-year period of 2014-2018 with losses.

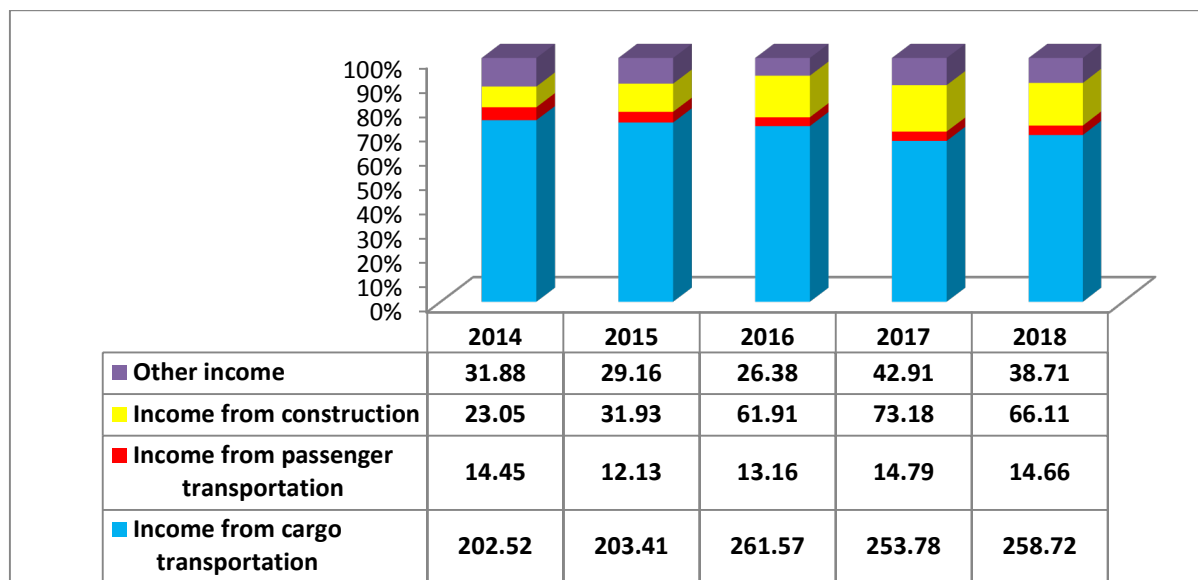
Table 3. “Azerbaijan railways” CJSC’s income, operating expenses and total losses, million manats

	2014	2015	2016	2017	2018
Total income	271.9	276.6	363.0	384.7	378.2
Total operational expenses	-305.2	-338.1	-370.4	-427.6	-489.0
Losses prior to profit tax	-59.0	-864.5	-565.6	-553.2	-370.0
Total losses for the year	-48.87	-706.27	-498.65	-553.95	-371.2

(Source: *Consolidated financial report of "Azerbaijan Railways" CJSC*)

If we look at the structure of the Company's income, it is clear that most of its income – 65-70 percent – comes from freight (Figure 3).

Figure 3. Structure of "Azerbaijan Railways" CJSC's income (million manats)



(Source: *Consolidated financial report of "Azerbaijan Railways" CJSC*)

Familiarization with the financial balance of the Company shows that both construction and passenger transportation activities are detrimental to the Company.

Efficiency indicators. Based on the Company's consolidated financial statements, we have calculated some indicators for its financial performance (Table 4).

Table 4. Some financial performance indicators of "Azerbaijan Railways" CJSC

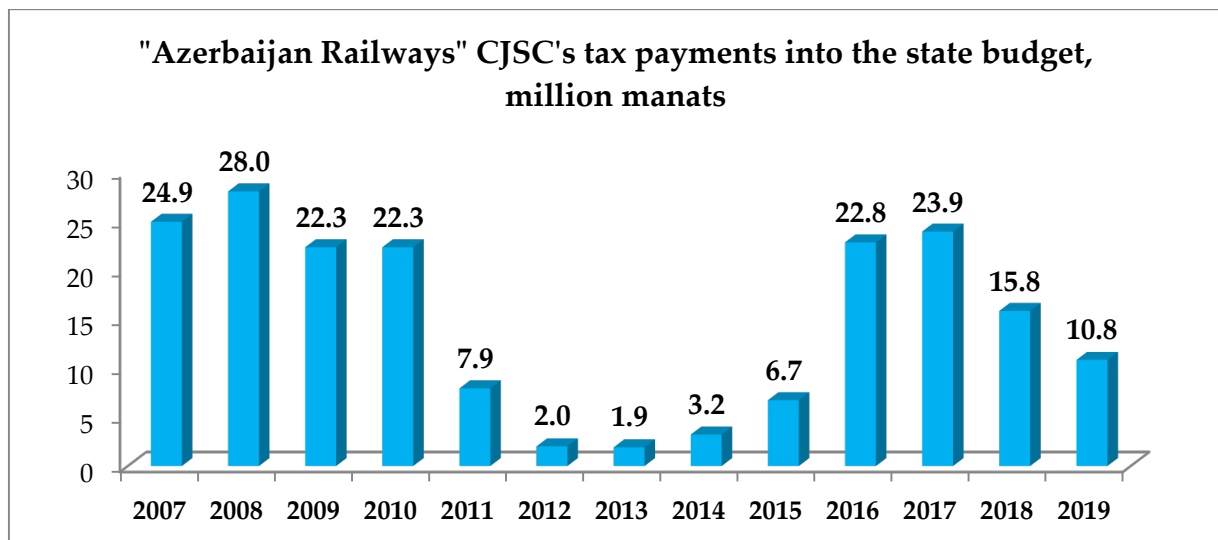
	2014	2015	2016	2017	2018
Independence ratio (capital/assets)	0.73	0.43	0.3	0.23	0.29
Debt-to-capital ratio (assets/shareholder capital)	0.37	1.32	2.31	3.42	2.52
Liquidity ratio (current assets/current liabilities)	1.31	0.48	0.39	0.7	0.65
CIR - Cost Income Ratio	1.12	1.22	1.02	1.11	1.29
Debt ratio (borrowed capital assets)	0.27	0.57	0.7	0.77	0.71

(Source: *calculated by the author on the basis of the Company's consolidated financial reports*)

It is clear from the data in the table that compared to 2014, the Company's efficiency indicators in 2018 deteriorated. As a result of the increase in debt, the independence ratio decreased from 0.73 in 2014 to 0.29 in 2018 (respectively, the debt ratio increased from 0.27 to 0.71), the debt-to-equity ratio increased from 0.37 to 2.52 in the same period, the liquidity coefficient fell from 1.31 to 0.65. The ratio of operating expenses to operating income has always been higher than 1, which indicates that the Company's operating activities ended in a loss. Thus, the problems of efficiency in the activities of the Company are quite serious. This is due to the high level of debt of the Company, the inability of its income to cover even operating expenses, the large non-operating losses, and so on.

Interaction with the state budget. "Azerbaijan Railways" CJSC is one of the largest taxpayers of the state budget. It became clear from our study that in the 2007-2010 period, "Azerbaijan State Railways" annually paid taxes in the amount of 20-25 million into the state budget. However, after the establishment of "Azerbaijan Railways" CJSC, the Company's payments into the state budget decreased sharply: whereas in 2010, the amount of tax payments the Company made into state budget amounted to 22.3 million manats, in 2011 the figure dropped to 7.9 million manats (decreased 2.8 times) and in 2012 to just 2.0 million manats, which is 11 times less than in 2010 (Figure 4).

Figure 4. Tax payments of "Azerbaijan State Railways" and "Azerbaijan Railways" CJSC, actual (million manats)



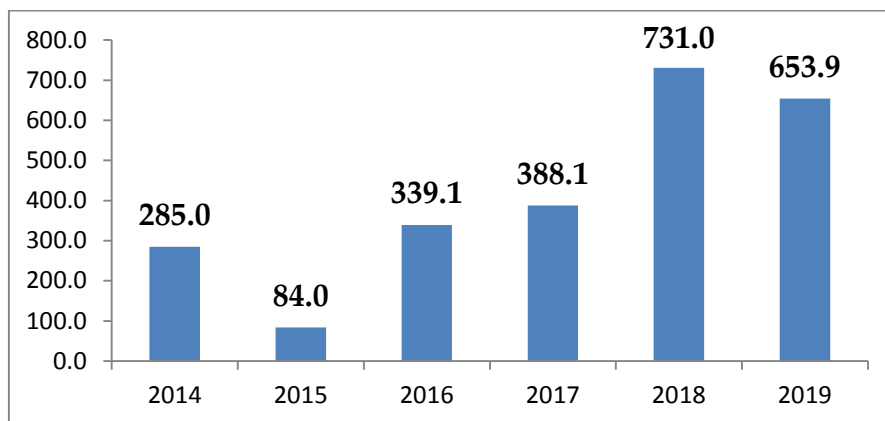
(Source: *Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the government's report on budget execution in different years*)

Interestingly, in 2015-2017, during the economic crisis in the country and when “Azerbaijan Railways” CJSC was operating at a greater loss, the Company's payments into the state budget increased rapidly again and amounted to reach about 24 million manats (in 2017). In the last two years, there has been a decrease in tax payments again. The government's reports on the execution of the state budget do not provide an explanation of these fluctuations in the Company's tax payments.

Unlike the company's tax payments into the state budget, the amount of investments allocated to the Company from the state budget is constantly increasing (Figure 5).

As can be seen, in the period from 2014 to 2019, the Company received 2,481.1 million manats in investments from the state budget, the total amount of the Company's tax payments into the state budget was 83.2 million manats. In other words, the investments allocated to the Company from the state budget during this period was about 30 times higher than what it paid into the state budget.

Figure 5. Budget investments in “Azerbaijan Railways” CJSC (million manats)



(Source: *Government's reports on budget execution in different years*)

External borrowings of the Company. According to the Ministry of Finance, the external debt of “Azerbaijan Railways” CJSC amounted to 545.3 million US Dollars at the end of 2016, to 649.9 million US Dollars at the end of 2017 and to 838.0 million US Dollars at the end of 2018. “Azerbaijan Railways” CJSC is in the risk group for repayment of external debts.

Ways of enhancing the Company efficiency

At the end of 2016, with the technical support of the Asian Development Bank (ADB), a “Railway Sector Development Program” was developed and is being implemented to reform the country's railway system in the areas of corporate, institutional, financial and human resources. Within the framework of the program, which also

involves KPMG, an international consulting company, a strategy (Business Plan) was developed. It reflects the scope of strategic goals for the comprehensive development of "Azerbaijan Railways" CJSC in 2017-2022 and measures to achieve these goals.

According to the Company, an agreement was signed with McKinsey & Company on 21 May 2020 to develop the "2030 Corporate Strategy" of "Azerbaijan Railways" CJSC. The implementation of the project is currently under way.

Application of corporate governance. Within the framework of the ongoing "Railway Sector Development Program" and the above-mentioned Business Plan, there are plans to make changes to the organizational and management structure of "Azerbaijan Railways" CJSC in 2018-2020, and establish a clear management model and organizational structure. According to the information provided by the Company, in order to improve management and strengthen the financial independence of "Azerbaijan Railways" CJSC in accordance with the requirements of the "Rules and Standards of Corporate Governance in State-Owned Joint Stock Companies" within the framework of the Program, proposals have been prepared on the formation of an effective corporate governance mechanism, including the establishment of a Supervisory Board, and relevant government agencies have been contacted over this.

Structure optimization. Resolution No. 550s of the Cabinet of Ministers of the Republic of Azerbaijan dated 21 October 2016 mentions "Azerbaijan Railways" CJSC among the large state companies that will not be privatized in the medium term. According to another list approved in the same order, 20 non-profile enterprises and organizations (15 medical institutions, two hotels, two factories, one camp) subordinated to "Azerbaijan Railways" CJSC will be removed from this subordination and privatized in the medium term.

Restructuring and liberalization of the sector. The "List of natural monopolies" was approved by Resolution No. 189 of the Cabinet of Ministers of the Republic of Azerbaijan dated 19 July 2013. According to the resolution, the following types of activities of "Azerbaijan Railways" CJSC are attributed to natural monopoly: 1) activities of main and local railway lines, road facilities and structures involving operation, movement, management and traffic safety; 2) services of railway stations and passenger terminals.

This means that the operator's activity in freight and passenger transportation by rail is not and cannot be a natural monopoly. In other words, the fact that only "Azerbaijan Railways" CJSC is engaged in freight and passenger transportation

services by rail in the country is not the result of a natural monopoly but may be the result of a state-owned company's concentrating its resources and using its power and administrative authority to exclude other participants from the market.

There are a number of interesting experiences in the world in the field of restructuring and liberalization of this sector. These practices include both the introduction of public-private partnership in the sector and the privatization of many of the sector activities. For example, the number of private operators and large companies providing various services in the area of railway infrastructure has been growing in Poland, Romania, Turkey and a few other countries for the last 10 years.

Recommendations

We consider it expedient to implement the following recommendations to improve the activities and increase the efficiency of "Azerbaijan Railways" CJSC and ensure that the country's railway transport sector becomes a competitive participant in the regional transport and logistical networks:

In the area of restructuring and liberalization of the sector:

- Implementation of work in the direction of business line and functional restructuring in the railway sector;
- Involvement of private operators in freight and passenger transportation in the sector, its opening to foreign companies and creation of conditions for the formation of a competitive private sector in different links of the value chain;
- State policy development in the railway sector should be delegated to the relevant ministry: the ministry should develop a state policy on the development of the railway sector, its place and role in the country's economy and regional logistical networks. "Azerbaijan Railways" CJSC as a state company should prepare and implement its own development and competitive strategy because liberalization requires the establishment and development of private firms in this sector along with state-owned companies;
- When "Azerbaijan Railways" CJSC provides services as a natural monopoly, it should start creating equal conditions for its operators and future independent transportation companies;

In the area of optimizing the Company's structure:

- It is expedient to speed up the process of privatization of non-profile enterprises and organizations subordinated to “Azerbaijan Railways” CJSC;
- It is expedient to separate and privatize the units providing construction, repair and other infrastructure services within “Azerbaijan Railways” CJSC;
- The creation of a competitive private sector engaged in similar services should be encouraged;
- The Company's preference for outsourcing of construction, repair and other services is expedient in terms of saving on maintenance costs of the relevant institutions;

In the area of enhancing the efficiency of the Company’s financial activity:

- Carry out in-depth analysis of the value chain to identify the Company's key "harm" links and develop measures to ensure their profitability;
- Optimize the cost structure in passenger transportation and determine the no-loss level of passenger transportation;
- In-company cost standards should be developed to optimize operating costs;

In the area of application of corporate governance:

- The Supervisory Board should be added to the management structure of the Company in its current Charter;
- The process of forming the Company's Supervisory Board should be accelerated;

In the area of stepping up transparency and accountability:

- It is expedient to increase the responsibility of company executives and responsible government agencies to comply with the existing requirements of the country's legislation and the Company's charter regarding the disclosure and publication of quarterly and annual activities and consolidated financial statements. To this end, the legislation should provide for severe sanctions against companies and their managers who do not comply with these requirements.

CURRENT SITUATION AND WAYS OF INCREASING EFFICIENCY IN THE AIR TRANSPORT SECTOR

Abil Bayramov

Summary

This study analyzes the current situation in the air transport sector, the level of participation of both public and private sectors in air transport, the role of the "Azerbaijan Airlines" CJSC in the country's economy and its impact on equal opportunities in the sector, and provides recommendations on ways of increasing the efficiency of the air transport sector and the "Azerbaijan Airlines" OJSC.

Since AZAL does not disclose key information about its activities, the current assessment is based on the analysis of information on the activities of AZAL in the opinions and reports of the State Statistics Committee, the Chamber of Accounts, as well as research of local and international organizations and the media.

