



AZERBAIJAN

In-Depth Review of the Investment Climate and Market Structure in the Energy Sector



2005



Energy Charter
Secretariat

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SUMMARY AND PRELIMINARY MAIN FINDINGS OF THE SECRETARIAT

Azerbaijan, located at the crossroads of the Middle East, Europe and Asia, is a country rich in oil and gas resources, which offer great potential for its future development. Azerbaijan's macroeconomic performance in recent years has been robust with growth rates of approximately ten per cent per year. Extraction and processing of oil and gas-related activities account for more than 30 per cent of GDP, and are likely to increase further in the future.

1.1. Foreign investment

Azerbaijan welcomes foreign direct investment¹. Up to now approximately \$50 billion of foreign capital has been committed to its oil and gas sector, which is the primary source of economic growth in Azerbaijan. The most important investment to date is the development of the Azeri, Chirag, and Gunsheli fields ("ACG") by an international consortium led by BP (so-called "contract of the century"). The second largest discovery so far is the Shah Deniz gas field with estimated reserves of more than 1 trillion cm. Further investments in the range of \$10 billion are expected in the coming years, mainly in connection with the development of this field and others.

Since gaining independence in 1991, Azerbaijan has succeeded in establishing a comprehensive legal framework for investment, reflecting its transition to a market economy. Core pieces of this framework are the Law on Protection of Foreign Investment, the Law on Investment Activity, the Law on Privatisation of State Property, and related presidential decrees. These laws provide significant legal guarantees to foreign investors, including the principle of non-discrimination, freedom of capital movements, stability of legislation, compensation in case of expropriation, and access to international arbitration.

Important legislation has also been established in the energy sector. The most relevant laws are the Law on Energy, the Law on the Use of Energy Resources, the Law on Subsoil, and the Law on Natural Monopolies. Other key legislation relates to company law, commerce, taxation and land ownership.

While the existing legal framework reflects the overall favourable approach towards foreign investment, some restrictions nevertheless exist. Participation of foreign investors in the energy sector requires prior approval of the Government. Restrictions also exist on foreign ownership of land, and in privatisation procedures. Registration procedures may be sometimes complex and relatively lengthy. More generally, there is concern about the proper implementation of legal rules and the effectiveness of the fight against corruption. Other continuing problems relate to the wide discretionary powers of the bureaucracy, the high number of decision-making layers and regulations, and a perceived lack of confidence in the domestic court system. Foreign investors also complain about a certain lack of transparency, too lengthy administrative procedures, and deficiencies in the skills and competence of local personnel. The Azeri Government is aware of these shortcomings and various measures have already been initiated in almost every mentioned area.

It needs to be underlined that the situation is, in general, better for investors in the energy sector than in other sectors, given the fact that the Azeri Government attaches great importance to the further development of this key industry, and therefore undertakes

¹ The following overview draws partially from the EBRD Paper "Strategy for Azerbaijan" of 17 December 2002, and a paper on "Investment Climate in Azerbaijan", prepared on behalf of the UN Economic and Social Commission for Asia and the Pacific for a Regional Round Table on FDI for Central Asia, Dushanbe, Tajikistan, 3-4 April 2003.

considerable efforts to create favourable conditions for them. In addition, foreign investors almost exclusively operate on the basis of individually negotiated production sharing agreements, which may contribute to a higher level of legal stability and security than the general legal framework.

In the *gas sector*, foreign investment is permitted in upstream activities. Most gas is currently produced by SOCAR. However, the participation of foreign investors is expected to increase in the future with the further development of the Chirag deposit and the Shah Deniz field.

Considerable efforts are undertaken by foreign investors to improve the international *transportation routes to export the oil and gas*. A consortium of major oil producers in Azerbaijan and Kazakhstan is constructing a new pipeline from Baku via Georgia to Ceyhan on the Turkish-Mediterranean coast (“BTC” pipeline). The project is scheduled for completion in 2005. A new gas pipeline to Turkey is also in the making designed to export gas from the “Shah Deniz” field, which will make Azerbaijan a net exporter of gas.

Developments in the petroleum industry of other Caspian littoral countries, in particular Kazakhstan and Turkmenistan, may increase the role of Azerbaijan as a transit country for crude oil, refined products and eventually natural gas. There are also opportunities for Azerbaijan to become a transit country for electricity flows on a regional scale. To fully take advantage of these opportunities, a focused effort will be required, directed at establishing coherent and clear rules and policies for investing and operating energy transit projects.

A Business Council under the President has been established to further improve the business environment. Previous numerous and burdensome licensing procedures have been considerably facilitated, and the tax regime simplified. A State Oil Fund was set up to serve as an instrument for economic stability and future economic development. Furthermore, reform programs aiming at poverty reduction and economic growth were launched with the support of the IMF and the World Bank.

1.2. Market structure, including privatisation and restructuring

A number of additional steps have been taken in recent years to enhance liberalisation, private sector development and the establishment of a market economy. Several ministries and government agencies were merged in order to streamline competences and improve coordination. With regard to energy, the Ministry of Fuel and Energy plays the key role. However, state-owned companies (SOCAR, Azerigaz, Azerenergy) continue to perform some regulatory functions. The Ministry of Fuel and Energy also as a rule coordinates decisions with other government offices (certain Ministries and Agencies) and the decision making procedure can still be lengthy and not entirely streamlined. It is expected that work on the clear definition of domains of competences and improving coordination will continue.

Another key issue is restructuring and privatisation. Since 1991, more than 29,000 small enterprises and over 1,000 medium-sized and large enterprises have been privatised through cash and voucher privatisations. However, privatisation has been relatively slow in the energy sector. To date, only the *oil business* has been privatised, notwithstanding the fact that the state-oil company SOCAR continues to play a decisive role. SOCAR will eventually be re-organised and privatised – according to current plans this might happen within the next 5-10 years.

Gas transportation and distribution is in the hands of the state-owned company “Azerigaz”. Plans to un-bundle this company are in an early stage. A first step might be to give the management of gas distribution to a private company.

More advanced is the privatisation of the *electricity sector*. While power generation and transmission are still controlled by the state-owned company “Azerenergy”, regional electricity distribution companies have been transferred to private operators under long-term management contracts. There are also plans to set up an independent regulator.

1.3. Policy challenges and outlook

In order to fully realize its huge potential as an energy producer, Azerbaijan will have to deal with a number of significant challenges. On the general political level, the unresolved conflict with Armenia over the Nagorno-Karabakh region continues to put a heavy burden on the Azeri economy. On the delineation of the Caspian seabed some progress has been achieved, but an agreement with Iran and Turkmenistan still needs to be reached.

The national infrastructure is in poor condition and requires major upgrades. Both the gas and power sectors are in urgent need of modernisation. In addition, Azerbaijan’s ability to export oil and gas necessitates the further development and completion of the pipeline system. Furthermore, the development of the non-energy sector will be crucial for Azerbaijan’s future in the long-term.

The attraction of more FDI will be crucial to meet these multiple demands. In this respect, Azerbaijan needs to continue its efforts to further improve its investment climate, and open up new investment opportunities in the gas and power sectors.

With regard to the investment climate, the Secretariat has identified a number of areas where it sees room for further improvements. They relate, in particular, to the (1) remaining restrictions for foreign investors in privatisation procedures, (2) still burdensome administrative procedures, (3) the crucial role of contract stabilisation provisions for foreign investors, (4) inconsistencies and possible discrepancies within the existing legal framework, such as in the investment-related legislation, (5) the delineation of responsibilities of different government agencies, (6) the combination of commercial and regulatory functions in state companies, (7) transparency concerning the implementation of laws, and (8) the communication channels between government officials and oil and gas companies.

With regard to the restructuring and privatisation process in the energy sector, high levels of debt, still relatively low collection rates and low tariff levels undermine the financial viability of “Azerigaz” and “Azerenergy” and make it difficult to find investors. A related problem is the generous implicit subsidies that the Government provides to the majority of the electricity and gas consumers, and which amount to approximately \$500 million annually (roughly 30 per cent of total state budget).

The situation has, however, improved lately, in particular with regard to the collection rate (which currently stands at 60-65 per cent). Nonetheless, further efforts to raise the collection rate, to establish cost-reflective tariffs and to reduce state subsidies seem necessary in order to create more attractive conditions for private investors in the gas and power sector. In addition, much will depend on the actual outcome of the Azeri Government’s plans to re-organize the state companies SOCAR and “Azerigaz”, and whether a coherent strategy will be set up concerning the restructuring of the power generation and transmission sector, including the establishment of an independent regulator.

IN-DEPTH REPORT

ON

INVESTMENT CLIMATE

AND

MARKET STRUCTURE

IN THE ENERGY SECTOR OF AZERBAIJAN

I. Executive Summary

Azerbaijan is located at the crossroads of the Middle East, Europe and Asia. It is a republic with a presidential form of government headed by Mr. Ilham Aliyev. Azerbaijan was admitted to the Council of Europe in 1991, and is an observer in the WTO since 1997.

The country is rich in oil and gas resources, which offer great potential for its future development. Azerbaijan's macroeconomic performance in recent years has been robust. GDP grew at a rate of approximately ten per cent per year, and inflation has been held below two per cent. Extraction and processing of oil and gas-related activities account for more than 30 per cent of GDP, and may increase further in the future. The Azerbaijani currency, the manat, is stable. The consolidated government budget recorded a surplus of 1.5 per cent of GDP in 2001. The external debt ratio continues to be moderate at about 22% of GDP in 2001. Azerbaijan fulfils the conditions of Article VIII of the IMF's Articles of Agreement.

Azerbaijan welcomes foreign investment. It has attracted significant amounts of FDI in recent years (total FDI stocks currently stand at \$3.8 billion), of which more than 65 per cent have flown into the oil and gas sector. Further investments in the range of \$10 billion are expected in the coming years, mainly in connection with the development of newly discovered oil and gas fields.

The Azeri government accords high priority to liberalisation, private sector development and the establishment of a market economy. A number of important steps have been taken in recent years in this direction. In 2001, a new State Oil Fund was set up, to serve as an instrument for economic stability and future economic development. Reform programs aiming at poverty reduction and economic growth were launched under the auspices of the IMF and the World Bank. A new Privatisation Law was adopted in May 2000. The restructuring of the gas sector is under preparation. First steps to privatise the electricity sector have been undertaken.

In order to fully realize its huge economic potential, Azerbaijan will have to deal with a number of significant challenges. The results of unresolved conflict with Armenia, which occupied 20 per cent of the territory of Azerbaijan, continues to put a heavy burden on the Azeri economy. While some progress on the delineation of the Caspian seabed has been achieved, an agreement with Iran and Turkmenistan still needs to be reached. The further development and completion of pipelines will be key to Azerbaijan's ability to export oil and gas. The restructuring and privatisation process in the energy sector is far from complete. In addition, the development of the non-energy sector will be crucial for Azerbaijan's future in the long-term.

II. Introduction

2.1. Geography

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|-------------------------------|---|
| Capital | Baku (population of approximately 1.8 million) |
| Main industrial cities | Ganja, Sumgait |
| Area | 86,600 sq. km |
| Climate | Mild continental, falls within 9 climatic sub-zones ranging from sea littoral subtropical to high alpine. |
| Terrain | Large, flat Kura-Araks Lowland with Great Caucasus Mountains to the north and Karabakh Upland in the west. Baku lies on the Apsheron Peninsula. |
| Irrigated land | 1 million hectares, irrigation systems partially in disrepair |

2.2. People

| | |
|--------------------------|--|
| Population | 8,200,000 |
| Ethnic Groups | Azeri 90%, Dagestani 3.2%, Russian 2.5%, Armenian 2%, other 2.3% |
| Religions | Islam, Russian Orthodox, Armenian Gregorian Orthodox, Georgian Orthodox, other |
| Official Language | Azeri |

2.3. Political System

| | |
|---------------------------|---|
| Independence | October 18, 1991 (from Soviet Union) |
| Legal System | Based on civil law system |
| Executive Branch | Head of State – President Ilham Aliyev (since October 2003) |
| Head of Government | Prime Minister Artur Rasi-Zadeh |
| Judicial Branch | Supreme Court |
| Legislative Branch | Milli Mejlis (National Assembly) |

2.4. Economy

| | |
|--|---|
| Real GDP (2003) | USD 6.86 billion |
| Real GDP per head | USD 845.5 |
| Real GDP growth (YoY percent change, 2003) | 11.2% |
| Consumer price index (YoY percent change, 2002) | 2.8% |
| Annual average exchange rate (Manat per \$, 2003) | 4,920.8 |
| Structure of GDP by main sectors (2003) | Industry 37.8%, agriculture 13.1%, transport and communications 9.5%, trade 7.4%, construction 12.1%, other 20.1% |

| | |
|--|--|
| Major industrial products | Oil and natural gas, petroleum products, oilfield equipment, steel, iron ore, cement, chemicals and petrochemicals, textiles |
| Major agricultural products | Cotton, grain, rice, grapes, fruit, vegetables, tea , tobacco, livestock |
| Private sector contribution to GDP (2002) | 73.3% |
| Exports (2002) | USD 2,591.7 million |
| Major export products | Oil, oil products, food, machinery and equipment, textiles, chemicals, metals and plastics |
| Major export partners (2002) | EU 67.5%, CIS 12.9%, other 21.4% |
| Imports (2002) | USD 2,626.4 million |
| Major import products | Machinery and equipment, vehicles, mineral products, metals, chemicals, plastics, food |
| Major import partners (2002) | CIS 32.4%, EU 32%, other 21.4% |
| FDI inflow (2002) | USD 3,060.3 million |
| Sources of FDI, percent of total | UK 39%, USA 17.1%, Turkey 12.2%, Norway 10.2%, Japan 7%, France 5.9%, Italy 5.9%, Russia 0.6%, Other 2.1% |

2.4.1. Macroeconomic Situation

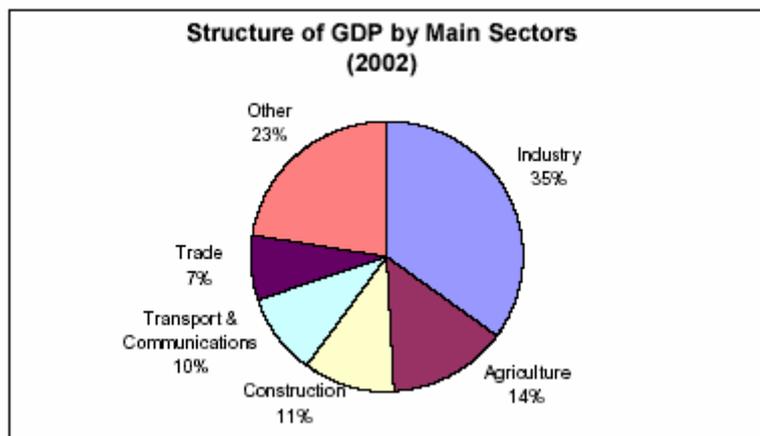
After a severe decline in GDP in the first half of the 1990s, the Azeri economy has recorded an impressive macroeconomic performance, with real GDP growth averaging 10 per cent in recent years. In the first six months of 2004, real GDP increased by 10.6 per cent, across a broad range of sectors (industry, agriculture, construction, transport and communications). With oil prices at a high level, GDP growth in 2004 could amount to 10 per cent. The economy continues to be highly dependent on oil and gas-related activities, with hydrocarbons production and processing contributing more than 30 per cent of GDP in 2003. Fig. 1 illustrates the structure of GDP in 2003.

The annual average inflation rate decreased to between 1.5 and 1.8 per cent in 2000-2003. In the first half of 2004, it stood at 6 per cent. This largely reflects the inflation effects of higher fuel oil and natural gas for electricity production, related to a switch from preferential tariffs for certain social groups (e.g. refugees, internally displaced persons and pensioners) to direct subsidies.

The exchange rate has remained broadly stable in recent years, with National Bank intervention limited to the prevention of large fluctuations, while allowing a steady nominal depreciation of the Manat. The current exchange rate (as of September 2004) is approximately AzM 4,917 per USD.

The current account deficit increased from 12.3 per cent of GDP in 2002 to 28.3 percent of GDP in 2003. The deficit is likely to increase significantly in the next two or three years due to import expenditures related to major oil and gas deals. According to the IMF, foreign direct investment more than financed the current account deficit, which had resulted largely from oil-sector related imports.

Figure 1: GDP Structure in 2003



Government finances remain strong with a consolidated government budget surplus of 572,7 billions Manat of GDP in 2003 (equivalent to 0.7 per cent of GDP excluding the Oil Fund). In its 2004 draft budget the government has set deficit on the consolidated surplus of 0.3 per cent of GDP.

The energy sector increasingly dominates Azerbaijan's economy. Hydrocarbons (crude oil and refined products, natural gas) account for more than 85.4 per cent of exports. The development of the non-oil sectors will be vital for a balanced growth. Creating a stable and predictable business environment is particularly crucial for attracting investment in the non-energy sectors. In addition, providing supplies and services to support the oil and gas sector is a growing area of economic activity.

The development of pipelines will be key to Azerbaijan's ability to export oil and gas. At the moment, the following routes are in use or under development:

- A northern route for early oil was opened in November 1997 to move Azerbaijani crude via Russia to the Black Sea port of Novorossysk.
- The Western Route was commissioned in April of 1999 for the transportation of the Azerbaijani crude oil from the Chirag deposit via Georgia to a Black Sea port Supsa.
- The construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline is underway, a landmark event for the region's economic development, with over \$4 million to be spent daily on BTC construction in 2003-2004. The \$2.9 billion pipeline will transport Caspian crude to the Mediterranean by 2005.
- Limited amounts of Kazakh crude have been shipped via barge and rail through Azerbaijan to Georgian ports on the Black Sea, and negotiations continue to bring Kazakh producers into BTC.
- The construction of the gas pipeline from Shah Deniz to Turkey across Georgia is underway.

The Government's strategy for further economic development identifies the following main long and medium-term objectives:

- Achieving balanced sectoral growth and preventing excessive dependence on the oil sector. Hence the need to create conditions for the development of the non-oil sector.
- Improvement of the investment climate, ensuring a business-friendly environment, and encouraging transparency in economic processes;
- Further improvement of the banking sector, budget planning and introduction of international accounting standards;
- Efficient management of oil revenues;
- Utility restructuring and privatisation.

In acknowledgement of the achievements, the IMF approved a 3-year Poverty Reduction and Growth Facility program in July 2001. This was a clear sign of support for the government's economic reform efforts. Securing this agreement sent a strong signal to foreign investors of the government's commitment to structural reforms. The Azeri government also has the support of the World Bank, the EBRD, the IBD, the ABD, and other international financial institutions.

2.4.2. Foreign Direct Investment

Azerbaijan's abundant natural resources (industry experts suggest that Caspian oil and gas reserves as a whole may approach those of the North Sea) have been a major factor in attracting foreign investment. Azerbaijan has the third highest cumulative inflow of FDI in value terms amongst CIS countries (after the Russian Federation and Kazakhstan). Foreign direct investment flow in 2003 was 3060.3 million USD, of which 2810.2 million USD was directed to the oil and gas sector. Compared against its population and GDP, Azerbaijan is by far the most attractive FDI destination among many countries of the regions. In 2003 FDI in Azerbaijan accounted for 44.6% of GDP.

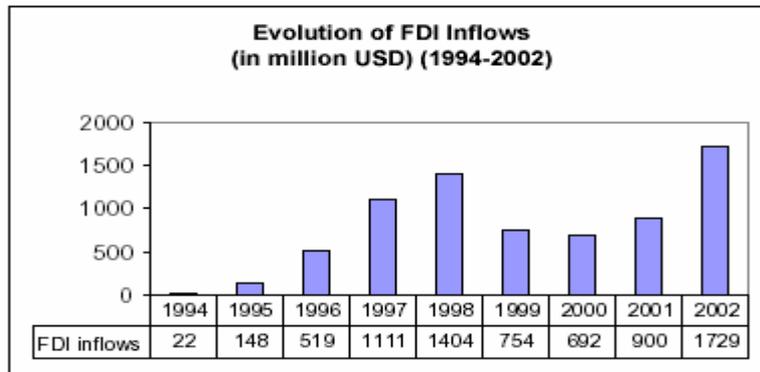
FDI inflows are expected to increase considerably in the coming years as major investments in the oil and gas sector proceed, including the construction of the Baku-Tbilisi-Ceyhan pipeline. Significant reforms and progress in the privatisation of electricity distribution companies and the upcoming privatisation of gas and water utilities should help to open the infrastructure sector to private sector investment. However, foreign investment in non-energy sectors remains very modest. The evolution of FDI flows in recent years is shown on Fig. 2.

FDI remains concentrated in the oil and gas sector, which accounted for 65 per cent of the cumulative total of US\$ 8.7 billion over 1993-2003. In 2000, 85.9 per cent of all FDI was in the oil and gas sector, and its share in FDI is expected to remain high in the future. The amount of FDI in the oil sector has been a major achievement, underscoring not only Azerbaijan's hydrocarbon potential and the commitment of oil investors to developing this potential, but also the Government's ability to negotiate and carry through complex investment projects.

Beyond the oil sector, FDI inflows have been low. Nevertheless, much of the recent non-oil FDI in Azerbaijan has been predicated, albeit indirectly, by the oil sector development. These sectors include the oil services industry, construction and building materials, and telecommunications. Traditional manufacturing and agriculture has received little FDI.

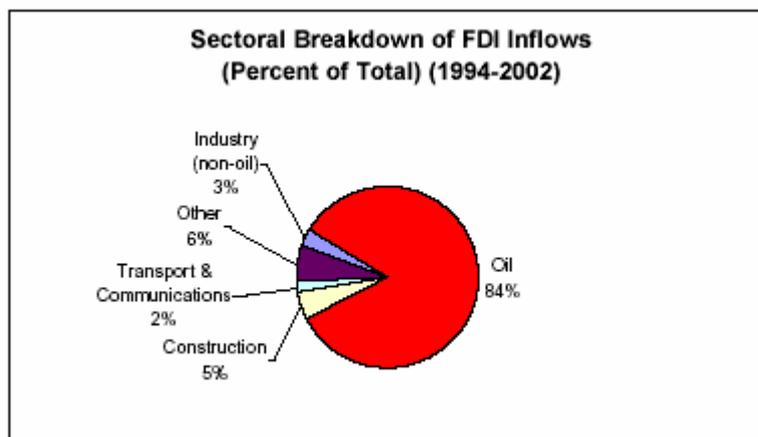
The sectoral breakdown of FDI inflows in 1994-2002 is shown on Fig. 3.

Figure 2: FDI inflows.



The first big success in attracting FDI was the conclusion of the so-called "contract of the century" in the oil sector in 1994, whereby an international consortium of oil companies (the Azerbaijan International Operating Company, AIOC) undertook to develop the offshore Azeri, Chirag and Guneshli oil fields ("ACG") located in Azerbaijan's sector of the Caspian Sea. The AIOC is led by British Petroleum, which holds 34 per cent, and American companies, holding about 26 per cent. The contract has a duration of 30 years, and a value of US\$ 8 billion. By the end of 2003, AOIC had spent about US\$ 3.3 billion. Oil revenues during the 30-year project life span are foreseen to reach US\$ 70 billion. With full development of the AIOC's Azeri-Chirag-Guneshli fields and development of new fields, oil production is projected to peak at between 1.5 and 2 million barrels per day sometime between 2010 and 2020.

Figure 3: FDI by sector, 1994-2002.



Since the signing of the "contract of the century", the Azerbaijan parliament has ratified a total of 21 Production Sharing Agreements (PSA), three of which have since been dissolved or terminated. The active PSAs could result in investments of more than US\$ 30 billion. These PSAs provide a solid foundation for foreign investment in the oil and gas-related sectors of the economy. Phases One and Two of "ACG" full field development were sanctioned in autumn 2001 and 2002 respectively, with Phase Three sanctioned in 2004. In 2003 ExxonMobil commissioned a new semi-submersible drilling rig "Gejdar

Aliiev”, which can operate at sea depths of up to 1000 meters. This was the first drilling rig commissioned in the Caspian Sea after the collapse of the U.S.S.R.

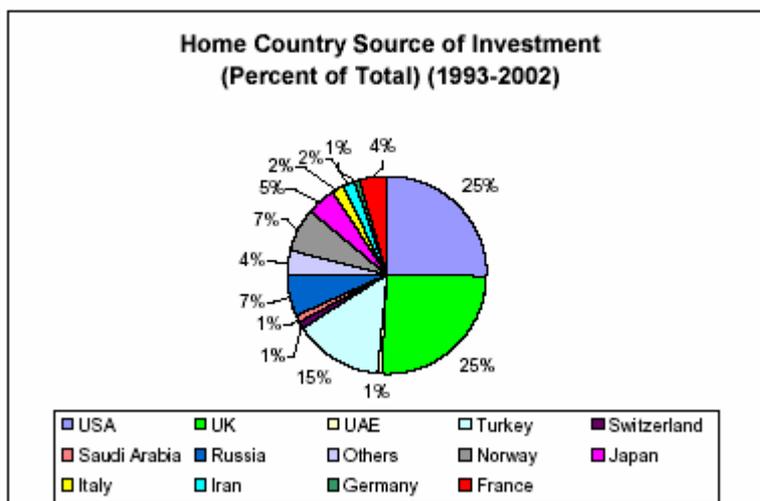
US companies are the main investors in the country, comprising 28.2 per cent of the total cumulative investment during 1994-2001. While at the last years UK became the largest foreign investor with now about 39 per cent of total investment. Other important investors in the country come from Norway, Japan, France, Germany, Italy.

The most significant foreign investors in the hydrocarbon sector include the AIOC consortium, Unocal Khazar Ltd (US), Exxon Azerbaijan Ltd (US), TPAO (Turkey), Pennzoil Caspian Corp (US, acquired by Devon), Statoil Apsheron (Norway), Lukoil Overseas (BVI) Ltd (Russia), Itochu Oil Exploration (Japan), Total (France) and Agip (Italy).

The oil equipment and services sector has also attracted significant FDI, with the presence in Azerbaijan of Halliburton (US), Schlumberger (France), Kvaerner (Norway) and Aker Maritime (Norway).

Sources of FDI accumulated during the period 1993-2002, have been as follows (Fig. 4):

Figure 4: FDI by source.



The Government of Azerbaijan welcomes foreign direct investment, realizing that it plays a vital role in the development of the country's economy. Foreign investors are, in principle, allowed to invest in any sector of the economy (except restrictions related to national security and defence). The Law on Protection of Foreign Investments provides that foreign investors be treated not less favourably than domestic investors. The Law also includes guarantees concerning the repatriation of profits, and other revenues, and protects in case of expropriation and nationalisation. It likewise includes a “grandfathering clause” in the event new legislation is less favourable to foreign investors (for further details see section III below).

In 2001, with the restructuring of the Cabinet of Ministers, the Foreign Investment Agency, as well as the former Ministries of State Property, Economy and Trade, and the

Antimonopoly Committee were merged together into a new Ministry of Economic Development, which is currently responsible for investment regulatory and promotion policy. The Ministry is also responsible for coordinating state agencies in their activities in this field. The Department for Investment and International Economic Cooperation is dealing with a variety of investment-related issues within the Ministry of Economic Development. The functions of this body are as follows:

- Formulating the national investment policy and monitoring of its implementation, with necessary links to national economic development programmes; and drafting amendments to the existing investment legislation;
- Implementation of the country's policy on attracting foreign investment through economic policy instruments.

The government continues its efforts to improve the investment climate. For example, the government has substantially reduced licensing requirements, streamlined licensing procedures, simplified the tax regime, curtailed excessive powers of law enforcement agencies, improved public procurement rules and established a Chamber of Accounts. Further measures like the reform of the customs and tax authorities, the strengthening of the judiciary, and the preparation of a comprehensive anti-corruption programme are planned. In July 2003, a "Business Council" consisting of domestic and foreign companies and reporting to the President, has been established.

Among the main strengths of Azerbaijan as an investment location - besides its endowment with natural resources - are:

- Geographical location with a large potential to become a transit country for pipelines and flows of oil and gas from Turkmenistan and Kazakhstan, and a hub for transport of goods between Russia, the Middle East and Central Asia;
- Educated, skilled and motivated labour force;
- Stable macroeconomic situation.

The challenge facing Azerbaijan is to upgrade its commercial laws, implement regulations to standards that are generally acceptable internationally and to make those laws and regulations fully effective, particularly through the completion of the court system reform, the tackling of corruption, and other measures to strengthen the rule of law. The government recognises that these areas need urgent attention and various measures have been initiated. The decisive and effective implementation of these measures and further actions will be required to achieve the government's objective to accelerate non-oil, private sector development.

2.4.3. Privatisation

A new privatisation law was adopted in May 2000 and the President approved the second privatisation programme shortly thereafter. A list containing nearly 450 enterprises open for privatisation to both foreign and domestic investors was published in March 2001, including enterprises of telecommunications, fuel and energy, mechanical engineering, chemicals, poultry, as well as the state-owned airline AZAL.

The new privatisation law envisages international tenders to be run on a case-by-case basis for the largest state-owned enterprises. Once the decision has been made in respect of the

form of privatisation, the second privatisation programme provides for the possibility of consulting companies being appointed by tender to advise on the main tender process itself. Furthermore, the second privatisation programme provides for a number of pre-privatisation measures that may be carried out, such as restructuring of enterprises, transfer of enterprises into private management by way of open tender, debt restructuring and the provision of financial aid. In July 2001, a presidential decree, aimed at making the process more transparent, expanded the list of enterprises that may be privatised via investment tenders.

In the period between the privatization was started and through July 1, 2004 some 40 thousand small enterprises and facilities were privatized with a total value of 619 billion manat, including 767 industrial enterprises, 398 construction enterprises, 3210 trade enterprises, and more than 10 thousand enterprises in the services sector etc. Total revenues from the privatization of small enterprises amounted to 444 billion manats. In 1997 conversion into joint stock companies of medium and large enterprises was initiated, and as of July 1, 2004 1533 large state owned enterprises (including 352 industrial enterprises) with a total Chartered Capital of 5.4 trillion manat were restructured into joint stock companies. Presently, private sector accounts for more than 73% of the GDP.

With regard to the energy sector, the government is currently engaged in discussions with potential investors on the transfer of Azerbaijan's electricity distribution companies to new long-term management. Recently, tender results were announced for long-term management contracts for Baku's and three other cities' electricity distribution networks and contracts were signed. In January 2002, the Azerbaijani government succeeded in placing under long-term private management the Baku electrical distribution network. The Ganja, Sumgait and Alibayramli electrical distribution networks were also placed under private management in 2002. Moreover, the government is engaged in preparations for the restructuring of the gas sector. To this end, in connection with the set up of an action plan, an announcement for tenders for the selection of consulting companies was made in cooperation with the World Bank. It is to be expected that an agreement with the winner of the tender should be signed after the Presidential Decree On Privatization of the Gas Sector is issued.

The Ministry of Economic Development maintains a web site with information about ongoing privatisations available in English and Azeri (www.economy.gov.az).

More detailed information is provided in section IV below.

2.4.4. Energy Policy

The Energy Policies of Azerbaijan focuses on encouragement of development and export of huge hydrocarbon reserves. The Ministry of Fuel and Energy (MFE) was established in Azerbaijan in April of 2001. MFE is a central executive body responsible for the development and implementation of the state policy in the fuel and energy complex of Azerbaijan. The main tasks of the Ministry include:

- Development and implementation of the state policy in the fuel and energy complex of the Azerbaijani Republic;
- Implementation of activities aimed at satisfying energy needs of the economy and the population;

- Securing the interests of the State and control in the efficient energy uses;
- Implementation of activities with a view to furthering international cooperation in the fuel and energy complex and attracting foreign investments in the sector;

The main functions of the MFE are:

- Development of the Fuel and Energy Balance of the Azerbaijani Republic and its implementation together with the bodies concerned;
- Development of the main directions of the FEC development, as well as production and consumption projections for individual energy types; presentation thereof to appropriate bodies and participation in relevant implementation activities;
- Participation in the development of activities and work to ensure energy security of the Azerbaijani Republic;
- Development, in cooperation with the relevant executive bodies, of actions aimed at improvement of the FEC structure and implementation thereof in accordance with the legislation;
- Regulation of state owned enterprises' activities in the FEC in accordance with the legislation;
- Participation in the state regulation of natural monopoly entities in the FEC within its competence;
- Representation of interests of the State in the companies (where the State is the founder, or one of the founders) in the FEC etc.;

Structurally the Azerbaijani FEC comprises SOCAR, AOO "Azenergy", AOZ "Azerigaz", and AO "Azerbaijani Gas Processing Plant".

The central apparatus of the Ministry of Fuel and Energy comprises the following divisions:

- Division of fuel and energy operations;
- Economics division;
- Finances and accounting division;
- Capital investments and project evaluation division;
- Energy control division;
- Division of strategic development and special major projects;
- Division of international relations; Personnel division;
- General division.

In addition, the MFE structure also includes *Gosenrgonadzor* state enterprise.

The main objectives of the Government of Azerbaijan in the energy sector include:

- Ensuring the energy security of the country;
- Development of the fuel and energy complex;
- Improvement of energy production and energy consumption efficiency;

Ensuring a rational use of the energy resources.

III. Legislative Framework for Foreign Investment in the Energy Sector

3.1. Overview

Since gaining independence in 1991, Azerbaijan has gradually set up a legal framework for developing a free market economy, and for attracting foreign investment in particular. Since 1992, the National Assembly adopted approximately 120 top-priority laws regulating all economic processes. Among the most important laws with regard to investment in the energy sector are laws on investment, property, land reform, privatisation, taxation, and energy.

The following laws and regulations are relevant:

- Constitution of the Azerbaijani Republic adopted on 12 November 1995 by a referendum;
- Tax Code of the Azerbaijani Republic (Baku, July 11, 2000);
- Law “On Entrepreneurial Activities ” (Baku, 15 December 1992, No. 405);
- Law “On Amendments to the Law “On Entrepreneurial Activities”” (Baku, 24 December 1996, No. 214-IG);
- Law “On Investment Activities” (Baku, 13 January 1995, No. 952);
- Law “On the Protection of Foreign Investments” (Baku, 15 January 1992, No. 57);
- Land Code approved and enacted by the Law No. 695-IG of 25 June 1999;
- Law “On Land Reform” (Baku, 16 July 1996, No. 155-IG);
- Law “On Unfair Competition” (Baku, 2 June 1995, No. 1049);
- Law “On Antimonopoly Activities” (Baku, 4 March 1993, No. 526);
- Law “On Natural Monopolies” (Baku, 15 December 1998, No. 590-IG);
- Customs Code of the Azerbaijani Republic;
- The Law “On Exit from, and Entry in to the Country and on Passports” (Baku, May 29, 1997, № 813);
- The Law “On the Legal Status of Foreign Citizens and Stateless Persons” (Baku, March 13, 1996);
- The Law “On Currency Regulation” (Baku, October 21, 1994, № 910);
- “Rules for Currency Operations Regime for Residents, and Non-Residents of the Azerbaijani Republic” Registration № 2859 of June 13, 2002;
- Decree of the President of the Azerbaijani Republic “On the State Committee on Securities under the President of the Azerbaijani Republic” (Baku, July 26, 1999);
- The Law “On the State Procurement” (Baku, February 11, 1997, № 247-IG);
- The Law “On Privatization of the State Property” (May 16, 2000, № 878-IG);
- Decree of the President of the Azerbaijani Republic “On the Approval of By-Laws Regarding Specialized Investment Voucher Funds” (Baku, May 14, 1997, № 579);
- Decree of the President of the Azerbaijani Republic “On the Approval of By-Laws Regarding State Privatization Options” (Baku, May 14, 1997, № 578);
- Resolution “On Reorganization of a State Enterprise, and its Restructuring into a Joint Stock Company” approved by the Law № 208 IG of November 29, 1996;

- Resolution “On Privatization of Property Leased from the State” approved by the Decree of the President of the Azerbaijani Republic № 550 of February 7, 1997;
- Decree of the President of the Azerbaijani Republic “On Approval of Certain By-Laws, which Ensure Actual Privatization of the State Property” (Baku, September 4, 1996, № 498);
- Decree of the President “On Strengthening the Financial Discipline in the Energy Sector” (March 25, 2002 № 893);
- Resolution “On the State Privatization Shares (Vouchers) in the Azerbaijani Republic” approved by the Decree of the President of the Azerbaijani Republic of March 25, 1996;
- The Law “On Legal Rules and Regulations” (Baku, November 26, 1999, № 242);
- The Law “On Energy” (Baku, February 1, 1999, № 541-IG);
- The Law “On Electricity” (Baku, June 13, 1998, № 723);
- The Law “On the Subsoil” (Baku, February 13, 1998, № 439-IG);
- The Law “On Environment Protection” (Baku, August 4, 1999, № 173);
- The Law “On the Use of Energy Resources” (Baku, May 30, 1996);
- The Law “On Environmental Security” (Baku, August 4, 1999, № 172);
- The Law “On Power Plants and Heat Generation Plants” (Baku, December 28, 1999, № 84-IG);
- The Law “On Gas Supply” (Baku, June 30, 1998, № 513-IG).

3.2. Investment-related Laws and Regulations

3.2.1. Overview

The two main applicable laws in this area are the Law on Protection of Foreign Investment, and the Law on Investment Activity. Together, they set the basic legal framework for investment activities in Azerbaijan.

Presently, a new draft law on investments is being developed with the participation of the World Bank, and the draft will be sent to the Milli Mejlis of the Republic in the near future.

The Law on Protection of Foreign Investment includes a definition of “foreign investment” and determines the forms in which foreign investment may be made. It stipulates that the legal status of foreign investment must not be less favourable than that for domestic enterprises. Foreign investors may engage in any economic activity not banned by the legislation of Azerbaijan. They may also participate in privatisation.

Foreign investment is fully and unconditionally supported. To this end, the Law contains provisions on investment protection, including guarantees in case of nationalization and requisition, the free transfer of profits in foreign currency, and a stabilisation clause protecting temporarily against disadvantageous legislative changes. The latter provision is of particular importance in the energy sector, since most – if not all – major investment

projects involving foreign investors are implemented on the basis of production sharing agreements.

The Law on Protection of Foreign Investment likewise deals with the establishment and operation of foreign investment. It lists certain types in which foreign investments may be made, and provides rules on the registration process. Concerning the operational phase of an investment, the Law includes regulations on, inter alia, import and export activities, property rights on real estate, concession contracts, taxation, intellectual property rights, auditing, accounting, and the liquidation of companies with foreign capital.

The Law also provides for the possibility to establish free economic zones, and includes rules on dispute settlement. Finally, the Law ensures that if an international agreement to which Azerbaijan is a party provides other rules than those established in the present Law, the international rules shall apply.

The Law on Investment Activities deals with the general social, economic and legal environment for investment activities in general (i.e. not limited to foreign investment). It defines the terms “investment”, “investment activities and their objects”, and “investors”. It also contains a number of basic rights of investors, such as the right to make an investment, to own, use and dispose of it, and to participate in privatisation. The Law establishes the principle of non-discrimination of investors with regard to such activities, and includes provisions on investment protection. To this purpose, it prohibits state authorities, in principle, to interfere with authorised investment activities. The Law also provides for compensation in case of an expropriation, and protects against legislative changes deteriorating the investment conditions.

The Law confirms that investors are subject to the legislation of Azerbaijan. In particular, they need to apply for the required permissions and licences, and have to observe any other norms or standards established by the competent authorities. The Law also stipulates that investors and state authorities are liable for any violation of their respective obligations. In addition, the Law deals with the financing of investments, price formation, and the termination of investment activities.

Finally, the Law contains rules on public investment. In this context, it sets out the objectives of such investment, establishes procedures for taking decisions on undertaking state investments, lists different categories of investment, and provides for provisions on their adjustment and coordination.

The Law on Investment Activities and the Law on Protection of Foreign Investment partially overlap. This is the case, for instance, with regard to investment protection. The respective provisions are sometimes not consistent, resulting in some legal uncertainty for foreign investors. One example relates to the protection in case of legislative changes having negative effects on the investment. The Law on Investment Activities provides that in such a case the legislation effective on the date of the investment shall (indefinitely) prevail. By contrast, according to the Law on Protection of Foreign Investment, this effect should be limited to ten years. Another example of diverging concepts is the definition of an “investment” or “foreign investment” respectively (see section 3.2.2.5 below).

3.2.2. Selected Policy Areas

3.2.2.1. Establishment of enterprises, including registration

Under Azerbaijani law, foreign investors may engage in investment activities not prohibited by law. Private entities may freely establish, acquire, and dispose of interests in business enterprises.

Pursuant to Article 6 of the Law on Foreign Investment, enterprises with foreign capital may carry out any kind of activity if it is allowed by the Legislation of Azerbaijan. Enterprises with foreign capital may be engaged in some kinds of activity, the list of which is determined by the President of Azerbaijan, on the basis of special permission (licenses) only. This is the case, for example, for the energy sector. According to Article 7, there can be restrictions for the activity of enterprises with foreign capital taking into account the defence and national security interests of Azerbaijan.

In accordance with Article 16, enterprises with foreign investments shall be established in the form of joint-stock companies and limited liability companies, and other economic societies, as well as in any other forms not contradicting to legislation of Azerbaijan Republic. The followings types may be established with participation of foreign capital and operate on the territory of Azerbaijan Republic:

- Enterprises sharing with foreign investors (joint ventures);
- Enterprises completely belonging to the foreign investors (foreign enterprises);
- Representations (bureau, offices, agencies) of foreign legal entities.

Joint ventures and foreign enterprises shall be legal entities of the Azerbaijan Republic. The procedure of establishing the enterprises with foreign investments shall be determined by the legislation of Azerbaijan Republic.

Pursuant to Article 18 of the Law on Protection of Foreign Investment, an enterprise with foreign investments shall be registered by authorized state bodies (including the Ministry of Justice, the tax authorities and social insurance, employment and other special purpose mandatory funds). The Cabinet of Ministers shall establish the procedure of registration as well as requirements for establishment, and other documents necessary for its fulfillment. Enterprises with foreign investments shall acquire the rights of a legal entity from the moment of registration. Information on registration shall be published in the press by the registration body. Data on registration of enterprises with foreign investors shall be included into the State Register, which is kept by the Ministry of Justice. Refusal of the state registration of the enterprises with foreign investments shall be possible only in case of violation of legislation of the Azerbaijan Republic on the procedure for establishing such kind of enterprises, or if the documents needed for registration do not comply with the established requirements as well as in cases when the goals, tasks, and forms of activities are in conflict by legislation of the Azerbaijan Republic. Refusal of registration can be appealed in legal form.

The Government applies no formal screening mechanisms for general foreign investment. The law only requires determining that documents of enterprises seeking registration are in order.

3.2.2.2. Real Estate

Legislation on real estate include the Civil Code, the Law on Real Estate Registration, the Land Code (1999), the Law on Land Reform (1996), the Law on Land Leasing (1999), and the Law on Land Market (1999). Azerbaijani citizens and Azerbaijani legal entities, including enterprises with foreign investment, can legally own, buy, sell, and trade property. By contrast, Azerbaijani law imposes certain restrictions on land ownership by foreign citizens, people without citizenship, and foreign legal entities. As a general rule, they may only lease land. Azerbaijani legislation does, however, not prohibit foreign investors from acquiring ownership interests in land and structures through creation of joint ventures with local capital or the establishment of wholly foreign-owned companies in Azerbaijan, as these are viewed as Azerbaijani legal entities.

3.2.2.3. Concessions and licences

Pursuant to Article 40 of the LFI, concession rights for search, exploration of fossils deposits, and exploitation of other natural resources shall be provided to foreign investors on the basis of concession contracts concluded between the foreign investors and the Cabinet of Ministers of the Azerbaijan Republic and ratified by the Supreme Council of the Azerbaijan Republic. Unilateral change of the terms of a concession contract shall not be allowed if not otherwise provided in the contract.

Licensing was for years a huge problem for business in Azerbaijan as the licences required were too many, process of issuance was too cumbersome and unclear, and the number and variety of officials enforcing these licences was too big. The system was slow and costly, delaying needed business activities. In order to improve the business environment, the President issued a Decree in September 2002 reducing the number of the types of activities requiring licences from 240 to 30, and adopting regulations on granting licences. The supervision of observance of the licensing legislation by state organs, as well as by companies is entrusted to the Ministry of Economic Development.

3.2.2.4. Taxation

Foreign investors in Azerbaijan are subject to three different forms of taxation, depending on the type of investment or business. If the investor has entered into a production sharing agreement, the PSA will stipulate the tax rules relevant to that particular investment. With the enactment of a Host Government Agreement (HGA) governing activities on the Main Export Pipeline BTC running from Azerbaijan through Georgia to Turkey, Azerbaijan introduced a new tax regime applicable to companies working in connection with the pipeline. Investors operating outside the PSAs and HGA activities are subject to a statutory tax regime based on the tax code. The latter regime is described below.

In the past, tax rules were scattered among numerous laws and regulations. In 2000, a new Tax Code was passed. It entered into force in January 2001, replacing the confusing number of separate pieces of law. Further amendments were made in 2002-2003. For the first time, a comprehensive legal framework for all tax rules and procedures was set up. This increased significantly the transparency of the tax regime for the taxpayer. Furthermore, rate cuts and modernized tax procedures were adopted. Business

representatives and foreign investors consider the new Tax Code to be a major improvement over previous legislation.

The Tax Code contains the rates and procedures for direct and indirect taxes. Tax rates might be lower according to Treaties on the Avoidance of Double Taxation concluded with a number of countries, in particular for withholding taxes. In 2003, there have been notable improvements in tax administration. For example, demands for advance tax payments from foreign businesses, a problem in recent years, have largely disappeared.

The following briefly describes the cornerstones of the tax regime:

- **Profit tax for legal persons.** Profit tax for legal persons is paid by resident enterprises and by non-resident enterprises at the same rate. The common profit tax rate is 24 percent. The taxation base may be reduced by deduction of costs related to generating revenues of an enterprise. Certain types of bad and doubtful debts may also be deducted, as well as depreciation of capital assets. Incidentally, for industrial capital investments, an accelerated depreciation is applied. A simplified taxation procedure is applied to enterprises, whose turnover for the preceding three months does not exceed 22500-times standard accounting unit (a standard accounting unit equals 5500 manat, which is roughly 1.1 USD), e.i. some 123.8 million manat (some 25.2 thousand USD) The simplified tax rate for the city of Baku is 4%, while for other cities and regions of the Republic and in the Nakhichevan AR, 2%. Legal entities subject to simplified taxation are exempt from profit tax, VAT, and property tax.
- **Income tax for natural persons.** Both, residents, and non-residents pay income tax. Residents (natural persons, who are physically present in the territory of the Azerbaijani Republic for more than 182 days a year) pay in Azerbaijan a tax on their incomes generated in any part of the world. At the same time, the sums paid by a resident as income tax beyond the Azerbaijani Republic from incomes generated in locations other than Azerbaijan are refunded against the taxes paid in Azerbaijan. At the same time, these sums should not exceed the amount of taxes levied in the Azerbaijani Republic at prevailing rates for the same incomes. Non-residents pay taxes only on incomes from Azerbaijani sources. The income tax rate is progressive and is set at 14% and 35% [the 35% rate is applied for annual income of more than 36 million manats (some 7200 USD), or for a monthly income of more than 3 million manats (some 600 USD)]. Non-taxable part of a monthly income is 150 thousand manats (some 30 USD). Some types of incomes and categories of persons are exempt from taxation, for example, incomes from agricultural activities. As of 2003, natural persons engaged in entrepreneurial activities without incorporation of a legal entity are also subject to a simplified tax procedure (see term and conditions in the “Profit tax for legal persons” section). Natural persons paying a simplified tax are exempt from income tax and VAT.
- **Value added tax.** VAT is levied on goods, services and works within the country, as well as on imported goods, services and works. Persons engaged in entrepreneurial activities, whose taxable operations for the preceding three months do not exceed 22500 standard accounting units, must register for VAT purposes. The normal VAT rate is 18%. Reduced VAT rates are not envisaged, although VAT exemptions are granted, in particular, for acquisition of property in the process of privatization, imports of national and foreign currency (except for numismatic

purposes) etc. Exported goods are subject to a zero VAT rate. International freight and passenger transport are also subject to a zero rate VAT. Exporters are entitled for VAT compensation within 45 days.

- **Withholding taxes.** Withholding taxes on payments to foreign organizations are levied at rates between 4% (insurance premiums and leasing payments) and 10% (dividends, interest, rent, and royalties). In addition to the tax on incomes of a non-resident permanent establishment, any amount of net profit of this permanent establishment transferred (credited) to this non-resident is subject to a 10% tax.
- **Other taxes and levies.** All enterprises and natural persons, who produce or import excisable goods, are subject to taxes. Excisable goods include petroleum products, tobacco products, and alcoholic beverages. Natural persons and enterprises, both residents and non-residents, also pay property tax. On natural persons the tax is levied at 0.1% of the book value of privately owned buildings (the tax is not levied if the value does not exceed 6000 standard accounting units). Enterprises pay property tax at 1% of average annual residual value of the enterprise's assets. Natural persons and enterprises pay property tax for vehicles they own based on the engine displacement (for 1cm³). The rate is 0.2 and 0.4% of standard accounting unit. Road tax is levied on foreign road vehicles entering the country at a rate determined based on the type of a vehicle. Land tax is also levied on land use. Enterprises engaged in development of natural resources must pay development tax (royalty) (between 3 and 26 % for mineral resources, except for crude oil). Land tax is also levied on land plots owned by residents and non-residents at rates that vary depending on the region, type of plot and the price of land.
- **Payroll Taxes.** Finally, there are social contributions, which consist of a 27 per cent employer contribution rate charged on all employees' gross salaries. A presidential decree of September 2002 stipulated a further reduction of tax rates as of January 1, 2003. It aims to extend the application of the simplified tax, as well as to reduce payroll taxes.

Bilateral treaties on the avoidance of double taxation

Azerbaijan has concluded bilateral treaties on the avoidance of double taxation with the following countries:

Georgia - 18.02.1997 (since 01.12.1997 is in force), Ukraine - 30.07.1999 (since 03.07.2000 is in force), the Russian Federation – 03.07.1997 (since 01.12.1997 is in force), Norway – 24.04.1996, the United Kingdom – 23.02.1994, France – 20.12.2001, Uzbekistan – 27.05.1997 (since 26.11.1997 is in force), Kazakhstan – 16.09.1996 (since 07.05.1997 is in force), Poland – 26.08.1997, Turkey – 09.02.1994, Austria – 23.02.2001, Belgium – 18.05.2004, Byelorussia - since 01.02.2002 is in force, Libya – 11.02.1998, Romania – 29.11.2002 (since 29.11.2004 is in force), and Pakistan – 10.04.1996.

3.2.2.5. Investment Protection

Definition of foreign investors and foreign investment

According to Article 2 of the LFI, foreign investors may be

- Foreign juridical bodies;
- Foreign citizens, persons without citizenship and citizens of the Azerbaijan Republic having a permanent residence abroad in case they are officially dealing with business in the country of citizenship or permanent residence;
- Foreign states;
- International organizations.

Article 3 of the LFI defines “foreign investment” as all kinds of property and rights, including the rights for intellectual activity not concerning to values invested by foreign investors to entrepreneurship and other projects for gaining profit. Foreign investors may realize their investment in the territory of the Azerbaijan Republic by means of:

- Shares in enterprises established jointly with juridical bodies and citizens of the Azerbaijan Republic;
- Establishing enterprises completely belonging to foreign investors;
- Purchasing of enterprises, property complexes, buildings, constructions, shares, stocks, bonds and other securities, as well as other property which the foreign investor may possess according to the legislation of the Azerbaijan Republic;
- Obtaining the rights for land utilization and other natural resources as well as other property rights;
- Concluding contracts with juridical bodies and citizens of the Azerbaijan Republic stipulating other forms of foreign investments.

On the other hand, Article 1 of the Law on Investment Activity defines an “investment” as financial means and material intellectual values invested to business objects and other kinds of activities in view of gaining profit or social effectiveness. Such means and values include the following:

- Monetary means, bank deposits, credits, shares and other securities;
- Movable and immovable property (buildings, constructions, equipment and other material values);
- Scientific, practical and other intellectual values issued in proper order; non-patent technical, technological, commercial and other knowledge such as technical documentation, skills and production experience, required for any kind of production ("know-how");
- Rights on land, water and other resources, buildings, constructions, equipment and other rights for properties originating from copyright;
- Other values, where the investment is carried out in the form of capital deposits intended for the creation and reproduction of capital funds, and for the development of substantial production in other forms.

Non-discrimination

Article 5 of the LFI stipulates that the legal rules for foreign investments and foreign investors must not be less favourable than rules for investment activities of juridical bodies and citizens of the Azerbaijan Republic, except those which are stipulated by Law. Additional tax and other privileges can be determined for foreign investors in priority areas of the national economy and in separate regions by the legislation of Azerbaijan. The

principle of non-discrimination is reiterated in Article 18, paragraph 1, of the Law on Investment Activities.

General Protection

Pursuant to Article 9 of the LFI, foreign investments on the territory of Azerbaijan Republic shall enjoy complete and absolute legal protection which is provided by the present Law and other legislative standards as well as by international agreements of the Azerbaijan Republic.

Stabilisation of legislative framework

Article 10 of the LFI provides a guarantee against legislative changes. In case that subsequent legislation worsens the conditions of investment the legislation valid at the moment of investing shall apply during ten years. However, this provision shall not apply to legislative changes concerning defence, national security, environmental protection, taxation, finance and credit, moral and public health.

By contrast, Article 18, paragraph 2, of the Law on Investment Activities stipulates that the protection against unfavourable legislative changes has infinitive duration.

Protection of property rights

The Azeri Constitution provides specific protection of private property. A modern Civil Code came into effect in 2001. The Code includes fundamental provisions on contracts, commercial relations, ownership rules and securities. The recently adopted Civil Procedure Code simplifies court procedures.

Intellectual property

In the mid-1990s, Azerbaijan began implementing a national system for registering and protecting intellectual property rights with the assistance of the World Intellectual Property Organization (WIPO), of which it is a member. Azerbaijan enacted modern copyright legislation (Law on Copyright and Related Rights) in 1996, patent legislation (Law on Patents) in 1997, and trademark legislation (Law on Trademarks and Geographic Names) in 1998. Azerbaijan is also a party to the Paris Convention for Protection of Industrial Property, and the Berne Convention for the Protection of Literary and Artistic Works.

Pursuant to Article 32 of the LFI, the protection and exercise of rights of enterprises with foreign investments concerning intellectual activity as well as other rights not categorised as proprietary interest ("know-how", commercial secrets, etc.), shall be ensured in accordance with the legislation of Azerbaijan.

Expropriation and nationalisation

Article 11 of the LFI protects against nationalization and requisition. Foreign investments shall not be subject to nationalization except in cases where they cause damage to the people and State interests of Azerbaijan. A decision on nationalization shall be taken by the Supreme Council. Foreign investments shall not be subject to requisition except in

cases of natural calamity, emergencies, epidemic, epizooty and other circumstances of extreme nature. A decision on requisition shall be taken by the Cabinet of Ministers. In case of nationalization and requisition, prompt, adequate and effective compensation shall be paid to a foreign investor.

By contrast, pursuant to Article 18, paragraph 3, of the Law on Investment Activities it is sufficient that expropriation has a legal base and is accompanied by full compensation.

Pursuant to Article 12 of the LFI, compensation paid to foreign investors should correspond to the real cost of investment at the moment of taking a decision on nationalization or requisition. Compensation should be paid in foreign currency and be transferable abroad at the investor's will.

Foreign investors shall have the right to compensation of damages, including lost profit caused as a result of actions of state bodies or their officials contradicting legislation of the Azerbaijan Republic. Disputes on the amounts of compensation and reimbursement of losses, as well as on the terms and procedure of payment shall be settled by an Arbitration Court, the Supreme Court of the Azerbaijan Republic, or an international Arbitration Tribunal if it is so provided in an agreement of the parties or by an international agreement to which Azerbaijan is a party.

Transfer of capital and re-investment

Article 14 of the LFI includes guarantees for the transfer of income and other sources in foreign currency. After payment of taxes and other duties a foreign investor shall have the right to transfer abroad his income and other sums, including compensation and reimbursement of losses in foreign currency obtained legally in connection with the investment.

Pursuant to Article 15 of the LFI, profits gained in the territory of the Azerbaijan Republic may be reinvested in the same currency, deposited in banks of the Azerbaijan Republic, or may be used for purchasing foreign currency in accordance with the procedure and terms established by the National Bank of the Azerbaijan Republic (“NBA”).

Azerbaijan has a liberal exchange system, and, in general, there are no restrictions on converting or transferring funds associated with an investment into a freely usable currency at a market rate of exchange. Conversion is carried out through the Baku Interbank Currency Exchange Market and the Organized Interbank Currency Market. The Baku Electronic Currency Exchange System (BEST) was launched in July 2002. Cash exchange is carried out at numerous currency exchange points. No difficulties exist in obtaining foreign exchange. The average delay for remitting investment returns is two to three business days.

In late 2001, the NBA required that cash transactions be conducted in Azerbaijani manats. Additional requirements relating to the disclosure of the source of currency transfers have been imposed in an attempt to reduce illicit transactions. There have been no recent changes in, nor are there plans to change, remittance policies that would tighten access to foreign exchange for investment remittances. In June 2002, the NBA liberalized some overseas transfer provisions for Azerbaijani legal residents, including an increase of

advance payments for import transactions from \$10,000 to \$25,000 and a waiver of all restrictions for withdrawing foreign currency in cash.

Performance requirements

Performance requirements are not imposed on new investment, but investors who participate in the privatisation process of enterprises often assume specific obligations regarding future investment and employment. Foreign investors are not required to purchase from local sources or export a certain percentage of output. Except for those state monopolies, there is no requirement that nationals own shares in enterprises. In addition, investors may assume in PSAs specific obligations and requirements. Furthermore, according to Article 22 of the LFI, a Reserve Fund shall be created in the amount of 25 per cent of the authorised capital in enterprises with foreign investments.

Employment of personnel

There are no legal requirements for employment of host country nationals. Foreigners who wish to work in Azerbaijan must register with local authorities at their place of residence and obtain work permits from the Ministry of Labour. Heads of representative offices and branches of foreign legal entities and their deputies do not require work permits.

Other guarantees on investment operations

Pursuant to Article 25, enterprises completely belonging to foreign investors and joint ventures with more than 30 per cent of foreign investments in their authorised capital shall be entitled to export their own products (works, services) without licences. Enterprises with foreign investments shall be entitled to import their own products (works, services) for their own economic activity without licences.

According to Article 26, property imported into the Azerbaijan Republic as a deposit into the authorised capital of a joint venture or for establishment of enterprises completely belonging to a foreign investor shall be exempted from customs duties and taxes. Property imported into the Azerbaijan Republic by foreign employees of enterprises with foreign investments for personal needs shall be exempted from customs duties.

Termination of investment

According to Article 13 of the LFI, in case of termination of an investment activity, a foreign investor has the right of compensation of the investment and gained profits in terms of money or goods at real value at the moment of termination.

Pursuant to Article 35 of the LFI, an enterprise with foreign investment may be liquidated in cases and in accordance with the procedure provided in the legislation of Azerbaijan.

Dispute Settlement

The LFI contains rules on dispute settlement. According to Article 42, disputes between foreign investors and enterprises with foreign investments and the state bodies, enterprises, organizations and other legal entities of the Azerbaijan Republic, as well as disputes between participants of the enterprises with foreign investment, disputes between the

participants and an enterprise itself should be settled in Azeri courts or, if so agreed between the parties, by arbitration, including international arbitration, and, in cases provided by legislation of the Azerbaijan Republic - at the bodies on settlement of economic disputes.

Changes in Azerbaijan's legal framework have made arbitration a potentially more effective mechanism to settle disputes. In February 2000, the Law on International Commercial Arbitration came into force providing for the possibility of local arbitration in international commercial matters. In May 2000, the parliament ratified Azerbaijan's accession to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which provides for binding international arbitration of investment disputes between foreign investors and the state. Azerbaijan is a party to the World Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States and is also a member of the Multilateral Investment Guarantee Agency (MIGA). The Civil Procedure Code provides that foreign arbitral awards may be enforced in Azerbaijan so long as they do not contravene legislation or public policy, and if reciprocity exists.

While dispute settlement mechanisms are improving in Azerbaijan, effective means of protecting and enforcing property and contractual rights are not yet fully assured, even though the Azerbaijani government does not officially interfere in the court system.

Bilateral investment treaties on the protection and promotion of foreign investments

Azerbaijan has concluded bilateral investment treaties with the following countries:

the United Kingdom of Great Britain and Northern Ireland – 04.01.1996 (ratified on 11.12.1996), France - .1.09.1998 (ratified on 02.04.2000), United States - 01.08.1997 (ratified on 02.08.2001), Italy – 25.09.1997 (ratified on 17.02.1998), Uzbekistan – 27.05.1996 (ratified on 02.11.1996), Kazakhstan – 16.09.1996 (ratified on 30.04.1998), Kyrgyz Republic – 23.04.1997, Georgia – 08.03.1996 (ratified on 10.07.1996), Iran – 28.10.1996 (ratified by Azerbaijan), China – 07.03.1994, Poland – 26.08.1997 (ratified on 12.02.1999), Turkey – 09.02.1994, Germany – 22.12.1995 (ratified on 25.06.1996), Egypt – 24.10.2002 (ratified on 13.05.2003), Belgium – 18.05.2004, Libya – 11.02.1998, Pakistan – 09.10.1995 (ratified on 18.12.1996), Romania – 29.11.2002 (ratified on 29.01.2004), and Moldova – 27.11.1997 (ratified on 28.01.1999).