Objective of the study

The transition to a market economy, as well as the modern requirements of the international air transport market, have created a need for reform in the civil aviation sector. It is known that the activities of civil aviation enterprises are under stringent control. At the same time, the need for external influence on the state of the civil aviation market is questioned neither in literature nor in practice. The disputes only revolve around the degree and methods of state regulation. In this sense, it is quite important to analyze the current level of state regulation in the field of civil aviation in Azerbaijan and the impact of the monopolistic status of the "Azerbaijan Airlines" CJSC (AZAL) on the country's economy. The main objective of this study is to provide recommendations on the optimal limits of state participation in this field by analyzing the role of the state in the field of air transport and the nature of its relations with other market players.

The study also aims to identify opportunities for air transport companies to improve the quality of transport products created in the process of passenger and cargo transportation in the market, as well as services related to the transport process. The study also touches upon issues such as a model of the civil aviation market, the possibility of both state regulation and liberalization of civil aviation management in market conditions.

We believe that identifying opportunities for both public and private sector participation in air transport can help reduce passenger and cargo travel time, increase customer satisfaction, reduce operating costs, build capacity for cheaper airfare and eventually increase competitiveness.

The gradual liberalization of the market can attract investment in infrastructure and open up opportunities for service providers such as airlines, ground handling, catering and maintenance companies, as well as encourage investment in critical infrastructure elements of the aviation sector, including airport facilities and equipment. The overall conclusion is that a safe, reliable and efficient aviation sector can play an important role in economic development.

Role of the sector on the national economy

A comparative analysis of revenues in the transport sector shows that air transport is one of the important players in the sector. This is most evident in the total volume of air freight around the world. In particular, although air freight accounts for only 0.5 percent of total freight traffic (worldwide), it accounts for 35 percent in terms of value⁶⁹.

According to the State Statistics Committee of the Republic of Azerbaijan⁷⁰, transport sector revenues in 2018 amounted to 6,231,943,000 manats. Of this amount, 270,841,000 manats were obtained from transportation by rail, 170,841,000 manats by sea and 2,066,918,000 manats by air.

Considering the fact that we are talking about all types of transportation (including pipelines, oil pipelines, gas pipelines, etc.), it is obvious that air transport has a significant share. A comparison of the relevant figures for recent years also shows that air transport is one of the important participants in the sector (See Table 1). This

⁶⁹ <https://www.icao.int/Newsroom/Pages/RU/air-cargo-growth-requires-renewed-commitment-to-home-declaration-icao-council-president.aspx>

⁷⁰ <https://www.stat.gov.az/source/transport/>

Table 1. Revenues from transportation in the transport sector, thousand manats

	Total			Revenue from cargo transportation			Revenue from passenger transportation		
	2016	2017	2018	2016	2017	2018	2016	2017	2018
Total	4 780 684	5 628 015	6 231 943	3 775 392	4 452 895	4 871 247	1 005 292,0	1 175 120,0	1 360 696
Railway	262 435	279 202	270 841	249 277	264 962	256 167	13 158,0	14 240,0	14 674,0
Sea	160 096	179 725	170 567	159 398	178 793	168 952	698,0	932,0	1 615,0
Air	1 053 949	1 647 341	2 066 918	717 528	1 185 343	1 538 459	336 421,0	461 998,0	528 459,0
Pipelines	2 047 004	2 203 546	2 272 532	2 047 004	2 203 546	2 272 532	-	-	-
Oil pipelines	1 515 830	1 599 097	1 539 697	1 515 830	1 599 097	1 539 697	-	-	-
Gas pipelines	531 174	604 449	732 835	531 174	604 449	732 835	-	-	-
Automobiles	1 214 938	1 273 879	1 396 899	602 185	620 251	635 137	612 753,0	653 628,0	761 762
Streetcars	-	-	-				458 130,0	487 691,0	578 402
Trolleybuses	-	-	-				154 623,0	165 937,0	183 360
Underground	42 262	44 322	54 186				42 262,0	44 322,0	54 186,0

Source: <https://www.stat.gov.az/source/transport/>

is also reflected in the structure of transportation. In particular, revenues from cargo transportation in the transport sector as a whole amounted to 4,871,247,000 manats in 2018. Of this amount, 256,167,000 manats were obtained from transportation rail, 168,952,000 manats by sea and 1,538,459,000 manats by air.

Revenues from passenger transportation by air are higher. In 2018, revenue from passenger transportation in the transport sector as a whole amounted to 1,360,696,000 manats. Of this amount, 14,674,000 manats were obtained from transportation by rail, 1,615,000 manats by sea and 528,459,000 manats by air.

Although the revenue from air transport is large, the cost of transporting cargo and passengers is also quite high. For this reason, the question of economic efficiency of transportation arises, and when approached from this aspect, it turns out that there are serious problems in terms of efficiency in the air transport sector. If we look at specific figures, the picture becomes clearer. Expenditures on passenger and cargo transportation in 2018 amounted to 3,902,532,000 manats in the transport sector as a whole. Of this amount, 323,427,000 manats fell to rail, 174,677,000 manats to sea and 2,187,832,000 manats to air transport (See Table 2). In relation to the income (2,066,918,000 manats) obtained in 2018, the expenditures appear to be quite high.

Table 2. Expenditures on cargo and passenger transportation, thousand manats

	2016	2017	2018
Total	2 583 043	3 407 283	3 902 532
Railways	327 401	460 350	323 427
Sea	173 960	162 394	174 677
Air	975 035	1 626 498	2 187 832
Pipelines	390 673	418 547	393 426
Automobiles	557 946	634 494	714 170
Streetcars	-	-	-
Trolleybuses	-	-	-
Underground	158 028	105 000	109 000

The summary report on the activities of the Cabinet of Ministers of the Republic of Azerbaijan in 2019 states that in 2019, 235.3 million tons of cargo was transported by all types of vehicles, or 2.2 percent more than in 2018, and the total cargo turnover decreased by 3.8 percent compared to the previous year and amounted to 89.8 billion ton/km. 155.3 million tons of cargo were transported by automobiles, 15.2 million tons by railway, 6.0 million tons by sea, 0.2 million tons by air, 58.6 million tons by pipelines. The volume of transit cargo was 10.3 million tons. In 2019, 2056.5 million people, or 2.7 percent more than in the previous year, were transported and the total passenger turnover increased by 1.1 percent to 33,864,800 passenger/km. 1,813.3 million passengers were transported by automobile vehicles, 236.7 million by underground, 2.7 million by air, 3.9 million by rail and 22,200 by sea.

Key players

“Azerbaijan Airlines” (AZAL) is the national carrier of the Republic of Azerbaijan. It was established as an international carrier in 1991. Prior to that, AZAL was one of the most efficient branches of Aeroflot (Soviet Union), carrying 1.5 million passengers a year. Its main task is to ensure safe and regular flights, meet the requirements of international and domestic markets in air services. “Azerbaijan Airlines” is registered with ICAO as AZALAVIA, is coded with triple AHY code, as well as two-letter code J2 and 771 in IATA.

“Azerbaijan Airlines” has a monopoly position in air transport services. This is also evident from the chart of “AZAL” approved by Decision No. 105 of the Cabinet of Ministers of the Republic of Azerbaijan dated 30 April 2008. According to the decision, the bodies subordinated to “AZAL” include:

1. “Azerbaijan Airlines” passenger airline;
2. “BUTA AIRWAYS” passenger airline;
3. “Azalagro” Yevlakh airline;
4. National Aviation Academy;
5. Heydar Aliyev International Airport;
6. “Ganja” International Airport;
7. “Nakhchivan” International Airport;
8. “Lankaran” International Airport;

9. "Zagatala" International Airport;
10. "Gabala" International Airport;
11. "Azeraeronavigation" Air Traffic Department;
12. Main Aviation Security Department;
13. "AzalOil" Fuel and Lubricants Department;
14. Branches and representative offices.⁷¹

In addition, many services are provided by companies founded with the participation of "AZAL". For example, the "Ground Handling Company" (GHC JV) was established in March 1999 by the "Azerbaijan Airlines" State Concern and British "International Handling Company". The main behind of the establishment of the "Ground Handling Company" JV was to provide ground handling services for aircraft in accordance with IATA standards, as well as ready packing of luggage, mail, cargo and dangerous goods.

"AZAL"'s "Azeraeronavigation" enterprise was established on 1 April 1996 and is an independent civil aviation enterprise. It builds its activity on the principles of full economic accounting and self-financing and is the official state customer in the field of air navigation services in the airspace of the Republic of Azerbaijan.

"AZALOIL" is a company responsible for the filling of all types of aircraft, automobile and motor vehicles with relevant fuels and lubricants and special liquids at all airports located in the territory of the Republic of Azerbaijan; develops the main base, improvement of conditions for filling aircraft and automobile vehicles with fuel and lubricants; studies the supply and demand in the field of fuels and lubricants that are important to the operation of aircraft, vehicles and aerodrome mechanisms, and creates the necessary supply of fuel and lubricants.

"AZAL" Aviation Technical Center provides complete routine technical servicing of aircraft and based on operational requests from customer airlines.

Cargo Aviation Company (CAC) is one of the structural units of the "Azerbaijan Airlines" CJSC. The main activity area of CAC is to perform cargo air transportation in a timely, quality and safe manner. CAC operates regular and charter flights to Europe, Asia, Africa and the CIS.

The monopoly position of "Azerbaijan Airlines" as a state-owned company affects the activity of airlines in the market. This fact determines the urgency of the question on

⁷¹ <http://e-qanun.az/framework/27430>

limits of state intervention in the existing market. It should be noted that we do not deny the need for state regulation of the civil aviation market, but the main question is to what extent such regulation is expedient.

In 2019, the passenger flow at the international airports of the "Azerbaijan Airlines" Closed Joint-Stock Company amounted to 5,572,000 people, which is 6.5 percent more than in 2018. 4,760,700 passengers fell to the share of Heydar Aliyev International Airport and this figure increased by 7.1 percent compared to last year. 4,126,000 passengers were served in international directions at Heydar Aliyev International Airport. "AZAL" and "Buta Airways" (low-cost) expanded their flight geography in 2019, as a result of which the number of passengers carried has increased by 12.7 percent compared to 2018 to 2,700,400 people. In the reporting year, compared to the previous year, cargo and luggage transportation increased by 3.2 percent and amounted to 15,000 tons. Postal transportation dropped by 57.5 percent and amounted to 506.8 tons. The number of passengers transported to 50 international destinations increased by 16.6 percent and amounted to 2,077,400 people. 623,100 passengers were transported on domestic routes. In 2019, "Buta Airways" carried 34.6 percent more passengers than in 2018, i.e. 623,800 passengers, and the occupancy rate of passenger seats increased by 3.3 percent compared to the previous year and amounted to 90.3 percent. During the reporting year, passenger turnover on "AZAL" flights increased by 11.3 percent to reach 4,746.6 million passenger-km. On international flights, this figure increased by 12.2 percent to reach 4,329.5 million passenger-km. In general, the occupancy rate of passenger seats on "AZAL" flights increased by 3.5 percent compared to 2018 and by 3.9 percent on international flights, reaching 75.6 percent and 74.7 percent respectively.

Today, the aircraft of "AZAL"'s and Azerbaijan's first low-cost airline, "Buta Airways", fly to more than 40 cities in Europe, Asia and the Americas. The air fleet of Azerbaijani airlines consists of modern Airbus, Boeing and Embraer aircraft, including two Boeing 787-8 Dreamliners and two long-haul Airbus A340-500 aircraft. Over the next 10 years, "AZAL" plans to include 10 Airbus 320 NEO aircraft and six Boeing 787 Dreamliners in its fleet.

Airport management. The International Civil Aviation Organization (ICAO) states in its "Airport Economics Guide" that while acting as a regulator and supplier of public services, the state must clearly distinguish between regulatory and operational functions, defining the roles and responsibilities in relation to each function. This is

due to the fact that too close a relationship between a regulator and a service provider can lead to a conflict of interest and undermine public confidence⁷².

Heydar Aliyev Airport is the base airport of “Azerbaijan Airlines” and its low-cost subsidiary “Buta Airways”. The current state of the ownership structure and management does not preclude a conflict of interest.

Recent years have seen an increase in the practice of transferring airport management from the state to the private sector in the world. In this case, the assets usually remain in state ownership, while day-to-day operations are managed by concessionaires. Such an agreement allows airports the opportunity to increase commercial revenues from retail trade, parking, office rent, etc.

Currently, air traffic control is being transferred to more competitive service providers as well.

Over the past year, many new airlines such as Etihad Airways, IranAir, Kuwait Airways, GulfAir, Flynas, Arkia, Pegasus Airlines, SmartAvia, UrAirlines, Nordwind have started operating at the airport.

State guarantee for “AZAL” loans

“AZAL” has received a large amount of state-guaranteed loans. Although there is no information about this on the website of the state company, it is possible to find some information on the website e-qanun.az.

According to an Order of the Cabinet of Ministers of the Republic of Azerbaijan dated 27 May 2011, “Boeing” and the “Azerbaijan Airlines” Closed Joint-Stock Company signed agreement No. 3374 dated 4 August 2008 on the purchase of a Boeing-767 300ER passenger aircraft. A long-term targeted loan in the amount of AZN 57,800,000 (fifty seven million eight hundred thousand) was allocated by the Central Bank of the Republic of Azerbaijan to the “Azerbaijan Airlines” CJSC through an agent bank at the request of the “Azerbaijan Airlines” CJSC in order to fulfill the obligations of the party and the Central Bank of the Republic of Azerbaijan was granted a state guarantee for the payment of interest to be accrued on it.

According to an Order of the Cabinet of Ministers dated 24 October 2011, a total of 6,635,000 (six million six hundred thirty five thousand) manats were allocated to the Secretariat of the Presidential Administration of the Republic of Azerbaijan from the

⁷² https://www.icao.int/publications/Documents/9562_cons_en.pdf

2011 state budget of the Republic of Azerbaijan for the purpose of repaying the creditor debt arising from the flights performed by the “Azerbaijan Airlines” Closed Joint-Stock Company and the arrears that may be generated before the end of the year.

According to an Order of the Cabinet of Ministers dated 12 June 2012, the Central Bank of the Republic of Azerbaijan provided the “Azerbaijan Airlines” CJSC with a long-term targeted loan in the amount of AZN 165,000,000 (one hundred sixty five million) and interest accrued on it. The Central Bank of the Republic of Azerbaijan was granted a state guarantee for the repayment of the loan.

According to an Order of the Cabinet of Ministers dated 22 October 2012, the “Azerbaijan Airlines” Closed Joint-Stock Company signed Agreement No. 550-QSC with “Embraer” on 25 September 2012 on the purchase of 4 Embraer-190 AR aircraft, Agreement No. 582-QSC with “AJW Capital Partners Limited” on 15 October 2012 on for the purchase of three Airbus A-340-500 aircraft, including one possessing a special structure, Agreement No. 589-QSC with “Agusta Westland SpA” on 17 October 2012 on the purchase of 6 helicopters, Agreements No. 590-QSC and 591-QSC with “ECC Leasing Company Limited” on 17 October 2012 on the purchase of 2 Embraer-170-100 LR aircraft, and a long-term targeted loan in the amount of USD 655,000,000 (six hundred fifty five million) was allocated by the Central Bank of the Republic of Azerbaijan to the “Azerbaijan Airlines” Closed Joint-Stock Company through an agent bank. The Central Bank of the Republic of Azerbaijan was granted a state guarantee for the repayment of the and interest accrued on it.