3.2.2.6. Transparency

The Law “On Legal Rules and Regulations” establishes that the Laws of the Azerbaijani Republic, Decrees and Ordinances of the President of the Azerbaijani Republic are published in the “Azerbaijan” daily and in the “Register of the Legal Acts of the Azerbaijani Republic”, which are official publications. Resolutions of the Milli Mejlis of the Azerbaijani Republic are published in the “Azerbaijan” daily and in the “Gazette of the Milli Mejlis of the Azerbaijani Republic”. Resolutions of the Cabinet of Ministers of the Azerbaijani Republic are published in the “Register of the Legal Acts of the Azerbaijani Republic”, and in the “*Respublica*” daily, which are official publications, and, as necessary to ensure an immediate and wide dissemination, are published by other media. Legal Rules and Regulations of central executive bodies of the Azerbaijani Republic are published by the Ministry of Justice in the “Bulletin of Legal Rules and Regulations of Central

Executive Bodies of the Azerbaijani Republic”, which is considered an official publication.

3.2.2.7. Privatisation

Overview

The basic legal act is the Law “On Privatisation of State-Owned Property”. It entered into force on 12 August 2002 and replaces the previous Law of 1992 and the State Program of Privatisation of the State-Owned Property in the years 1995-1998.

According to the Law, the state provides some guarantees to investors: There is no limitation on the sale of enterprises, part of enterprises, or the shares that foreign investors can acquire in the privatisation process. However, the latter are required participating in the privatisation process with special options, which are not needed for domestic investors. The Law defines "foreign investors" as citizens of foreign states, foreign legal entities and their representative offices, as well as local legal entities with more than 50% foreign investment.

Article 6 of the Law distinguishes various categories of property for privatisation purposes:

- Property prohibited to privatise (namely soil, forests and water reserves; patent, standardization and measurement enterprises; natural reserves and preservations; highways, bridges and tunnels of state importance);
- Property that must be kept in state ownership until issuance of a special decision;
- Property to be privatised through decision of the relevant agency of the executive power;
- Property to be privatised through decision of the seller of the state-owned property.

According to the Law, privatisation may be implemented through the following methods:

- Privatisation of state enterprises by individual projects;
- Privileged sale of shares to employees. This method implies submission of a certain number of privatisation vouchers for shares of the company;
- Sale of state property through specialized voucher and cash auctions;
- Sale of state property through auctions. Unlike sale through specialized voucher and cash auctions there is only one winner - the person bidding the highest number of vouchers or the largest amount of cash;
- Sale of state property through investment tenders. Generally, not less than 51% of the property of the privatised enterprise shall be sold through this procedure;
- Sale of leased state property;
- Declaration of the state enterprise to be bankrupt and subsequent sale. The decision is to be adopted either by the President or the Ministry of State Property.

Pursuant to Article 4 of the LFI, foreign investors may participate in the privatisation of state and municipal property, as well as uncompleted objects on terms and orders determined by the legislation of the Azerbaijan Republic.

Foreign investors have the right to participate in privatisation with the net profit gained in Azerbaijan without any requirement for submission of options.

Owners of privatised enterprises are permitted to exercise a right of first refusal with respect to the purchase of the land underlying such enterprises. Although privatised companies may purchase land subject to these and other restrictions, foreign investors (and stateless persons) are still not permitted to own land in Azerbaijan.

The Law also deals with other rules on privatisation, such as documentation of the privatisation agreements, and rights and responsibilities of the parties (see below).

Competent authorities

There have been several changes in the title and status of the state bodies responsible for privatisation. In the beginning, the State Property Committee was the privatisation agency of the government. On December 24, 1999, a Presidential Decree established the Ministry of State Property. Its main responsibilities included purchase and sale of property on behalf of the Azerbaijan Republic, acting as the seller of state-owned property, keeping statistical and accounting records of privatisation revenues and transferring those revenues to the state budget, keeping a register of state owned property in the capacity of a guarantor of a storage of shares owned by the state, and pursuing international cooperation.

By Presidential Decree of April 30, 2001, the Ministry of State Property - together with some other state bodies - was liquidated and the Ministry of Economic Development was created on their base. Among the objectives of this central body are the regulation of privatisation and management of state property, restriction of monopoly and development of competition. Within the Ministry exists a Department of Privatisation of State Property.

Legal Procedures for Privatisation

The legal procedures for privatising state-owned property include the provision of information about privatisation opportunities, payment for privatised property, requirements set by the state for new owners, legal documentation of privatisation, and responsibility for violation of laws. These procedures are regulated by the Law on Privatisation, and the Second Privatisation Program.

Providing of information

The Ministry of Economic Development, its local branches and public mass media provide information about privatisation opportunities and the privatisation process as a whole. Schedules of voucher auctions and competitive biddings, as well as information on specific enterprises being privatised must be published in mass media and special publications at least thirty days prior to the beginning of a competitive bidding, auction or open selling of shares. Information on the sale of enterprises that might be of interest to foreign investors may be posted on the web site of the Ministry.

Results of privatisation of state-owned enterprises should be published in mass media within 15 days. This information should include the address of enterprises offered for sale

through auction, the amount of funds to be paid to the government budget in the result of an auction, and rules and timing of clearance with other participants of auction.

Payment for privatised property

The buyer of a privatised enterprise may pay a lump sum or make instalments during a certain period of time, which must not exceed two years. Cash proceeds from the privatisation include other profits gained from the selling of privatised entities and shares, privatisation options, and collecting fees imposed during privatisation. Cash from the privatisation must be transferred to the state budget.

Requirements for buyers of privatised enterprises

The state may set certain requirements for the new owners of privatised enterprises. One example is the protection of rights of the staff of the privatised enterprises. The mandatory signing of collective agreements between the new owner of the enterprise and the personnel is regulated in accordance with the labour legislation. Environmental requirements are also imposed. The seller has to provide information on the environmental situation of the subject of privatisation. Environmental requirements may also be envisaged in the sales agreement.

Documentation

Ownership rights of the buyer of the privatised property shall be documented by a corresponding document issued by the seller of the state-owned property. Owners of the privatised entities may purchase or rent the land (with an option of future purchase of the land plot where the entity is located) in accordance with the legislation. The buyer receives the ownership rights for the shares purchased at the check or cash auction immediately after approval at the auction.

Violation of laws

In case of a violation of laws and regulations as well as agreements on privatisation, the Ministry of Economic Development has the right to prosecute the offenders. Examples include:

- Violation of the rules and regulations for privatisation of state-owned property;
- Privatisation of state owned property by a person who is not recognized as a buyer of the state-owned property.

History of Privatisation

Privatisation in Azerbaijan has lagged behind other CIS countries. One of the main reasons was political instability resulting from the conflict with Armenia. Privatisation in Azerbaijan has been organised on the basis of State Programs of Privatisation of State-Owned Property. The first one was adopted in 1995 and covered the period of 1995 – 1998. It established objectives, main tasks, priorities, ways, phases and terms of privatisation, classification of privatised enterprises, transforming them into joint-stock companies, specific privatisation vouchers, and their utilization procedures. The first stage

of the privatisation consisted in privatising small and medium enterprises. Large state-owned enterprises were to be privatised during the second stage of privatisation.

The First Program classified enterprises as small, medium and large. All medium and large businesses slated for privatisation were to be transformed into joint-stock companies, and then privatised. The following four privatisation forms were established:

- Privatisation of small businesses;
- Privatisation of medium and large businesses;
- Privatisation of joint-stock and pooled banks;
- Selling the shares in specialized industry and inter-industry investment funds.

The First Program also gave a definition of a “State Ownership Share”, which consists of four vouchers of the same value. In total, 32, 000, 000 vouchers were issued, and the circulation period was three years. It also determined the State Privatisation Option granting to its owner foreign investor rights to purchase a voucher for the subsequent participation in privatisation. The Option's circulation period was also set as three years.

The First Program established more complicated privatisation process of medium and large enterprises. The privatisation of joint stock and pooled companies were to be performed by the State Property Committee through the selling of the shares held by the State in auctions, irrespective of the organization/legal form.

The Second Privatisation Program was adopted on August 10, 2000. It provides a classification of enterprises and entities in terms of privatisation, rules for selecting the forms and methods of privatisation as well as for utilization of the vouchers and options, privileges provided to the labour collectives of the privatised enterprises, sale of the pieces of land where facilities built up by natural or legal persons are located, participation of the foreign investors in the privatisation process, limitations on privatisation, revenues from privatisation and their distribution, pre-privatisation restructuring and improving of enterprises and support to newly privatised enterprises, information and methodical support to the process of privatisation and other issues connected with the privatisation of state-owned property.

It introduces a special committee - the State Committee for Control over Privatisation - composed of top officials of various ministries. Unlike the 1995-1998 Privatisation Program, it is not designed to cover any specific period, and will be effective during an indefinite period of time.

Experience with methods of privatisation, including voucher privatisation

Under the Rules on Regulation of the Circulation of State Privatisation Vouchers of 2000, sale and purchase of vouchers may only be undertaken by licensed professionals. Persons who possess more than 400 privatisation vouchers and do not have receipts for the purchase of the privatisation vouchers were obliged to register their privatisation vouchers with the State Securities Committee ("SSC") within 45 days. Vouchers may only be used to purchase shares in privatising state enterprises if they have been deposited with the National Depository Centre ("NDC"). In order to participate in voucher auctions or investment tenders holders of more than 100,000 privatisation vouchers must present them to the NDC at the latest 30 days prior to the last day on which vouchers will be accepted as

payment for the enterprise being privatised. The deadline of validation of vouchers was prolonged from beginning of 2002 until beginning 2008.

New rules have also been adopted to regulate the sale and use of privatisation options, which foreign investors are required to use to participate in investment, voucher and cash tenders as well as in connection with purchases of shares of privatised companies in the secondary market. The Rules On Regulation of Issuance, Circulation and Cancellation of State Privatisation Options provide that at registration, a buyer of options must present, inter alia, a receipt for the pre-payment of 5% of the value of options (on the date of the filing of the investor's application to acquire the options). Submission of bids to purchase shares in privatised companies must be considered by the SSC within 3 business days, and if the bidder is accepted the whole option price is paid. If the bid is rejected the 5% deposit is returned to the bidder.

The number of options required to be submitted at privatisation tenders as well as in connection with purchases of shares of privatised joint-stock companies on the secondary markets has also been clarified:

- Voucher auctions for shares of joint-stock companies - 1 option for each voucher tendered;
- Cash auctions for shares of joint-stock companies - the minimum share/voucher ratio set for the voucher auction for shares of the particular enterprise;
- The secondary market - the minimum share/voucher ratio set for the voucher;
- Privatisation of small enterprises or purchase on the secondary market of small enterprises - option price set on the date of the sale-purchase agreement with respect to the enterprise based on the entire value of the enterprise determined by the MSP;
- Investment tenders, etc. - as determined on a case-by-case basis by the MSP in conjunction with the SSC.

According to the legislation on privatisation, state-owned enterprises and entities of great importance for the country's economy are privatised through individual projects, and 51 or more per cent of the shares is offered for sale in order to attract strategic investors.

Another conventional method of privatisation – so called “insider privatisation” has also been used in Azerbaijan. Insiders participated in privatisation of small and medium-sized enterprises. In almost all cases they had a preferential right of privatisation. However, in the future privatisation of large enterprises, the government will apply a case-by-case approach. Due to the Law on Privatisation insiders are staff members with major employment in that enterprise, those who are eligible to return to the previous employment in that enterprise, retired persons who had been working in that enterprise for more than seven years as well as persons who have been laid off as a result of staff reduction after January 1, 1995 and have obtained a status of unemployed.

3.2.2.8 Other relevant legislation

Article 30 of the LFI obliges enterprises with foreign investments to keep accountancy and reporting according to the rules in force in Azerbaijan Republic, and, if they so wish, following the rules in force in the country of an investor's origin.

Azerbaijan's bankruptcy law does not function effectively.

3.2.3. Exceptions to National Treatment

Azerbaijan currently maintains three exceptions in the “Blue Book”. They relate to the acquisition of real estate by foreigners, and the participation of foreign investors in privatisation procedures (see Annex).

3.3. Energy-related Legislation

During the last half of the 1990s and the beginning of this decade, several laws were enacted with regard to the energy sector. The most important legislation includes the following:

- The Law on Energy (adopted in 1998);
- The Law on Usage of Energy Resources (adopted in 1996);
- The Law “On Electricity” (adopted March 3, 1998);
- The Law “On Power Plants and Heat Generation Plants” (adopted December 28, 1999);
- The Law “On the Subsoil”;
- The Law “On Gas Supply” (adopted in 1998).
- Law on Natural Monopolies.

Also relevant are several Decrees, by both the President of Azerbaijan and the Cabinet of Ministers, concerning the regulation of the energy sector.

3.3.1. The Law on Energy

The Law No. 541-IG “On Energy” of 1 February 1999 summarises the most general principles of the state regulation of the oil, gas and electricity sectors. In accordance with the Constitution of the Azerbaijan Republic, the State, without prejudice to the exclusive rights of any natural or legal persons and having exclusive ownership rights over the deposits of all primary energy resources, enjoys the sole rights in the following areas:

- Exploration;
- Development of deposits and production of energy material and products;
- Construction and operation of underground storage facilities;
- Construction and management of main energy transportation systems.

Any natural or legal person wishing to engage in energy-related activities should, under the procedure established by law and on the basis of an energy contract or application, obtain a special permit from the competent executive authority. Any natural or legal person wishing to engage in new energy-related activities or substantially expand an existing activity should obtain a new special permit.

Such a permit may be issued subject to the use of advanced technologies enhancing the efficient use of energy materials and products, safety, health and environmental protection and, at the same time, do not call for unjustified expenditures.

Energy contracts are concluded between the relevant executive authority and a contractor. They should clearly define the relevant energy and contractual area, permitted exploration techniques and the procedure of reporting exploration results to the relevant executive authority.

Any legal or natural person is responsible under the Law for the efficient use of energy materials and products, and for the observance of rules for the use of energy and waste disposal not exceeding the established standards.

The relevant executive authority determines economic, technical and organisational requirements in the area of energy efficiency. All commissioned energy installations must comply with these standards.

Any person involved in energy-related activities and using energy materials and products should protect the environment from pollution in accordance with the relevant laws, rules and regulations. Environmental protection costs, safety and public health measures and all investigation carried out or expert conclusions are settled by the enterprise, which engages in energy-related activities. Upon receipt of an application for the energy contract or for a special permit (license), the appropriate executive authority initiates an expert evaluation, performed by independent experts, and determines the impact of the corresponding activities on the local environment.

A contractor must give priority to the use of the existing main energy transportation systems of the energy materials and products covered by the contract. Favourable conditions must be created for the access of the contractor to the main energy transportation systems. In the absence of such systems, or if they do not comply with the contractor' conditions, he has the right to build and operate such means of transportation at his own expense.

In order to satisfy national needs, the energy contract envisages the right of the state to purchase energy materials and products at international market prices. A contractor wishing to transport his energy materials and products through the energy transportation systems of a third party should comply with the following requirements:

- To set up prices and tariffs, as well as commercial and technological terms and conditions for the transportation of energy materials and products;
- To accept any order for the transportation of energy materials and products, regardless of their origin, by capacity allocation or reservation and establish the prices without unjustified delays, restrictions and levies, and be impartial with regard to all orders;
- To make available his own unused transport facilities.

Third party transportation of energy materials and products may not affect transportation of the contractor's energy materials and products.

3.3.2. The Law on the Use of Energy Resources

According to this Law of 30 May 1996, the state policy in this area shall be based on the following principles:

- Accept any order for the transportation of energy materials and products, regardless of their source, destination or ownership, as well as establish prices, while avoiding unjustified delays, restrictions and duties; treat the orders on equal basis;
- Implement state regulation of activities of legal and natural persons in energy saving through economic and administrative measures;
- Give priority to energy saving requirements, apply economic and legal incentive mechanisms to activities related to production (mining), processing, transportation, storage and use of energy;
- Establish and apply advanced energy use standards;
- Exercise overall state oversight over the energy use by enterprises and organizations;
- Develop norms and standards in the area of energy saving and energy efficiency, making them mandatory throughout the energy sector;
- Combine the interests of producers, transporters, and consumers of energy;
- Mandatory metering and recording of energy use by all enterprises and organizations regardless of ownership type;
- Mandatory energy audit construction and rehabilitation projects;
- Application of economic sanctions for energy waste;
- Popularization of economic, environmental, and social advantages of energy saving;
- International cooperation in addressing energy saving related issues;
- Development and application of energy saving technologies.

3.3.3. The Law on Subsoil

Relations concerning prospecting and exploration, rational use and protection of the subsoil in the territory of the Azerbaijani Republic, including its sector of the Caspian Sea, and relations concerning work safety, protection of the state interests and interests of citizens and users of the subsoil are regulated by the Law No. 439-IG “On Subsoil” of 13 February 1998.

The law identifies the basic subsoil use principles as follows:

- Ensure a sound, comprehensive, and safe subsoil use;
- Ensure environment protection;
- Expansion and strengthening of the natural resource base;
- Ensure transparency of the subsoil use;
- Establish conditions favorable for investments into subsoil use;
- Payment for the subsoil use.

The Law stipulates that users of subsoil may be legal or natural persons of the Azerbaijani Republic or of other States. The subsoil may be used on the basis of a special permit

issued by an appropriate executive authority in the form of a license in accordance with the procedures established by this Law.

Subsoil is made available for use through competitive bidding, auctions or direct negotiations. The license is a document confirming the rights of its holder for activities on geological studies of the subsoil and development of mineral deposits, the amount of which is officially certified.

A state fee is collected for the issue of the license. Its amount is set by an appropriate executive authority. Activities with a view to studying the subsoil must be registered with the State Geological Fund.

The state licensing system represents a unified procedure for the issuance of licenses and includes informational, analytical, economic and legal preparation of the documents concerning the use of subsoil and processing of those documents.

The use of subsoil in the territory of the Azerbaijani Republic is subject to various types of payments, except for the instances provided for in Article 44 of this Law, as follows:

- State licensing fee;
- Fee for the use of subsoil;
- Mining royalty;
- Contributions towards reproduction of the mineral base;
- Fees for the use of the territorial sea and the seabed.

Additionally, the users of subsoil pay taxes and make other payments as stipulated by Law. Fees for the use of subsoil may be collected in the form of cash payments, or in kind as a portion of the produced mineral resource or by other products produced by the subsoil user.

The form of making payments for the use of subsoil is established in the license in accordance with the legal rules and regulations. It is not permitted to request provision of information representing the commercial secret of the user of subsoil as a payment in kind for the use of subsoil.

The subsoil is made available for use either for a fixed or indefinite period. A fixed period is set up for:

- Geological studies - for a period up to 5 years;
- Production of natural resources - for a period of up to 25 years;
- If both activities are combined - for a period up to 30 years.

Upon agreement of both sides, the period of the subsoil use may be extended, subject to implementation of the agreed license conditions by the user.

With a view to ensuring national security and environmental protection, the use of certain parts of the subsoil may be restricted or prohibited in specific cases, such as the need to protect human life and health, natural disasters, use of armed forces, or persistent violation of rules for the use of subsoil. The relevant executive authority has the right to set the size

and number of the subsoil areas and the ceilings on the amount of the exploited natural resources.

Actions by the state authorities or by any economic agents (subsoil users) aiming at:

- The restriction of participation of legal or natural persons in a tender or auction, contrary to terms and conditions of such a tender or an auction, wishing to obtain rights for the use of subsoil in accordance with the Law “On Subsoil”;
- The refusal to issue licenses to the winners of tenders or auctions;
- The substitution of direct negotiations for tenders;
- The discrimination of the subsoil users who develop structures that compete with the economic agents enjoying a dominant position in the use of subsoil

are prohibited and considered as null and void. Such measures implement the antimonopoly requirements with respect to the use of subsoil.

3.3.4. The Law on Natural Monopolies

The Law No. 590-IG “On Natural Monopolies” of 15 December 1998 establishes the organisational and legal basis of the state regulation with respect to natural monopolies and aims at ensuring a balance of interests between the natural monopoly and consumers. The Law regulates relations on the market of products, works and services with the participation of natural monopolies, consumers and the relevant executive bodies of the state and local governments.

Natural monopoly activities include, inter alia:

- Transportation of oil and refinery products through the main pipelines;
- Services related to pipeline transportation, storage and distribution of natural gas;
- Services related to transmission and distribution of electricity and heat.

Activities of natural monopolies are regulated by the relevant executive authorities (hereinafter referred to as the “Natural Monopoly Regulation Bodies”). In order to ensure the regulation of activities of natural monopolies and with a view to preventing or eliminating activities that may negatively affect interests of consumers or impede an economically justified transition from a monopoly situation to free competition, the Natural Monopoly Regulation Bodies may take appropriate measures envisaged by this Law and other rules and regulations, such as the regulation of product prices; the determination of consumers eligible for mandatory service; or the introduction of minimum supply levels in the event of an impossibility to fully satisfy the demand of consumers for a product produced by the natural monopoly.

The Natural Monopoly Regulation Bodies exercise control over the activities of natural monopolies in accordance with this Law and other rules or regulations of the Azerbaijani Republic. They include:

- Acquisition of ownership and use of rights over capital assets for the production (sales) of goods, which are not subject to state regulation under this Law;

- Transfer to another economic agent of ownership and use of rights of natural monopoly agents through sale, lease, and other action over capital assets for the production (sales) of goods, which is subject to state regulation under this Law;
- Lease of capital assets.

3.3.5. Pipeline/transit regulations

There is no specific law regulating transit of oil through pipelines. The main law addressing this issue is the Energy Law as described above. The Azerbaijani legislation includes the principle of freedom of transit; non-discrimination as to pricing and origin; and terms and conditions for access to transportation networks, including oil pipelines.

3.3.6. Presidential Decree on Financial Discipline in the Energy Sector

On March 25, 2002, the President of Azerbaijan issued Decree No. 893 "On Strengthening the Financial Discipline in the Energy Sector." The Decree was issued because "Azenergy" (the state-owned joint stock electric company) and "Azerigas" (the state-owned joint stock gas company) have only paid for a small percentage of their fuel deliveries and have continued to increase their debts to the State Oil Company of the Azerbaijani Republic (SOCAR). In 2001, Azerenergy paid SOCAR for only 0.5 per cent of the value of its fuel while Azerigas paid for just 1.3 per cent of the value of its gas. The decree establishes a two-stage approach to the problem: Stage 1 implements measures to prevent creating new debts. Payments to SOCAR are planned at 20 per cent in 2002, 30 per cent in 2003, 45 per cent in 2004, 65 per cent in 2005, and 80 per cent to 100 per cent in 2006. During Stage 1, the unpaid amounts will be regulated through securities to provide record keeping and transparency. In Stage 2, the debt will be restructured when the accrual of new debts has been stopped. By the end of 2006, Azerbaijan plans to increase collection from distribution networks to 100 per cent.

Decree No. 893 also sets the goal of eventually switching all thermal power plants to natural gas fuel, and announces plans to restructure Azerenergy and Azerigas and speed up the process of privatisation or concession of electricity and gas distribution networks. The Decree states that a Tariff Board has been established that will undertake a comprehensive analysis of utility tariffs, set optimum levels, and promptly regulate them. In addition, Decree No. 893 announces the government's intention to restructure SOCAR. This would include improving the settlement operations of SOCAR with its industrial customers and increasing collections from domestic fuel users. Azerbaijan intends to reduce costs by privatising SOCAR's servicing and social facilities or transferring them to other institutions. It is planned that the difference between domestic and export prices will be reduced for oil, oil products, and natural gas.

The Azeri government recognizes that in order to create free competition in the power generation sub-sector, several measures must be fully implemented: fair tariffs and non-discriminatory access to the high voltage power grid, creation of truly independent power generation companies, implementation of a power trading and resale system, and re-considering the taxation system for power generation in order to discourage monopolistic control of the power market and encourage alternate forms of power generation. Future laws and decrees towards this end can therefore be expected.

3.4. Membership in International Organisations

Azerbaijan participates, inter alia, in the following international organizations:

- Black Sea Economic Cooperation (BSEC);
- Customs Cooperation Council (CCC);
- Commonwealth of Independent States (CIS);
- European Bank for Reconstruction and Development (EBRD);
- Economic Commission for Europe (ECE);
- Organisation for Economic Cooperation (OEC);
- Economic and Social Commission for Asia and Pacific (ESCAP);
- Energy Charter;
- International Bank for Reconstruction and Development (IBRD);
- International Development Agency (IDA);
- International Finance Corporation (IFC);
- International Labour Organization (ILO);
- Islamic Development Bank (IDB);
- Non-Aligned Movement (NAM) (as observer),
- Organization of the Islamic Conference (OIC);
- Organization on Security and Cooperation in Europe (OSCE);
- Partnership for Peace (PP);
- United Nations Organization (UN);
- United Nations Conference on Trade and Development (UNCTAD);
- United Nations Industrial Development Organization (UNIDO);
- World Intellectual Property Organization (WIPO);
- World Trade Organization (WTO) (as an observer);
- United Nations Environment Programme (UNEP)
- United Nations Development Program (UNDP)
- Global Environment Fund (GEF).

IV. Market Structure and Privatisation

4.1. Overview

Azerbaijan is a major oil producer and could also be a major natural gas producer if there were sufficient gas transmission infrastructure in place that could move the gas to western markets. Azerbaijan has encouraged foreign investment in its oil and gas sub-sectors since it became an independent country in the early 1990s.

Development of its hydrocarbon resources has allowed Azerbaijan to transition from being a net energy importer to a net energy exporter. A historical summary of Azerbaijan's Total Primary Energy Production (TPEP) and Consumption (TPEC) is shown in Table 1.

Table 1: Azerbaijan's TPEP and TPEC, 1994-2003 (in Quads)

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|------|------|------|------|------|------|------|------|------|------|------|
| TPEP | 0.66 | 0.65 | 0.65 | 0.62 | 0.73 | 0.84 | 0.82 | 0.86 | 0.86 | 0.86 |
| TPEC | 0.76 | 0.73 | 0.65 | 0.64 | 0.55 | 0.57 | 0.57 | 0.60 | 0.61 | 0.62 |

Table 2

Note: 1 Quad = 1 quadrillion Btu. Source: DOE/EIA

4.2. Oil and Gas

4.2.1. Upstream Activities

4.2.1.1. Evolution of Sub-sector Structure

Azerbaijan holds a special place in the history of oil and gas development. In the nineteenth century Baku was one of the world's two main sources of petroleum. Alfred Nobel and his brothers made their fortunes here.² When Azerbaijan regained independence in 1991, its oil and gas fields and the government's plans to re-open them to outside investment attracted considerable interest among foreign investors. Under President Heidar Aliyev, Azerbaijan has succeeded in drawing as much or more foreign investment than has the much larger Russian Federation. Indeed, investors find the country's application of its laws - if not its legal proclamations - and its adherence to contracts with investors among the best in the region.³

Azerbaijan's early law-making has been exemplary in this regard. The "Law on Protection of Foreign Investments" of 1992 provides that foreign investors will be treated in a manner "not less favoured" than the treatment accorded to local investors (Article 5). It further provides for repatriation of profits, revenues, and other investment-related funds as long as the applicable Azerbaijani taxes and fees have been paid (Article 14). And significantly, it provides a ten-year grandfather clause in the event new legislation less favourable to the foreign investor is adopted (Article 10, exempted, however, are changes to tax legislation).

Preference is made in this law for disputes between foreign investors and enterprises with foreign investments and the state bodies to be settled in local Azerbaijani courts. Yet the law leaves open the possibility of bringing the dispute before arbitration, including arbitration abroad. Less clear is the notion that, in certain cases provided by legislation of the Azerbaijan Republic, disputes should be settled "at the bodies on settlement of economic disputes," (Article 42). In February 2000, a new law "On International Arbitration," sought to improve this mechanism for the settlement of disputes, providing for local arbitration of international commercial matters. Several months later, in May, the parliament ratified Azerbaijan's accession to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, calling the first time for binding international arbitration of investment disputes between foreign investors and the state.⁴

Azerbaijan has a Subsoil Law⁵ providing that natural resources such as oil and gas belong to the state. This law reaffirms previous legislation under Article 2 of the Economic Independence Law and Article 10 of the Property Law, both promulgated by presidential decree in 1991.⁶ In exercising its rights, the state may grant licenses for exploration (up to five years) or production (up to 25 years), and these terms may be extended. Licenses may be awarded through bidding, auction or in exceptional circumstances by negotiation.

² Terry Adams, "Downsizing the Caspian: OPEC and the Realities of Caspian Oil to the Year 2014," APS Review Oil Market Trends, September 24, 2001.

³ This was the general opinion of oil and gas companies interviewed during the period from March 1 – April 1, 2003.

⁴ Azerbaijan Country Commercial Guide, FY 2002, Ch. 7, Investment Climate, US Trade Office.

⁵ Law on Subsoil, No. 439, effective February 13, 1998.

⁶ Foreign Investment in Azerbaijan's Mineral Resources Sector, East-West Executive Guide, July 1, 1996.

Parallel to the license scheme under the Subsoil Law, exploration and exploitation can also occur by way of an “energy contract” with the state under the 1999 Energy Law.⁷ Energy contracts have shorter terms than do licenses issued under the Subsoil Law.

Notwithstanding the two laws mentioned above, nearly all hydrocarbon exploration and production in Azerbaijan have taken place under production sharing agreements (PSAs) between the state, represented by SOCAR, the state-owned oil company, and participating investors. Azerbaijan has entered into some 24 PSAs thus far (6 of which have been cancelled due to insufficient drilling results.) Moreover, it should be noted that the PSAs for the field project “Azeri-Chirag-Guneshli” have a direct bearing on the distribution of equity shares in the under-construction Baku-Tbilisi-Ceyhan (BTC) export pipeline, with those companies with greater production in the Caspian taking out a greater stake in BTC. Investors in exploration and production activities in both Azerbaijan and Kazakhstan make up the BTC pipeline group.⁸

The PSAs, as well as framework legislation on foreign investments,⁹ provide protection against subsequent adverse changes of legislation, including taxes. Tax rates for oil and gas consortia and for the MEP are provided in the PSA and host country agreement (27% profits tax for project participants, operating companies and participating shippers under the MEP; 25% or 32% profits tax for the contracting parties and operating companies under the PSAs, depending on when they were concluded.) The true test of the PSAs will come after the projects enter the production and transport phases, which are expected to begin within the next few years.

The production sharing agreements presently in force in Azerbaijan have resulted in multi-billion dollar investments in the country’s petroleum sector. These investments suggest a degree of satisfaction among the oil and gas companies with the Azeri legislative framework for the exploitation of hydrocarbons. A political squabble with Iran over the demarcation of the Caspian has also impacted access to the Sharg-Araz-Alov exploratory offshore oil and gas wells and activity there has been sidelined until an agreement among the five littoral states can be worked out.

The fact that Azerbaijan, in the relatively short period since the demise of the Soviet Union, has concluded roughly \$50 billion in oil and gas related foreign contracts (to be committed over the course of the next 30 years in line with existing PSAs), bears testimony to the confidence that the foreign investor has in the country’s legal regime. But that is not to say that investment conditions cannot improve. Azerbaijan has made headway in establishing favorable terms of access for foreign investment in the oil and gas sector.

Developments in the oil and gas sector underpin Azerbaijan’s hopes to reach self-sufficiency in the energy sector. Clearly, the country possesses enough crude oil and natural gas to cover demand in the domestic fuel and power sector for a very long time.

⁷ Law on Energy, No. 541, effective February 1, 1999.

⁸ Robert Perkins, ConocoPhillips Buys Back Into Baku Oil Line, Platt’s Oilgram News, October 31, 2002.

⁹ See, e.g., the Law on Protection of Foreign Investments, No. 97, effective January 15, 1992 (Article 10 provides a stability clause exempting the investment from subsequent legislation worsening the terms of the investment for a period of 10 years after the time of investing, except for reasons of national security, environmental protection, finance and credit, and morals and public health), and the Law on Investment Activity, No. 952, effective January 13, 1995 (Article 18(2) includes a similar provision but gives the term of protection as the period of the contract relating to the investment.)

However, before the full-scale development of the biggest offshore fields, Azerbaijan will still face the need inherited from the Soviet times to import some primary energy resources. This import dependency is visible in two instances: first, Azerbaijan imports electricity even though the thermal and hydroelectric plants are capable of generating sufficient quantities of electricity, since transmissions losses are high; second, Azerbaijan imports natural gas to keep the thermal power plants running.

In accordance with the obligations before the IMF, the government of Azerbaijan is to draft guidelines for bringing domestic energy prices in line with world prices. The implementation of the programme is to begin in 2005. In connection with the anticipated gradual increase in energy prices, especially the price of natural gas, the government is also drafting measures to compensate low-income families for price hikes.¹⁰

The import dependency in electricity and natural gas has had its negative impact, visible, for example, in the complex arrangements between Georgia and Azerbaijan designed to offset Georgian debt by deliveries of electricity (until May 2004, Georgia had only delivered about 2/3 of the contracted quantity), as well as in the occasional need to switch back to fuel oil at power plants in cases when gas supplies fail due to repairs of the main gas import line or other reasons. In mid-2004, Georgian and Azerbaijani experts tried to draw up avenues for cooperation in the power sector, as well as a new mechanism for settlement of power-sector debts. As a minimum, the two countries will have to devise a new compensation schedule.¹¹

The Government of Azerbaijan is taking steps to mitigate these problems. For example, Azerenergy, the national power company, is working with a number of international financial institutions and foreign companies on the rehabilitation of the grid to reduce power losses. SOCAR, meanwhile, is working with foreign oil companies on the development of gas resources that will provide Azerigaz and Azerenergy with the natural gas they need. It is estimated that the completion of the grid modernization and gas field development programs will take a few years (until 2007 or so), and during this period of time Azerbaijan will remain dependent on energy inputs from neighboring countries¹².

In response to the need of better managing oil revenues, the Azerbaijani government set up in 1999 the State Oil Fund of Azerbaijan (SOFAZ). Its goal in establishing the fund was to manage the oil export revenues in a manner that facilitated spending on social and economic development programs guarding against economic crisis and promoting diversified economy.

The funds receipts come from profits from oil sales, oil transit fees, rents, bonuses and returns on equity. As of January 1, 2003, SOFAZ reported \$692 million in funds. In 2003, it had revenues of about \$375 million and expenditures of about \$243.4 million. As of January 1, 2004, funds stood at \$815 million.¹³ In early 2004, SOFAZ forecast revenues of \$182 million this year, with most of the money (\$147 million) to come from oil and gas activities. Of the latter figure, revenues from the sale of oil and gas will account for the most, but investor's credit payments to SOCAR will account for \$6 million and crude oil and natural gas transportation will account for another \$15 million.

¹⁰ FSU Oil and Gas Monitor, 21 January 2004.

¹¹ FSU/CE Power Report, 5 May 2004.

¹² FSU/CE Power report, 12 May 2004.

¹³ FSU Oil and Gas Monitor, 4 February 2004.

Placement and management of the Fund's assets are expected to bring in another \$15 million.

In 2003, the fund allocated \$127.8 million towards covering Azerbaijan's share in the BTC pipeline, \$50.5 million towards refugee support, \$1 million for management, and \$0.6 million for profit tax. In the same year, about 69% of the assets were held in dollars and the rest in euros. About \$60.7 million were under management by Deutsche Bank, \$50 million by Societe Generale (France) and \$41.5 million by Switzerland's Clarident¹⁴.

SOFAZ plans to spend \$166 million in 2004, with payments to the state budget accounting for most expenditures (\$128 million). Some 0.46 million USD will be spent on support programs for refugees and persons displaced from the country's area occupied by Armenia, while \$17 million will be used to pay for Azerbaijan's share of costs in the BTC pipeline construction project.

In the opinion of many experts, SOFAZ has been a well-managed operation. For example, an official with the UK's Department for International Development (DfID) has voiced his satisfaction with SOFAZ's performance after reviewing the fund's accounts, particularly the way the fund operates in a transparent manner. DfID is working with SOFAZ to help it start issuing international-standard financial reports. DfID is developing special forms that will show all payments made by oil companies to the government and will submit these forms to SOFAZ in April 2004. The fund's executive director (Mr. Sharifov) also serves as a chairman of the Extractive Industries Transparency Initiative.¹⁵

The Government of Azerbaijan plans to finalize in 2004 the draft of a long-term oil revenue management strategy and submit it to the President for consideration. The need for such a strategy has been stressed by the IMF and the World Bank. The strategy could also help in the drafting of the 2005 budget.

The Government forecasts that the two largest projects (ACG and Shah Deniz) are to bring revenues of \$64 billion over the next 20 years at an average world price of \$25 per barrel of oil, \$45 billion at an average price of \$20 per barrel and \$24 billion at an average price of \$17 per barrel.¹⁶

The Information and Resource Center for the Oil Industry of Azerbaijan has provided its own version of a program for the use of money in SOFAZ over the next two years. It recommends that the fund's currency reserves be deposited in banks for safekeeping, with the rest of the funds to be used for welfare programs, settlement of debts and arrears and investment in local industrial and agricultural enterprises. Accordingly, the program calls for the set-up of two separate funds, the Reserve Fund and the Consumer Fund. The Reserve Fund would hold 40% of SOFAZ's money, to be used only in times of economic, currency or financial crisis. The remaining 60%, the program says, should be put in the Consumer Fund, which would use 50% of its money for poverty reduction, increases in salaries, pensions and allowances. Another 25% of the Consumer Fund, the program continued, will be used to settle debts and arrears, and the remaining 25% will go towards

¹⁴ Ibid., 9 July 2003.

¹⁵ FSU Oil and Gas Monitor, 14 April 2004.

¹⁶ Ibid., 8 October 2003, quoting Echo of 1 October 2003.

investments. The Centre said that it had presented its program to the Cabinet of Ministers and SOCAR and that SOFAZ representatives had seen the document¹⁷.

In early 2003, SOCAR started a separate special fund in order to accumulate extra tax deductions resulting from the rise in world oil prices. By the end of the third quarter of 2003, the account had accumulated about \$15 million. Company sources said that the fund will be used if oil prices fall below \$20 per barrel and the company is unable to pay taxes to the state budget.¹⁸

Many independent observers have voiced the opinion that Azerbaijan compares favourably to other oil-rich countries and has a better reputation as a place to do business in than many other countries in the region. Azerbaijan has a good record on keeping the terms of agreements once they are signed and enacted, and has avoided reversing to pressure in its relationship with foreign investors to achieve a revision of terms. Azerbaijan does not vacillate on questions of pipeline routes and firmly supports the chosen options. It also has a very clear and reasonable position on Caspian jurisdiction and other policy issues of interest to the oil industry. Of course, there is a lot of leeway in terms of possible improvement, for example in transparency and inefficiency, but Azerbaijan clearly projects an air of a place open for business.

The history of major oil exploration and production contracts is not without its problems. Early optimism for an oil bonanza that could dwarf the Middle East did not materialize in full. Dry holes and other problematic geological conditions have led some foreign investors to cancel their contracts in recent years. However, the Government has made a consistent effort to maintain favourable conditions for investors. It has done so by keeping the process of negotiation and approving of contracts close to the political leadership of the country. Investors know that they are working out the deal with officials who are close to the leadership, and they also knew that the leadership will do everything possible to ensure that the PSAs would receive parliamentary approval once the negotiations are complete. Recent changes in the political leadership have witnessed a continuation of this favourable investment climate¹⁹.

PSAs provide stability of fiscal and tax regimes. Foreign investors praise the fact that the sanctity of contracts has been maintained and the government has never asked terms and conditions to be reconsidered or contracts to be re-opened for negotiations. However, some contracts are not covered by the PSA regime, and there is some lingering vagueness about future obligations and the enforcement of the legal framework. The separate structure established with the help of the World Bank and the IMF to manage oil revenues (SOFAZ) is also reassuring for investors in terms of transparency and public governance.

A Council for Business Dialogue has been established under the President of Azerbaijan, with some participation of foreign investors. In its activities, it aims at the establishment of a manageable structure where issues related to business climate and investment can be considered.

Azerbaijan has volunteered to be a participant in the Extractive Industries Transparency Initiative (EITI), an action plan first introduced by Tony Blair. EITI aims at establishing

¹⁷ FSU Oil and Gas Monitor, 24 March 2004.

¹⁸ Ibid., 12 November 2003.

¹⁹ Ibid., 6 August 2003.

accountability for payments from industry to host governments, assuring that companies report to civil society all payments made to governments. The lead role in reporting payments in Azerbaijan is played by SOFAZ, which, however, only deals with non-operational revenue (bonuses, acreage fees, etc.).

4.2.1.2. Recent Exploration and Production Activities

Oil

Azerbaijan was the world's first oil producing country, and has the potential of becoming one of the most important. Since the beginning of exploration, 71 oil and gas fields have been discovered in Azerbaijan, of which 54 are under production at the moment. So far, more than 1.4 billion tons of oil and more than 480 bcm of gas have been produced. Azerbaijan presently has in the range of 4-13 billion barrels of proven oil reserves (0.54-1.76 billion tons, depending on the source consulted), and there are also most likely very large additional reserves offshore in the Caspian Sea. At the moment, there are 28 known oil and gas fields offshore, of which 18 developed (17 by SOCAR and one by AIOC), with more expected to come onstream.²⁰

There are now 33 major oil companies active in Azerbaijan, including ones from the United States, the United Kingdom, Russia, Saudi Arabia, Japan and China. The Government of Azerbaijan signed with those 35 companies 24 major PSAs related to oil deposits, resulting in more than \$4 billion investment in Azerbaijan's oil sub-sector. However, joint ventures had limitations on exporting oil directly which discouraged development of some fields, so in 2000, Azerbaijan decided to abolish joint ventures and convert them to PSAs. Recent exploratory drilling has produced mixed results and several PSAs shut down after they were unsuccessful in finding oil (*cf.* below).

The status of some offshore Caspian oil fields is still being disputed. In 2002, Azerbaijan reached agreements with Russia and Kazakhstan on the division of the bed and subsoil in the Caspian (waters are held in common). Subsequently, the three countries started preparing to sign a trilateral accord on the issue. Azerbaijan, Kazakhstan, and Russia have generally agreed among themselves to divide the offshore area on the basis of equidistant division of the sea. However, Iran and Turkmenistan have argued for different ways. Turkmenistan has disagreed with Azerbaijan over the Kyapaz, Khazar, and Osman fields. Azerbaijan also disputes Iran's claims in awarding licenses to Royal Dutch Shell and Lasmco to do seismic exploration in the Caspian offshore area near the two countries. In July 2001, an Iranian gunboat ordered a BP ship to leave the South Caspian area where it was exploring its Araz, Alov, and Sharg concession under a license from Azerbaijan. Iran accused Azerbaijan of sending an exploration vessel into Iranian waters and fired on it from gunships, as well as sending two military jets over the ship. Azerbaijan responded by claiming that Iran had violated its territory. The consortium working the area, led by BP, immediately suspended work on the field thought to contain 2.2 billion barrels of oil, and has not resumed operations since. Subsequently, negotiations have been held between Iran and Azerbaijan.²¹

In early 2004, a new round of negotiations began between Azerbaijan and Turkmenistan on the methods of dividing the central Caspian Sea into national zones. Both countries

²⁰ Qasanov, Abulfat: State and Prospects of Development of Oil and Gas Production in Azerbaijan Basin of Caspian. Paper presented to a conference, Brussels, 2004.

²¹ FSU Oil and Gas Monitor, 30 July 2003.

have said that the Caspian ought to be divided up into exclusive national zones according to the median-line principle rather than treated as a common property by the five littoral states. However, the two sides disagree on the exact line of delineation. In the past (1997), Turkmenistan has claimed that all of the Azeri field and part of the Chirag field in the block awarded by Azerbaijan in 1994 to the Azerbaijan International Operating Co. (AIOC) led by BP are actually property of Turkmenistan. Later in 1997, Turkmenistan protested the decision of Azerbaijan to award the Kyapaz offshore field to a LUKoil-Roisneft consortium, claiming that the field (which it calls Serdar) is actually in the Turkmen sector of the Caspian. While work at AIOC's block is progressing, the Kyapaz contract was cancelled. In 1998, Turkmenistan said it had awarded the field to Mobil (now part of ExxonMobil), only to cancel the contract in the same year without explanation. Turkmenistan has closed its embassy in Baku since 2001 and has threatened to take the delineation dispute to the international court system.²² Tehran, on the other hand, has repeatedly stated its objections to bilateral agreements in the Caspian and has called for the adoption of an agreement among all five littoral states. It has asserted that each littoral state should receive a 20% share of the sea²³. The Government of Azerbaijan stands for a balanced, non-confrontational approach on the matter of delineation of the Caspian between the littoral countries.

In late 2003, Azerbaijan, Iran, Kazakhstan and Russia signed the Convention on the Protection of the Caspian Environment (Turkmenistan officials were present during negotiations, but did not get authorization from Ashgabat to sign). While the Convention has no bearing on the jurisdiction over the Caspian's waters and seabed, but is still an important stepping stone towards a five-way agreement on the legal status of the Caspian sea. It obligates its members to reduce and prevent pollution of the sea, to carry out environmental restoration programs and to utilize the sea's resources in a measured and sustainable fashion. It also obligates the members to work with each other and with international organizations to achieve these goals. The Convention was negotiated under the auspices of the United Nations Environmental Program (UNEP).²⁴

The five littoral countries in the Caspian have set up a Caspian Working Group that meets for discussions of the jurisdiction of the Caspian Sea. So far, more than a dozen meetings have been held with the aim of drafting and facilitating the adoption of a five-way agreement on the issue. The representatives of all five littoral states have approved in December 2003 a joint declaration saying that progress had been made in the talks and that further discussions would be needed to achieve a consensus solution. Azerbaijan supports a solution that involves a division of the sea into exclusive national zones²⁵.

Azerbaijan's interests in the oil industry are operated by SOCAR. SOCAR also acts as a party in the negotiating process leading to agreements with foreign investors. Each contract is negotiated on its merits and on its own terms. Once SOCAR and its foreign partners agree on the conditions for investment, the government sends the proposed contract to Parliament for approval. In other words, each contract is treated as a separate, independent piece of legislation.²⁶ Except for AIOC's contract, all subsequent 14 offshore

²² FSU Oil and Gas Monitor, 4 February 2004.

²³ Ibid., 22 October 2003.

²⁴ Ibid., 12 November 2003.

²⁵ Ibid., 17 December 2003.

²⁶ Ibid., 26 November 2003.

contracts refer to particular geologic structures, covering a total of 30 structures in the Caspian Sea.²⁷

The State Oil Company of the Azerbaijani Republic (SOCAR) is involved in prospecting, exploration, and development of oil and gas deposits throughout the territory of the Republic, including on-shore and off-shore; preparation, processing, and transportation of oil, gas condensate, as well as products thereof; marketing of the products both in the domestic market and abroad; construction of hydro engineering structures including stationary sea platforms; and is involved in major scientific research and design effort. SOCAR owns its own sea vessels including floating cranes, tankers, pipe-laying vessels, specialized seismic exploration vessels, as well as passenger ships. Moreover, SOCAR has 7 semi-submersible and 6 jack-up drilling platforms.

At the moment, the following contracts are with SOCAR's participation (Figure 5 and 6, Table 3). SOCAR's plans include the development of some fields that have been abandoned by outside investors (both offshore and onshore) since the foreign operators failed to find sufficient quantities of hydrocarbons to justify development. In particular, a contract involving the Karabakh structure with a U.S.-led consortium (Caspian International Petroleum Co., CIPCO) was abandoned by Pennzoil (CIPCO operator) in 1999 after test wells indicated the field contains some gas and about 40 million tons of oil rather than the expected 100 million tons. Similarly, another U.S.-led consortium known as the North Abzheron Operating Co. (NAOC) decided to abandon its Ashrafi/DanUlduzu contract area when the operator (Amoco) and its partners decided that the test wells are disappointing. Despite the presence of some gas and 20-40 million tons of oil, NAOC believed that the project was not economically viable.

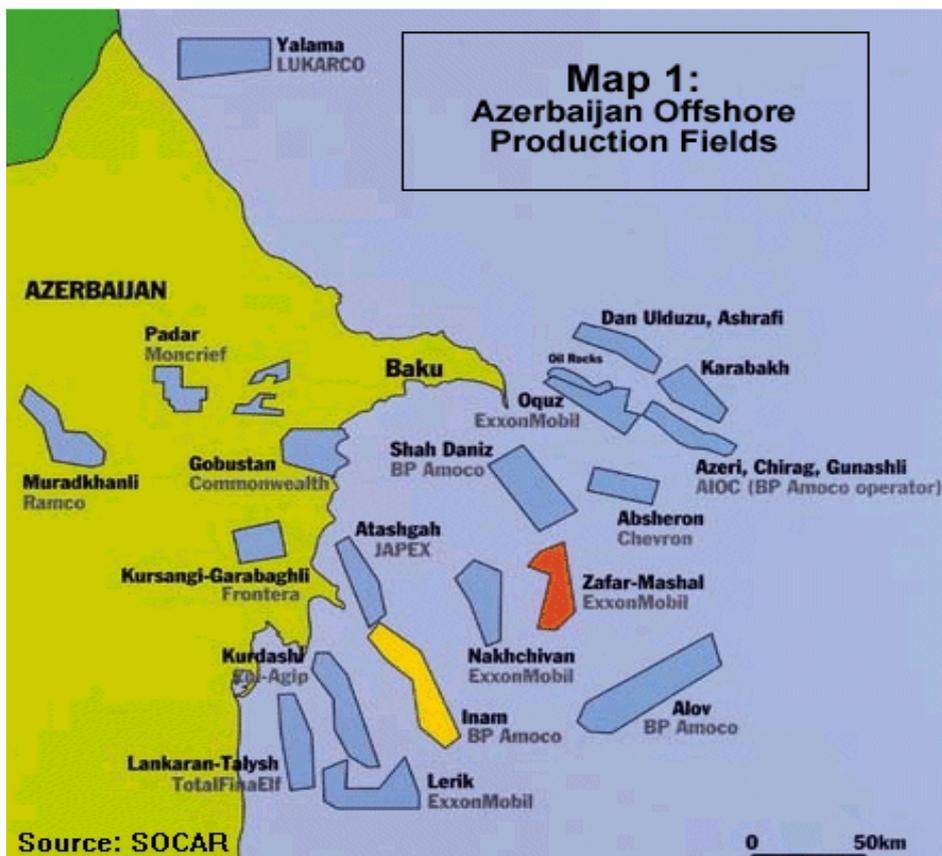
Figure 5: Main Contract Areas and Prospect Structures in Azerbaijan



Source: BP.

²⁷ Qasanov, op.cit.

Figure 6: License areas by license holder.



Source: SOCAR.

Several other deals were similarly cancelled: ChevronTexaco stopped working on the Abzheron gas field, while ExxonMobil dropped the Oguz project. Agip is no longer working on Kyurdashi, Total stopped activities at the Lenkoran/Talysh block offshore, and Ramco quit the onshore field of Muradkhanli. Most recently, the Japan Azerbaijan Operating Co. (JAOC) withdrew from its Ateshgydakh - Yanan-Tava - Mugan-Deniz structure after failing to reach target due to high pressure in one of the exploratory wells and finding minor quantities of hydrocarbons in the other. The JAOC cancellation brought the number of annulled contracts to six out of 22²⁸. The cancelled contracts are valued at 10-12 billion and have brought the forecast of expected investment in oil and gas upstream projects somewhat down, from about \$60 billion to about \$50 billion.²⁹

²⁸ FSU Oil and Gas Monitor, 11 February 2004.

²⁹ Nezavisimaya Gazeta, 1 April 2004.

Table 3: Contracts with SOCAR participation³⁰

| | Project Block | Reserves Forecast | | Consortium | Shares, % | Status as of May 2003 |
|---------------------|--|-------------------|----------|--------------------------|-----------|---|
| | | Oil, mmt | Gas, bcm | | | |
| A. CONTRACTS | | | | | | |
| 1 | Azeri, Chirag, Guneshli (ACG, AIOC) | 730 | 96 | BP (operator) | 34.1367 | Oil is produced at Chirag since 1997 ("early oil"). In 2003 production was at a rate of 133,000 bpd. Since 2002 AIOC is developing the Azeri field, including drilling of wells and the construction of a stationary platform. Production is expected to begin at Central Azeri in 2005 ("Phase One"). East Azeri is to be brought onstream in 2006, and West Azeri in 2007 (Phase Two). On the deep-sea part of Guneshli – in 2008 (Phase Three). Oil will be exported via the BTC line, which is under construction since 2002. |
| | | | | Unocal | 10.2841 | |
| | | | | SOCAR | 10 | |
| | | | | INPEX | 10 | |
| | | | | StatOil | 8.5633 | |
| | | | | ExxonMobil | 8.0006 | |
| | | | | TPAO | 6.75 | |
| | | | | Devon | 5.6262 | |
| | | | | Itochu | 3.9205 | |
| | | | | Delta Hess | 2.7213 | |
| 2 | Araz, Alov, Sharg | 300 | 400 | SOCAR | 40 | Part of the block is located in an area disputed by Iran. In 2001 BP discontinued operations until a final settlement of the territorial dispute could be reached. |
| | | | | BP (operator) | 15 | |
| | | | | ExxonMobil | 15 | |
| | | | | StatOil | 15 | |
| | | | | TPAO | 10 | |
| | | | | Alberta Energy | 5 | |
| 3 | Abzheron | 120 | 3000 | SOCAR | 50 | The first exploration well was drilled in this gas-prone area in 2001 with disappointing results. The second well should have been drilled by using the DSS-20 (Lider) semisubmersible in 2004, but the investors preferred to pay a penalty and drop the contract. |
| | | | | ChevronTexaco (operator) | 30 | |
| | | | | Total | 20 | |
| 4 | Ateshgyakh, Yanan-Tava, Mugan-Deniz (JAOC) | 75-90 | | SOCAR | 50 | Two exploration well were drilled in 2001-2003, failing to prove reserves. The first one had to be abandoned due to encountered excessive pressure, and the second one discovered reserves of oil that were deemed of no commercial interest. JAOC has fulfilled its obligations for exploration drilling. The project was dropped by JAOC in May 2004. JAOC said it preferred to stop operations and pay compensation to SOCAR rather than pursue the project further. |
| | | | | JAPEX | 22.5 | |
| | | | | INPEX | 12.5 | |
| | | | | Itochu | 7.5 | |
| | | | | Teikoku | 7.5 | |

³⁰ **Projects marked in yellow shade have been abandoned.**

| | Project Block | Reserves Forecast | | Consortium | Shares, % | Status as of May 2003 |
|----|---|-------------------|----------|---------------------------|-----------|--|
| | | Oil, mmt | Gas, bcm | | | |
| 5 | Hovsany, Zyh | 17-20 | | LUKoil (operator) | 50 | The two onshore fields are located in the southern part of the Abzheron peninsula. They have been under development for about 50 years, but are thought to contain residual reserves, which the partners hope to tap under a field rehabilitation program. The value of the contract is said to be \$200-250 million. LUKoil has said it intends to refine the output in Azerbaijan and market the products via its own distribution net in the country. Feasibility study is under development. LUKoil has objected to a \$100 million clean-up program of grandfathered pollution, claiming that the cost of such a program will bring returns below its target rate of 15%. |
| | | | | SOCAR | 50 | |
| 6 | Zafar-Mashal | 140 | | SOCAR | 50 | Two exploratory wells must be drilled under the contract. The first one was drilled in 2003, but could not reach the target depth of 6,800 meters because it encountered a "power water obstacle". The second one was spudded in early 2004. |
| | | | | ExxonMobil (operator) | 30 | |
| | | | | ConocoPhillips | 20 | |
| 7 | Inam | 170 | 100 | SOCAR | 50 | The first exploratory well was drilled in 2000-2001, failing to reach the target due to excessive formation pressure. BP planned to re-start operations on the block in 2004 after completing seismic map of the area, but later said it will resume exploratory drilling in early 2005. |
| | | | | BP (operator) | 25 | |
| | | | | Shell | 25 | |
| 8 | Karabakh (Caspian International Petroleum Co., CIPCO) | 40 | | Pennzoil (operator) | n/a | Abandoned by the Pennzoil-led American consortium (CIPCO) in 1999 after test drilling revealed the reserves are in the range of 40 million tons rather than the expected 100 million tons. |
| 9 | Kurdashli | | | Agip (operator) | n/a | Project abandoned. |
| 10 | Kursangi, Karabagli (Salyan Oil) | 100-150 | | CNPC (operator) | 50 | Fields are under a rehabilitation program. CNPC consolidated its 50% stake in Salyan Oil in 2002 and declared its intentions to invest \$80 in the project in 2003. Salyan Oil produced 306,000 tons of oil in 2002. In early 2004, CNPC said it may reduce further investment, sinc effort in its other block (Gobustan) failed to produce any oil. |
| | | | | SOCAR | 50 | |
| 11 | Lenkoran - Talysh | | | Total (operator) | 35 | First well drilled in 2001, giving zero results. The partners preferred to pay \$15 million penalty instead of drilling a second well. Project abandoned in 2003. |
| | | | | SOCAR | 25 | |
| | | | | Wintershall | 30 | |
| | | | | OIEC | 10 | |
| 12 | Mishovdag, Kalameddin, (Karasu Operating Co.) | 9 | | Nations Energy (operator) | 85 | Fields are under a rehabilitation program. Oil production is about 135,000 tpy. |
| 13 | Muradkhanli | | | Ramco (operator) | | Project on this onshore field was abandoned. |
| 14 | Nakhichevan | 110 | 85 | ExxonMobil (operator) | 50 | The first exploratory well was drilled in 2002, failing to prove reserves. The contract requires the drilling of a second well. The second well is expected to be drilled from the DSS-20 semisubmersible when it becomes available after work on the |
| | | | | SOCAR | 50 | |

| | Project Block | Reserves Forecast | | Consortium | Shares, % | Status as of May 2003 |
|----|---|-------------------|----------|------------------------------|-----------|--|
| | | Oil, mmt | Gas, bcm | | | |
| | | | | | | Zafar-Mashal block. |
| 15 | North Abzheron (Ashrafi-Dan Ulduzu) – North Abzheron Operating Co. (NAOC) | 20-40 | some | Amoco (operator) | n/a | Project abandoned after disappointing test well results. |
| 16 | Oguz | 95 | 50 | ExxonMobil (operator) | 50 | The contract requires the drilling of only one exploratory well, completed in 2001. It failed to prove reserves. Exploratory period expired in 2003. In 2002, ExxonMobil said it does not plan to extend the contract. |
| | | | | SOCAR | 50 | |
| 17 | Padar | 50 | | Moncrief Oil (operator) | 64 | Preparations underway for exploratory drilling. |
| | | | | SOCAR | 20 | |
| | | | | ISR Oil | 16 | |
| 18 | Pirsagat | ... | ... | Shengli (Sinopec) - operator | 50 | Rehabilitation, exploration and development contract signed in June 2003. Investment over a 25-year period is expected to be \$140 million. |
| | | | | SOCAR | 50 | |
| 19 | Savalan | 120 | | SOCAR | 50 | A 20% share in the project is yet to be placed. Part of the block is in an area disputed by Iran. |
| | | | | ExxonMobil (operator) | 30 | |
| 20 | Shah-Deniz | 101 | 625 | BP (operator) | 25.5 | Reserves proved by drilling. First stage of development approved in February 2003, including field infrastructure and a pipeline to Turkey. Drilling of wells underway. Deliveries of gas to Turkey expected to begin in 2006. |
| | | | | StatOil | 25.5 | |
| | | | | SOCAR | 10 | |
| | | | | LukAgip | 10 | |
| | | | | OIEC | 10 | |
| | | | | Total | 10 | |
| | | | | TPAO | 9 | |
| 21 | South-West Gobustan (Gobustan Operating Co.) | 30 | 12 | CNPC (operator) | 80 | In March 2003 CNPC completed the buy-in by acquiring its share from Switzerland's Rosco, which is the largest shareholder in A&B Geoscience. At the time of the completion of the deal, A&B Geoscience had started exploratory drilling on the block. Later CNPC increased its stake. The exploratory period expired on 27 November 2003. In early 2004, CNPC said it may drop the block, since seven wells drilled had failed to produce any oil, but later said it will invest about \$15 million in 2004. Drilling will depend on results of seismic exploration and may involve the sinking of four exploratory and eight development wells. |
| | | | | SOCAR | 20 | |
| 22 | Yalama | 150 | | LUKoil (operator) | 80 | Based on the results of exploration, the area of the block was expanded in April 2003. The first exploratory well is to be drilled in |
| | | | | SOCAR | 20 | |

| | Project Block | Reserves Forecast | | Consortium | Shares, % | Status as of May 2003 |
|-----------------------------|---|-------------------|----------|-----------------------|-----------|--|
| | | Oil, mmt | Gas, bcm | | | |
| | | | | | | 2004 by using the DSS-20 (Lider) semisubmersible, but some delay may occur since the rig is used at ExxonMOBil's Zafar-Mashal block, where the first well encountered geological problems. Drilling may begin some time after June 2004. |
| C. UNDER NEGOTIATION | | | | | | |
| 1 | Garachukur | 5.6 | | Shengli (Sinopec) | | The field has been in operation for some time and holds small residual reserves. |
| | | | | Azpetrol | | |
| | | | | Middle East Petrol | | |
| 2 | Binagadineft (Binagadi, Sulu-Tepe, Ateshgekh) | 5 | | Enka Insaat ve Sanayi | | Of the three onshore fields, Binagadi is thought to contain some 5 million tons of residual reserves. Enka reportedly want the oil for a refinery it intends to construct in Turkey. |
| | | | | Azpetrol | | |
| | | | | | | |

Source: *Neft i capital*, May 2003, *FSU Oil and Gas Monitor*, 7 January, 11 and 18 February, 21 April, 19 May, 2 June 2004, *Nezavisimaya Gazeta*, 18 June 2003.