Like a number of other monopolies, “AZAL” has a fairly large share in the amount to be repaid from the State Loan Guarantee Fund (principal debt). In particular, according to the Opinion of the Chamber of Accounts of the Republic of Azerbaijan on the Draft Law of the Republic of Azerbaijan “On Execution of the State Budget of the Republic of Azerbaijan for 2018” and the annual report on the Execution of the State Budget, the amount of state guaranteed loans repaid from the Guarantee Fund (principal debt) constituted a total of 295.5 million manats in 2018 and 388.6 million manats in 2019. Most of these debts are associated with the “Azerbaijan Airlines” CJSC, the State Oil Company, “Azercosmos” OJSC, “Azerenergy” OJSC, “Azeraluminum” OJSC and the “Azerbaijan Railways” CJSC.

As a result of the control measures carried out by the Chamber of Accounts, it was determined that overdue and unpaid amounts received from the Guarantee Fund for which the Ministry of Finance signed loan agreements with the main borrower

constituted 27,686,600 US dollars, 157,500 Euros and 159,310,400 manats under 19 contracts in force as of 01.01.2018 and 46,338,500 US dollars, 5,188,200 Euros and 261,046,800 manats under 30 contracts in force as of 01.07.2018.

Nevertheless, "AZAL" continues to replenish its aircraft fleet. In particular, the "Azerbaijan Airlines" (AZAL) CJSC will soon bring a B777-200 (LR) airplane to Baku. Boeing has so far produced 59 aircraft designed for VIP government transport⁷³. The cost of the aircraft is 291.2 million US dollars⁷⁴.

Subsidies allocated to AZAL

The opinion of the Chamber of Accounts of the Republic of Azerbaijan on the draft Law of the Republic of Azerbaijan "On State Budget of the Republic of Azerbaijan for 2020" states that the share of the "Azerbaijan Airlines" Closed Joint-Stock Company in the distribution of subsidies provided for in the "Economic Activity" section of the functional classification of the draft state budget for 2020 is 10 million manats⁷⁵. The main purpose of the subsidy is to compensate for the travel of World War II veterans and their equals to the CIS countries and the sale of tickets for flights to the Nakhchivan Autonomous Republic at discounted prices⁷⁶.

Many countries around the world have got rid of the practice of state support of national airlines. This is the case not only with unprofitable airlines (for example, the Hungarian national airline "Malev" ceased to operate in 2012). Successful airlines such as "Lufthansa" and "British Airways" parted company with the government a long time ago ("Lufthansa" became privately owned in 1997 and "British Airways" in the late 1980s). The French government owns 14 percent of "Air France-KLM". Born Kyos, the director general of the Norwegian AIR, said that France and other governments should leave the aviation business – then the market will work better. The Norwegian government has sold the last 10 percent of its shares to its main competitor in the local market, "Scandinavian Airlines"⁷⁷.

⁷³ http://airsoc.com/articles/view/id/5dde6581c4263c50418b4567/azerbaijan-s-azal-to-add-first-vip-configured-b777-200-lr?fbclid=IwAR31CPIP6t4ioc29n4AU3oOOETLRK0Axmm6_Ys-wH5LmY9H1Fg1Hm6BX5TY

⁷⁴ <https://www.aircraftcompare.com/aircraft/boeing-777-200lr/>

⁷⁵ http://sai.gov.az/upload/files/2020_REY.pdf

⁷⁶ <http://openazerbaijan.org/topics/ara-d-rma/azal-x-rcl-yir-bordlar-n-is-dovl-t-od-yir/>

⁷⁷ <https://skift.com/2018/09/04/why-do-national-airlines-still-exist/>

Key findings

Transparency and accountability. It is difficult to obtain detailed information about “AZAL”'s activities. Despite being a state-owned company, “AZAL” does not publish its reports in local sources. However, in accordance with Article 5.3 of the Charter of the “Azerbaijan Airlines” Closed Joint-Stock Company, in order to ensure transparency, the Company is to publish its annual financial statement and consolidated financial statements together with the auditor's report no later than four months after the end of each financial year. It is also required to publish information on the conclusion of deals (deals of special significance) in the amount exceeding 25 percent of the value of its net assets in the manner prescribed by law.

In addition, in accordance with the “Law on Accounting” and Decisions No 97 and No. 321 of the Cabinet of Ministers dated 27 May 2010 and 1 October 2014 respectively, “AZAL”, as a public and state-owned enterprise receiving a loan, is required to publish the audit report on its website before the end of April of the following year. However, the company has not yet disclosed its reports to the public.

The evasion of the “Azerbaijan Airlines” Closed Joint-Stock Company from disclosing its reports was reflected in the report of the Board of the Chamber of Accounts of the Republic of Azerbaijan on the results of the audit of financial and economic activities of “Azerbaijan Airlines”, which was published in January 2018. The press service of the Chamber of Accounts told “Sputnik-Azerbaijan” news agency: “A number of shortcomings have been revealed in the area of disclosure of financial statements and auditor’s report by the “Azerbaijan Airlines” Closed Joint-Stock Company, calculation of revenues and expenditures and their approval by relevant state agencies, use of the opportunities for partial elimination of unprofitable activities, calculation and payment of taxes and other mandatory payments, accounting and reporting on the use of some assets, determination of rents for the use of state property, and functionality of the internal audit system. Also, revenues from commercial activities, funds allocated from the state budget at the expense of capital investment and borrowed funds are mainly transferred into the same settlement account, which has led to certain risks in the use of funds in accordance with the intended purpose.”

The information posted on the etender.gov.az website on the contracts signed on the basis of procurement lists 174 contracts concluded by “AZAL” as the procuring entity. However, the official website of “AZAL” does not provide any information on these agreements. According to Article 5.3 of the “Law on Public Procurement”,

information on a procurement contract concluded as a result of bidding shall be published in the media outlet that published the request for proposals within five banking days and posted on the official website.

Ensuring transparency in the activities of state-owned companies, including “AZAL”, is also reflected in the documents of international organizations. The “Rules on Corporate Governance Practices of State-Owned Enterprises” approved by the Organization for Economic Cooperation and Development and the national standards developed in accordance with these rules emphasize the provision of transparency in the activities of the Joint-Stock Company.

Governance. The Decision of the Cabinet of Ministers of the Republic of Azerbaijan “On approving a number of regulatory acts related in increasing the efficiency of legal entities the control package of shares (stocks) of which is owned by the state” dated 4 June 2019, adopted in accordance with Order No. 2300 of the President of the Republic of Azerbaijan dated 5 September 2016 “On additional measures to increase the efficiency of the activities of legal entities the control package of shares (stocks) of which is owned by the state”, establishes the rules and standards for assessing the effectiveness of state-owned legal entities the control package of shares (stocks) of which is owned by the state. Although about a year has passed since the decision was made, there is no information on the application on the part of “AZAL” of the rules and standards specified in the decision. According to the current Charter of “AZAL”, the Board of Directors and President of the Company are the main bodies in the management structure of the Company. However, the decision of the Cabinet of Ministers envisages the establishment of an effective Supervisory Board (Board of Directors) as one of the standards of corporate governance.

Customer satisfaction. The State Statistics Committee has released information on how people prefer to leave Azerbaijan. It is noteworthy that those leaving the country prefer overland options. In particular, 83.4 percent of Azerbaijani citizens traveling abroad in January-June of this year used rail and automobile transport, 15.8 percent air and 0.8 percent sea transport. Even though air transport is more convenient in reaching the destination comfortably and quickly, the fact that “Azerbaijan Airlines” (AZAL) ticket prices for any destination are about twice as expensive as in other countries does not allow people to use this means of transport. As a result of

“AZAL”'s pricing policy, both the country's economy and airlines are losing, and our citizens are facing the loss of both money and time⁷⁸.

Ways to increase sector's efficiency

Recognition of equal opportunities for both public and private sector participation in air transport. We believe that recognition of opportunities for both public and private sector participation in air transport can help reduce passenger and cargo travel time by air, increase customer satisfaction, decrease operating costs, build capacity for cheaper airfare and increase competitiveness. Gradual liberalization of the market can attract investment in infrastructure and open up opportunities for service providers such as airlines, ground handlers, catering and maintenance companies, as well as encourage investment in critical infrastructure elements in the aviation sector, including airport facilities and equipment. The overall conclusion is that a safe, reliable and efficient aviation sector can play an important role in economic development.

Recommendations:

1. **Transfer of Heydar Aliyev International Airport to private management.** A number of countries around the world have begun to take airports out of state control and transfer them to private management. Different models have been used for this purpose. As a rule, the assets remain the property of the government and a concession agreement is concluded for a certain period of time to provide management services. In Saudi Arabia, Medina Airport has been transferred to private management using a "construction-operation-transfer" model under a contract with “TAV Turkish Airports Group”. Other Saudi airports have entered into management agreements with private administrative firms, including the Dublin Airport Organization in Riyadh and the Dublin Airport Service in Jeddah. A number of airports in Brazil are managed on the basis of concessions on 30-40-year contracts with the participation of both local and foreign investors.
2. **Analyze gaps in current efficiency and determine the level of assistance required to increase productivity and service levels at both Heydar Aliyev Airport and regional airports if Heydar Aliyev Airport is to continue to remain under**

⁷⁸ <https://yenimedia.info/2019/07/29/azal-in-f%C9%99aliyy%C9%99ti-bar%C9%99d%C9%99-ekspert-r%C9%99yi/>

government control. Such an analysis could allow the government to identify ways to improve airport infrastructure and influence airlines and service providers.

Although air transport infrastructure is built at public expense, policy options should not exclude the transfer of powers and private sector participation. If airports take a monopolistic position, they may face a significant risk when investing due to low utilization of services. For private sector participation to bring benefit, it is important that the policy has a clear framework and that investors can be confident that the policy meets its commercial potential.

3. **Promotion of public-private cooperation in the field of air transport.** It is possible to have both public and private sources of funding in the aviation sector. Private investment in air transport is justified, especially in cases of high demand for passenger and cargo transportation. Private companies can provide services in areas such as airport management, in-flight catering, luggage and other ground services, and retail outlets. In exchange for concessions for the provision of such services, private companies can make initial investments in airport infrastructure and equipment.

Ways to increase the efficiency of “AZAL”

1. **Ensuring transparency and accountability in the activities of the “Azerbaijan Airlines” CJSC.** As noted earlier, “AZAL” as a public borrower of guaranteed loans must publish an audit report on its website by the end of April of each year. Unfortunately, “AZAL” does not comply with this requirement of the legislation. For this reason, it is advisable to amend the legislation on administrative liability for non-publication of information of public importance.

2. **Application of corporate governance in the activities of the “Azerbaijan Airlines” CJSC.** Applying an effective corporate governance system by learning from the best practices of developed countries can ensure transparency in “AZAL”, enhance the company's international reputation, facilitate the attraction of investments and reduce the cost of attracted capital.

3. **Develop a policy on service standards.** The development of such standards can both increase the company's responsibility and lead to better customer satisfaction.

PROBLEMS AND PROSPECTS FOR IMPROVING DRINKING WATER SUPPLY AND INCREASING THE EFFICIENCY OF PUBLIC FUNDS

Rasim Hasanov

Introduction

The water sector has always been one of the most important determinants of socio-economic development and has a socio-ecological and fiscal resource nature. To emphasize the importance of the water sector for Azerbaijan in modern times, suffice it to say that on 27 July 2020, during the peak of the global pandemic (COVID-19) and the deepening global economic crisis caused by the turmoil in oil markets, the President chaired a special government meeting on water issues.

Regarding the volume of reserves and water use in general, it was noted at this government meeting that “as a whole, the country's water resources are estimated at about 35.6 billion cubic meters. The last time surface water resources in the country were assessed was in 1970 and groundwater resources in the 1980s. Although about 40-50 years have passed, water resources have not been re-evaluated. An average of 653 million cubic meters of drinking water is taken annually from 35.6 billion cubic meters of water. Approximately 57 million cubic meters, or 9 percent, of the 653 million cubic meters of water is used for technological processes and 286 million cubic meters of water is disposed of for various uses. Only about 283 million cubic meters of water, or 45 percent of the water entering the network and 50 percent of the water taken, is delivered to consumers. In other words, the volume of water supplied to consumers is smaller than the water lost. 73 percent of main water canals are ground canals.”

In 2004, the supply of drinking water in Azerbaijan was 40 percent and the number of people in Baku who regularly received drinking water was 29 percent. At present, these figures have reached 70 and 82 percent. Thus, it is possible to say that in modern Azerbaijan there are serious problems with the supply of drinking water to the population, as well as in the supply of irrigation water for agricultural needs. Given that the organization of water supply has very serious financial and investment requirements, it is extremely important to consider the technical and

environmental aspects of the water supply system in the country together with its feasibility study.

Objective of study: The study conducted under the contract has two important objectives: 1. Identify the factors and influences determining the efficiency of state companies in Azerbaijan during the current period of transformation; 2. Evaluate the use of water resources in the national economy and the effectiveness of the activities of "AzerSu" OJSC.

In other words, the goal of this study is to determine the legal and economic environment in which state-owned companies operate in the modern economy, assess economic competitiveness opportunities and use of state assets, determine the impact of the water sector on economic development, and evaluate direct socio-economic results of the activities of "AzerSu" OJSC.

Existing potential of the water sector

Drinking water resources in Azerbaijan are limited and unevenly distributed. According to the Ministry of Ecology and Natural Resources of the Republic of Azerbaijan, currently the country's surface water reserves are 27 cubic kilometers. In dry years this reserve decreases to 20-21 cubic kilometers. Sources of surface water resources are rivers, lakes, reservoirs and glaciers. 70-72 percent of fresh water sources are located outside the country.

As a result of climate change, water resources have declined by about 15 percent in recent decades. International climate models show that by 2050, our water resources may decline by another 15 percent. In the past, the drought lasted for two to three, but in the last eight years there have been continuous droughts.

19-20.6 cubic kilometers of Azerbaijan's surface water resources are formed by trans-boundary rivers and 9.5-10 cubic kilometers by local rivers. With the exception of the Samur River, the annual water reserves of rivers flowing directly into the Caspian Sea are 2.2-2.5 cubic kilometers, of which 1-1.1 cubic kilometers are from the north-eastern slope of the Greater Caucasus, 1.2-1.4 cubic kilometers from the Lankaran natural region. The total water reserves of the right and left tributaries entering the Kura River basin are 7.5-7.8 cubic kilometers.

Under natural conditions, the river water in the country is fresh and the total mineralization rate is 0.3-0.5 grams/liter. The chemical composition of river water is dominated by hydrocarbonate and calcium ions. The waters of the Jeyranchol and

Absheron-Gobustan rivers have a chemical composition of sodium sulfate with a degree of mineralization of 0.5-1.5 grams/liter and more.

The surface flow of rivers in Azerbaijan varies sharply depending on the hydrological year and season. Reservoirs have been established on a number of rivers to reduce dependence on this variability and have reliable water sources that can be used throughout the year. There are about 140 reservoirs in the country. The largest of these are Mingachevir on the Kura River (with a volume of 16 billion cubic meters), Shamkir (with a volume of 2.6 billion cubic meters), Araz on the Araz River (with a volume of 1.3 billion cubic meters), Sarsang (with a volume of 0.5 billion cubic meters) on the Tartar River. The total area of reservoirs is 87,000 hectares and the volume of water is about 22 cubic kilometers.

There are about 450 lakes with a total area of 394 square kilometers in Azerbaijan, of which about 200 dry up in the summer. The total water reserves of the lakes are about 0.9 cubic kilometers, and the reserves of freshwater lakes are about 0.03-0.05 cubic kilometers. The annual operational reserves of usable groundwater in the country are about 9 billion cubic meters. While being the poorest country in the South Caucasus in terms of water and freshwater resources, Azerbaijan lags behind many other countries in terms of per capita water.