Among the relinquished blocks, SOCAR is particularly interested in the offshore Karabakh and Ashrafi areas. The first step would be to re-evaluate the projects, and if results show that development would be possible, work will first begin on Karabakh. For the time being, SOCAR is looking completing the feasibility studies and at sources of financing of any undertakings on relinquished blocks. In any case, work will not start before 2006 or 2007.³¹

The foreign petroleum industry definitely views Azerbaijan as a country with positive investment climate for upstream operations, even though onshore fields are declining and the offshore zone of Azerbaijan is now seen as less promising in terms of potential for new discoveries than Kazakhstan's offshore zone. However, the fact that 34 international corporations from 16 countries are already working on oil and gas upstream projects in Azerbaijan, and more are either negotiating for rights or are expected to begin operations soon under existing contracts, speaks for itself. Over the next three years, investors are expected to pump over \$10 billion in offshore exploration and development and pipeline projects. At this point, the main task of Azerbaijan is not to just attract investment in the petroleum industry, but to also make the country less vulnerable to the risks involved in oil and gas projects. This can be accomplished by encouraging development of agriculture, transport and other sectors of the economy.³²

Gas

Azerbaijan has proven natural gas reserves in the range of 11-30 trillion cubic feet (Tcf) (depending on the source consulted). However, there is insufficient infrastructure to move associated gas from many of the Caspian offshore oil fields and some of it is being flared. In 1999, Azerbaijan passed a law requiring planning for associated gas exploitation to go with each oil project. In October 1999, SOCAR and USTDA signed a \$425,000 agreement to help fund a comprehensive natural gas study.

At the moment, most of the gas is produced by SOCAR (about 80% of total output). The remainder is produced by AIOC at the Chirag deposit. Total production in the country is forecast at 4.7 bcm for 2004, somewhat lower than the level of 2003 – 5.12 bcm..

The Shah Deniz natural gas field, which was discovered in 1999, is estimated to contain about 625 bcm of gas and 101 million tons of gas condensate, making it the largest find of the last 20 years. The estimated cost for development and infrastructure at Shah Deniz is \$4.5 billion and the first production is expected by 2006. The annual production rate is expected to be 286 billion cubic feet (Bcf). In 2003, EBRD announced that it plans to issue a \$200-million credit to SOCAR to finance its 10% share in the project. The credit agreement as drafted is for \$170 million. At the moment, Phase 1 of the \$3.2 billion development of Shah Deniz is underway, involving a platform from 15 wells, two submerged pipelines of 100 km each from the field to the Sangachal terminal, and the Baku-Tbilisi-Erzurum gas pipeline. During Phase 1, a total of 178 BCM of gas and 34 million tons of condensate are expected to be produced.³³

³¹ FSU Oil and Gas Monitor, 18 February 2004.

³² Ibid., 5 May 2004.

³³ FSU Oil and Gas Monitor, 19 May 2004.

Of the other natural gas fields in Azerbaijan, the Nachivan field is estimated to contain 900 Bcf in reserves. There is also a natural gas reserve at Gunashli.

Oil Shale

Azerbaijan is believed to possess at least 400 million tons of oil shale in the Abzheron, Guba, Ismaili and Shamakhi-Gobustan regions. Deposits have been known since at least the 1940's and 1950's, but until now there has been little need to encourage research and use of this resource. However, deforestation has made the use of wood for cooking and heating less attractive, and the refineries have not produced fuel oil for the power plants for some time now. Shale is therefore now seen as a possible resource from which heavy oil (shale tar) could be produced in specially designed facilities. The tar could in its turn be processed to obtain gas for the eight gas-fired power plants in Azerbaijan that account for almost 80% of the country's generating capacity. Shale and shale tar could also be used in rural areas and small towns for heating and cooking. The Geology Institute is currently working to determine the exact volume of reserves of oil shale and their quality, and eventually promote an informed policy of shale oil utilization in the country³⁴.

4.2.1.3. Production and Consumption

Oil

Overall, crude oil production has been increasing since the late 1990s because of foreign investment and new technologies and in 2003 stood at 15.37 million tons, or 310,000 bpd. Exports were slightly down in 2003 at 8.72 million tons, compared to 8.92 million tons in 2002.³⁵ SOCAR expects crude production to be flat until the commissioning of the ACG expansion in 2005 and the putting of the Baku-Tbilisi-Ceyhan (BTC) pipeline in operation (*cf.* below). A historical summary of petroleum production and consumption in Azerbaijan is shown in Table 4 and Figure 7 (also includes natural gas).

Table 4: Petroleum Production and Consumption in Azerbaijan, 1992-2001 (in thousands of b/d)

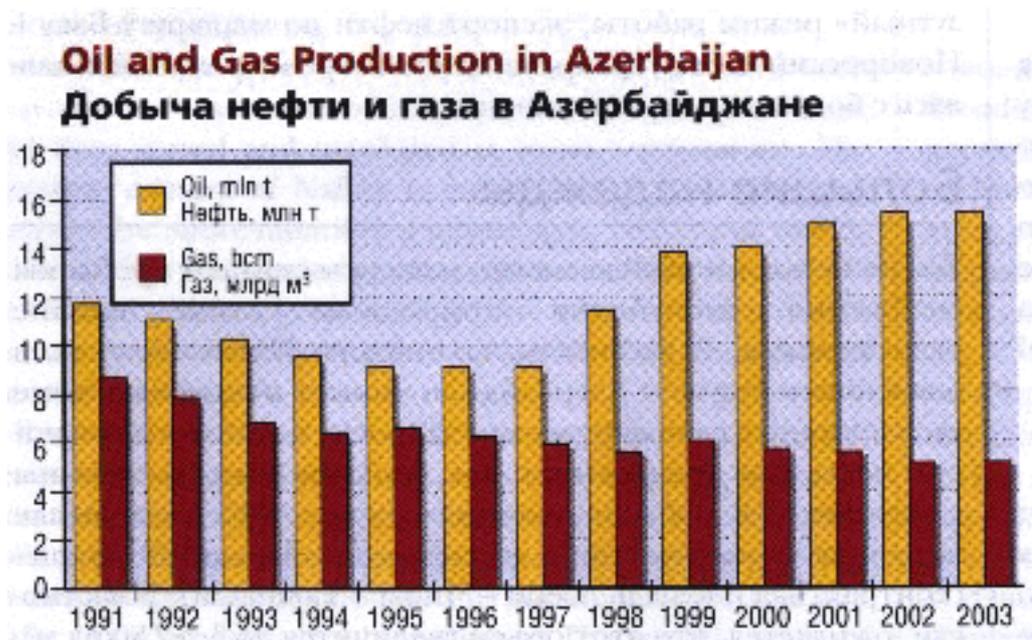
| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|-----------------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| Production (total)* | 222 | 208 | 192 | 182 | 182 | 180 | 237 | 283 | 286 | 307 | 307 | 308 | 154 |
| Production (crude oil only) | 213 | 200 | 184 | 175 | 176 | 173 | 230 | 276 | 280 | 301 | 305 | 306 | 152 |
| Consumption | 203 | 194 | 187 | 179 | 134 | 129 | 146 | 149 | 137 | 140 | 125 | 125 | 64 |

Source: Ministry of Fuel and Energy

³⁴ FSU/CE Power report, 10 March 2004.

³⁵ *Ibid.*, 14 January 2004.

Figure 7: Oil and Gas Production in Azerbaijan in Recent Years.



Source: Oil and Gas Eurasia.

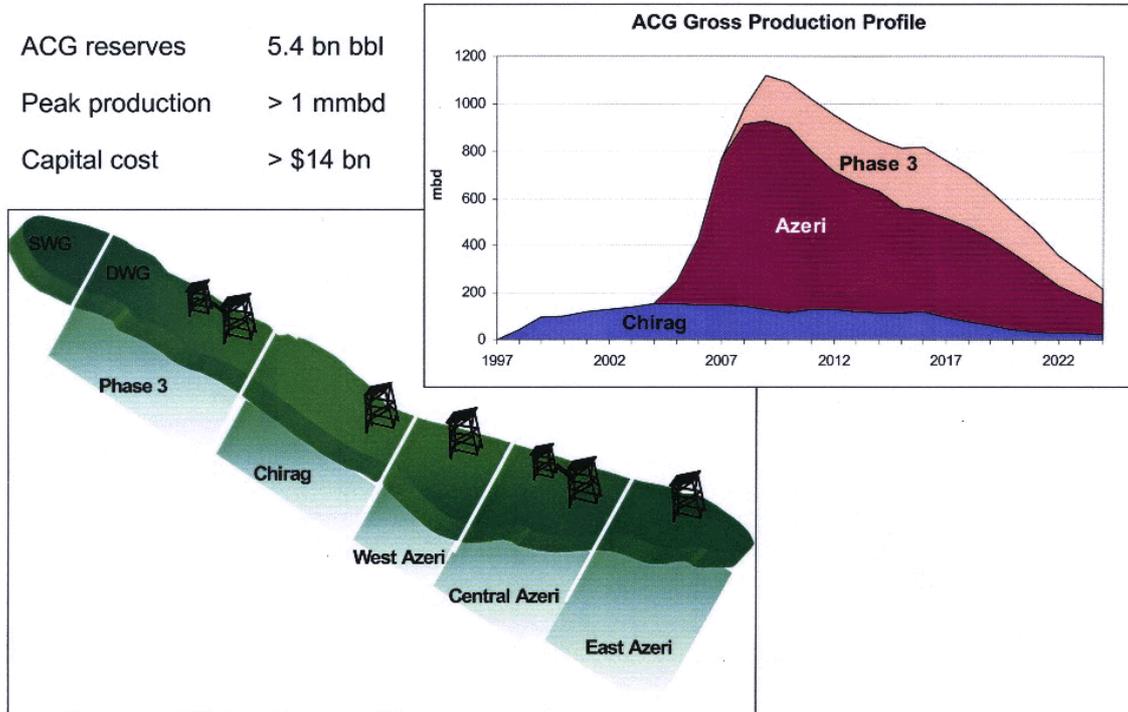
Azerbaijan's plans to increase oil output are mainly related to the "contract of the century" signed with 10 energy companies in 1994. It is a 30-year, \$8 billion that resulted in the formation of the Azerbaijan International Operating Company (AIOC), which began operations under Azerbaijan's first production sharing agreement (PSA) in 1997 under the leadership of BP of the United Kingdom. AIOC has a contract to develop three fields - Azeri, Chirag, and the deepwater portions of Gunashli (ACG). The total estimated reserves of ACG are 700 million tons of oil, 119 billion cubic meters of non-associated gas and 7.8 million tons of condensate.

The AIOC consortium currently produces "early oil" from the Chirag field. In August 2001, the government of Azerbaijan and AIOC signed an agreement to expand ACG by investing \$3.3 billion. This expansion plan is designated "Phase One," and includes a drilling platform for 48 wells, a natural gas compressing facility, an underwater pipeline from the field, and a modernization of the oil terminal. Once its main program is underway, output from ACG is expected to rise significantly. Under the main oil program the central part of the Azeri field is to be developed first ("Phase One Development", to be put onstream in the first half of 2005. Production from the Central Azeri field is then likely to peak at 350-375,000 bpd. After this, the consortium plans to develop the western and eastern sections of the Azeri field, which should begin producing in the second quarter of 2006 and the first quarter of 2007, accordingly ("Phase Two"). Production is expected to add another 350- 420,000 bpd from the two platforms, bringing ACG production to 700,000 bpd or more.

The final stage of AIOC's main oil program ("Phase Three") will involve the development of the deepwater section of the Guneshli field, adding another 300,000

bpd. At full swing, the entire block would thus peak at around 1 million bpd.³⁶ Figure 8 illustrates the development plan and the production profile of ACG.

Figure 8: ACG Development Scheme and Production Profile.



Source: BP.

At the moment, AIOC produces considerable “early oil” from the Chirag-1 stationary platform. AIOC's production in 2003 was 131,000 barrels per day (b/d), i.e. 6.45 million tons. AIOC exports in 2003 constituted 6.2 million tons via the Baku-Supsa pipeline (*cf.* below)³⁷.

In 2003, AIOC’s budget stood at \$2.194 billion. In 2004, AIOC planned to spend \$2.454 billion, including capital expenditure of \$2.364 billion. The target for 2004 is 125,000 bpd, somewhat lower compared to 2003 due to the expected halting of oil production in the third quarter when a modernization project is scheduled to link the Chirag platform by an underwater pipeline.³⁸

In 2003, the ACG project brought to Azerbaijan 8.1 million barrels of profit oil, worth some \$200-220 million. In 2004, AIOC expects profit oil to be about 7.5-7.7 million barrels.³⁹ Lifting cost at the ACG block are in the range of \$6-7 per barrel.⁴⁰ Figure 9 illustrates the expected level of revenue generated by AIOC for the Azerbaijani government.

³⁶ FSU Oil and Gas Monitor, 4 and 18 February 2004.

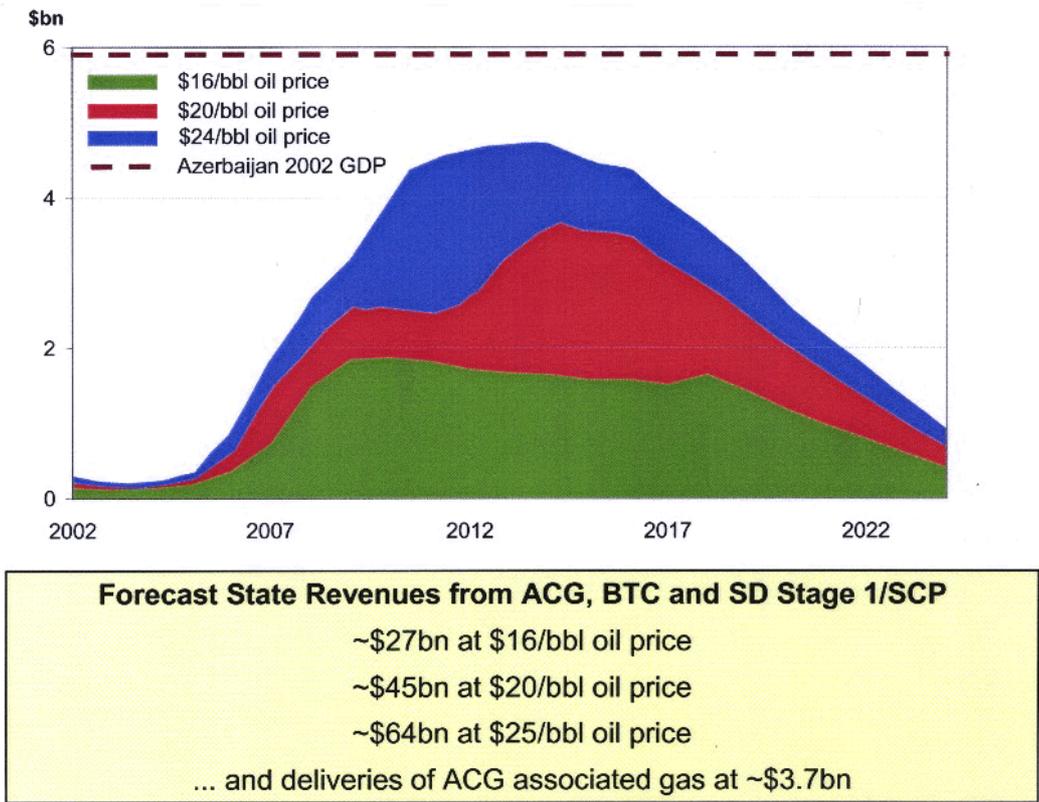
³⁷ Ibid., 21 January 2004.

³⁸ Media Press, 23 December 2003, quoted in FSU Oil and Gas Monitor, 7 January 2004.

³⁹ Ibid. (based on Media Press, 25 December 2003).

⁴⁰ Nezavisimaya Gazeta, 1 April 2003.

Figure 9: Revenue from the AIOC Contract for the Azerbaijani Government



Source: BP.

SOCAR currently produces at a rate of about 9 million tons per year, of which 8 million tons by SOCAR itself onshore and offshore and 1 million tons by three joint ventures and two consortiums consortia set up by SOCAR and foreign companies. SOCAR has 14 oil and gas producing affiliated companies, including seven onshore and six offshore.

SOCAR’s effort is mainly directed to known fields and deposits. In 2004, the company increased its exploratory drilling and will drill only about 3,000 meters, 1,350 meters more than in 2003. SOCAR announced that it has to commit large sums every year to maintain oil production onland and offshore, which hampers the company from expanding exploration. Therefore, the company can afford drilling only 3,000-5,000 meters in exploratory programs per year.⁴¹ On the other hand, SOCAR’s long-term well drilling program for 2004-2010 plans for the drilling of new production wells both onshore and offshore. Under the draft program for comprehensive measures in the fuel and energy sector for the period 2004-2013, 411 new wells will be drilled in 2004-2010 in order to maintain SOCAR’s annual output of oil at about 8.5 million tons and of gas at about 3.5 BCM. SOCAR plans to drill 62 new onshore and offshore wells in 2004 and 56 wells in 2005.⁴²

SOCAR has recently indicated that oil production at all onshore deposits and some offshore deposits is unprofitable, since it does not cover the costs of extraction. The

⁴¹ FSU Oil and Gas Monitor

⁴² FSU oil and Gas Monitor, 31 March 2004.

factors which cause costs of extraction to be high are several: high water cut, high electricity consumption, etc. On average, the extraction of a ton of oil is accompanied by the extraction of 13 tons of water (93% water cut) onshore and 5 tons of water (83% water cut) offshore. Both oil and water are brought to the surface with the help of mainly abyssal pumps. To bring a ton of the mixture to the surface, as much electricity is needed as to produce 14 tons of oil. The maturity of the fields operated by SOCAR causes problems with the recouping of the sizeable outlays needed to keep production going.⁴³

Gas

Over 95% of Azerbaijan's gas production comes from offshore fields, rather than onshore. The Guneshli natural gas field currently accounts for more than 40% of Azerbaijan's natural gas production. It is expected that increased future production will come from the Shah Deniz and AIOC (Azeri, Chirag, Guneshli) fields.

The bulk of production (about 74%) comes for the time being from fields operated by SOCAR. Fields operated by joint ventures produce about 2% and the remainder 24% come from AIOC's Chirag field. Total production is about 5.5 bcm per year. At Chirag, deliveries of gas to the gas network are limited due to the capacity of the connecting line and flaring is expected to continue through 2005 (some 0.25 bcm per year), by which time gas flaring should be eliminated.

Gas production forecast for 2004 stands at 4.8 bcm, or about 45-50% of consumption in the country. SOCAR expects that its own production will remain flat until 2010 and then decline. Increased supplies to SOCAR are to come from its participation on behalf of the government in the ACG and Shah Deniz projects. The Government hopes to double gas production by 2008 compared to 2003, i.e. gas output should reach 10.4 BCM in 2007, approximately matching domestic consumption. The growth would be mainly due to the commissioning of the Shah Deniz gas and condensate deposit in 2006 and the growing output of gas at ACG deposits⁴⁴.

Gas produced onshore is typically used locally without further processing. Gas produced offshore may be delivered to consumers either unprocessed or processed, depending on the location. About 60% of the total production of gas in the country is delivered via high pressure lines to the Azerbaijan Gas Processing Plant located at Karadag.⁴⁵

Almost all of the domestically produced gas (about 98%) is delivered by SOCAR to two other state-owned companies. The national gas utility, Azerigaz, takes about 45% of the output for distribution to residential and industrial users. The rest of the gas is delivered to the Azerbaijani Gas Processing Plant, which, after performing dehydration of natural gas, delivers it to the "Azerigaz" company. Starting from 2004, SOCAR will increase by about 1 BCMY deliveries to the plant to 3.3-3.5 BCMY. The plan has an annual capacity of 6.5 BCM.⁴⁶

⁴³ FSU Oil and Gas Monitor, 3 March 2004.

⁴⁴ FSU Oil and Gas Monitor, 10 December 2003.

⁴⁵ Nasiraddin Tusi Ltd. The Current Status of the Natural Gas Sector. Presentation to a conference, Brussels, 2004.

⁴⁶ FSU Oil and Gas Monitor, 13 August 2003.

In March 2004, AIOC completed a 28 inch gas pipeline that stretches 186 km from the Central Azeri fixed platform to the Sangachal terminal 35 km south of Baku. Also in early 2004, AIOC and SOCAR signed an agreement to build a 5-km gas pipeline (to be completed in late 2004), connecting the Sangachal terminal to the national pipeline system. The line will cost \$13 million and will be completed in September 2004. It will transport associated gas to Azerbaijan's distribution network and will have a capacity of 20-25 million cubic meters per day⁴⁷. The gas is to be pumped at a pressure of 40-41 atm, requiring a pressure regulating station at the junction to the national system, which operates at about 20 atm⁴⁸.

Overall, the two lines will allow gas from AIOC's block to be fed into Azerbaijan's national system, reducing the need to rely on imported natural gas. At present, AIOC is pumping a mixture of crude oil, formation water and associated gas from the Chirag field to the Sangachal terminal; at the terminal, water and gas are separated from the crude. The gas, which is itself a mixture of various gases, needs to be processed at a drying facility (separating heavier components) in order to meet pipeline specifications. However, the gas drying facility is yet under construction, and gas is therefore flared. Once the gas-drying unit is installed, AIOC will be able to separate marketable gas and load it into the new pipeline for delivery to SOCAR.⁴⁹

Most of the natural gas in Azerbaijan is used at power plants that previously burned fuel oil. However, the policy of the government is to switch to natural gas in order to allow SOCAR to make more money by exporting crude oil rather than refining it at the country's two refineries, Azerneftiyag and Azerneftyanajag⁵⁰.

An historical summary of natural gas production and consumption in Azerbaijan is shown in Table 5.

Table 5: Dry Natural Gas Production and Consumption in Azerbaijan, 1992-2001 (in Tcf)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|-------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Production | 0.278 | 0.240 | 0.225 | 0.235 | 0.223 | 0.210 | 0.197 | 0.212 | 0.200 | 0.202 |
| Consumption | 0.400 | 0.388 | 0.332 | 0.318 | 0.328 | 0.323 | 0.197 | 0.212 | 0.200 | 0.237 |

Source: State Committee of Statistics of Azerbaijan

Gas demand in Azerbaijan peaked in the late 80s and in 1991 stood at 13 bcm. The bulk was used for industrial applications (2.8 bcm, about 21%) and power generation (4.4 bcm, 33.9%). The population consumed 3.2 bcm of natural gas, i.e. some 24.6%. Budget financed organizations and public utilities consumed 2.6 bcm or 20%.

In 2002 consumption dropped to about 7.56 bcm. Electricity production accounts for almost half of the total consumption (3.8 bcm or 50.3% of the total demand). Other consumers include: population (2.4 bcm or 31.7%) budget financed organizations and public utilities (0.64 bcm or 8.4%), and industry (0.73 bcm or 9.6%).

⁴⁷ Ibid. 24 March 2004 and 11 February 2004.

⁴⁸ FSU Oil and Gas Monitor, 7 April 2004.

⁴⁹ FSU Oil and Gas Monitor, 24 March 2004.

⁵⁰ FSU Oil and Gas Monitor, 4 February 2004.

In practical terms, gas imported from Russia is almost exclusively used at the two power plants at Ali Bairamly and Mingechavir, while gas produced by SOCAR and AIOC is delivered to customers in the region of Baku and in other regions of the republic.

The Azerbaijan Gas Processing Plant at Karadag uses multistage technology to strip propane, butane and condensate from the rich gas stream fed via two lines connecting offshore fields to the plant. One of the lines leads from the Bahar field and the fields in the Oil Rocks area operated by SOCAR, where a line from ACG delivers gas from the Early Oil project of AIOC. The other line leads from the Bulla-Deniz field to Sangachal, where it receives rich gas streams from other sources⁵¹.

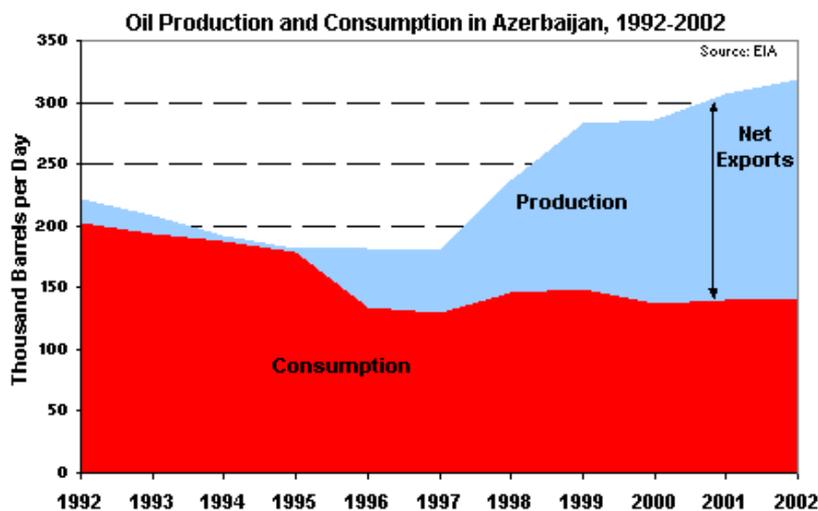
4.2.1.4. Exports and Imports

Oil

In 2003 Azerbaijan's export to other countries of the world amounted to 9.09 million tons of crude oil valued at 1.816 billion USD. That was 0.3 million tons more than in 2002. Besides, in 2003 Azerbaijan delivered 1.86 tons of petroleum products to the world markets, including 252 thousand tons of gasoline worth 59.9 million USD, 11.4 thousand tons of base gasoline worth 2.02 million USD, 122 thousand tons of jet fuel for the value of 26.3 million USD, and 113.3 thousand tons of fuel oil valued at 17.9 million USD, as well as other petroleum products for 7.8 million USD. Gross revenues from exports of crude oil and petroleum products were 2159.92 million USD in 2003.

Exports of crude oil and refined products constitute about 85.4% of total exports in Azerbaijan and about 75% of government budget revenues⁵². Azerbaijan imported minor quantities of oil products in 2003 (about 35,000 tons, worth some \$22 million)⁵³. Figure 10 illustrates oil production and exports over recent years.

Figure 10: Oil Production and Exports



Source: U.S. DOE (EIA).

⁵¹ Nasiraddin Tusi Ltd., op cit.

⁵² Nezavisimaya Gazeta, 1 April 2003.

⁵³ FSU Oil and Gas Monitor, 29 October 2003.

Gas

At present Azerbaijan is a net-importer of natural gas. In 2001 Azerbaijan imported from Russia 3.53 bcm of natural gas, including 3.09 bcm supplied by Itera, with the rest supplied by TransNafta. In 2002 Azerbaijan imported from Russia some 3.9 bcm of natural gas. SOCAR signed with Itera a monopoly contract for the purchase of gas to be supplied via *Shirvanovka-Gadgigabul* gas pipeline at 52 USD per 1000 cm. In 2003 4.1 bcm of natural gas was imported.

In December of 2003 SOCAR and Gazexport (Russia) signed a contract for delivery of natural gas to Azerbaijan through 2008, with volumes to be agreed by the parties on an annual basis. The Agreement envisages delivery of 5.5 bcm of natural gas in 2004 to cover Azerbaijan's import need of gas about 50%, at conditions similar to those of Itera and at the same price (\$52 per 1,000 m³).⁵⁴ However, Gazprom reportedly failed to agree with Itera on the transit of Turkmen gas across Uzbekistan to the Transcaucasian countries, and no other mutually advantageous scheme could be worked out.⁵⁵ Gazprom claimed that there is "lack of vacant gas transporting capacities in Uzbekistan". According to Gazprom, 48 bcm will go in 2004 through Uzbek pipelines, which have barely enough capacity to cope with 46 bcm. Gazprom's new partner, Hungarian Eural TG, will account for 36 bcm of the total, leaving no place for Itera.⁵⁶ As a result Gazexport (Gazprom's export subsidiary) is now in the process of taking over Itera's contracts in the region. In 2004, Gazexport is expected to ship up to 5.5 BCM to Azerbaijan. The gas would be supplied by KazRosGaz, Gazprom's 50/50 joint venture with Kazakhstan's state-owned KazMunaiGaz. The joint venture purchases gas produced at the Karachaganak gas and condensate field in Kazakhstan, processes it at the Orenburg plant in Russia and exports it to CIS and non-CIS countries. In accordance with the agreement between Gazexport and KazRosGaz the latter would deliver to Azerbaijan in 2004 4.5 bcm, while Gazexport would supply 1 bcm.

Shipments of gas to Azerbaijan are limited by the capacity of the main pipeline from Russia. Designed to handle up to 20 BCMY, it is in poor condition and throughput is limited to about 18 million CM per day (about 6.5 BCMY)⁵⁷. Since Azerbaijan produces about 4.7 BCMY and consumes about 9.5-10 BCMY, the import pipeline is currently utilized almost to full capacity.

It is expected that Azerbaijan will become a net exporter of natural gas in the future as the Shah Deniz field is developed. Azerbaijan has signed agreements with Statoil and BP to develop and export natural gas. Azerbaijan could have an annual natural gas production of 400-500 Bcf by 2010, once the infrastructure is in place and flaring of associated gas is eliminated. However, before the development of Shah-Deniz, Azerbaijan is expected to continue importing natural gas over the next few years.

Azerbaijan signed an agreement with Turkey in March 2001, under which it would begin deliveries of natural gas in 2004. However, project delays caused Azerbaijan and Turkey to re-negotiate their agreement in February 2003, and now gas exports to Turkey

⁵⁴ FSU Oil and Gas Monitor, 3 March 2004 based on Media Press 23 December 2003, and 4 February 2004. Other sources (Rossia Neft of 26 March 2004, quoted in FSU Oil and Gas Monitor on 31 March 2004) indicate a price of \$59 per 1,000 CM.

⁵⁵ FSU Oil and Gas Monitor, 4 February 2004, based on Vremya Novostei, 3 February 2004.

⁵⁶ Ibid., 7 January 2004.

⁵⁷ Ibid.

will begin in 2006. The new schedule calls for 71 billion cubic feet (Bcf) to be delivered in 2006, increasing to 222 Bcf in 2009. The gas going to Turkey will most likely come from the Shah Deniz field, as it is developed, with SOCAR supplying the gas produced by the international consortium developing the field. It should be noted that development of the Shah-Deniz deposit, as well as the supply of the gas produced to the international markets falls within an exclusive competence of the operator, identified by the International Consortium of companies participating in the project.

4.2.2. Oil and Gas Pipelines

4.2.2.1 Oil Pipelines

Azerbaijan's importance as a source of petroleum has benefited from the existence of two major transit pipelines leading from Baku to seaports, one to the north across Russia to Novorossiysk (the “northern Pipeline”), and the other one to the west across Georgia to Supsa (the “Western Pipeline”). More yet are in planning and construction phases. A map of the major oil pipelines in Azerbaijan is shown in Figures 11 and 12.

The Northern Pipeline (#1 in Figure 12) connects Baku to Novorossiysk in Russia and has a nominal capacity of 103,000 b/d of crude oil (5 million ton per year), but there have been periods when it could not be used, since it passes through the area of conflict in Chechnya. A by-pass has been constructed to avoid such shut-downs. The Russian pipeline operator Transneft commissioned the 120,000 b/d Chechnya pipeline bypass and restarted operation in December 2000. Further upgrades could boost the capacity of this line to 300,000 bpd (15 million tpy). The main deficiency of the Northern Pipeline is the absence of a “quality bank” and measuring of oil accepted and delivered by weight; thus, suppliers of lighter and sweeter oil (0.14-0.18%) produced in Azerbaijan suffer losses in terms of volume and quality of exported oil, because at the pipeline terminal in the port of Novorossiysk they receive the Russian Urals mixture with a high sulfur content (some 1.3%) and higher density. According to the Platt’s pricing agency, as of 05/10/04 the price of the Azeri Light barrel delivered by the Western Pipeline via Supsa is 9.57 USD higher than that of the Russian Urals shipped from the port of Novorossiysk. Losses of an Azeri oil exporter (7.48 barrels per ton), given the design capacity of the Northern Pipeline (5 million tons per year) would amount to more than 353 million USD. Such is loss attributed to quality difference. Additional losses attributed to density differences would account for 1 million barrels for 5 million tons per year, which (at current Azeri Light prices (as of 05/10/04) of 46.50 USD FOB Supsa) would amount to 46.5 million USD. Total losses would amount to almost 400 million USD a year. According to the SOCAR estimates its 2001 oil sale losses attributed to quality were 40-50 million USD. The company proposed establishment of the “oil quality bank”, so that suppliers were able to receive compensation for quality difference.

The still operational international Treaty Between the Azerbaijani Republic and the Russian Federation on the Transit of Azerbaijani oil through the Territory of Russia, signed on January 18, 1996 for the period of seven years envisaged that SOCAR would pump through the Northern Pipeline some 50 thousand barrels of oil per day at 15.67 USD per ton (some 2.10 USD per barrel). In November of 2003 Russia propose conclusion of a new agreement at the level of governments. The Azerbaijani side did not find it possible to demote the status of the Treaty and did not support the initiative

of the Russian side. As of now, none of the sides utilized its right to denounce the existing Transit Treaty. In 2005 the Azerbaijani side intends to export some 2.7 million tons of oil via the Northern Route. It should be noted that the transit tariff of 15.67 USD per metric ton applies to transportation of the oil in transit across the territory of the Russian Federation, i.e. from the border measuring point at Shirvanovka to board of tanker at the port of Novorossiysk. This tariff does not include the cost of transportation across the territory of Azerbaijan.

The Northern Pipeline is also used occasionally by AIOC as an additional outlet with regard to the Western Pipeline. However, AIOC intends to stop using the route in mid-2005, when the BTC project is due to be commissioned. The use of the Western Pipeline (*cf.* below), on the other hand, is not to be affected by the completion of BTC. Accordingly, SOCAR prefers to extend the agreements with Russia to use the route on an annual basis, rather than enter in a new long-term contract, especially given the fact that it costs \$3 per ton to move oil via the Western Pipeline from Baku to Supsa, compared to \$15.67 from Baku to Novorossiysk. It should be noted that capital and operating costs related to the Western Pipeline are factored into the development costs of Azeri-Chirag-Guneshly deposits. The said costs represent tariffs for oil transit across the territory of Azerbaijan (0.29 USD/bl) and Georgia (0.20 USD/bl) amounting to 3.67 USD per ton. In the first quarter of 2005 (with the start of the Azeri deposit operation) tariff establishment procedure for the Baku-Supsa pipeline will be changed to include the oil pipeline operating costs. Azerbaijan has informed Russia that it will reconsider a long-term deal if it would reduce its shipping costs, but Russia has yet to signal that it would do so. Quite the contrary, there were indications that Russia's long-term deal proposal involved the request to pay taxes for crude shipments and a separate fee for using the port facilities in Novorossiysk (Azerbaijan only pays now the \$15.67 per ton pumping fee)⁵⁸. On the other hand, Russia has flatly rejected the idea to use the pipeline in reverse to feed oil into the BTC pipeline.⁵⁹

The Western Pipeline (#2 in Figure 12) connects Baku to the Georgian port of Supsa on the Black Sea; it is capable of carrying 145,000 b/d and is currently operating near full capacity. AIOC has chosen to transport all of its "early oil" oil via the Western Pipeline instead, because of the higher expenses and the quality problems of the Northern Pipeline, and the Western Pipeline is carrying exclusively AIOC oil. The Georgian International Oil Company, a subsidiary of AIOC, has built a \$550 million oil terminal at Supsa and upgraded the 515-mile pipeline and its six pumping stations (three in Azerbaijan and three in Georgia) and the pressure reduction stations (located in Georgia).

During the first five years since it began operating in 1999, the Western Pipeline has transported over 220 million barrels of oil. A total of 236 tankers have been loaded. For the indicating period it has been loaded 36 tankers with Azerbaijani surplus oil. The pipeline has an ISO 14001 certificate.⁶⁰ Georgian officials have suggested increasing the pipeline capacity to 300,000 b/d to accommodate the expected increases in AIOC's oil volume, but AIOC plans to use the new Baku-Tbilisi-Çeyhan Pipeline once it is

⁵⁸ FSU Oil and Gas Monitor, 11 February and 21 April 2004.

⁵⁹ Oil and Gas Eurasia, May 2004. FSU Oil and Gas Monitor, 14 April 2004.

⁶⁰ FSU Oil and Gas Monitor, 24 March 2004.

completed. Figure 9 illustrates the route and the use of the Western and Northern Pipelines.

In September 2002, there was a groundbreaking ceremony for the \$3 billion 1,730-kilometer Baku-Tbilisi-Çeyhan (BTC) Pipeline (#3 in Figure 12). This pipeline, sometimes referred to as the “Main Export Pipeline” (MEP), will link Baku with the Turkish port of Çeyhan on the Mediterranean Sea via Georgia and will be able to transport about 1 million b/d of Azeri oil to the west. In addition, it could also someday carry Kazakh oil westward, if the proposed Trans-Caspian Pipeline (#5 in Figure 11) is built or plans to utilize tankers to move oil from Kazakhstan to Baku materialize.

The idea to transport Russian oil via the BTC has also been put forward. The suggestion was first made in 2000 by Gia Ghanturia, president of the Georgian International Oil Co. (GIOC), who said that he would like to see a pipeline built from Novorossiysk to Supsa, with a link to BTC. Later GIOC made arrangements with Rosneftegasstroy, a Russian pipeline construction company, on the Novorossiysk-Supsa line, but it was not clear whether and when construction will start. The idea has little support in the industry, since one of the main advantages of the BTC is that it is reserved for higher-quality Caspian oil. Crude oil from Azerbaijan and Kazakhstan is lighter and less sour than Russia’s main export blend, known as Urals. Should BTC be open for crude from Russia, flows would have to be controlled carefully to maintain the quality and the integrity of each shipment. Most likely, this would require the establishment of a quality bank. However, Transneft, the Russian pipeline operator, has been consistently resisting the idea to establish a quality bank inside Russia. Given these considerations, Azerbaijani operators believe that the Novorossiysk-BTC link is an idea that is not likely to have much practical effect on logistical arrangements for Russian and Caspian exports.⁶¹

Current plans call for the BTC Pipeline to begin transporting oil in mid-2005. Investors in the BTC Pipeline include most of the companies who have also invested in AIOC, and it is expected that these BTC investors will fund 30% of the cost of the pipeline as their equity in the project, with the remaining 70% to be financed by the U.S. ExIm Bank, Japan's ExIm Bank, the International Finance Corporation, and the EBRD. In April 2004, the BTC company, operator of the pipeline project, received the first \$1.6 billion tranche from international financial organizations. BTC shareholders have been repaid the \$1 billion that they had invested in the project before credits were received. The remaining \$600 million will be used for company operations until September 2004, when another tranche ranging from \$400 to \$600 million is to be received. The final tranche of up to \$200 million is due in the first quarter of 2005. Project crediting will reach a total of \$2.6 billion.

⁶¹ FSU Oil and Gas Monitor, 25 February 2004.

Figure 11: Western and Northern Pipelines (Source: BP)

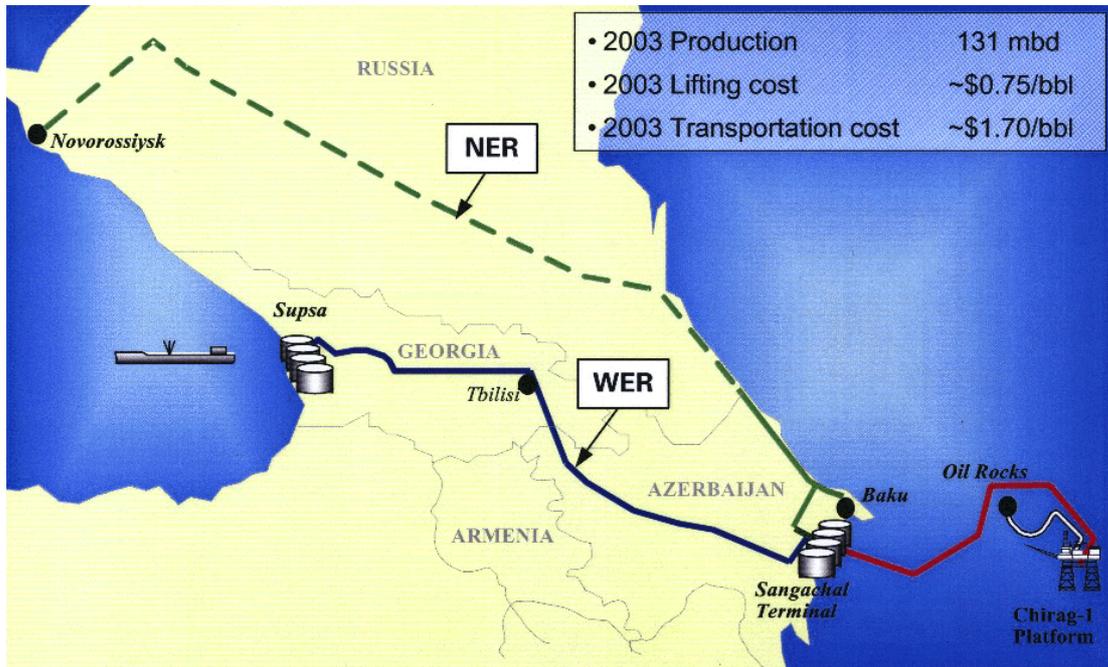


Figure 12: Azerbaijan's Oil Pipelines (Key: 1 - Northern Pipeline; 2 - Western Pipeline; 3 - BTC Pipeline; 4 - Baku-Iran Pipeline; 5 - Trans-Caspian Pipeline) Source: ???



As of April 2004, BTC was complete 60% in Georgia and 50% in Azerbaijan. In Turkey, the aim of the pipeline company (BOTAS) is to complete the construction process on time and at the agreed cost of \$1.4 billion, despite some past delays. Prior the start of the construction, BTC had signed an agreement with BOTAS that it would

construct the 1,076 km section in Turkey for a flat \$1.4 billion. It is expected that the cost of transportation from Baku to Ceyhan will be about \$21 per ton⁶².

In 2003, Azerbaijan, Georgia and Turkey signed a Security Protocol for the East-West Corridor, the route that crude oil and natural gas pipelines will take through the Caucasus to eastern Turkey. This latest intergovernmental agreement between the three countries is meant to provide the foreign companies participating in billion-dollar projects with the assurance that the governments of these states will provide adequate security for the sections of the pipelines that run through their territories. The terms of the Protocol include the actual physical protection of the pipelines, exchange of security information, joint trading and the implementation of anti-terrorist measures. The three states will coordinate their security measures with BP.

At the time of the signing, SOCAR sources indicated that another document is in the works, designed to address concerns related to the rights of any peoples along the routes of the pipelines, as well as concerns raised by NGOs with regard to the construction of the lines. The document had been submitted to the World Bank, the IMF and the EBRD for their consideration⁶³.

Figure 13: Regional Oil Pipeline Projects (existing and under construction)



Source: U.S. DOE (EIA).

⁶² FSU Oil and Gas Monitor, 14 and 21 April 2004, 2 June 2004.

⁶³ FSU Oil and Gas Monitor, 30 July 2003.

Before the BTC Pipeline gathered general support, a 190-mile pipeline from Baku to Tabriz in northwest Iran had been proposed (#4 in Figure 12), which would connect with the existing Iranian pipeline network and feed Iranian refineries located in North Iran. Although advocates of this 200,000 to 400,000 b/d pipeline have claimed it would be cheaper and easier to build than the BTC Pipeline and an international developer (France's Total) had expressed an interest, it is unlikely to be built. Azerbaijan has insisted that Iran first acquiesce on disputed Caspian offshore drilling rights before the matter can even be discussed, but Iran has shown no willingness to do this. Also, the United States is opposed to any pipeline deals involving Iran. As a result, the Iran pipeline proposal is unlikely to find funding sources such as those who have come onboard for constructing the BTC Pipeline.

Analysis of prospects of the use of the Odessa-Brody pipeline (see Figure 12) across the territory of Ukraine is no longer topical for transportation of the Azerbaijani oil, because since September of 2004 this route is used in reverse flow to supply tanker deliveries of the Russian oil from the Uzhny Terminal.

4.2.2.2 Natural Gas Pipelines, Transmission and Storage

Domestic Market

Natural gas is in use in Azerbaijan from 1859. During the Soviet era, an extensive natural gas infrastructure was built in Azerbaijan; this gas transmission and distribution network extends to over 80% of the population and about 85% of cities and villages. There are presently 4,500 kilometers of high pressure transmission lines, 31,000 kilometers of medium and low pressure distribution lines, and seven compressor stations. This network now needs considerable modernization and rehabilitation - because of corrosion, as much as 5% of the gas is lost to leakage. The total losses of the system are currently 15%, including gas not being billed to customers. The World Bank has financed the rehabilitation of the gas regulating and metering stations in the Absheron Peninsula around Baku. New meters with electronic flow calculators were installed in 52 of these stations.

There are several major gas transmission pipelines within Azerbaijan. The most important are the 378-kilometer Gazi-Mammad-Gazakh twin pipelines that carry natural gas westward across Azerbaijan to the city of Gazakh near the Georgia border and 520-kilometer north-south Astara-Shirvanovka pipeline that carries gas from the Iranian border to the Russian border. In 2003, Azerigas completed a gas measuring center at Gazakh, on the border with Georgia, and on the border with Russia. The project is part of an EU INOGATE initiative to rehabilitate the Azerbaijani pipeline networks for gas imports and exports. A similar centre was built earlier at Shirvanovka on the country's border with Russia.⁶⁴

There are five compressor stations (CS), located at Shirvanovka, Siyazan, Gazi Magomed, Agdash and Gazakh. The CS have not been in use since 1994, when deliveries of gas from Russia were interrupted⁶⁵. Azerbaijan's entire system generally operates at a reduced pressure well below design parameters, due to extensive wear and tear.

⁶⁴ FSU Oil and Gas Monitor, 16 July 2003.

⁶⁵ Nasiraddin Tusi Ltd., op.cit.

Azerbaijan has two underground gas storage facilities, located southwest of Baku at Karadagh and Galmaz. Both are derived from depleted gas wells and both are in need of upgrades to increase their storage capacities. Karadagh has a current capacity of about 1 billion cubic meters, but it could hold about 5 billion cubic meters if upgraded. Galmaz also has a current capacity of about 1 billion cubic meters, but it could be upgraded to about 3 billion cubic meters capacity. A map of Azerbaijan's natural gas transmission network is shown in Figure 14.

In May 2002, the Japanese Bank for International Cooperation confirmed its letter of credit for building a 90-kilometer gas pipeline from Karadagh to Digyakh to the Severnaya power plant, which is under construction. Mitsui and its affiliate, Toyo Engineering, are building the pipeline and the power plant. Gas compression facilities are also being built at Karadagh and Severnaya. The Frunze works at Sumsk in Ukraine are building the compression equipment. It is expected that the pipeline and compression facilities will be completed by the end of 2003.

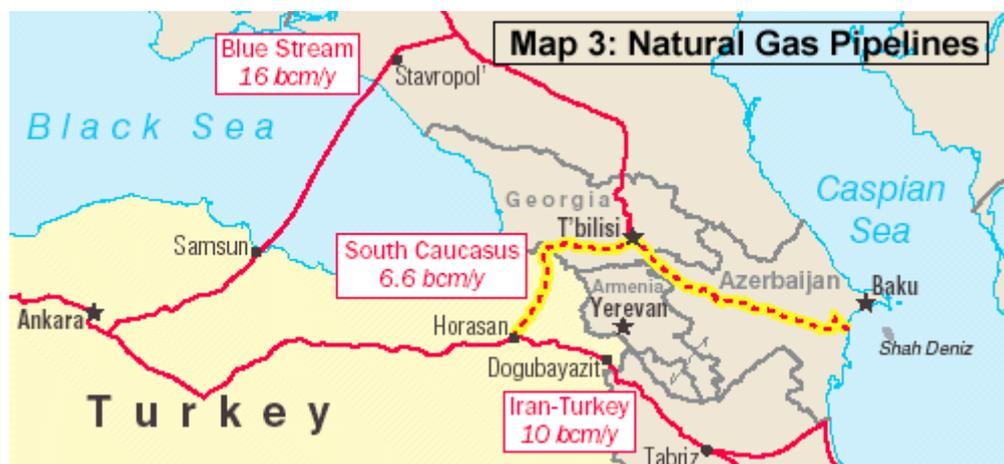
International Markets

The Shah Deniz resource base is what the hopes of Azerbaijan for becoming a net gas exporter are based on. The country is well-positioned to become a reliable supplier to Georgia and Turkey and, in the more distant future, to Europe. BP and its partners plan to begin exports via the South Caucasus Pipeline (SCP, cf. Fig. 13), a conduit that will run from Baku to Erzurum in Turkey in a line parallel to the BTC oil pipeline. At Erzurum, SCP will connect to the gas transmission system of Turkey, which in its turn could be linked to the gas pipeline systems in Southern and Central Europe (cf. Fig. 13).

In early 2003, the Shad Deniz consortium partners sanctioned the first phase of the project, with Statoil taking a leading role in the marketing effort for the project's output of about 8.4 BCM of gas and 2 million tons of condensate.

The 690 km, \$900 million SCP will initially deliver about 2 BCMY from late 2006. Between 2009 and 2018, it will pump annually about 8.4 BCM of gas, of which about 6.6 BCMY to Turkey, 0.3 BCM to Georgia and 1.5 BCM to Azerbaijan itself.

Figure 15: Major Regional Gas Pipelines



Source: U.S. DOE (EIA)

The SCP could be expanded to handle up to 22 BCMY by adding midline compression. Initially, it will operate at 90 bars and deliver gas at 55 bars without compression in Georgia.

Turkey's Botas and Greece's DEPA have already agreed to construct a 285 km line between Karacabey in Turkey, crossing the Sea of Marmara and reaching the Greek border at Ipsala/Kipi. From there, the line will continue to Komotini to link to the Greek system. The pipeline is to cost around \$300 million and is to become operational in 2006. Initial deliveries to Greece will be in the range of 0.5-0.75 bcm per year, but with upgrades and the construction of a link between Greece and Italy deliveries could be increased to 3.5 bcm per year by 2015 and to about 10 bcm per year at a later moment in time. A second five-member consortium headed by OMV of Austria is planning to construct a large diameter gas line between Turkey and Austria that could be operational by 2009 and allow for up to 20 BCMY to be delivered to Central Europe.⁶⁶

Azerbaijan is one of the backers of the proposed Trans-Caspian Gas Pipeline, linking Turkmenbashi, Turkmenistan, to Baku via a pipeline running under the Caspian Sea. From Baku, the pipeline would go to Tbilisi, Georgia, and then to Erzurum in Turkey, where it would link up with the Turkish natural gas pipeline network. It is envisioned that the pipeline would be 1,700 kilometers long and carry about 16 billion cubic meters of natural gas per year. In November 1999, there was a joint declaration by Azerbaijan, Turkey, Georgia, and Turkmenistan supporting the pipeline with Credit Suisse and First Boston appointed as financial advisors for the project. However, financing has not yet been found, and it is not clear whether this proposed pipeline project will proceed.

⁶⁶ IBS Research Energy Line, 10 March 2003. FSU Oil and Gas Monitor, 1 October 2003, 7 January, 31 March, 7 April 2004.

4.2.2.3. Oil and Products Shipping in the Caspian and Transit in Azerbaijan

With the commissioning of the Caspian Pipeline Company (CPC) project linking the main oil fields of Kazakhstan to the port of Novorossiysk on the Black Sea, crude oil produced in Kazakhstan is no more shipped to Azerbaijani ports for further transit in any significant quantities. Most crude oil shipments across the Caspian to Azerbaijani ports originate now in Turkmenistan. Turkmen crude oil is delivered to Baku in small tankers. Over the last few years, such deliveries have been somewhat under 2 million tons per year.

Refined products are shipped to Baku for further transit both from Kazakhstan (the port of Aktau) and Turkmenistan (the port of Turkmenbashi). From Baku, cargoes are usually taken by railroad across Georgia to the Black Sea.

Azerbaijan's existing terminals are the one in Dubendi (capacity 12 million tonnes of oil a year), Azpetrol's facility in Baku (up to 10 million tonnes of oil and products a year) and the recently-built Sangachal terminal of Azpetrol (10 mn tonnes a year); all are consistent with relevant international requirements. In the future, a brand new terminal may be constructed at Sangachal to handle transshipments of oil from Kazakhstan.

The Dubendi marine oil terminal in Azerbaijan is operated by the Middle East Petrol Co. from Dubai. At present the terminal handles about 15,000 tons per month of Turkmen fuel oil, but expects operations to be stepped up to 65,000 tons of fuel oil per month. The oil is then shipped to Georgia via railroad.⁶⁷ Turkmenistan also hoped to export in 2004 20-30,000 tons of diesel fuel per month from the Turkmenbashi Oil Refinery via Azerbaijan and Georgia.⁶⁸ In the second half of 2003, the Middle East Petrol Co. begun talks with ChevronTexaco on the prospects of transshipping crude oil produced at Tengiz in Kazakhstan via Azerbaijan. Volumes were expected to exceed 75,000-80,000 tons monthly. Over the first seven months of 2003, oil and products transit via the Dubendi terminal amounted to over 1.7 million tons (just under 3 million tons extrapolated on a 12-month basis).⁶⁹

The tanker fleet on the Caspian consists mainly of small vessels capable of handling 7-12,000 tons of products, either of a single grade or several grades in different tanks. The fleet is virtually a monopoly of the Caspian Maritime Shipping Co. ("Caspar"), a government-controlled entity of Azerbaijan. The company has a fleet of 33 vessels and has ordered three more in the same class of product carriers, capable of handling simultaneously up to 8 grades of products.

Recently some industry sources have indicated the possibility to increase shipments of crude oil from Kazakhstan by tankers from the port of Aktau to Baku, where deliveries would be fed into the BTC pipeline. Alegratrans, an affiliate of the U.K.-based Greenoak, stated its intention to build by 2006 three 60,000-ton tankers at the Krasnyie Barriky shipyard in Astrakhan. Alegratrans believes it could take up to 20

⁶⁷ FSU Oil and Gas Monitor, 29 October 2003.

⁶⁸ Ibid., 13 August 2003.

⁶⁹ Ibid.

million tons of crude oil by tankers across the Caspian to the BTC pipeline. However, Caspar sources indicate that large tankers will necessitate the deepening of the shipping channels in the vicinity of the ports and the construction of new terminals, as well as increase the risks of large-scale spillage and damage to the environment. Caspar believes that the tankers in the 7-12,000 tons product carrier class with a draft of up to 7-8 meters are best suited for the Caspian. The management of the port of Aktau in Kazakhstan also seems to have voiced concerns regarding plans to ship large quantities of crude across the Caspian.⁷⁰ Earlier, sources in Kazakhstan have indicated that the option of constructing an underwater pipeline from Aktau to Azerbaijan has been considered, along with other options. Such a pipeline would have a capacity of around 20 million tons per year and feed oil into the BTC line. Regardless of which option may be chosen (tankers or underwater pipeline), the project will involve the construction of a pipeline from the fields in Kazakhstan to Aktau, and the feasibility of such an undertaking is still under consideration⁷¹.

In late 2003, sources in Kazakhstan indicated that an agreement may soon be reached with Azerbaijan on the terms under which Kazakhstani producers may use the BTC. At the same time, the sources indicated that the technical aspects of the transportation agreements will be worked out at a later time. The sources indicated that Azerbaijan and Kazakhstan are conducting a dialogue with the aim of establishing favourable conditions for producers interested in moving crude from Kazakhstani offshore fields to market via the BTC line, and that the dialogue is progressing in a very constructive fashion. Under this framework, no direct link between BTC and the fields in Kazakhstan would be available; oil would rather be loaded on tankers at Aktau and shipped to a terminal located near Baku. The sources indicated that the Government of Kazakhstan is taking steps to facilitate the deal and wants to build a fleet of tankers for the purpose; media sources reported that the tankers are already under construction in a neighbouring country. In early 2004, sources in Kazakhstan indicated that the country will be able to access the BTC line on the same most favourable tariff terms as BTC shareholders⁷²

In the same context, SOCAR, the shareholders in the BTC Co. and KazMunaiGaz held talks in late 2003. The idea to bring oil into the BTC from offshore fields in Kazakhstan has been linked to the construction of an oil terminal at the Kuryk port (50-75 km southeast from Aktau), to which pipelines will be connected in Kazakhstan. The ultimate capacity of the terminal would be 20 million tons per year. However, at the first stage of the project only up to 7.5 million tons would be handled, to be shipped from the terminal by tankers to Baku. The requisite infrastructure should be constructed by 2006, when the Kashagan field in Kazakhstan is expected to produce its first oil. Later on, a pipeline may be constructed across the Caspian.⁷³ At the moment Aktau is the only international port in Kazakhstan. In 2002, it loaded 5.55 million tons of oil and petrochemicals, and in 2003 – about 6 million tons.⁷⁴

⁷⁰ Nezavisimaya Gazeta, 11 June 2003.

⁷¹ FSU Oil and Gas Monitor, 24 September 2003.

⁷² FSU Oil and Gas Monitor, 15 October 2003, 17 March 2004..

⁷³ Ibid.

⁷⁴ Ibid., 10 September 2003.

Azerbaijan has also considered using the Azerneftyanajag refinery terminal to receive oil from Kazakhstan for processing at the SOCAR refineries. The terminal is intended to load tankers with products and provide bunker services and is unable to unload either crude oil or products. After assessing the required investment for the project, SOCAR decided in late 2003 to abandon it.⁷⁵

In the interim before the commissioning of the BTC in 2005, Iran has stepped in and offered swap agreements to companies producing oil in Russia, Kazakhstan and Turkmenistan. A pipeline between the port on Neka in Iran and Tehran is used to feed crude oil to the Tehran and Tabriz refineries with combined capacity of 350,000 bpd. Equivalent quantities of Iranian crude are then shipped out of Iran's ports on the Persian Gulf for export on the Caspian producers' behalf.

Swap quantities are limited to the capacity of the Neka port. In late 2003, Iran announced its intentions to boost the capacity of the Neka-Tehran pipeline by 70,000 bpd by expanding the port capacity to 170,000 bpd. In early 2004, the project was commissioned and at the same time further expansion began ("stage two") targeting a throughput of 380,000 bpd, with a possible further increase to 500,000 bpd, also involving minor upgrades on the two Iranian refineries. The second phase upgrade to about 380,000 bpd can easily be achieved by installing additional pumping capacity on the 32-inch pipeline from Neka to the Tehran refinery.

The Neka swap is at the moment operating at near-full capacity (about 120,000 bpd). Most of the crude in the swap is Siberian Light shipped from Astrakhan in Russia (40-50,000 bpd). Kazakh oil from a variety of fields including North Buzachi comes in a close second (40-50,000 bpd), and Turkmen oil from the Cheleken field is third (about 20,000 bpd). The scheme is used by Dragon Oil in Turkmenistan, Russia's LUKoil and a number of small producers in the region. The swap avoids Russia's busy pipelines and has the added bonus of facilitating exports eastwards to Asian markets. The latest customer to emerge is China's CNPC, which announced its intention to swap oil produced at its North Buzachi field in Kazakhstan. Cargoes will get mixed at Neka to a blend that will match Iranian Light⁷⁶.

Swapper pay a fee to Iran of about \$2 per barrel, which for the time being, when the BTC is still under construction, is about \$1 per barrel less if compared to the cost of shipping oil by rail via Azerbaijan. Besides, the rail connection from Azerbaijan to Georgia has a limited capacity of about 200,000 bpd⁷⁷.

Using the Iranian swap to levels exceeding the current one will require additional shipping capacity in larger tankers. The Neka port upgrades will include five new berths. The National Iranian Tanker Co. is participating in a joint venture that intends to build six new Panamax 60,000-ton tankers, three at Astrakhan and three at a new shipyard (presently under construction) at Neka. The tankers will use state-of-the-art Norwegian technology for offshore loading and unloading of tankers through pipes and valves that rest on the seabed when not in use. The technology was first used by LUKoil in Arctic waters and is particularly suitable for the North Caspian shallow

⁷⁵ Ibid., 3 September 2003.

⁷⁶ Ibid., 3 September 2004, Platt's Oilgram News, 1 March 2004, Upstream, 20 May 2004.