The first pipeline built for drinking water supply of the Absheron Peninsula is the Shollar-Baku water pipeline. The construction of the water pipeline, which takes its source 187 kilometers from Baku, began in 1911. However, due to interruptions in the construction of the pipeline, "Shollar" water was delivered to the population of Baku in 1917. The design capacity of the Shollar pipeline is 1.27 cubic meters per second (109,000 cubic meters per day). The volume of water supplied by the pipeline, which was put into operation as part of a "military option", initially amounted to about 1/3 of the project capacity. The productivity of this source, which has been operating continuously since 1917, has hardly changed. "Shollar" provides an average of 1,200-1,300 liters of water per second throughout the year. The construction of the Second Baku Water Pipeline, which originates in Khachmaz District, began in 1934 and was completed in 1958. This source supplies 2.73 cubic meters per second (240,000 cubic meters per day) of fresh water to Baku. The 175km reinforced concrete pipeline currently supplies drinking water to Siyazan and Shabran districts. The Second Baku Water Pipeline, which has twice the capacity of the Shollar-Baku water pipeline, derives water from artesian wells, reservoirs and springs. Currently, the following projects are being implemented in Azerbaijan to upgrade water infrastructure:

1. Loan Agreement was signed between the Government of the Republic of Azerbaijan and the World Bank on 17 August 2007 to ensure reliable and sustainable water supply and sewage services under the “National Water Supply and Sewerage Services Project I” and Approved by Order No. 247s by the Cabinet of Ministers dated 27 August 2007.
2. “Water Supply and Sewage Investment Program” Loan Agreement between the Republic of Azerbaijan and the Asian Development Bank was signed on 29 November 2005, approved and entered into force on 1 March 2006.
3. “Small Towns Water Supply and Sewage Project” Loan Agreement between the Government of the Republic of Azerbaijan and the Japan International Cooperation Agency was signed on 29 May 2009 and entered into force on 30 June 2009.
4. “The National Water Supply and Sewage Program in 6 Districts of Azerbaijan” co-financed by “AzerSu” OJSC with the Islamic Development Bank is being implemented. In April 2011, the Government of Azerbaijan formally applied to the Islamic Development Bank (IDB) for financing the project. The Exclusion Agreement and the Agent Agreement submitted by the IDB were signed by the Government of Azerbaijan and the Islamic Development Bank and entered into force in April 2012.
5. “The Reconstruction and Expansion of Water Supply and Sewage Systems of Khirdalan” project co-financed by the Government of Azerbaijan and the Saudi Development Fund is being implemented.
6. “The Reconstruction of Water Supply and Sewage Systems of Kurdakhani settlement” Grant Agreement in the amount of 26.18 million USD was signed between “AzerSu” OJSC and the Ministry of Foreign Affairs and Trade of the Republic of Korea. A contracting agreement was also signed with Korean companies Hyundai Engineering, Halla Energy & Environment, Sunjin Engineering, Yooshin Engineering.
7. Project on reconstruction and expansion of water supply and sewage systems in Badamdar settlement is being implemented within the framework of the “Reconstruction and Expansion of Water Supply and Sewage System in Baku” project co-financed by the Government of Azerbaijan and the Saudi Development Fund. The Loan Agreement for the project was signed on 20 November 2009 and approved in April 2010.

In addition to the above-mentioned projects involving foreign investment, more than 15 local projects are currently being financed from the state budget.

Efficiency of the water sector

Clean water is an extremely important resource for human life and health. At the present stage of development, the right of people to water and hygiene services has been recognized by mankind as an argument that needs no proof. According to the UN General Assembly's Resolution of July 2010, everyone has the right to adequate water (currently 50-100 liters per day) for personal use and household needs. Such water should be affordable in terms of price and quality (the cost of water should not exceed three percent of household expenditures). According to UN standards, water must be physically accessible at the same time (the water source should not be more than 1,000 meters away from the house and it should not take more than 30 minutes to bring it). The daily water supply in the Republic of Azerbaijan is 56.2 liters and water costs are a very small part of household expenditures.

Studies show that the demand for fresh water is growing against the background of climate change. Since the 1980s, groundwater use has increased by 1 percent per year. At the same time, the Intergovernmental Panel on Climate Change estimates that any increase in global warming will reduce the volume of renewable water resources by about 20 percent for 7 percent of the world's population.

According to UN experts, in the 21st century, water will become a more important strategic product than oil and gas. World water use has doubled in the last hundred years. According to the World Water Commission, everyone needs 20-50 liters of water (average 40 liters) for cooking and personal hygiene during the day. However, 40 percent of the world's population (3 billion people) suffer from water shortages. In 2025, those suffering from water shortages will make up two-thirds of the world's population.

According to expert estimates, every dollar invested in improving water supply and sanitation brings in \$3-34. To show how important the water problem is to humanity, we consider it important to note that 260 of the world's largest rivers flow through two or more countries, and the lack of clear regulatory agreements is always conducive to conflict. In the last 50 years, there have been 507 water conflicts around the world, 21 of which have taken the form of armed conflict. According to UN estimates, the Araz and Kura rivers are among the world's hotspots that could turn into a military conflict.

Recently, the practice of assessing various aspects of resource capacity of production is expanding in a number of advanced countries. Traditionally, the least considered direction among such assessments is the assessment of production water content. However, in general, the deepening of the chronic shortage of water resources has led to a significant increase in attention to this factor. Studies show that the water capacity of production varies widely between countries. According to the State Report "On the state and use of water resources in the Russian Federation", the water capacity of the economy is characterized by the following data.

Average characteristics of water balance over years (billion m³/year)

	Precipitation	Inland flows	Flows from other countries	Renewable volume of water	Water reserves per capita	Water reserves for domestic needs per capita
World	108928	42921				5685
Europe	12561	6578			...	8864
America	44408	19655			...	19522
Asia	26855	11865			...	2634
Africa	20371	3931			...	3129
Russia	7865	4313	212.2	4525	30815	29372
Azerbaijan	38.7	8.1	26.6	34.7	3529	826
Armenia	16.7	6.9	0.9	7.8	2652	2341
Georgia	71.5	58.1	5.2	63.3		
Iran	398	128.5	8.55	137	1688	1583
Turkey	465	227	-15.4	212	2621	2811

It is worth noting that there are only 12 countries in the world with the lowest per capita water resources due to inland water flows. Azerbaijan is 10th from the bottom. In our opinion, this fact makes it necessary to pay more attention to the water

problem in our country and to take a more demanding approach to the activities of relevant agencies and companies. Therefore, we believe that in order to improve the use of water and solve problems in Azerbaijan, along with the current Water Code, a Water Strategy must be formulated and implemented as a matter of urgency. Studies show that the strategic goals of water use in our country at the stage of modern development should be defined as water capacity of production, water losses and reduction of pollution of water basins. These are important for both drinking and industrial water use. Thus, from the world experience and the essence of the production process, it is considered that the reduction of water capacity actually leads to the reduction of energy capacity of production, and therefore reduces costs as a whole and increases the efficiency of water use.

Key water sector players in the Azerbaijani economy

Legal aspects of water use in the Republic of Azerbaijan are regulated by the Water Code approved by Law No. 418 of the Republic of Azerbaijan dated 26 December 1997.

“AzerSu” Open Joint Stock Company is an organization that provides consumers with drinking water and sewage services in a centralized manner. The Joint Stock Company organizes the collection, processing, transportation and sale of water from sources, and carries out wastewater treatment. It is also engaged in the design, construction, operation and maintenance of water treatment plants, reservoirs, pumping stations, water pipelines and sewage collectors. According to the Law on Natural Monopolies, the activities of “AzerSu” OJSC are assessed as activities in the field of natural monopolies.

By Decree No. 252 of the President of the Republic of Azerbaijan dated 11 June 2004, “AzerSu” Open Joint-Stock Company was reorganized on the basis of the Absheron Regional Joint-Stock Water Company established by Resolution No. 1038 of the Milli Majlis of the Republic of Azerbaijan dated 12 May 1995. All shares of the company belong to the state. The State Committee for Property Affairs of the Republic of Azerbaijan acts as the custodian of the Company's shares on behalf of the state (Ministry of Economy of the Republic of Azerbaijan since 2019).

By the end of 2019, “AzerSu” OJSC provided drinking water to 1,554,028 subscribers across the country. 1,494,064 of them are population and 59,964 are non-population consumers. The company has 20,000 km of water, 5,000 km of sewage and rainwater lines on its balance sheet. At present, projects on the reconstruction of water supply

and sewage systems in cities and regions of the country are being implemented. The work is funded from the state budget and loans from international financial institutions. As of 01 January 2020, the number of employees in “AzerSu” OJSC was 13,600.

“AzerSu” OJSC is a centralized supplier of drinking water and sewage services to consumers. The Joint Stock Company organizes the collection, processing, transportation and sale of water from sources and carries out wastewater treatment. It is also engaged in the design, construction, operation and maintenance of water treatment plants, reservoirs, pumping stations, water pipelines, sewerage collectors

The current organization chart of “AzerSu” Open Joint Stock Company was approved by Decision No. 328 of the Cabinet of Ministers of the Republic of Azerbaijan dated 29 July 2019. The chart includes the Executive Office of “AzerSu” OJSC, 30 organizations and three legal entities (enterprises) subordinated to it. The authorized capital of “AzerSu” OJSC currently amounts to 422.9 million manats.

The latest information disclosed to the public by “AzerSu” OJSC is the Consolidated Financial Statement on the activities of “AzerSu” and its subsidiaries (Group) in 2018. Although the auditors of “RSM Azerbaijan”, an external expert invited to evaluate the report, said that they were confident that the assessments were based on accurate information, it was also noted that “this confidence does not give any guarantee that significant distortions will not be discovered in an audit conducted in line with International Auditing Standards.” In other words, auditors questioned the objectivity of consolidated financial statements. Analysis of the statement shows that the company's long-term assets increased by about 200 million during the year, reaching 813.5 million manats (614.5 manats in 2017) and current assets increased by 26 million manats to reach 105.6 million manats. An interesting point here is that a serious element of the growth of the company's assets, in our opinion, is the large amount of receivables, which cannot be considered necessary – about 78 million manats. Another important point is the increase in the company's accumulated losses by 480 million manats. The increase in losses occurred during the year when public investment increased by 316 million manats to 4,190 million manats. The “additionally paid capital” of unclear nature increased by 450 million manats to reach 2013 million manats.

The Company's “Statement on Consolidated Profits or Losses and Other Gross Incomes” states in the “Operating Losses” line that total losses decreased by 28 million manats during the year. According to the table, the decrease in operating

losses occurred against the background of a decrease in administrative expenses by 7.5 million manats, "other operating expenses" by 75 million manats and other incomes by 57.5 million manats. However, when summarizing the information on the items of expenditure given in this section, it is clear that operating losses in 2017 amounted to 752.364 million manats and in 2018 to 623.274 million manats. The difference, i.e. the amount of loss reduction during the year, was 129.09 million manats.

The reasons for this discrepancy are not clear from the report, and in our view, this fact indicates the validity of the cautious approach to the "confidence level" set out in the Auditor's opinion.

In our opinion, another point of interest with this section is that even though "pre-tax losses" were 479.1 million manats (625.5 million manats according to our estimates), "profit tax expenses" for the year were 1.069 million manats. How legitimate is it for a loss-making enterprise to pay a "profit tax"? It is important to note that in the "current liabilities" section of the statement, the "Accounts payable on income tax" line indicates 2.3 million manats. In our opinion, one of the possible explanations for this may be related to the consolidated nature of the report. Even if this is the case, the explanation cannot be considered satisfactory and is evidence of "errors" in the consolidated report.

The main company of the group, "AzerSu" OJSC, has the legal status of a state-owned enterprise. The group includes eight separate legal entities, each with its own share capital. As of 31 December 2018 and 31 December 2017, "AzerSu" OJSC had approved and issued 20,000,000 shares with a par value of 0.02 manats. "AzerSu" OJSC has full control and 100 percent participation in all subsidiaries. During 2018, the Group recorded additionally paid capital in the amount of 444,664 manats (665 manats in 2017) based on the value of completed investment projects accepted by the State.

During 2018, the fair value of non-financial assets provided free of charge by various budget organizations on the date of transition was 3,735,000 (7,389 manats in 2017).

Loans from international financial institutions reflect loans provided directly to the State to finance projects related to the development and improvement of the water supply system in the Republic of Azerbaijan. The State, in turn, transferred the relevant rights and obligations on these loans to the Group through a refinancing agreement between the State and the Group on the same terms.

- Loans from the World Bank (IDA): On 6 July 1995, the IDA signed a loan agreement in the amount of 91,463 manats. On 30 June 2003, another agreement was signed in the amount of 22,802 manats. The loans were provided to finance the Greater Baku Water Supply System Reconstruction Project.
- Loans from KfW: On 25 September 2006, KfW issued two loans in the amount of 14,827 Euros (28,865 manats) and 26,350 Euros (51,298 manats). The loans were provided to finance the Open Program for Municipal Infrastructure project. As of 31 December 2018, the total reduced amount of loans was 14,827 Euros (AZN 28,865) and 23,228 Euros (45,220 AZN) respectively (as of 31 December 2017: 14,827 Euros (30,109 manats) and 17,756 Euros (36,057 manats) respectively).
- On 30 September 2006, Natixis, a French corporate and investment bank, granted a loan of 35,000 Euros (68,138 manats). The loan was provided to finance a project entitled "Reconstruction of Hovsan waste management system and Zykh pumping station".
- On 29 November 2005, ADB provided a loan to the State with an annual effective interest rate of 12,795 manats. The loan was provided to finance a project called "City Water Supply and Sewage Project".
- Interest-free loans from the Ministry of Finance of the Republic of Azerbaijan:
 - ✓ On 29 November 2016, two loans in the amount of USD 17,382 (29,549 manats) and 11,943 manats;
 - ✓ On 7 June 2017, loan in the amount of 11,183 USD (19,011 manats);
 - ✓ At the end of 2017, loan in the amount of 11,280 USD (19,176 manats);
 - ✓ At the end of 2018, loan in the amount of 11,390 USD (19,363 manats).
- Loan from the International Bank of the Republic of Azerbaijan: On 15 July 2016, the Group signed a loan agreement with the International Bank on the basis of a state guarantee in the amount of 239,720 manats with an interest rate of 1 percent per annum. As of 31 December 2016, the Group disbursed the full amount of this loan to finance current infrastructure projects. As of 31 December 2018, there is an unpaid interest balance of 73 manats on the loan.

Total creditor arrears for construction services and for material, transport, water, energy supply and utility services provided to the Group by suppliers as of 31

December 2017 was 493.995 million manats and as of 31 December 2018 was 434.072 million manats.

Differences between IFRSs and applicable local tax legislation have led to temporary differences between the carrying amount of assets and liabilities and their tax bases for the purposes of preparing financial statements.

As of 31 December 2018, the total balance of deferred tax assets for losses carried forward and other temporary differences was 1,161,719 manats (as of 31 December 2017, it was 1,080,566 manats).

The Group does not file a consolidated tax return. In terms of the current structure of the Group, the tax losses and current tax assets of the individual entities of the Group cannot be offset by the current tax liabilities and taxable profits of the other entities of the Group. For this reason, deferred tax assets and liabilities are offset against each other only if they relate to the same taxable entity.

Several subsidiaries of the Group have tax losses. In accordance with the tax legislation of the Republic of Azerbaijan, they can be transferred over the next five years. However, deferred tax assets are not recognized because they relate to subsidiaries with a history of losses and these losses cannot be used to offset taxable profit within the Group. The Group conducted an assessment and concluded that it was not possible to recover the deferred tax assets on the balances of the loss-making subsidiaries in the near future. For this reason, the Group has recognized the full provision for deferred tax assets on these entities.

Ways of increasing the efficiency of “AzerSu” OJSC

According to the corporate governance law on joint-stock companies, the legislation of Azerbaijan is based on the European model. Until 6 March 2004, joint-stock companies were governed by the Law on Joint-Stock Companies (12 July 1994). After this date, the law came into force and now the main regulatory act in the activities of JSCs is the Civil Code. In January 2011, the Ministry of Economic Development adopted the "Azerbaijan Corporate Governance Standards" prepared with the participation of the general public. However, since the use of the standards was voluntary, it was highly doubtful that it would be applied in practice. Although more than six years have passed, no JSC that is not a bank or insurance company has yet declared that its charter is in line with these standards.

A very important difference between state-owned enterprises along with their specialized associations and ordinary enterprises is that they have de facto acquired “unofficial management functions” due to an established tradition or a “special status” that in many cases leads to a more favorable business environment for them. In addition to their own area of activity, such enterprises have a significant impact on the economic environment in a wide range of other areas. It is important to keep in mind that some of them are the forces that shape price trends in the economic cycle, and for this reason should actually be quite profitable. It is worth remembering that the negative impact of the current "mode" of operation of such enterprises on the economy is not limited to the financial results. Their existing "model of action" can also be considered a major obstacle to the formation of an improved competitive environment in the economy. In our opinion, one of the most important factors preventing the adoption of a special law or, to put it more accurately, a competition code that would regulate competition relations in Azerbaijan, a country with a 30-year history of a market economy, is the position of such "heavyweight" enterprises.

An important aspect that characterizes the efficiency of the use of state assets in Azerbaijan is the activity of large taxpayers with a structurally creative role. Despite the favorable conditions created for them, the activities of such state-owned enterprises, which manage a large amount of state assets, cannot be considered acceptable. In particular, with their "natural monopoly" status, "cheap" and highly profitable activities in the conditions of free market relations, they failed not only to neutralize the negative effects on the economic environment but have actually aggravated the situation for their own "narrow" economic interests.

According to Resolution No. 321 of the Cabinet of Ministers of the Republic of Azerbaijan dated 1 October 2014, the list of organizations of public importance required to maintain and submit their reports in accordance with International Financial Reporting Standards (except for credit organizations, insurance companies, investment funds, non-state (private) social funds, and legal entities traded on the stock exchange) includes, along with other structures, those belonging to our research area. One of the important missions of International Financial Reporting Standards (IFRSs) is to ensure the transparency and comparability of the institution's activities in order to assess its effectiveness and efficiency of the use of financial resources in organizations of public importance. In other words, the application of IFRS standards in the activities of such highly important joint stock companies as “AzerSu” is an extremely important task.

Conclusions and recommendations

1. One of the main priorities of the government should be to ensure that the socio-political significance of the openness of the activities of public institutions is fully established at the level of national legislation and turned into a norm of activity. To this end, it is necessary to establish a mechanism for compiling and publishing a detailed report on the activities of these institutions (action plan, performance and justification of financial costs).
2. It is important to take special measures taking into account that the role of public institutions in the implementation of national legislation as a "pilot" can stimulate more organized implementation of the legislation in other structures.
3. In order to ensure the adequacy of information openness in the studied organizations, it is necessary to develop and apply standards of websites in such organizations.
4. Given that the transformation of information into an important value-creating factor in modern times, it is important to strengthen special activities in the studied organizations in order to study public opinion and provide flexible, reasonable and authoritative responses to relevant information.
5. Given that the formation of such organizations and the main factor of modern "sustainable development" is the protection of the state, it is important to ensure that the support of the state's national economic development goals becomes a decisive factor in the activities of these organizations.
6. It is considered expedient that along with the current Water Code, the Water Strategy should be urgently developed and implemented to improve water use and solve problems in Azerbaijan.
7. Research shows that the strategic goals of water use in our country at the stage of modern development should be defined as water capacity of public production, water loss and reduction of pollution of water basins. These are important for both drinking and industrial water use. Thus, from the point of view of international experience and the essence of the production process, it is considered that the reduction of water capacity actually leads to the reduction of energy capacity of production and therefore reduces costs and increases the efficiency of water use in general.

PROSPECTS FOR INCREASING GOVERNANCE EFFICIENCY IN AZERBAIJAN'S TELECOMMUNICATION SERVICES SECTOR

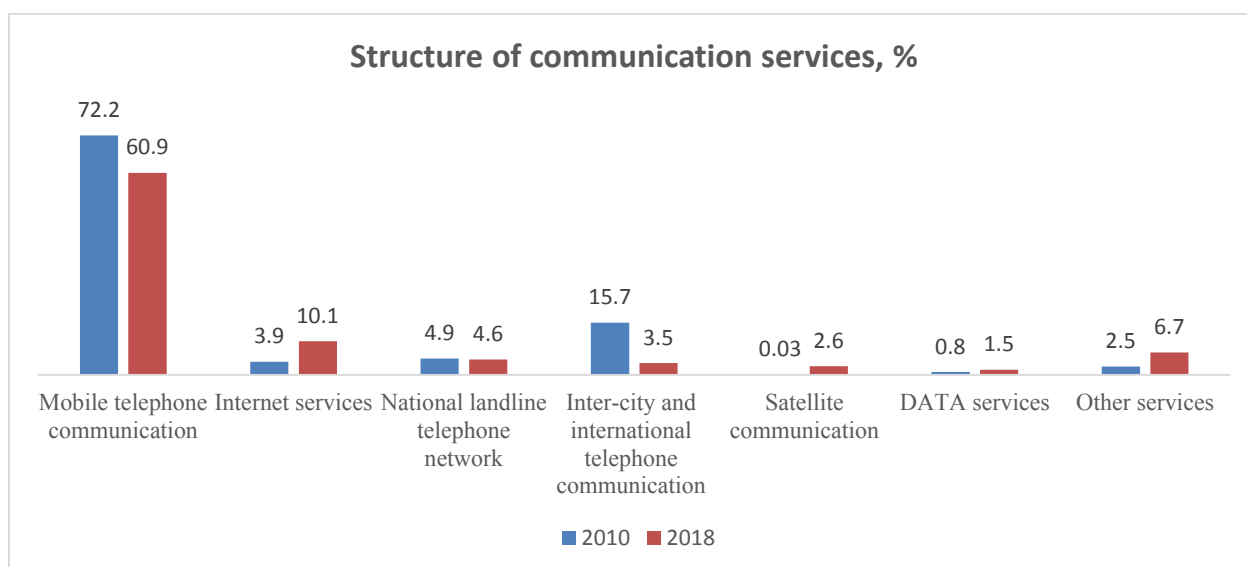
By Rovshan Agayev

The communications sector does not have a significant share in the Azerbaijani economy. In 2019, communication and information services accounted for only 1.8 percent of the GDP⁷⁹. However, in the last 10 years, this sector has been one of the two areas of economic activity with the highest real growth rates. According to an analysis the State Statistical Committee (SSC) has carried out in comparison with the 2010 prices, whereas real growth of the Azerbaijani economy as a whole in 2010-2017 was at 9 percent, of trade at 41 percent, of agriculture at 24 percent, of the processing industry at 20 percent and of construction at 19 percent, the communications and information sector doubled in real terms⁸⁰.

The central place in the structure of communication services is occupied by mobile communication. However, in 2010-2018, the share of mobile telephone communication in the total services of the sector continued to decline, falling from 72.2 to 60.9 percent. The decline in the market share of telephone services is certainly due to the rapid development of the Internet. The expansion of Internet services via both mobile and landline telephone networks, as well as the availability of video and voice calls through various applications (WhatsApp, Signal, Facebook, etc.) for households and businesses, have reduced the demand for telephone services.

⁷⁹ «Ölkənin sosial-iqtisadi inkişafının yekunları -2019»: <https://www.stat.gov.az/news/macroeconomy.php?page=6>

⁸⁰ «İqtisadi fəaliyyət növləri üzrə ümumi daxili məhsul istehsalı (2010-cu ilin qiymətləri ilə)»
https://www.stat.gov.az/source/system_nat_accounts/



The availability of Internet communication services has significantly reduced the market share of the national landline telephone network and international telephone communication. In 2010-2018, the share of inter-city and international telephone services in communication services decreased from 15.7 to 3.5 percent, and the share of the national landline telephone network dropped from 4.9 to 4.6 percent.

There are both public and private telecommunications companies in Azerbaijan's telephone services sector. In parallel with state-owned enterprises, private operators are available in all three segments of the telephone services sector – mobile and landline network services, as well as Internet services.

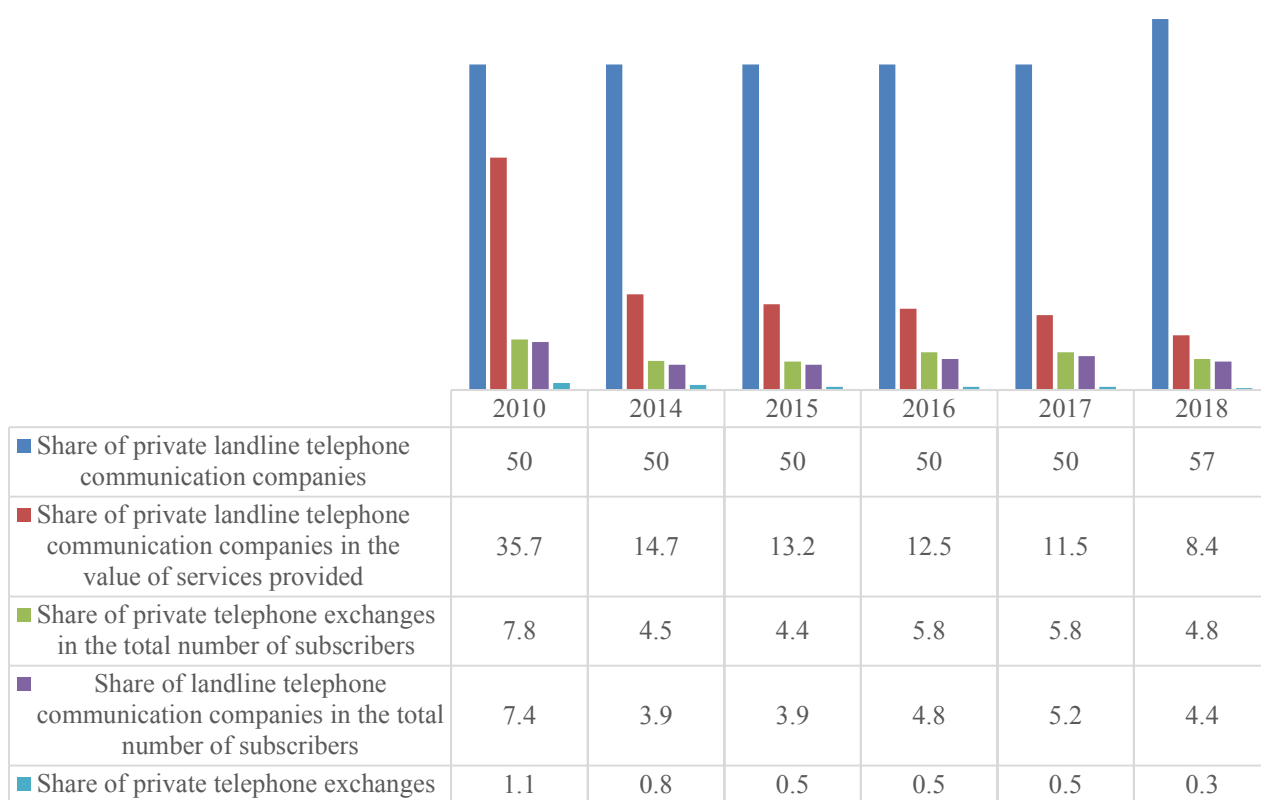
There are four mobile telephone operators in Azerbaijan. Two of them belong to the private sector – “Azerfon” and “Baksell”. The state participates in the other two companies – “Azercell” and “Naxtel”.

There is no information in public sources about the size of the state share in “Naxtel”. However, information on the transfer of a 51.3 percent share of “Azercell” to the state ownership in March 2018 for 222 million euros was published on the company's website⁸¹.

Unlike the mobile communication market, the public sector is dominant in landline network services. Statistics shows that seven companies operate in the market of landline network services. Three of them are state companies (“Aztelekom” LLC, “Baku Telefon Rabitasi” LLC and “Nakhchivan Telecom” LLC), and the other four enterprises are private.

⁸¹ <https://www.azercell.com/az/news/show/835/>

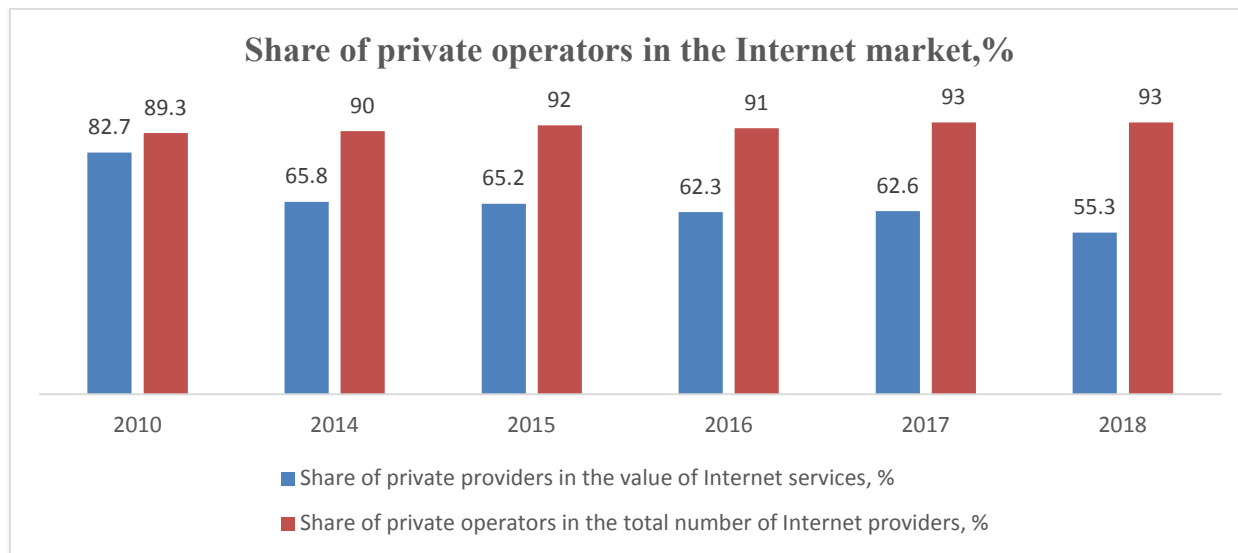
Share of private companies in the landline network market, %



In terms of numbers, private landline network companies have a bigger share - in 2018, four out of seven companies offering services, or 57 percent, were non-state enterprises. However, the share of private landline network companies in other indicators of the market share is very low. In 2010-2018, the share of private operators in the value of landline network services dropped from 35.7 to 8.4 percent, in the number of automatic telephone exchanges fell from 1.1 to 0.3 percent, in subscriber capacity from 7.8 to 4.8 percent and in the number of subscribers decreased from 7.4 to 4.4 percent. An analysis of absolute figures reveals that the number of private automatic telephone exchanges decreased from 16 to 6, the number of state-owned automatic telephone exchanges increased from 1,378 to 1,943, the amount of income from telephone services in the private sector dropped from 18.9 million 5.5 million manats and in the public sector increased from 34.1 million to 60.2 million manats. Whereas the actual number of telephone numbers in use in the private sector decreased from 106,200 to 64,000, in state-owned enterprises it rose from 1,333,400 to 1,398,400. Thus, proceeding from the key indicators characterizing the market, we can conclude that the share of the public sector in landline network services is close to 95 percent.