⁷⁷ Upstream, 20 May 2004.

waters. The tankers are intended to bring Russian and Kazakh oil to Neka, but industry sources indicated that a second batch of six vessels of the same type will bring oil from Aktau in Kazakhstan to Azerbaijan when the yet-to-be-developed Kashagan field comes onstream⁷⁸.

However, the future of the Iranian swaps is not entirely clear: first, Kazakhstan and China agreed to build an oil pipeline; second, CPC is now fully functional and could be expanded; third, once operational, BTC may offer better terms for companies that otherwise would use swap via Iran. Kazakhstan, in particular, has considered an intergovernmental accord with Azerbaijan that would reserve about 20-40% in BTC's capacity of 1 million bpd for Kazakhstan, primarily in conjunction with the development of the Kashagan field.⁷⁹ The agreement was initialled in October 2003 and allows as much as 400,000 bpd of oil from Kazakhstan to be shipped via the BTC. The project requires new large oil terminals in both countries and an expansion of Kazakhstan's tanker fleet. Apart from the port of Aktau in Kazakhstan, which currently has a capacity of 8 million tons per year, a new facility is planned about 50 km to the south of at Kuryk, some 50 km south of Aktau, capable of handling 16-20 million tpy. Upstream operators and BTC shareholders are also expected to take part in the negotiations.

The Government of Azerbaijan is working to provide clear signals to businesses about the advantages of transit across the country. A working group has been set up by SOCAR and KazMunaiGaz to prepare the accord, which will contain the legal arrangements for the transshipment of oil between the two countries and export via BTC. The deal enhances the proposed East-West Energy Corridor between the Caspian and the Mediterranean.⁸⁰

The railroad between Baku and Batumi has been used since 1996 to transit Kazakhstani oil under an agreement with Chevron (now ChevronTexaco). The crude was shipped out of Aktau to a terminal near Baku, where it was loaded into a pipeline, then delivered to a rail facility, loaded on tankcars and sent to Batumi⁸¹. The same railroad is also used for transit shipments of products. In the past, the use of the port of Batumi for transit operations have been subject to some concern over the situation in Adjara, and transit has had to be diverted to the port of Poti instead. However, Poti's facilities have a limited capacity and the port authorities have asked during such periods of overloading to redirect fuel oil deliveries via other routes⁸².

Azerbaijan and Georgia plan to cut rates for oil and oil product transit from Kazakhstan and Turkmenistan, in the hope of bigger supplies. It costs \$32 per ton (about 4.30-4.50 per barrel) to carry a ton of crude oil or refined products from the Caspian (Aktau) to the Black Sea (Batumi) by railroad (existing pipelines are used to capacity by Azerbaijani operators). On average, 9 million tons of oil and products cross by railroad Azerbaijan and Georgia from Kazakhstan and Turkmenistan, of which about 3.5 million tons from Kazakhstan. Products shipments are about 4

⁷⁸ Platts' Oilgram News, 1 March 2004.

⁷⁹ FSU Oil and Gas Monitor, 10 September 2003.

⁸⁰ Ibid.

⁸¹ Ibid., 25 February 2004.

⁸² Ibid, 17 March 2004.

million tpy, and the remainder crude oil. All of the products shipped by railroad from Baku to Batumi are handled by Azertrans, a subsidiary of Azerpetrol set up in 2000. The tariff reduction would be in the range of \$2 per ton by all types of ports, terminals and railroads.⁸³

On the other hand, however, Georgia had earlier in 2004 announced a decision to raise tariffs, boosting them to \$6 per ton of crude and \$8 per ton of products (about \$0.80-\$1.00 per barrel). Georgia indicated this rise would bring tariffs closer in line with international norms. Following Georgia's move, the Transport Ministry in Azerbaijan also asked for tariff increases, but the Ministry of Economic Development did not approve the request. Georgian and Azerbaijani officials met later to discuss tariff and transit policies.⁸⁴ During the discussions, a decision was made to reduce the tariffs by at least \$2 per ton instead of increasing them. Azerbaijan and Georgia agreed on a policy to keep tariffs on a level that would make transit via the Baku-Batumi route more competitive as compared to alternative routes across Iran and Russia. The two sides also discussed ways to boost transit along the route from the current level of about 180,000 bpd (9 million tpy) by 100-200%. At the moment when these decisions were taken, the breakdown of the cost of transportation included a \$4 per ton charge of unloading and transshipment cost at Dubendi and Baku, \$5 per ton charge for crude oil transportation by rail in Azerbaijan (\$6-8 per ton for products), \$5 per ton charge for crude oil transportation by rail in Georgia (\$6-7 per ton for products), and \$6 per ton tanker loading cost at Batumi. The total was thus \$20 per ton for crude oil (of which \$9 in Azerbaijan) and \$22-25 per ton for refined products (of which \$10-12 in Azerbaijan).⁸⁵

4.2.3. Oil Refining, Storage, Distribution

There are two refineries in Azerbaijan, both located in the vicinity of Baku, owned and operated by SOCAR (Azneftiyag and Oil refinery plant of Baku named after Geydar Aliev). Installed capacity is around 22 million tons per year, but refinery runs have been much lower than that and over the last few years have been around 6.5 million tons per year. The bigger of the two refineries (Azneftiyag) has an installed capacity about 14 million tons per year, and the other one (Azneftyanajag) has a nameplate capacity of 10 million tons per year. Over the last few years, runs at each refinery have been 3-3.5 million tons per year. Oil is exclusively supplied by SOCAR out of its own crude oil production, which is in the range of 9 million tons per year. SOCAR is therefore looking for ways to increase load factors at the refineries and has evaluated options for processing oil from Kazakhstan and Turkmenistan. Test runs will have to be conducted with lots of oil from other countries to determine whether the quality of the oil is suitable for the refineries in Azerbaijan.⁸⁶

International financial institutions have encouraged Azerbaijan to stop subsidizing domestic crude oil and refined products prices and to bring them more in line with world market prices. The Azerbaijani government has pledged continuing co-operating with the IMF on the issue. While there is for the time being no commitment

⁸³ Ibid.

⁸⁴ Ibid., 25 February 2004.

⁸⁵ Ibid., 17 March 2004.

⁸⁶ FSU Oil and Gas Monitor, 1 October 2003.

to follow on all of IMF's recommendations on the matter, there are also no serious differences with the IMF on domestic fuel pricing policies and discussions between the parties will go on. Prices are expected to be increased over the next few years, although not above levels that the government considers affordable for workers. Besides, price hikes may be limited to light-end products such as gasoline and diesel fuel, since raising prices to fuels that are an input to industrial processes (such as fuel oil for power plants and benzene for petrochemicals) may hurt the competitiveness of the Azerbaijani economy and reduce the living standards of its citizens.

Initially the price hikes was scheduled for the start of 2004, as the Government of Azerbaijan and the World Bank planned to work out by that time a mechanism to dampen the social consequences of price rises. Working out of the mechanism turned out to take more time. The IMF has supported a quarterly price adjustment scheme with an up to 10% quarterly price increases, in the belief that price fluctuations of this scale will not cause serious problems in Azerbaijan. The government, on the other hand, will not revise excise duties on petroleum products in the course of their wholesale price adjustment. The IMF said in March 2004 it will not disburse the next \$18 million tranche of its poverty alleviation programme unless the government clearly commits to raising domestic fuel prices to world levels. So far, the IMF has released \$62 million from the \$119 million credit⁸⁷.

Output of LPG in Azerbaijan in 2003 was about 150,000 tons (extrapolated from a 1H basis of 74,400 tons), with the local market absorbing about 85-90% of the produced LPG.⁸⁸ LPG is used as motor and household fuel and both its output and consumption are growing at a fast rate (by about 35-40% in 2003 over 2002). When demand peaks during the summer at more than 12,000 tons per month, Azerbaijan has had to halt LPG exports, most of which are directed to Georgia.

On a half-year basis, sales of gasoline in Azerbaijan in 2003 were about 458,000 tons (198,500 tons in 1H), exceeding 2002 demand by 13.1%. Diesel fuel sales were meanwhile up by about 2.5% to 520,000 tons (227,100 tons in 1H). Fuel oil sales rose by 44% in 2003 as compared to 2002 to 2.4 million tons (1.1 million tons in 1H). Total refined products demand in 2003 was thus about 4.4 million tons, dominated by fuel oil (about 54% of total).⁸⁹

The main distributor of refined products in Azerbaijan is Azpetrol.

Azpetrol has a fleet of 600 rail tank cars and 76 tank trucks used to bring products to gas stations. It also has five LPG trucks. In early 2004, Azpetrol announced its intention to buy an extra 400 rail tank cars to transport petroleum and refined products. Azpetrol said that the tank cars will be purchased with an International Bank of Azerbaijan credit, issued by the Black Sea Bank for Trade and development under the Merchant Development program. The four-year credit will be worth \$4 million and will carry an interest of LIBOR +4%⁹⁰.

⁸⁷ FSU Oil and Gas Monitor, 19 November 2003, 2 June 2004, 31 March 2004.

⁸⁸ Ibid., 27 August 2003.

⁸⁹ Ibid., also 3 September 2003.

⁹⁰ Ibid., 18 February 2004.

4.2.4. Natural Gas Distribution and Utilization

Natural gas transport, storage and distribution at the moment is a monopoly run by the government-owned company Azerigaz. The objective is to secure gas supplies to almost 100% of the cities, towns and villages (at the moment, there are some 840,000 customers). Azerigaz handles about 10 billion cubic meters (bcm) per year, including about 5.5 bcm of imported gas from Russia. Peak consumption is about 18-20 million m³ during the summer and 30-32 million m³ during the winter per day. The domestic supplier is SOCAR, which in addition to its own production also takes gas produced by AIOC. In the future, SOCAR will also take gas produced by other upstream operators under the gas terms of their PSAs. However, transport of gas from the Shah Deniz field to foreign markets will be operated by the members of the upstream consortium, who established the Azerbaijan Gas Supply Co., independently from the domestic market transportation and distribution network.

For the moment, domestic gas is mostly associated and has to be first processed at the Karadagh gas processing plant. SOCAR then sells the gas to Azerigaz, which in turn transports it and re-sells it to residential and industrial customers. On the other hand, Azerenergy takes direct delivery from foreign suppliers (Gazprom) at its power plants, with Azerigaz acting as transporter only. Azerigaz also sells some domestically produced gas to Azerenergy.

The tariff council at the Ministry of Economic Development is responsible for setting gas tariffs. Azerigaz purchases gas from SOCAR at 75,520 Manat per 1000 m³ (VAT included) and resells it to users at fixed prices that are not differentiated for location. There are altogether six groups of such users. For example, the tariff is set at (all quotes with VAT included): 35,560 Manat for residential customers; 106,301 Manat for customers funded by the state budget; 236,000 Manat for commercial and industrial customers; 194,000 Manat for domestic gas sold to Azerenergy.

The tariffs for residential customers are three times below actual cost; entities funded from the budget also pay for gas less than its cost. An additional problem is the transportation tariff for imported gas used by Azerenergy, set at 1,407 Manat per 1000 m³ per 100 km, much less than actual cost. The problem is compounded by the fact that about 60% of consumption is by residential customers and results in the need to extend budget subsidies to Azerigaz, which in turn refunds SOCAR.

The possibility of extending long-term management contract over the Azerbaijani gas distribution networks to private companies is under consideration. The issue has been somewhat delayed by the privatisation of the Azerbaijani Gas Processing Plant. The Government intends to privatize the plant together with other segments of the industry. However, before privatisation could be done, the issue of wholesale gas pricing in the country would have to be dealt with. At the moment, gas prices and tariffs are set by the government.⁹¹ The Ministry of Economic Development, which is the owner of Azerigaz's assets, intends to develop a privatization programme for the sector.

⁹¹ Ibid., 1 October 2004.

The existing high pressure pipelines serving the domestic market are designed to operate at 55 bar and are sufficient to handle current volumes of consumption. Their status, however, is difficult to assess in full, since no inspection has been carried out, except on the Shirvanovka-Syazan section of the main pipeline used to import gas from Russia. This section operates at about 35 bar, with the pressure in the rest of the high pressure system rarely exceeding 20 bar. When the South Caucasus Pipeline comes into full operation, there will be need to construct a pressure reduction station at its junction to the domestic pipeline system, since SCP is designed to operate at 90 bar.

The underground gas storage facilities are in need of rehabilitation (particularly the compressor stations), especially if the increased domestic production and consumption are taken into account. Available storage capacity is seasonal (one injection-withdrawal cycle per year) and is about 1.2 bcm active gas, well above the current need for storage (about 0.8 bcm per year). Deliverability is up to 7-8 million m³ per day from the site located at Karadagh (12-14 wells, 30 km from Baku) and another site located some 80 km from Baku (80 wells). Expected increase of production, exports and consumption call for more storage capacity, possibly as much as 3-5 bcm per year.

There is only one compressor station (CS) serving the domestic gas transportation and distribution system, located at Kazi Magomet. The CS at the gas storage sites are intended for injection only. There is also a small CS that serves the Shimal TPP by delivering gas from the Karadagh gas processing plant.

The low pressure distribution net needs considerable upgrades. The current policy is to first enter into management contracts similar to those for the power distribution networks, and let the private operators evaluate the need of upgrades and propose particular steps.

4.2.5. Oil and Gas Exports and Imports

It is expected that in 2004 oil exports of SOCAR would amount to 2.5 million tons, and together with the commercially transported oil (according to AMOK data), some 8 million tons; petroleum product exports would amount to some 2 million tons. The main exporters oil and oil products are SOCAR's marketing and economic operations department (about 75% of exports) and SOCAR's Azerneftiyag refinery (about 25% of exports).⁹²

4.2.6. Energy Services and Diversification Plans

Azerbaijan's long history as petroleum producing country has been associated with the development of petroleum-related services and equipment manufacturing industries. The largest such company, known as Azneftekimyamash (ANKM), accounts for about 70% of all oil and gas production, workover and service equipment produced in Azerbaijan. The company exports to 35 countries outside the FSU and

⁹² Ibid., 7 April 2004.

also supplies equipment to oil-producing regions throughout the FSU. ANKM includes 14 plants and four R&D institutes.

The quality of ANKM's output has improved significantly over the recent years. Five of ANKM's plants have received API and ISO-9001 quality certification. Two of its R&D units (Azinmash Institute and Neftemash Construction Bureau) have also received ISO-9001 certificates. Equipment for quality testing and control has been procured from Japan and personnel has been trained to work in accordance to international standards. Management has also been improved and now includes a marketing department in the head office and each of the main industrial divisions.

ANKM cooperates with Russian enterprises within the framework of intergovernmental agreements between Baku and Moscow. Partners in Russia include the Kurgan locomotive plant for building and installing drilling and repair rigs capable of lifting up to 125 tons, Perm-based enterprises that make engines, and possibly Russelprom to jointly produce pumping and compression equipment. ANKM's plants now operate in accordance with Russian safety and environmental standards. ANKM plans to set up a network of service bases in oil-producing regions of Russia.⁹³

Upstream activities will be supported by the services of a core sample storage facility and oil bank. The facility has already signed a contract with BP to obtain cores from every deposit in Azerbaijan operated by that company. The oil bank will store samples from all of Azerbaijan's 78 deposits. The core storage and oil bank will operate by using Azlab's facilities.⁹⁴

In early 2004, the Geology Institute of Azerbaijan's Academy of Sciences signed a collaborative research agreement with Utah University's Energy and Geology Research Institute (EGI), joining several Russian and Kazakhstani research organizations to undertake a regional petroleum systems research project at EGI, focusing on the Central Caspian. The project, supported by about 10 petroleum companies, will run for an year and will result in the collection and analyses of oil, gas-condensate and rock samples and the development of a standard biostratigraphic zonation. The project may help adjust the estimates of the petroleum potential of the Caspian, which vary wildly – from between 17 and 33 billion barrels in proven reserves according to the U.S. EIA to 100 and even 200 billion barrels in the opinion of some more enthusiastic sources⁹⁵.

The exploration activity in the Caspian has turned out to be a slower process than expected, owing to a shortage of drilling rigs, among other things. For example, in mid-2004 the only new exploration project underway in Azerbaijan's sector of the Caspian was the first well at Zafar-Mashal drilled by ExxonMobil. In October, when the DSS-20 (Lider) rig is expected to reach its target at 6,800 meters depth, the rig is to be turned over to LUKoil for drilling on its Yalama-D222 block.⁹⁶

⁹³ FSU Oil and Gas Monitor, 14 April 2004.

⁹⁴ Ibid.

⁹⁵ Ibid., 31 March 2004.

⁹⁶ Ibid., 2 June 2004.

4.3. Coal

Azerbaijan has no significant deposits of coal, and currently no coal production. Azerbaijan's coal consumption has decreased since the early 1990s, as its use has been displaced by other fuels. An historical summary of coal production and consumption in Azerbaijan is shown in Table 6.

Table 6: Coal Production and Consumption in Azerbaijan, 1992-2001 (in millions of short tons)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|-------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| Production | n/a |
| <i>Anthracite</i> | <i>n/a</i> |
| <i>Bituminous</i> | <i>n/a</i> |
| <i>Lignite</i> | <i>n/a</i> |
| Consumption | 0.16 | 0.00 | 0.04 | 0.00 | 0.01 | 0.01 | 0.01 | 0.00 | 0.00 | 0.00 |

Source: ??

4.4. Electricity

4.4.1. Power Sector Overview, Generation Capacity

Until 2002, the state-owned company Azerenergy acted as a vertically integrated monopoly in generation, transmission, distribution and sale of electricity. In 2002, two separate distribution companies were established, one covering the regions of Abzheron-Baku and the northern regions, and the other the remainder of the country. Subsequently, the operational management of these two distribution companies was transferred to private investors – Barmek (Turkey) and Bayva (Azerbaijan). In the region of Nachichevan, an integrated structure continues to exist. Azerenergy continues to own and operate the generation and transmission assets.

The state-owned company Azerenergy has a monopoly on power generation in Azerbaijan. Currently, it operates eight thermal plants (TPPs) and six hydropower plants (HPPs). Most of the generating capacity is thermal (Table 6). These generating plants have a total installed capacity of about 5.1 GW and turn out some 21 billion kWh per year, which should be sufficient to cover domestic demand, which has hovered around 22 billion kWh per year

There has been a relatively flat trend for Azerbaijan's installed electricity generating capacity, with slight increases in hydroelectric capacity offset by decreases in thermal-electric capacity. An historical summary of installed electricity generating capacity in Azerbaijan is shown in Table 7. Nameplate capacity of power plants is listed in Table 8.

Table 7: Installed Electricity Generation Capacity in Azerbaijan, 1992-2001 (in GWe)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|-----------------------------------|------|------|------|------|------|------|------|------|------|------|
| Hydroelectric | 0.77 | 0.77 | 0.77 | 0.78 | 0.70 | 0.69 | 0.68 | 0.79 | 0.95 | 0.95 |
| Nuclear | n/a |
| Geothermal/Solar/ Wind/Biomass | n/a |
| Conventional Thermal | 4.40 | 4.40 | 4.41 | 4.46 | 4.46 | 3.91 | 3.91 | 3.88 | 3.84 | 4.19 |
| Total Capacity | 5.17 | 5.17 | 5.18 | 5.24 | 5.15 | 4.60 | 4.59 | 4.67 | 4.79 | 5.14 |

n/a - not applicable Note: 1 GWe = 1,000 MWe; components may not add to total due to rounding.

Source: DOE/EIA

Table 8: Installed Capacity of Power Plants

| ## | Power Station | Year Built | Capacity per units (MW) | Number of units | Capacity MW | Type |
|----|----------------------------------|------------|-------------------------|-----------------|-------------|---------|
| 1 | Mingechavir | 1955 | 60 | 6 | 360 | Hydro |
| 2 | Shamkirkaya | 1981 | 190 | 2 | 380 | Hydro |
| 3 | Araz | 1971 | 11 | 2 | 22 | Hydro |
| 4 | Enikendskaya | 2002 | 37.5 | 4 | 150 | Hydro |
| 5 | Ter-ter | 1977 | 25 | 2 | 50 | Hydro |
| 6 | Azerbaijan | 1981 | 300 | 8 | 2,400 | Thermal |
| 7 | Ali Bayramli | 1962 | 150 | 7 | 1,050 | Thermal |
| 8 | Shimal (Conventional Thermal) | 1954 | 150 | 1 | 150 | Thermal |
| 9 | Shimal (steam-gas turbine) | 2002 | 400 | 1 | 400 | Thermal |
| 10 | Baku (Conventional Thermal) | 1928 | 40 | 2 | shutdown | Thermal |
| 11 | Baku 1(steam-gas turbine) | 2002 | 53 | 2 | 106 | Thermal |
| 12 | Baku 2 | 1952 | 6 | 3 | 18 | Thermal |
| 13 | Sumgait 1 (Conventional Thermal) | 1952 | 50 | 4 | shutdown | Thermal |
| 14 | Sumgait 2 (Conventional Thermal) | 1966 | 50/60 | 2/2 | shutdown | Thermal |
| | Sumgait 2 (Azerkimiya) | | 16 | 2 | 32 | Thermal |
| 15 | Gandja (Conventional Thermal) | 1962 | 30 | 3 | 90 | Thermal |
| | Total: | | | | 5,193 | |

Source: MFE

In general, most thermal-electric power plants in Azerbaijan are relatively old and in need of modernization. The largest of these is the Azerbaijan State Regional Power Plant (Azerbaijan GRES), which was built in the 1980s and consists of eight 300 MWe units, though actual capacity is significantly lower. The second-largest thermal-electric power plant, the Ali-Bayramly State Regional Power Plant (Ali-Bayramli GRES), also has had its electricity generating capacity significantly derated; like the Azerbaijan GRES facility, much of its equipment is in deteriorated condition.

By the early 2000s, it was even lower, with Sumgait 1 and 2 and Baku 2 out of operation altogether and other stations significantly derated. Since 2000, considerable work has been implemented to rectify the situation and improve availability of generation capacity, in particular, the following has been done:

- In 1996, the construction of the Yenikend HPP was re-started with the help of the first loan extended to the power sector of Azerbaijan since its independence. EBRD contributed \$54.24 million towards the construction of four units of 37.5 MW each;
- Rehabilitation of the Mingechavir HPP began with the help of funding extended by the EBRD and IDB. Two of the originally installed 60 MW units were replaced by new ones rated at 70 MW each. Azerenergy invested in the rehabilitation of two units of 60 MW each. When completed, the program will result in the availability at Mingechavir of 4 units of 70 MW each and two units of 60 MW each, or a total of 400 MW.
- Rehabilitation of Baku-1 TPP, by installing two gas turbine gensets and two heat utilization boilers (2x53 MWe + 2x200 tons of steam per hour). The plant will operate during the winter in cogeneration mode, supplying both power and heat to the two refineries in the region of Baku, while during the summer one of the units will be operated in cogeneration mode and the other for power only in partial load mode.
- A new \$200 million 400 MWe natural gas-fuelled expansion was completed in early 2003 to the Severnaya State Regional Power Plant (also known as the Shimal Power Plant) and is now in operation, built by Japans' Mitsui. A new gas pipeline from Karadagh to the power plant was also commissioned. Funding for both projects was extended by Japan Bank for International Cooperation (JBIC). In early 2004, Azerenergy said that the construction of a second steam-gas turbine 400 MW unit will begin in 2005, by using a low-interest loan from JBIC on terms similar to the first loan – 40-year.
- In May 2004, the national petrochemical concern Azerkhimya launched a 32 MW steam-gas unit at its EP-300 (ethylene-propylene) factory in Sumgayit. The units covers 50% of the power consumption and 100% of the steam consumption at Azerkimya's Sumgayit plant. It was built by Nichimen under a contract partially funded by the Export-Import Bank of Japan (JEXIM).

Further plans call for the improvement of capacity availability in the Baku-Abzheron area, which consumes up to 50-60% of power in the country and has a winter peak demand of 2,200 – 2,400 MW. Since the only two plants located in the area have a combined capacity of only 500 MW (400 MW at Shimal and about 100 MW at Baku-1), the area serviced by Barmek is short about 1,700-1,800 MW. Power is therefore supplied from the west (Azerbaijan GRES and HPPs, one 500 kV, one 330 kV and two 220 kV lines) and north (imports from Russia, one 330 kV line). The lines from the west cross difficult mountainous relief and are prone to frequent disruptions, and the line from the north can handle a maximum load of 400 MW.

Immediate plans for the improvement of capacity availability in the Baku-Abzheron area call for the construction of a second 400 MW unit at the Shimal TPP. Further plans include the following:

- In 2004, a feasibility study was initiated for the rehabilitation of the eight 300 MW units at the Azerbaijan GRES. Capacity of each unit should be increased from the actual 280 MW to about 310 MW, while cutting fuel consumption from 390 grams per kW to 330 grams per kW. Azerenergy has said it intends to take a credit from the EBRD for project implementation.
- In 2004, Azerenergy entered into several agreements aiming at the construction of a new power plant at Sumgayit. Bayerische Landesbank Girozentrale (Bayern LB) of Germany will act as a financial advisor to Azerenergy for the project, and Finland's Enprima will provide consulting services to make a feasibility study and start working on documentation for a tender to choose the general contractor for the project. The plant is expected to have a capacity of 400-500 MW and burn natural gas.
- Azerenergy would like to replace the obsolete and deteriorated equipment at Ali-Bayramly with three new 400 MWe units.

In the Nachichevan region, electricity is in especially short supply. Peak demand is around 150 MW, occasionally during the winter even over 200 MW, while available local capacity is only 22 MW at a single HPP shared with Iran. Azerenergy has therefore entered into agreements with Iran and Turkey about power import and exchange. Imports from Iran run at about 70-80 MW, mostly during the winter, and are compensated during the summer by exports via a single 200 kV line.

Several of Azerbaijan's thermal-electric power plants also cogenerate steam for industrial use. All except the Baku-1 power plant are in desperate need of refurbishment. The two Baku cogeneration facilities provide steam for the two oil refineries; only the steam generator is presently being operated at the Baku-1 facility (i.e., the entire output of the plant is used for steam production at the expense of power production), while the Baku-2 facility is in such decrepit condition that it now produces only a minimal amount of steam and power.

Two Sumgayt CHPs operating in co-generation mode have been stopped for lack of steam consumers.

The State Program of the Future Development of the Fuel and Energy Complex to 2015 has been developed. It envisages construction of new power plants, substations and high-voltage transmission lines, as well as a Complex Network Management System (SCADA). International financial institutions have agreed to provide loans for some projects.

Table 9: Thermal-Electric Generating Plants in Azerbaijan (10 MWe and greater)

| Generating Facility | Location (rayon) | Technology | Fuel | Capacity (MWe) | |
|---------------------|------------------|----------------------|--------------------------|------------------|----------|
| | | | | Nominal | Actual * |
| Azerbaijan | Mingechavir | Conventional Thermal | Natural Gas/ Fuel Oil | 2,400 (8x300) | 1,900 |
| Ali-Bayramly | Gazi-Mammad | Conventional Thermal | Natural Gas/ Fuel Oil | 1,050 | 840 |
| Sumgayit 1 | Sumgayit | Conventional Thermal | Natural Gas/ Fuel Oil | shut down | |
| Sumgayit 2 | Sumgayit | Conventional Thermal | Natural Gas/ Fuel Oil | shut down | |
| Sumgayit Azerkimya | Sumgayit | Conventional Thermal | Natural gas | 32 | 32 |
| Severnaya (Shimal) | Lokbatan | Conventional Thermal | Natural Gas/ Fuel Oil | 150 | 80 |
| | | Steam-gas turbine | Natural gas | 400 | 350 |
| Baku 1 | Baki | Conventional Thermal | Natural Gas/ Fuel Oil | shutdown | |
| | | Steam-gas turbine | Natural gas | 400 | 350 |
| Baku 2 | Baki | Conventional Thermal | Natural Gas/ Fuel Oil | suspended | |
| Gandja | Gandja | Conventional Thermal | Natural Gas/ Fuel Oil | 75 | 25 |

Note: Temporary limitation on loading of steam turbine unit on Shimal power plant is related to the problem of stability of power system operation

Japan is a leading foreign investor in the power generation facilities of Azerenergy. In mid-2004 the consulting arm of the Tokyo Electric Power Company (TEPCO) completed a study of the status of Azerbaijan's power generation sector. TEPCO and Azerenergy experts met in July to discuss the findings of the study.⁹⁷

4.4.2. Generation and Consumption

Electricity generation and consumption in Azerbaijan have both remained fairly flat over the past decade, in the range of about 15-21 billion kilowatt-hours (kWh) annually. Most of the generation is from thermal-electric power plants fueled by either oil or natural gas. In recent years, however, both generation and consumption have increased rapidly. An historical summary of electricity generation and consumption in Azerbaijan is shown in Table 10.

In 2003, electricity consumption in Azerbaijan grew by 13.4% to 22.7 billion kWh. In the same year, generation stood at 21.15 billion kWh, up 13.7% on 2002. The remaining 2.8 billion kWh were imported from Russia, Iran, Turkey and Georgia. Electricity exports in 2003 totaled 1.15 billion kWh.⁹⁸

In 2004, the Ministry of Fuel and Energy forecast that electricity output will reach 22 billion kWh by 2005, and 37 billion kWh by 2015.

⁹⁷ Ibid., 12 May 2004.

⁹⁸ Ibid., 14 January 2004.

Table 10: Electricity Generation and Consumption in Azerbaijan, 1992-2001 (in billion kwh)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-------------------------------|------|------|------|------|------|------|------|------|------|------|------|------|
| Net Generation | 18.6 | 18.1 | 16.6 | 16.1 | 16.1 | 15.9 | 17.0 | 17.2 | 17.7 | 18.2 | 18.7 | 21.3 |
| <i>hydroelectric</i> | 1.7 | 2.4 | 1.8 | 1.5 | 1.5 | 1.7 | 1.9 | 1.5 | 1.5 | 1.9 | 2.0 | 2.5 |
| <i>nuclear</i> | n/a |
| <i>geo/solar/wind/biomass</i> | n/a |
| <i>conventional thermal</i> | 16.9 | 15.7 | 14.8 | 14.6 | 14.6 | 14.2 | 15.1 | 15.7 | 16.1 | 16.3 | 16.7 | 18.8 |
| Net Consumption | 16.7 | 16.9 | 15.7 | 15.4 | 15.2 | 15.8 | 16.1 | 16.7 | 17.0 | 16.6 | 16.3 | 18.4 |
| Imports | 0.9 | 0.3 | 0.5 | 0.9 | 0.8 | 1.6 | 0.9 | 1.6 | 0.9 | 0.4 | 2.4 | 2.4 |
| Exports | 1.4 | 0.3 | 0.3 | 0.5 | 0.6 | 0.6 | 0.6 | 0.9 | 0.4 | 0.7 | 0.9 | 0.9 |

n/a - not applicable Note: generation components may not add to total due to rounding. Source: MFE

The Azerbaijan GRES accounts for more than half of the country's electricity production. The first of its eight units was commissioned in 1981, and the facility was completed in 1989.⁹⁹

4.4.3. Energy Transmission and Distribution Infrastructure

The state-owned company Azerenergy owns all of the high voltage transmission lines in Azerbaijan and also controls dispatch of the high voltage grid. The transmission grid voltages are 500 kilovolts (kV), 330 kV, 220 kV, and 110 kV. A breakdown of the components in the Azerenergy high voltage grid is shown in Table 11.