There are more private companies providing Internet services. According to official statistics, in 2010-2018, the total number of enterprises providing Internet services increased from 28 to 41, including the number of private operators from 28 to 41.

During this period, the number of state-owned operators providing Internet services remained unchanged – three. These companies mainly provide landline network services (“Aztelekomnet”, “Bakinternet” and “Azdatakom”).



The activities of companies providing international internet traffic to the country are separate, and there are only two companies in this field – “Delta Telecom” and “Azertelecom”, both of which are private. These companies provide international wired telephone communication, internet, data and voice transmission, and open internet channels (wholesale internet) to operators offering internet services to the population and businesses.

The main regulatory document in the field of telephone and Internet services is the Law on Telecommunications⁸². According to Article 23 of the law, telecommunication services include telephone (wired), cellular (mobile), paging, wireless telephone, domestic and international telecommunication services, Internet services, television and radio broadcasting services, etc.

According to Article 11 of the Law, in order to create a sound competitive environment, anti-monopolistic activities in the field of telecommunications are

⁸² <http://www.e-qanun.az/framework/10663>

regulated by the state. This regulation envisages the operation of all operators and providers of communication services on an equal basis.

In terms of their organizational and legal form, all state-owned companies operating in the telecommunications sector (“AzInTelecom”, “Aztelekom” and “Baku Telefon Rabitasi”) operate as a limited liability company (LLC). According to Decision No 292 of the Cabinet of Ministers dated 12.07.2012⁸³, although these companies are not part of the Ministry of Transport, Communications and High Technologies, they are directly subordinated to it.

According to Article 87 of the Civil Code⁸⁴, a limited liability company is a company established by one or more persons (individuals and (or) legal entities) whose authorized capital is divided into shares in the amount determined by the charter. Participants in a LLC are not liable for its obligations and bear the risk to the extent of the value of the funds invested in the activities of the company. According to Article 91 of the Code, the supreme body of an LLC is the general meeting of participants. In a company with one participant, the powers of the general meeting of the company are exercised by this participant alone. In cases stipulated by the company's charter, as well as in organizations of public importance, the company's board of directors (or supervisory board) or an inspection commission (inspector) are established. An executive body (collegial and (or) individually) shall be established in a limited liability company to manage its activities and report to the general meeting of participants. The head and members of the collegial executive body of the company or the head of the executive body of the company acting independently may also be elected from among those who are not its participants. According to Article 91-1 of the Code, the Board of Directors (Supervisory Board) of a company shall exercise control over the activities of its executive body in the period between general meetings of the company. If the charter does not provide for the election of an audit commission (appointment of an inspector), the powers of the audit commission (inspector) may be transferred to the Board of Directors (Supervisory Board) in accordance with this Code. The Chairman of the Board of Directors shall convene and chair its meetings at least once every three months and decisions shall be made by a simple majority of votes, each member having one vote.

It is almost impossible to assess the extent to which the management structure of leading state-owned enterprises in the telecommunications sector meets the standards of the corporate governance model even in terms of formal legal requirements. First

⁸³ <http://www.e-qanun.az/framework/39579>

⁸⁴ <http://www.e-qanun.az/code/8>

of all, this is the case because information on the management structure of any of these companies and the main document regulating their activities (charter) is not available in public sources. The websites of such agencies (<https://www.azintelecom.az/>, <https://www.aztelekom.az/>, <https://www.baktelecom.az/>) do not provide any information about the management structure and the main legal documents regulating their activities.

It is not possible to obtain any information about the supervisory boards of state-owned telecommunications companies, their activities and members in publicly available reports or through Internet search engines. Even if the charter formally provides for the existence of a Supervisory Board, according to the OECD “Rules of Corporate Governance in State-Owned Enterprises”⁸⁵, if state telecommunication companies differ from privately owned LLCs for a number of indicators, they can apply a corporate governance model. Such indicators include:

- Clearly defined powers of the Supervisory Board, executive body and a relevant regulatory ministry (agency);
- Clear legal norms governing the approved composition of the Supervisory Board and its relations with other governing bodies;
- Framework of decision-making powers given to all stakeholders, including employees;
- Specific requirements for information openness, accountability and transparency.

The rules also set specific requirements for Supervisory Boards to operate in state-owned enterprises. Strengthening and improving the quality of Supervisory Boards is a fundamental step in improving the corporate governance practices of public enterprises. These institutions should be identified as the key elements responsible for the company's operations. They should have the authority, competence and objectivity to perform strategic management functions and monitor management activities.

One of the main functions of Supervisory Boards of state-owned enterprises should be the appointment and dismissal of the Chief Executive Officer. Without this authority, it is difficult for state-owned enterprises to fully perform their monitoring functions and feel responsible for the performance of the enterprise. In some cases where the state is the main shareholder, the sole owner may appoint the Chief

⁸⁵ <https://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/45035654.pdf>

Executive Officer directly. However, in this case consultation with the Board is the main condition. Also, in such circumstances the rules and procedures for the appointment of the Chief Executive Officer should be transparent and based on professional criteria.

The experience of accountability and information openness of the state telecommunications enterprises being examined also does not meet the OECD corporate governance standards. According to these standards, public enterprise reports should include detailed information on the company's overall performance and results, financial assistance from the state, or government guarantees.

An analysis of the reports of Azerbaijan's leading operating in the telecommunications sector shows that not only the requirements of international standards on corporate governance but also national legislation in this area are not met. First of all, the overall report on the activities of any of these companies in accordance with the purposes of the charter and their results is not disclosed at all. It is particularly important for these reports to reflect information about the services provided, their structure, scope, dynamics and geographical distribution. On the other hand, Article 8 of the "Law on Accounting" requires public entities to prepare and disseminate their financial statements in accordance with international accounting standards. According to these standards, financial statements should include an extensive description of financial risks and their management, transactions with related parties, cash and cash equivalents, trade and other accounts payable, debt obligations, current and long-term assets, property, plant and equipment, revenue analysis, analysis of cost categories, taxes paid, investments in associated enterprises, changes in equity, financial information by business segments, financial income, financial expenses, etc.

The financial statements of "Aztelekom" LLC and "Baku Telefon Rabitasi" LLC provide extremely limited information. The latest report of "Aztelekom LLC" is for 2019⁸⁶ and the latest report of "Baku Telefon Rabitasi" LLC is for 2018⁸⁷. Both of these reports have the same structure and capacity, only disclosing information about the total income and expenses and their limited structure.

The financial statement of "AzIntelecom" LLC is more comprehensive than the above two⁸⁸. The latest financial report of the organization is for 2018. This report provides

⁸⁶ https://www.aztelekom.az/uploads/files/az_financial_2019.pdf

⁸⁷ <https://www.baktelecom.az/uploads/public/X%C9%99b%C9%99r%C9%99r/2019%20Hesabat.pdf>

⁸⁸ <https://www.azintelecom.az/upload/files/ce822a2ea4896440541fab4eb405e46e.pdf>

information on current and long-term assets, their structure, current and long-term liabilities, capital and profit.

The reports do not disclose any information on the liabilities of companies to the state budget, the structure of liabilities by type of payment. At the same time, information about investment projects implemented by companies at the expense of their sources of income and borrowings is closed to the public.

The preparation of financial statements of public enterprises in accordance with international standards is important not only in terms of transparency. Such reports also form the necessary database in terms of measuring the effectiveness of the activities of these entities. Measuring the efficiency of activities has been a legal obligation for state economic entities since last year. Thus, according to Decision No. 257 of the Cabinet of Ministers dated 04.06.2019⁸⁹, the “Procedure for evaluating the effectiveness of the activities of legal entities with shares (stocks) belong to the state” has been approved. According to the evaluation conducted on the basis of indicators proposed in these rules, when the efficiency factor is below 50 percent, the performance of state-owned companies is viewed as unsatisfactory. If it is at 100 percent, it is assessed as very good (including satisfactory in the 50-70-percent range and good in the 70-90-percent range). In total, 23 indicators are to be used in the main and additional groups to assess the effectiveness of activity. This includes the level of pre-tax profitability (EBITDA), the ratio between operating expenses and fixed operating income, return on attracted capital, return on equity, return on equity investment, return on assets, absolute liquidity ratio, labor productivity, solvency ratio, dividend ratio, use of production capacity ratio, energy efficiency, etc.

Improving competition and the quality of services in the communications sector necessitates reforms in this area. Until about 30 years ago, telecommunication and communication services were provided by the state all over the world with very few exceptions. However, long-term research and empirical analyses have revealed that the costs of public communication services in a non-competitive environment are high and the productivity and quality of services low. The presence of competition is important in terms of removing barriers for the entry of alternative operators, the impossibility for any single operator to dominate the market and the lack of opportunities to demonstrate restrictive behavior in relation to competitors. One of the key steps in this direction is the formation of an autonomous regulatory body that would not depend on the supreme government agency (for example, the Ministry of

⁸⁹ <http://www.e-qanun.az/framework/42596>

Communications) and develop policy in the communications sector. This body should monitor the activities of market players within the established policy framework and make decisions on the basis of legal instruments against any operator that worsens the competitive environment.

In European and even some post-socialist countries, the privatization of telecommunications companies, especially state-owned landline network companies, is a widespread practice. These countries have applied different approaches to the privatization of leading telecommunications companies in the 1990-2000s. For example, 67 percent of “HungaryTelecom”, 49.9 percent of “BelgiumTelecom” and 27 percent of “CzechTelecom” were privatized⁹⁰.

The denationalization of “Turktelecom”, the leading player in the sector in Turkey, began in the early 2000s. At present, 55 percent of the shares of “Turktelecom”, which provides landline network, mobile and internet services, are owned by “LYY Telekomünikasyon A.Ş.”, 30 percent by the state (including 25 percent by the Ministry of Finance and Treasury and 5 percent by the Turkish Wealth Fund) and 15 percent of shares are issued on the free market through the stock exchange⁹¹. “LYY Telekomünikasyon A.Ş.” is a joint venture established by three Turkish banks (İş Bankası, Akbank and Garantibank).

In Azerbaijan, reforms in the telecommunications sector have been in the spotlight of the government for the past 20 years. At the initial stage, in accordance with the “Second State Program on the Privatization of State Property in the Republic of Azerbaijan”, approved by Presidential Order No. 671 dated 29.03.2001, a decision was made to privatize a number of enterprises and facilities of the Ministry of Communications⁹². According to the order, “Baku Telefon Rabitasi” and “Aztelekom” LLCs, which currently dominate the telecommunications market, should have been declared open for privatization. The document stated that along with local investors, foreign investors are also allowed to participate in the privatization of these enterprises.

However, the order to denationalize these two companies was not implemented. The only thing that changed during this period has been their organizational and legal

⁹⁰ “Doğal tekellerin düzenlenmesi ve telekomünikasyon sektöründe düzenleyici kurum”. http://www.sbb.gov.tr/wp-content/uploads/2018/11/Dogal_Tekellerin_Duzenlenmesi-ve-Telekom%C3%BCnikasyon_Sektorunde_Duzenleyici-Kurum%E2%80%8B.pdf

⁹¹ <http://www.tyativimciiliskileri.com.tr/tr-tr/mali-operasyonel-veriler/sayfalar/faaliyet-raporlari.aspx>

⁹² http://www.e-qanun.az/alpdata/framework/data/4/f_4528.htm

status. Acting as production associations, “Aztelekom” became a limited liability company in July 2015⁹³ and “Baku Telefon Rabitasi” in July 2017⁹⁴.

In 2016, reforms in the telecommunications sector returned to the government's agenda. The “Strategic Roadmap for the Development of Telecommunications and Information Technologies in the Republic of Azerbaijan” was approved by Presidential Decree No. 1138 dated 06.12.2016⁹⁵. The Roadmap notes that one of the key objectives of the reform is to create a fair competition environment in the telecommunications sector based on liberal market principles, to identify and implement transparent and effective regulatory mechanisms and procedures. The following are the two main directions of such reforms:

- (i) Improving the sector governance**
- (ii) Liberalizing the telecommunications market**

Improving the governance structure primarily involves the establishment of an independent regulatory body. Currently, the Ministry of Communications and High Technologies (MCHT) of the Republic of Azerbaijan is the central executive authority exercising a regulatory function in the telecommunications sector in the country. At the same time, the MCHT participates as one of the key players in the telecommunications sector through its subordinate organizations. The Roadmap notes that, based on the experience of developed countries, when an independent authority regulates the telecommunications sector, it lays the groundwork for market development and greater investment.

In international practice, the regulatory body in the telecommunications sector performs a number of important functions. For example, the formation and development of the telecommunications market is one of the main functions. Its more important function is to achieve strategic ICT objectives. Such objectives include the quality control of services by the regulator, the protection of the interests of consumers, the determination of quality standards and optimal requirements. Examples of independent regulators include the Communications and Information Technology Agency in Turkey⁹⁶ and the National Communications Commission in Georgia⁹⁷.

⁹³ <http://www.ictnews.az/read-37698-news-1.html>

⁹⁴ <https://mincom.gov.az/az/view/organization/5/>

⁹⁵ <http://www.e-qanun.az/framework/34254>

⁹⁶ <https://www.btk.gov.tr/kurulus>

⁹⁷ <https://comcom.ge/en/the-commission/about-commission>

The government's approach is that the telecommunications sector in Azerbaijan should operate independently without the control of any central government body. Because if there is subordination, it is inevitable that if the decisions made contradict the decisions of the central executive body, they will be abolished. In addition, there are many agencies under the central government, and if the regulator is not independent, it will not be able to take any autonomous steps to ensure a competitive environment in the sector without taking into account the interests of those agencies. The Roadmap states that normative and legal acts regulating the activities of an independent regulatory body should be developed and approved in 2017-2020. The Roadmap also noted that the working group on reforms would develop a framework plan for the development of the telecommunications sector in Azerbaijan in 2017 and a three-year transition plan covering the establishment of an appropriate body to carry out regulatory functions by an independent regulator. During the three-year transition period, the MCHT will perform the duties and functions of the regulatory body. The end of 2020 is approaching, but there is no official document or information disclosed to the public about any steps to be taken in this direction.

The Roadmap on liberalization reforms in the telecommunications sector envisages two main steps: increasing the number of operators connected to international Internet channels and privatization in the sector.

Currently, two companies provide international internet traffic to the country, and the Roadmap aims to increase the number of these operators to three. The plans was to achieve this goal by 2020.

As for privatization in the telecommunications sector, the Roadmap notes that more than 50 percent of landline broadband services in Azerbaijan are provided by a small number of market participants. Liberalization of the broadband network market can be one of the key steps towards strengthening the communications sector in the country. Countries around the world are taking measures to effectively regulate the shares of participants, creating a competitive environment in the markets.

The government believes that, proceeding from international experience, market liberalization leads to the optimization of service prices, increased investment and improved quality of services. Increasing liberalization among market participants and improving the competitive environment can reduce the average cost of international calls by 48 percent and broadband network prices by 32 percent.

The Roadmap proposes to attract foreign investors and privatize telecommunications agencies under the Ministry of Communications and Information Technologies,

primarily “Aztelekom” LLC, the “Bakı Telefon Rabitəsi” Production Association and “AzInTelecom” LLC. Although the document envisages the implementation of these activities in 2018-2020, no tangible steps have been taken in this direction yet.

As can be seen from the analysis of official statistics, the share of the private sector in the market of landline telephone services does not exceed 4-5 percent. According to the latest statistics, even though the private sector has a relative advantage in the internet services market (around 55 percent), in the 2010-2018 period the market share of this sector declined rapidly, from about 90 to 55 percent. According to the “Law on Antimonopoly Activities”⁹⁸, a business entity with a market share of more than 35 percent is considered a dominant entity. At present, all players have a dominant position in the telecommunications sector of Azerbaijan, especially in the market of landline and mobile telephone services, with very few exceptions. According to Article 8 of the law, if dominant entities have the opportunity to create unreasonable obstacles to the entry of competitors into the market, it is considered a monopoly and should be punished by law. Currently, state-owned landline telephone companies have the technical and technological capabilities to create such barriers against competitors, especially independent operators offering broadband Internet services (especially fiber-optic lines). This means that state-owned companies have both the necessary infrastructure and the ability to provide services through this infrastructure.

Finally, one of the important points is the existence of contradictory provisions in the anti-monopoly law in relation to telecommunications companies. Thus, according to Decision No. 189 of the Cabinet of Ministers dated 19.07.2013⁹⁹, state communication companies such as “Aztelekom” LLC and “Baku Telefon Rabitasi” LLC were included in the list of natural monopolies. However, the definition of a “natural monopoly” in both the “Law on Antimonopoly Activity” and the “Law on Natural Monopolies”¹⁰⁰ does not correspond to the nature of the activities of these bodies. The above-mentioned regulatory and legal documents state that a natural monopoly is a market situation in which there is no competition due to the technological features of production, which is more efficient to meet the demand, and the goods (services) produced by monopolies cannot be replaced by other goods (services). In reality, however, the presence of a large number of market players (as well as private entities) in both landline and broadband Internet services, their ability to provide services at affordable prices and of the necessary quality, and their capacity to replace the state's

⁹⁸ <http://www.e-qanun.az/framework/8249>

⁹⁹ http://www.e-qanun.az/alpdata/framework/data/26/f_26296.htm

¹⁰⁰ <http://www.e-qanun.az/framework/5038>

natural monopoly suggest that they should be removed from the list. To do this, it is first of all important to remove communication services from Article 5 of the “Law on Natural Monopolies”, entitled “Areas of activity of natural monopolies”.

Main conclusions

Beləliklə, rabitə sektorunun iqtisadiyyatda rolu və telekommunikasiya xidmətləri bazarında mövcud idarəçiliyin analizinin **əsas nəticələr** kimi aşağıdakıları qeyd etmək mümkündür:

- 1) **State-owned companies dominate the landline telephone services market.** State-owned enterprises retain up to 95 percent of the services in this market. Between 2010 and 2018, the share of private companies in the market for these services decreased significantly from 35.6 to 8.4 percent;
- 2) **Although the private sector has a relative advantage on the Internet services market (55.3 percent), it has consistently lost its market share in favor of state-owned companies in recent years.** The market share of private Internet operators fell from 82.7 to 55.3 percent in the 2010-2018 time period even though more than 90 percent of all operators represent the private sector;
- 3) **The infrastructure of broadband internet services on the landline telephone market belongs entirely to the state.** Such an infrastructure advantage provides the state with a significant advantage over private Internet operators;
- 4) **A small number of economic entities have a dominant position not only in the domestic market of telecommunications services, but also in the segment of international services.** In particular, only two companies have the appropriate license to bring the Internet to the country through international channels;
- 5) **Although there are four companies operating in the mobile telephone services market, “Azercell”, which has a state share, has a dominant position in the market with a 48 percent share.** Each of the other three companies has a separate market share of less than 30 percent;
- 6) **Although the state sold its share of the mobile telephone services market in 2008 and completely denationalized this segment, in 2018 it returned to the market as one of the major players.** In particular, in 2018, the state re-acquired a 51.3 percent stake in “Azercell”, as a result of which about a quarter of mobile telephone services market now belongs to the public sector;

- 7) **Over the past 30 years, the world's telecommunications sector has undergone large-scale liberalization and denationalization reform.** All European countries without exception have gone for privatization of state-owned landline telephone companies;
- 8) **The first official decision on the privatization of leading telecommunications companies in Azerbaijan was made in 2001.** However, not a single step has been taken to implement this decision in the following years;
- 9) **Leading state-owned telecommunications companies have not moved to a corporate management model that would guarantee transparent, accountable and collegial governance.** Although the information released by these bodies states that there were Supervisory Boards (Boards of Directors) in them, it was impossible to obtain any official information on the powers of these structures and the possibility of real control over the existing management;
- 10) **State-owned telecommunications companies with the status of a limited liability company are not governed by the rules of the Cabinet of Ministers on the application of corporate governance standards in state-owned enterprises.** The main reason is that these rules apply only to state-owned joint stock companies.
- 11) **State-owned telecommunication companies have not switched to international standards in the field of preparation and disclosure of financial statements.** The financial statements posted on the websites of these bodies are limited in scope and do not contain explanatory notes;
- 12) **State-owned telecommunication companies are not interested in disclosing the most important normative legal acts to the public.** Even the most general information about the charter documents regulating the activities of these bodies, their structure and authorized persons is not posted on their websites;
- 13) **The Roadmap for the development of the telecommunications sector adopted by the government in 2016 identified privatization as one of the main goals for the sector.** However, despite the fact that a significant part of the time specified in the document for the implementation of activities (2018-2020) is already in the past, no tangible steps have been taken in this direction;
- 14) **The Roadmap envisages the establishment of an independent regulatory body for the telecommunications sector.** However, although a significant part of the time (2017-2020) set out in the document for the implementation of

activities is already in the past, no tangible steps have been taken in this direction;

- 15) **There are no real results related to the implementation of the measures envisaged in the Roadmap to increase the number of operators providing international Internet traffic to the country.** According to the document, the number of these companies should have been increased from two to three;
- 16) **Although the leading state-owned telecommunications companies are included in the list of natural monopolies, the nature of these services does not correspond to the concept of a "natural monopoly".** Thus, according to the current legislation, natural monopoly products and services include activities that are more favorable for the interests of consumers in a non-competitive environment to be provided by monopolies. However, there are currently many private entities in this sector and they can provide services that meet the needs of consumers.

Suggestions

Based on the generalization of the results, it is important to implement the following suggestions to improve governance and increase the efficiency of state-owned companies in the telecommunications sector:

- 1) **As a first stage of the reforms, the application of corporate governance standards in telecommunications companies, real activities of the Boards of Directors (Supervisory Boards) and the possibility of real control (influence) over executive bodies should be provided;**
- 2) **Requirements for information openness and transparency of these companies should be tightened;**
- 3) **Normative documents regulating the activities of companies, information on their structure and authorized persons should be made public through the Internet;**
- 4) **Companies' financial statements should be prepared and disclosed in accordance with international standards;**
- 5) **The process of denationalization of state-owned telecommunications companies should be completed as the second phase of reforms in accordance with the objectives set out in the Roadmap;**

- 6) Although the controlling stake is offered to a strategic investor through investment competitions when choosing the model of privatization of telecommunications companies, it is expedient to sell a certain part of shares (25-30 percent) on the open market through the stock exchange, as is the case in the Turkish model;
- 7) The process of establishing an independent regulatory body for the telecommunications sector and ensuring its effective operation in accordance with the objectives set out in the Roadmap should be completed as soon as possible.

WAYS OF ENHANCING EFFICIENCY OF “AGRICULTURAL PROCUREMENT AND SUPPLY” OJSC

Vahid Maharramov

The main objective of this study is to analyze the activities of the state-owned “Agricultural Procurement and Supply” Open Joint-Stock Company (APS OJSC), which procures food products by state enterprises and organizations in a centralized manner from the state budget, and to make suggestions on enhancing the efficiency of state participation in this area.

“Agricultural Procurement and Supply” OJSC was established to stimulate the production and processing of agricultural products in the country, to further enhance the efficiency and systematization of work on the centralized organization of procurement of agricultural and food products by the state. It should be noted that Decree No. 859 of the President of the Republic of Azerbaijan dated 11 April 2016 approved the “Rules for centralized procurement of food products by state enterprises and organizations (departments) at the expense of the state budget”¹⁰¹. In accordance with these rules, the procedure for purchasing food products is carried out as follows.

Procuring entities submit information on their food needs for the next year to the Ministry of Agriculture by 1 July of each year. Food needs of procuring organizations for the next year are determined taking into account the funds allocated to procuring entities for these purposes from the state budget.

The Ministry of Agriculture publishes an announcement on the food products to be purchased, the prices of these products and the conditions of procurement (including the procurement frequency) on the electronic portal by 1 August of each year.

The purchase price of each food product is determined by the Ministry of Agriculture in coordination with the Ministry of Economy. The Ministry of Economy and the Ministry of Agriculture conduct surveys at least once a quarter to determine wholesale market prices for each type of food. Prices are reviewed when product prices change later.

The Ministry of Agriculture collects information about the capacity of local producers of each type of food products to be purchased by 1 September of each year through its state agrarian development centers and posts it on the electronic portal. A contract for the next year is signed between the procurement and supply agent, food producers and sellers by 1 October of each year.

¹⁰¹ <http://www.e-qanun.az/framework/32561>

The procurement agent submits information on the concluded contracts to the Ministry of Agriculture, the Ministry of Economy and the Ministry of Finance by 10 October.

Thus, the purchase of agricultural and food products by state order in Azerbaijan is carried out with the involvement of a large number of government agencies. Although “Agricultural Procurement and Supply” OJSC was established to organize centralized procurement of agricultural and food products by state order, the Ministry of Agriculture, the Ministry of Economy, the Ministry of Finance and about 60 state agrarian development centers operating in the regions are also involved. Even according to the “Rules for centralized procurement of food products by state enterprises and organizations (departments) at the expense of the state budget”, “the purchase price for each type of food is determined by the Ministry of Agriculture in coordination with the Ministry of Economy.”

The fact that the procurement of food products in a centralized manner at the expense of the state budget is carried out only by the state-created “Agricultural Procurement and Supply” OJSC increases the risk of monopolization in this area. To prevent this, it is very important to improve public procurement, de-monopolize the sector, protect the rights of producers of food and agricultural products and consumers, and improve the competitive environment in public procurement.

Small and medium-sized farmers, agricultural producers and private catering establishments operating in the regions will be able to participate in competitions if the purchase of food products produced in the country at the expense of the state budget is not carried out in a centralized manner by a state company, but through open tender procedures. This may create a healthy competitive environment in this area.

Some key indicators for the sector

The value of products sold in the retail trade network in January-November 2019 amounted to 34.4 billion manats. Food products, beverages and tobacco products accounted for 17.4 billion manats, or 50.6 percent of the turnover, and non-food products for the remaining 17.0 billion manats (49.4 percent)¹⁰².

The role of trade and supply of food and agricultural products in the country's economy is as follows:

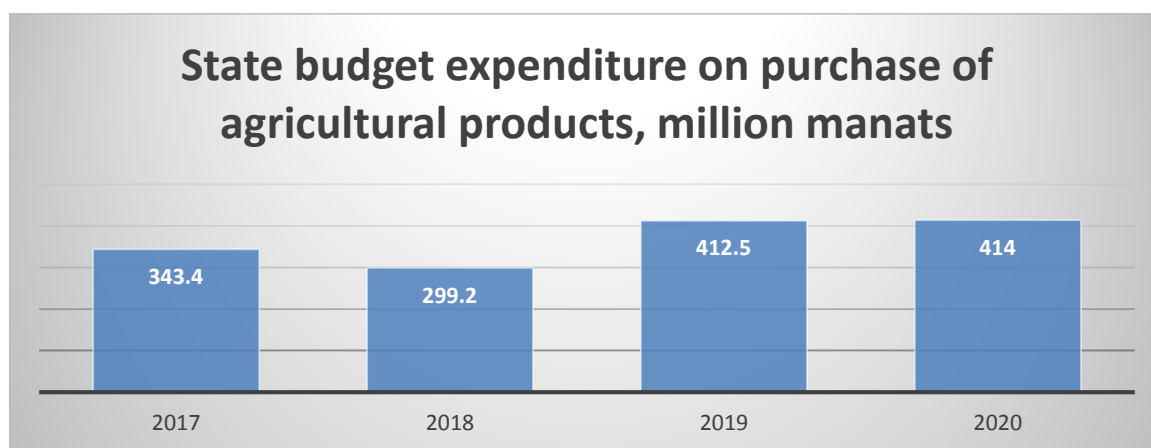
- Employment of a certain part of the country's population is provided, new jobs are created in this field as the population grows;
- Sustainable supply of food and agricultural products to the population and state institutions is carried out;
- Production and processing of agricultural products are stimulated;

¹⁰² <https://www.stat.gov.az/news/index.php?id=4421>

- Public procurement of food and agricultural products plays a role in regulating the economy and market prices;
- Trade of food and agricultural products provides access to the market and use of food products;
- Provides sustainable food supply for public procurement organizations (kindergartens, hospitals, penitentiary system, military units, etc.).

Every year, the state budget provides a large amount of funds for the purchase of food products. The following diagram shows the amount of budget funds allocated for the purchase of food products at the expense of the state for the last four years.

Figure 1. State budget expenditure on purchase of agricultural products



State budget expenditure on agricultural products in 2017 was 343.4 million manats, 299.2 million manats in 2018, 412.5 million manats in 2019, and will be 414.0 million manats in 2020.

International experience

In the vast majority of developed countries, tenders form the basis of public procurement. Procurement rules, the main method of which is competitive procedures, are recommended to all members by the UN and the World Trade Organization. The UN Commission on International Trade Law (UNCITRAL) has even proposed a model law for public procurement legislation and a typical law on procurement of goods (works) and services, which may serve as a possible basis. Procurement requirements for WTO member countries are set out in a multilateral agreement on public procurement within the WTO. Procurement activities of EU countries are regulated by relevant guidelines. The main principles are:

- Transparency - openness and accessibility of procurement information;
- Accountability and due process - strict adherence to procurement procedures under state and public control;
- Open and effective competition - non-discrimination;

- Fairness - equal opportunities for all procurement participants.

These principles form the basis of legislation in many countries and are reflected in a number of international instruments, in particular the Multilateral Agreement on Public Procurement within the World Trade Organization¹⁰³.

There are two dominant models of procurement in the EU: distributed (decentralized) and centralized.

In the **distributed model**, the government agency (departments, ministries, etc.) makes the necessary purchases to meet the needs. For this purpose, specialized procurement departments or other units with similar functions are set up.

The **centralized model** provides for the creation of a kind of procurement center, where procurement orders come from departments. At the level of maximum centralization, a special department responsible for all public procurement or an appropriate procurement department for a large company is set up.

Both schemes have advantages and disadvantages: the distributed model is very flexible, but more expensive. In turn, the centralized model, which provides for purchase at low wholesale prices, is less mobile and does not always take into account all the nuances in the application for the purchase of essential goods.

A combination of models is most effective when the overall management of procurement activities in the EU (development of regulatory framework, planning, control and coordination) is carried out by the Ministry of Finance or Economy, especially at the expense of the budget and special procurement by specialized procurement structures (departments). This is the structure of the public procurement system in the UK, where in addition to the Treasury, which is the main coordinating body, there are specialized industrial procurement services such as National Healthcare Supplies¹⁰⁴.

Both models have long been used in the civilized world. In England, they are under the authority of the State Treasury (Her Majesty's Treasury).

The United States has extensive experience in public procurement. The first law regulating the federal public procurement system was passed in the United States in 1792. Public procurement powers were vested in the Departments of Finance and Defense¹⁰⁵. In general, the procurement system for national needs in the United States is not centralized.

An analysis of world experience in the application of various procurement procedures shows that one of the most effective forms of organizing large purchases of goods and services is open tenders.

About “Agricultural Procurement and Supply” OJSC

¹⁰³ <http://bujet.ru/article/2895.php>

¹⁰⁴ <http://bujet.ru/article/2895.php>

¹⁰⁵ <http://bujet.ru/article/2895.php>

The Decree of the President of the Republic of Azerbaijan on the establishment of “Agricultural Procurement and Supply” OJSC states that the Company carries out centralized procurement and export of agricultural and food products from producers and sellers by state order, as well as their delivery to suppliers on the basis of applications. It is a commercial legal entity also providing other measures related to the organization of activities in the above areas¹⁰⁶.

The Charter of “Agricultural Procurement and Supply” OJSC was approved by Decision No. 289 of the Cabinet of Ministers of the Republic of Azerbaijan dated 4 July 2019. According to the Charter, “Agricultural Procurement and Supply” OJSC is a state-owned entity that is not part of the Ministry of Agriculture.

The management of the Company is mainly carried out by the Board of Directors. The Board of Directors of the Company consists of five members and is the collegial executive body of the Company. The Board of Directors resolves all issues related to the management of the Company except for the powers granted to the General Meeting by the Civil Code and Order of the Republic of Azerbaijan, and to the Chairman of the Company by the Company's Charter. The Board of Directors consists of the Chairman appointed and dismissed by the President of the Republic of Azerbaijan, his 2 (two) deputies and 2 (two) members appointed and dismissed by the General Assembly on the recommendation of the Chairman of the Company. The Board of Directors is headed by the Chairman of the Company.

The authorized capital of the company is 6,000,000 (six million) manats and consists of the nominal value of its shares. The authorized capital consists of 6,000,000 (six million) ordinary shares with a nominal value of 1 (one) manat.

Reports of “Agricultural Procurement and Supply” OJSC

A brief report on the work done by “Agricultural Procurement and Supply” OJSC in 2019 has been prepared and posted on the Company's website. It should be noted that although “Food Supply and Supply” Open Joint-Stock Company, the legal successor of the Company, was established on 11 April 2016, annual reports of the Company have not yet been published on the website. During the last three years, only two brief quarterly reports on the activities of the Company were covered in the media. For the first time since its establishment in 2016, the Company has published a report on its activity on its website. Unfortunately, the document presented to the public as a report shows only the physical weight of the products purchased and sold by the Company during the year. A number of questions arise because the report does not contain any information on the purchase and sale prices of goods and products.

The report prepared by the Company states that in order to study the needs of the procuring entities in 2019, advertisements were placed on the tedaruk.az portal and proposals were received from 310 manufacturers and sellers for 163 products. After conducting relevant research on these proposals, contracts were signed with 177

¹⁰⁶ <http://e-qanun.az/framework/40948>

producers and sellers. Procurement contracts were signed with 867 enterprises and organizations financed from the state budget, and according to them, food supply was implemented to 2014 supply points belonging to central and local executive authorities.

The report states that in 2019, a total of 57,629 tons of products were supplied. A total of 57,937 tons of products were delivered to 2014 supply points during the year. The two tables presented by the Joint-Stock Company separately in the report are summarized in one (Table 1).

Table 1. Volumes of purchases and sales of food products by categories

Source: “Agricultural procurement and supply” Open Joint-Stock Company

	Purchased	Sold	Difference
Fish and fish products	1 431 231	1 438 708	+7469
Canned vegetables	122 979	122 889	-90
Vegetable oils, liter	528 265	551 846	+23581
Spices, kg	418 598	426 310	+7712
Additives, kg	29 764	29 914	+150
Meat products, kg	4 375 759	4 413 728	+37969
Beverages (fruit juices, compotes, etc.), liter	2 861 859	2 868 752	+6893
Fruits and berries, kg	3 257 140	3 177 890	-79250
Cereals, kg	1 651 451	1 656 928	+5477
Beans, kg	773 354	794 231	+20877
Confectionary products, kg	2 446 154	2 484 802	+38648
Dried fruits, kg	176 695	177 205	+510
Milk and dairy goods, liter	11 336 347	11 414 459	+78112
Vegetables, kg	14 564 879	14 787 585	+222706
Chicken eggs, kg	853 951	772 244	-81707
Pickles, kg	107 218	106 757	-461
Flour and flour products, kg	12 691 457	12 711 349	+19892
Baby food, kg	2 038	2 045	+7
Total	57 629 139	57 937 642	+308 503

As can be seen from the table, the weight of food products supplied by producers and sellers in 2019 amounted to 57,629,139 kilograms. On the other hand, the volume of

products sold to organizations is 57,937 tons. There is a difference of 308,503 kilograms (308.5 tons) in the weight of the products purchased from producers and the product sold to consumers. In general, 18 groups of goods were supplied by producers and sellers to consumers, 14 of them registered an increase in weight in sales and four a decrease. There is no conformity of the products purchased and sold by “Agricultural Procurement and Supply” OJSC for 18 groups of goods. Although it is theoretically possible to link the decrease in the weight of some products with certain losses, it is very difficult to imagine the increase in the weight of most goods. For example, the data provided shows that the purchase and sale of canned vegetables decreased by 90 kilograms, fruits and berries by 79,250 kilograms and the weight of chicken eggs by 81,707 kilograms. Although the Joint-Stock Company does not provide a justification for the decrease in the mentioned products, it is theoretically possible that the goods may break, be crushed or deteriorate during transportation. And due to such reasons, there is a decrease in the weight and number of products delivered from the producer to the consumer. However, the fact is that the Joint-Stock Company has shown an increase in the weight of most of the goods and products supplied by producers and sellers to consumers. How can this happen? For example, 1,431,231 kilograms of fish and fish products supplied by a Joint-Stock Company from producers and sellers increased by 7,469 kilograms to 1,438,708 kilograms. Also, the vegetables weighing 14,564,879 kilograms on the seller's scales increased by 222,706 kilograms to reach 14,787,585 kilograms on the buyer's scales. Thus, according to the report, 57,629,139 kilograms of products were purchased from sellers and 57,937,642 kilograms of products were sold to buyers. According to this calculation, the volume of products sold increased by 308,503 kilograms. It is not ruled out that at the end of 2018 and 2019, there were stocks of goods in the warehouses of the Joint-Stock Company. If so, the amount and value of the balance of goods must be indicated in the report submitted by the Company. “Agricultural Procurement and Supply” OJSC did not clarify this issue.

Unfortunately, the report submitted by “Agricultural Procurement and Supply” OJSC did not mention the funds allocated by the state and how these funds are spent. The state budget envisaged 343.4 million manats in 2017, 299.2 million manats in 2018 and 412.5 million manats in 2019 for the purchase and provision of food products. The Company did not provide the public with any information on the purchase and sale prices of the products it supplied. According to the information provided by the previous management of the Joint-Stock Company in 2018, according to the results of nine months of 2018, the Joint-Stock Company supplied 53,000 tons of agricultural products from local farmers worth 106 million manats. 81 million manats of the supplied products were spent on the needs of public procurement organizations (kindergartens, hospitals, penitentiary system, military units, etc.) and 25 million manats worth of products were exported to foreign countries. We believe that the Joint-Stock Company should have provided the public with purchase prices for 163 products that it is a customer and supplier of. It should also be noted that according to the “Rules for centralized procurement of food products by state enterprises and organizations (departments) at the expense of the state budget”, “the purchase price

should not be lower than the wholesale market prices of food products for the time of the announcement (until August 1 of each year on the electronic portal). The purchase price of each type of food product is determined by the Ministry of Agriculture in coordination with the Ministry of Economy. The Ministry of Economy and the Ministry of Agriculture conduct surveys at least once a quarter to determine wholesale market prices for each type of food. When the prices of the products change later, the prices are reconsidered." As is evident, the Ministries of Economy and Agriculture should conduct surveys at least once a quarter to determine the wholesale market prices for each type of food and review the prices of products. This is a very complex and labor-intensive job. And it is a job that requires a subjective approach. Each of the 163 products that the Company is a customer and supplier of has a wide range. The prices of products with different quality indicators of the same name differ extensively. For example, the wholesale price of 1 kg of potatoes produced in Jalilabad District is 0.30-0.50 manats depending on the quality indicator, potatoes produced in Shamkir District are 0.40-0.70 manats, and the wholesale price of potatoes produced in Gadabay District is 0.90-1.20 manats. Thus, there is a price difference of four times the wholesale price of the same product. Along with the quality indicators of products for all groups of goods purchased by the Joint-Stock Company, purchase prices must also be presented to the public. Unfortunately, the report prepared by the Company does not contain such information. The non-disclosure of information about the purchase and sale in 2019 may raise doubts about the transparency of the Company's activities.

The report states that the Company has 11 regional offices in the districts, 11 regional warehouses in the district centers where the regional offices are located and support points in 35 districts, and rents an office building for the regional offices and 15,355.34 square meters of warehousing space. In addition, a central distribution warehouse of 5,100 square meters, 1,050 square meters of which being the refrigerator, has been established in Baku. A total of 1,389.3 cubic meters of refrigerators and freezers have been installed in 10 regional warehouses. 25 trucks have been purchased for transportation of food products to warehouses and from there to support points.

The report of "Agricultural Procurement and Supply" OJSC states that during 2019, fairs are organized in Yasamal, Binagadi, Narimanov, Surakhani and Absheron districts of Baku on weekends and public holidays. The report also states that "the main purpose of the fairs was to prevent artificial price increases through market interventions, facilitating the access of agricultural producers to the market and offering quality and cheaper agricultural products to the population". The report submitted by the Joint-Stock Company states that the prices of some products at the fairs were 20-30 percent lower than in other markets. However, even though agricultural fairs have been organized in Baku for more than 15 years, the existing prices at the fairs have not affected the prices of products sold in the markets at all. The fairs do not sell products at a cheaper price, they usually sell cheap products. In other words, customers are offered low-quality agricultural products. In general, only 2,000 tons of products were sold at fairs in Baku during the year, which is less than

half of the 4.5 million tons of products sold in the city during the year. It is therefore not quite serious of the Joint-Stock Company, which sells only 2,000 tons of products in Baku annually, to claim "prevention of artificial price increases by intervening in the market".

In its report, "Agricultural Procurement and Supply" OJSC noted that it has participated in and organized more than 10 festivals held in different regions during the year. The "Grassland Festival" in Gadabay, the "Regional Cuisine Festival" and the "Apple Festival" in Guba, the "Grape and Wine Festival" in Shamakhi, the "Hazelnut, Chestnut and Walnut Festival" in Zagatala, the "Perssimon Festival" in Balakan, the "Pomegranate Festival" in Goychay, the "Tea, Rice and Citrus Festival" in Lankaran were organized by local authorities. "Agricultural Procurement and Supply" OJSC participated in those festivals. The Company does not disclose in its report how much it spent to participate in the said events.

Clause 9 of the Charter of "Agricultural Procurement and Supply" OJSC approved by the Cabinet of Ministers states as follows;

9.1. The Company maintains accounting records in accordance with the Law of the Republic of Azerbaijan "On Accounting", prepares and submits financial statements, publishes annual financial statements and consolidated financial statements.

9.2. The Company maintains statistical records, compiles and submits statistical reports in accordance with the Law of the Republic of Azerbaijan "On Official Statistics". Despite such requirements of Article 9 of the Charter, the Company, which was established in 2016, has not yet released its financial and statistical reports to the public.

At first glance, "Agricultural Procurement and Supply" OJSC seems to have embraced the fundamental principles of public procurement adopted in civilized countries. However, our studies have shown that the activities of the Company are not transparent. The state-owned Joint-Stock Company has not published any information about its activities and sales since its establishment. It is impossible to determine the principles on which a non-transparent Company operates.

There is another fact that reflects the shortcomings in the activities of "Agricultural Procurement and Supply" OJSC. Maria Laushova, the head of the Mazrali village kindergarten in Imishli District, said in an interview with "Radio Liberty" on 29 August 2019 that there were problems with feeding children in accordance with the norm¹⁰⁷. In particular, the state sells food to them at a higher price than the Imishli market. "It is necessary to look at the market price. I buy onions from the state for 35 manats, which is five manats in Imishli markets. Children don't eat apples. I am afraid to write about that because they immediately send fruit that I have to throw away. They give us wrinkled apples." Maria Laushova says it would be good if the money was given directly to the kindergartens so that they could buy fresh fruits and

¹⁰⁷ <https://www.azadliq.org/a/u%C5%9Faq-ba%C4%9F%C3%A7alar%C4%B1nda-yem%C9%99k/30136452.html>

vegetables from the markets. According to her, in the current situation, some goods sent by the State Agrarian Trade Company are not edible:

A search of the website of “Agricultural Procurement and Supply” OJSC did not reveal any information on the main activities of the Joint-Stock Company. In particular, it is not possible to obtain any information on how the Company purchases agricultural and food products by state order.

It is not always efficient to organize the procurement of agricultural and food products in a centralized manner by state order. Indeed, in many cases during the season, prices of fruits and vegetables fall. In this case, there is an opportunity for public procurement organizations (kindergartens, hospitals, penitentiary systems, military units, etc.) to save money or buy more high-calorie products for the money you save. On the other hand, the Company’s current activities are reminiscent of Soviet-era supply points. These supply points bought cheap, low-quality, useless products from villagers and documented them in state enterprises, trade and public catering facilities at a price 4-5 times higher than their actual value. The head of the state enterprise proposes to transfer the funds intended for food directly to such enterprises and departments. We believe that it would be more efficient if the private sector in the regions procures food products by state order

Equal opportunities for private sector involvement

Experience shows that a state-owned company without major financial resources “is incapable of stimulating production and(or) processing of agricultural products, contributing to the development of agricultural producers, further improving the quality of food products, ensuring efficient use of public funds and creating a basis for improving the social well-being of the population engaged in the agricultural activities”¹⁰⁸. There are 10,000 private suppliers in the agricultural market in the country. The 3-year experience of the “Agricultural Procurement and Supply” OJSC shows that it is impossible to effectively organize centralized procurement of agricultural and food products in the country by state order. The effective functioning of this field requires formation and development of a healthy competitive environment.

We believe that if the purchase of food products produced in the country at the expense of the state is not carried out in a centralized manner a state company, but through open tender, the state, in addition to performing its direct functions, will create opportunities for small and medium-sized farmers, agricultural producers and private catering establishments operating in the regions to participate in competitions, set quotas for them and thus perform another function as well – create a healthy competitive environment in this area.

Thus, in order to create an equal competitive environment for the participation of the private sector in the procurement of food products by public enterprises and

¹⁰⁸ <https://president.az/articles/19227>

organizations at public expense, the implementation of public procurement by more than one contractor on the basis of competition and transparency, it is possible to ensure the efficient use of public funds in the field and purchase quality goods at minimum cost.

Ways of enhancing the efficiency

1. It may be more expedient for the Ministries of Economy and Finance to organize the procurement of food and agricultural products at the expense of state funds. The Ministry of Agriculture should be relieved of these responsibilities and more attention should be paid to the production of agricultural products and the solution of existing problems in this area.
2. There is a need for amending the “Rules for centralized procurement of food products by state enterprises and organizations (departments) at the expense of the state”. The government should create conditions for small state-owned enterprises and organizations in the regions to receive food products directly from producers at the expense of the state. Or state institutions and organizations should involve small and medium-sized farms in these competitions through tenders. In this case, a new market opportunity and a competitive environment will be created for a large number of farmers and villagers, and budget funds allocated for public procurement will be used effectively.
3. Establishment of a reserve fund of up to 20 percent of the total demand in Azerbaijan to eliminate frequent sharp changes in the prices of agricultural products in the domestic market, purchase and storage of fruits and vegetables produced by farmers and villagers in excess of demand during the season and entrust this to “Agricultural Procurement and Supply” OJSC. Purchased fruits and vegetables could be stored in refrigerators and warehouses in the country for some time and can be sold in domestic and foreign markets subject to demand. This being the case, it will be possible to keep the prices of fruits and vegetables in the markets in a narrow range. This will be beneficial for both producers and consumers.