Table 11: Azerbaijan's High Voltage Electricity Grid

| Voltage (kV) | Total Length (kilometers) |
|--------------|---------------------------|
| 500 | 694 |
| 330 | 961 |
| 220 | 1,226 |
| 110 | 2,283 |

Source: Shems Energy Ltd. for the World Bank

Power distribution within Azerbaijan is handled by four regional joint stock companies, Bakuelectricshebeke SC, Ali Bayramlyelectricshebeke SC, Gandjaelectricshebeke SC, and Sumgayitelectricshebeke SC, each of which purchases electricity wholesale from Azerenergy for resale. Each of these four regional companies has a distribution monopoly in its territory (the autonomous region of Nakchivan also has its own separate electricity distribution network). Azerbaijan has transferred the management of these four regional distributors via long-term concession agreements to private investors, with the Baku and Sumgayit distribution networks now operated by Barmek, a Turkish firm, and the Ganja and Ali Bayramli distribution networks now operated by Baki Plant of High Voltage Equipment, an Azeri firm. Expected outside investment resulting from these transfers will enable much-needed modernization and upgrades to the networks.

Barmek's operator contract for the power grid in Baku was signed in 2002 and is for a period of 25 years. It calls for the company to modernize the grid and reduce losses from 16% to 11%.¹⁰⁰

⁹⁹ Ibid., 24 March 2004.

¹⁰⁰ Ibid., 2 June 2004.

A map of Azerbaijan's electricity grid, showing the coverage of the four regional companies, is shown in Figure 16.

Regional electricity distribution companies have been transferred to private operators under long-term management contracts. Power generation and transmission on the other hand continues to be controlled by the state-owned company Azerenergy. The restructuring of Azerigas and the eventual privatisation of gas distribution is under consideration.

The power and domestic gas sectors are in urgent need of modernisation. High level of debts, still relatively low collection rates and low tariff levels undermine the financial viability of Azerenergy and Azerigas.

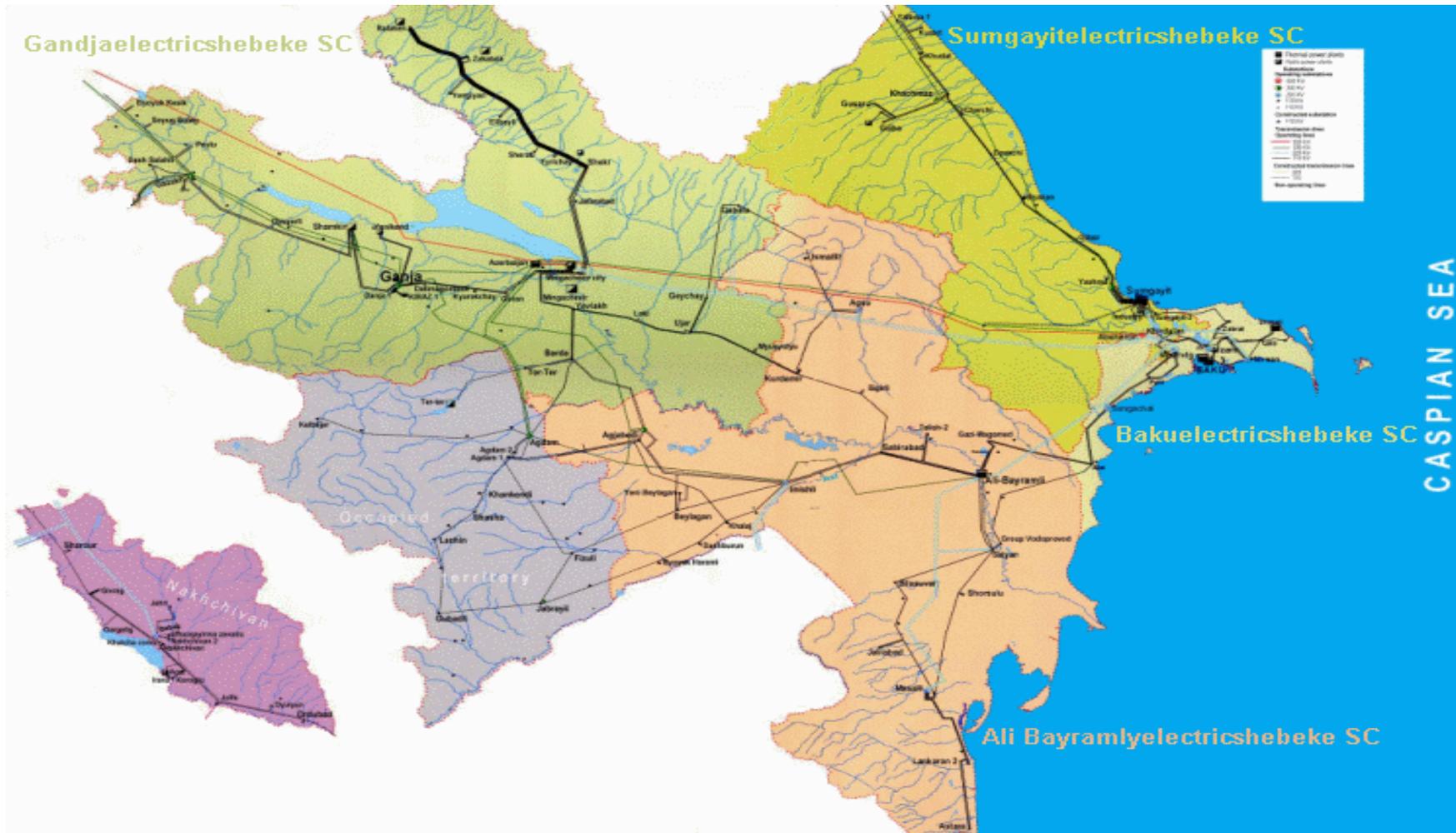
Azerenergy has received a \$0.6 million grant from Japan's humanitarian fund to use the services of consultants and draft a feasibility study for the upgrading of the company's dispatching system. The goal is to enhance system reliability and reduce electricity losses in transmission. The project is to be implemented with the help of the World Bank. In April 2004, the World Bank approved in principle a \$40 million loan intended to support Azerenergy's efforts to modernize and reduce losses in its high-voltage transmission system. The loan will be repayable over 15 years and carries a low 3-4% interest rate for the first five years. Azerenergy has stated that it intends to borrow the remaining \$7.4 million needed for the project from commercial sources.

The Russian electricity company United Energy Systems (UES) has stated its intention to set up several joint power projects with Azerbaijani utilities, aiming ultimately at the synchronization of the power systems of Russia, Azerbaijan and Iran. UES is interested in network construction and electricity generation in Azerbaijan. A memorandum of understanding was signed in May 2004 between UES and Azerenergy, calling, among other things, for feasibility studies to be conducted into the linking of the grids of Russia, Azerbaijan and Iran, and a new line to supply electricity to Azerbaijan in addition to the 330 kV Derbent-Yashma line already in operation. The MoU cemented the ties established between Russia and Azerbaijan in Moscow in December 2003, when an agreement on technical support for the parallel operation of the Russian and Azerbaijani systems was signed.¹⁰¹

Azerbaijan's grid connections with other countries include 500 kV, 330 kV, 35 kV, and 10 kV connections with Georgia; 154 kV and 34.5 kV connections with Turkey; and 230 kV, 132 kV, and 10.5 kV connections with Iran. Azerbaijan is part of the Trans-Caucasian Power Pool.

¹⁰¹ Ibid., 26 May 2004.

Figure 16: Azerbaijan's Electricity Grid



Azerenergy is looking at possibilities for the improvement of interconnections to neighbouring countries, in particular the construction of a second 330 kV line to Russia and a second high-voltage (330 kV) line to Iran. The enhanced capacity of the interconnections would help implement plans for regional exchanges of power. Over the recent years, Azerenergy has imported 1.2-1.5 billion kWh annually from Russia's UES. In late 2003, the two companies reached an agreement to continue imports at €2.6 per kWh. Quantities will not probably not increase, unless the capacity of the 330 kV line is increased, or a second line is constructed in parallel to the existing one. Plans call for the start of construction of a second line in 2004, which may result in an increase of imports by 300-400 million kWh annually. The project is expected to be implemented simultaneously with the establishment of an automatic safety system as part of the grids of Azerbaijan, Dagestan and the North Caucasus, resulting in improved stability and larger quantities of Russia's electricity exports to Azerbaijan. Azerbaijan is also involved in the establishment of the Imisli-Parsabad line intended to boost power exchanges with Iran.¹⁰²

In a separate project, Azerenergy is working with the Islamic Development Bank (IDB) to secure a credit for the construction of the 330 kV Khachmaz substation in North Azerbaijan, intended to get electricity from the Derbent-Yashma line between Russia and Azerbaijan and supply it to the northern areas of the country. In 2004, Azerenergy submitted a feasibility study to IDB, prepared by Energy C&I of Azerbaijan in a partnership with the multinational Dar el-Handasah consultancy. IDB and Azerenergy experts discussed the site of the substation.¹⁰³

In 2004, Azerenergy undertook upgrades to the transmission system of Nakhichevan, which has the status of an autonomous region. The enclave is largely dependent on imported electricity. Turkey delivers up to 40 MW via the Igdir-Babek line, Iran supplies up to 100 MW and Azerenergy's HPP on the Araz river generates about 20 MW. However, the total is still insufficient to cover peak demand, which may be as high as 220 MW during the winter. Annual imports into the region run at about 800 million kWh. Long, relatively low voltage transmission lines from Turkey cause a drop in voltage of up to 40% in some areas of the region. To alleviate the situation, Azerenergy began constructing a new substation in the Sharur-Sadarak regions.¹⁰⁴

4.4.4 Privatisation and Restructuring in the Power Sector

There have been various proposals how to proceed with restructuring and privatisation in the power sector. For example, EU's TACIS programme drafted a document proposing the sale of the distribution companies in the country. The chosen approach is instead to place the distribution companies under temporary management by private firms that undertake repairs and upgrades to the system and shoulder responsibility for collection of payments from customers and payments of debts to the budget. For example, after holding a tender, Turkey's Barmek Holding A.S. was awarded the right to run Bakedroset (the capital's distribution company) for 25 years, and at the same time agreed to invest \$266.54 million during the life of the project and, if need be,

¹⁰² FSU/CE Power Report, 1 October 2003.

¹⁰³ Ibid., 28 April 2004.

¹⁰⁴ Ibid., 19 May 2004.

another \$30 million. To assure reasonable cash flow, the Azeri government agreed to pay for some consumer entities that fail to settle their bills with Bakelectroset. The government drew a special list of such consumers, which typically includes facilities of strategic importance, such as army units and governmental and law enforcement agencies. Barmek did not receive any preferences and operates under a standard tax regime. Key taxes are a profit tax of 24% and various social payments deducted from salary funds.

At the time of the deal with Barmek (end 2001), the government argued that tariffs for the public and all other consumers, as well as wholesale electricity prices, should remain unchanged for three years. And the wholesale electricity price was determined at the level of 71 manat per kWh net of VAT. Prices for the consumer group "Population" were established at 96 manat per kWh, for the "trade and services" group, 296 manat per kWh, and for "other consumers" (including production, transport, budget financed, and other organizations), 153.4 manat per kWh including VAT.

The government's policy is to space out investments needed for upgrades in the distribution grids, so that they do not provoke a rapid rise in tariffs. Azerbaijan thus proposes to investors accepting lower initial returns with the prospect of higher tariffs and returns in the future. In the process, the government made some concessions, such as extending to Barmek the right to start negotiating higher tariffs and the provision of power from the government-owned Azerenergy to offset any debts incurred by consumers who are of strategic importance to the country. Other distribution companies have been placed under private management on similar terms.

Currently, tariffs for electricity are set by the Tariffs Commission at the Cabinet of Ministers (Government). The commission discusses tariffs with independent experts, but ultimately the decision is made by the government. As of mid-2004, electricity cost to Azerenergy was about 110 Manat per kWh, but the wholesale price to the two distribution companies (Barmek and Bayva) were set at only 71 Manat per kWh. This pricing policy necessitates the maintenance of a fuel subsidy to Azerenergy. Besides, Barmek and Bayva continue to charge many residential users about 20,000 Manat per month regardless of actual consumption, which is typically much higher, and the distributors are therefore unable to pay Azerenergy in full even at the low wholesale price that is set below cost. As a result, Azerenergy receives about 60% in cash, and the rest is carried forward as a debt. The management agreement with the distribution companies calls for an increase of payment in money by 10% each year, thus phasing out the practice within 4-5 years time

Presently, work is underway for the establishment of an independent regulatory commission in the power sector.

In the future, the right will be extended to the Fuel and Energy Ministry to sell Azerenergy shares. The gradual expansion of private companies in the electricity business is expected to make the entire sector more efficient.¹⁰⁵ Eventually, only the high voltage grid and the dispatch service would remain under the control of

¹⁰⁵ Russia/Central Europe Executive Guide, December 15, 2001.

government-owned Azerenergy, with generation and distribution to be transferred to private hands. While the precise ways and means of doing so are under discussion and there is no particular legal framework for the purpose yet, the possibility for such restructuring is indicated in the Law on Power. In addition, the possibility of introducing BOT schemes is also under consideration.

4.5. Other Types of Energy (Wind, Biomass, Solar, Geothermal)

Azerbaijan is considering implementing alternative energy projects. The State Programme of Comprehensive Measures in the Fuel and Energy Complex in 2004-2013 Period envisions ten small hydropower plants, six wind power and two solar energy projects and one biomass project. Their implementation is expected to create 9,680 new jobs.¹⁰⁶

4.5.1. Wind

By the Ordinance of the President of the Azerbaijani Republic of October 21, 2004 the State Program on the Use of Alternative and New Energy Sources in the Azerbaijani Republic was approved, which identified the Ministry of Fuel and Energy as the main coordinator of the implementation of measures envisaged in the Program. In addition to the use of solar energy, biomass, geothermal energy and small hydro, special importance is attached to the use of wind energy.

Studies of natural conditions and geographical location of Azerbaijan demonstrated that wind-generated electricity capacity reaches some 800 MW (some 2.4 billion kWh per year). As a result of many years of observation it was established that the most advantageous conditions for wind energy exist at the Apsheron Peninsula and in other coastal areas. Moreover, in the North-Western Region of Azerbaijan and in Nakhichevan the average annual wind velocity is between 3 and 5 meters per second, allowing it to use medium capacity wind generators, because for their proper operation winds of at least 3 meters per second are necessary. Baku and Apsheron Peninsula are characterized by considerable winds (6-8 mps), which could be used for large wind generators. Experts also claim that Azerbaijan may usefully operate wind generators at Gobustan.

The Ministry of Fuel and Energy, with a view to effectively utilizing wind energy, is involved in active work to further cooperation with foreign companies. Joint development of two wind generators has been started for the island of Pirallahy near the Apsheron Peninsula.

4.6. District Heating

District heating is not operating, except for Baki-1 TPP, which supplies some heat to the nearby refineries.

The existing heat supply infrastructure (boiler rooms and hot water lines) has been transferred from Azerenergy to the relevant municipalities. Currently, preliminary work is in progress in the Baki area aiming at the identification of the heat supply systems and an assessment of their condition.

¹⁰⁶ FSU/CE Power Report, 7 April 2004.

The construction and operation of individual boiler and district heating systems serving blocks of flats and groups of residences is not regulated and a considerable number of such systems have been put in operation recently. However, there is no reliable data on such systems.

4.7 Current Challenges in Restructuring

Subsidies in the gas and electricity sector run at present at about 11% of GDP annually. The government has recognised the large scale and unsustainable nature of indirect subsidies to electricity, gas and water consumers and started to take important decisions to restructure these sectors. To this effect, management changes have been made at Azerenergy and four regional electricity distribution companies have been set up and handed over under 25-year contracts to the private sector following a public tender process. The private sector involvement in gas distribution and water utilities is under consideration. Restructuring is expected to help reduce subsidies by improving collection and technical efficiency of the gas and power infrastructure. In addition, tariffs will be adjusted to reflect to a greater degree actual cost of service. Significant progress has already been achieved: implicit subsidies are now explicit, part of the state budget in the form of tax credits and account credits, improving transparency. The implementation program for these measures is by necessity phased: while the improvement of collection was built in the concession agreements of private operators from the very start, work on improving technical efficiency (e.g. by implementing SCADA) is yet to begin in earnest.

In March 2002, the President of Azerbaijan signed a decree on measures to strengthen financial discipline in the energy and water sectors. The Decree has approved a comprehensive energy sector reform programme following consultations with the IMF, with input from the World Bank and the EBRD. The key elements of the programme are: direct budget subsidies to socially disadvantaged and strategically important consumers; improvement of collections and enforcement mechanisms; creation of a Tariff Board and tariff regulation; close monitoring and accounting of utilities; private sector involvement in gas distribution and water utilities; and the restructuring of Azerenergy and Azerigas.

In April 2003, the Government of Azerbaijan outlined its policies in a letter of intent addressed to the IMF. The following are highlights from this Letter as they relate to the energy sector.

The Letter listed quantitative performance criteria and indicative targets for 2002 and proposed quantitative performance criteria until the end of 2003. These performance criteria are consistent with those previously identified under the program, with one important exception. Consistent with best practices for oil exporting countries, the Government is increasingly focusing its attention on the non-oil fiscal deficit - the consolidated deficit minus cash revenues from the oil sector - and has proposed that the fiscal performance be determined based on this concept, which will help Azerbaijan avoid excessive dependence on oil revenue. The quantitative performance criteria and indicative targets, as well as the program policies and objectives, are fully consistent with the State Program for Poverty Reduction and Economic Development

(PRSP), which has recently been finalized and approved by the President of the Azerbaijan Republic.

Regarding macroeconomic developments, indicators continue to be consistent with program targets; real **GDP growth** exceeds the program targets and inflation is low. All indicative targets were met, except for the targets on budgetary expenditure arrears for some periods of time, which were missed by small amounts.

Indicative targets for end-December 2002 related to net credit to the government, net domestic assets of the National Bank (ANB) and the consolidated government deficit were missed by small amounts. This was due to actions taken to finance Azerbaijan's share of the Baku-Tbilisi-Ceyhan (BTC) oil export pipeline.

The real growth and inflation targets for 2003 remain broadly appropriate. However, in the current environment of high uncertainty and instability in oil prices, the Government has recognized that there is a greater than usual risk in achieving its goals. As a result, the Government has prepared contingency plans to be implemented in the event that oil prices turn out to be either much higher or much lower than currently projected. In the event of much higher prices, the budget will save additional tax revenues. In addition, the Government will consider requiring SOCAR to use any additional after-tax revenue it receives from these higher oil prices to pay its tax arrears from previous years, and encourage SOCAR to review, jointly with the ANB, the possibility of saving any remaining excess earnings abroad in order to avoid adverse macroeconomic impacts of the foreign exchange inflows. In the event of modest declines in oil prices, these could be accommodated by drawing down on the higher revenues saved early from high oil prices. If prices decline sharply, so that average oil export prices are significantly below the budgeted level, the Government has begun to prepare medium to long term plans for the use of the growing oil and gas revenue. In particular, the Government will consider the future role and use of funds saved from the above-budget SOCAR tax payments.

Regarding progress on structural reforms, structural reforms have been broadly in line with the Government's commitments. However, some important structural measures took longer to implement than envisioned, and more time is needed. The timetable for the reduction in the number of specific import tariffs was adopted by end-March 2002, and the Government has begun implementing that timetable. The first two steps were taken on October 1, 2002 and April 1, 2003, converting specific tariffs for 19 product categories to *ad valorem* tariffs. These changes have also reduced the weighted average tariff in Azerbaijan significantly, from 7.9 percent in 2001 to much closer to our target of 6.5 percent. The final two steps will be taken on October 1, 2003 and April 1, 2004, after which specific tariffs will only apply to excisable goods.

Despite significant progress in other structural reforms, timetables for the unification of domestic and world market energy prices took longer than anticipated to design and approve. These timetables have now been adopted. The Government has recently increased the **domestic prices** of natural gas, gasoline, fuel oil and most oil products (except kerosene and diesel fuel) to estimated long run import or export parity, as appropriate. The price of diesel fuel has recently been increased, but not to world

market levels. In addition, as a result of reforms of SOCAR, crude oil is no longer sold in the domestic market.

In addition, the Government has allocated **subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR** (the State Oil Company of the Azerbaijan Republic), for the amount of fuel delivered to these utility companies but not paid for by them, published information on these subsidies and tax credits, and included these subsidies and tax credits in published reports on the execution of the consolidated budget. However, administrative difficulties have sometimes prevented the Government from taking these actions on the timely basis. The Government has therefore designed a new procedure for the timely allocation of these tax credits and subsidies. These subsidies have for the first time been included in the 2003 state budget approved by parliament, converting what had previously been quasi-fiscal subsidies into budgetary subsidies.

These steps are key elements the Government's comprehensive program to strengthen **financial discipline in the energy sector**. Other elements of this program that has been already implemented include the full payment by budgetary organizations. In addition, following the successful introduction of private management for the largest electricity distribution network in 2002, which contributed to a substantial increase in collection rates (although these rates nonetheless remain far too low), by end-2002 the Government had signed management contracts for the three remaining electricity distribution networks.

The Government has recently announced, and is in the process of implementing, a **restructuring of SOCAR**, designed to improve financial transparency and more clearly identify which parts of SOCAR are operating efficiently and which need further reforms. The process of privatizing parts of SOCAR's operations, particularly those not directly related to its core operations, have begun, with companies employing in total 10,000 people separated from SOCAR and privatized in 2002.

Structural reforms include a new Budget Systems Law designed in close cooperation with the staffs of the Fund and World Bank, the computerization of the treasury system, efforts to strengthen the customs and tax administration systems.

Based on an assessment of opinions of domestic and international investors, the government has since 2002 taken significant steps to **improve the business environment**, beyond the tax and customs administration reforms. Most importantly, the number of business activities requiring licenses has been dramatically reduced, and the process of receiving licenses for the few remaining industries requiring them has been streamlined. To further improve transparency, the Government has initiated the adoption of a new Constitutional Law, requiring the government to report to parliament early each year about the government's activities in the previous year.

The steps taken as described above have brought positive macroeconomic results. While some additional expenditures will be financed by higher non-oil revenues, the planned increases will also require slightly greater usage of oil revenues. As a result, the non-oil deficit (the overall fiscal balance, excluding oil-related revenue) remains well below the long-term sustainable level.

The most important element in the comprehensive agenda of fiscal reforms is the continuing development of the State Oil Fund of Azerbaijan (SOFAZ). In this context, we the Government has taken steps to **enhance the legislative foundation of SOFAZ and further integrate the oil fund and state budgets**. In particular, amendments to the Budget Systems Law: (i) call for parliamentary approval of the deficit and expenditure ceilings of the consolidated budget (with the consolidated budget defined to include the state budget, budget of the Social Protection Fund and budget of the Oil Fund, excluding Oil Fund revenues; (ii) require that all expenditures in the consolidated budget (except for expenditures on the management of the oil fund and its assets) be executed by the treasury, and that all capital expenditures be part of the State Investment Program; (iii) assign responsibility for the preparation of the consolidated budget to the Ministry of Finance; (iv) ensure that extra-budgetary funds do not make portfolio investments in domestic commercial activities or issue loans or loan guarantees; and (v) require that SOFAZ hold equity positions only through highly rated professional portfolio managers in international markets.

During 2003, the Government worked to design **mechanisms to compensate the poor** for planned increases in 2004 in kerosene and diesel fuel prices, as well as the eventual elimination of the implicit and explicit utility subsidies.

With regard to revenues, in the 2003 state budget the Government **completed the process of subjecting all taxpayers to the tax legislation**. Prior to 2001, large state owned enterprises paid taxes according to a pre-determined tax target, independent of the tax laws. In 2001, all these enterprises were required to begin paying taxes according to the tax legislation. However, it was at that time impossible for SOCAR to adhere to the tax laws while simultaneously providing substantial quasi-fiscal subsidies to the utility companies. Now that the cost of these subsidies is borne by the state budget, and not by SOCAR, the company has been instructed that it, too, must pay taxes according to the laws of the country, and do so in a timely fashion. In addition, during 2002, the Government has reviewed **the tax laws as they apply to SOCAR**, and has considered amendments to those laws based on international best practices for taxing state-owned oil companies. SOCAR's tax payments will now depend on changes in oil prices. In the current environment of high oil prices, the Ministry of Finance will **save any tax payments from SOCAR in excess of that anticipated in the approved budget, including any cash payments of pre-2003 tax arrears**. Should oil prices fall in the future, resulting in SOCAR tax payments below budgeted levels, these saved funds will then be used to offset the shortfall in revenues.

More generally, the Government plans to **improve procedures for revenue forecasting** by establishing a revenue forecasting commission under the aegis of the Cabinet of Ministers, and including representatives of the Ministry of Finance, Ministry of Taxes, State Customs Committee (SCC), Ministry of Economic Development, State Statistics Committee, SPF, SOFAZ, SOCAR, and ANB. This committee will be tasked with producing annual revenue forecasts, including preparing careful assessments of the revenue implications of any tax policy proposals, in line with the requirements of the new Budget Systems Law, prior to their consideration by the Cabinet of Ministers.

Regarding expenditures, beginning in 2003 the Government eliminated the earmarking of revenues for some **extrabudgetary operations of budget organizations**. For all budget organizations that continue to have authority to spend fees and other revenues they earn, the Government will continue its efforts to gradually reduce all remaining earmarking and thus more comprehensively integrating these funds into the state budget. The Government is also continuing its efforts to **eliminate all quasi-fiscal subsidies**. In 2002, all preferential utility and transport tariffs were eliminated, replacing preferential tariffs for internally displaced persons (IDPs) and refugees with explicit budget subsidies. In the 2003 state budget, the quasi-fiscal subsidies previously provided by SOCAR to Azerenergy and Azerigas have been included in the budget, and the Government has added an explicit subsidy from the budget for Azerchemia and informed SOCAR that they are no longer expected to provide fuel to Azerchemia without payment. The Government has issued no new instructions requiring SOCAR to finance IDP-related expenditures or other expenditures that should be financed by the budget. Starting January 1, 2004, SOCAR no longer provides any quasi-fiscal subsidies. Finally, while currently the government does not expect to have to pay additional funds for the construction of the BTC pipeline, should that prove necessary, it will consult with IMF staff on the procedures for financing these expenditures.

Regarding domestic and external debts, the Government is strengthening the **debt management system**. In conjunction with other amendments to the budget systems law, the Government has submitted an amendment which clearly **prohibits domestic borrowing by any ministry financed by the budget, other than the Ministry of Finance, and requires any funds borrowed by the Ministry of Finance to go through the treasury and be reflected in the state budget**. The Government will continue to be cautious in contracting **external debts**, adhering to the pre-set debt ceilings and not contracting or guaranteeing loans for commercial purposes.

The Government is determined to strengthen the State Pension Fund (SPF), which is responsible for pensions and most social support payments, and is taking steps to improve revenue collections. The important task is implemented of seeking to ensure that all taxpayers registered with the Ministry of Taxes are also registered with the SPF, thereby broadening the tax base. The Cabinet of Ministers has issued a decree instructing all state-owned enterprises—including SOCAR, Azerenergy, and Azerigas—to ensure the timely payment of their obligations to the SPF. Work on a substantive reform of the pension system in accordance with the our **Pension Reform Concept** is underway.

Regarding monetary and financial sector reforms, the Government has continued to implement a monetary policy aimed at domestic price stability. Exchange rate policy will likewise be unchanged, with the market allowed to determine the path of the exchange rate and the ANB intervening only to smooth out temporary fluctuations. The monetary instruments already at ANB's disposal are sufficient to sterilize the impact of planned SOFAZ spending as well as oil-related Foreign Direct Investment. The government will support the ANB in this effort, including by coordinating financial transactions and ensuring that the Ministry of Finance and SOFAZ provide the ANB with monthly updates of their expected pattern and volume of foreign exchange transactions. To assist in this effort, the government has

instructed SOCAR to provide each month, to the government and to the ANB, an updated forecast of SOCAR's cash flow.

Structural reforms in 2003-2004 incorporate efforts directed at the strengthening energy sector financial discipline, which remains at the heart of the economic reform program. Most energy sector quasi-fiscal subsidies have been put on budget, and thus government, parliament and the public are more aware of the true costs of these subsidies. Now there is the more serious challenge of actually reducing these subsidies. This will require a number of reforms: improvements in collections for utilities; increases in the efficiency of SOCAR, the utility companies, and key energy-consuming state-owned enterprises; and eventually a revision of electricity and gas tariffs to cover the true costs of providing these services.

Key to our efforts to strengthen financial discipline are steps to improve **payments for utility services**. Azerbaijan has made great strides in this area, by ensuring that budgetary organizations pay in full for their actual utility consumption, signing long-term management contracts for our electricity distribution companies, and giving these companies the right to cut off services to non-paying customers. Building on these reforms, in 2003 the Government set as a goal the signing of long-term management contracts for the gas and water distribution companies, and enhanced efforts to ensure that state-owned enterprises pay their utility bills. The Government sought to initiate the use of "smart cards" for the payment of utility services, to reduce the opportunities for corruption.

Ensuring that the power and gas companies pay their bills in many cases will require a **restructuring of their organization and operations**. This will be necessary to enhance their efficiency and reduce their energy consumption. In 2003, building on the recent decisions regarding SOCAR restructuring, the Government asked the assistance of EBRD in designing a more comprehensive restructuring of that company. The Government intends to also seek technical assistance in designing restructuring programs for Azerenergy, Azerigas, Azerbaijan Regional Water Company and Azerchemia.

The Government has requested assistance from the World Bank related to **utility tariffs**. In particular, the Government will seek their assistance in reviewing the tariff structure and determining a structure that would eventually cover the costs of providing the services, and in designing a system for compensating vulnerable households from the eventual increase in these tariffs.

Finally, having unified **domestic prices** of natural gas and most oil products with import or export parity, as appropriate, the Government works to unify in 2004 the domestic and estimated long run world market prices for the two remaining oil products - kerosene and diesel fuel - whose prices remain below world market levels, including by designing, in consultation with the World Bank, a mechanism to compensate the most vulnerable who are impacted by these price changes. In addition, to ensure that domestic energy prices stay unified with world market prices, by end-2003 an automatic mechanism was designed for the periodic adjustment of domestic prices of oil products and natural gas, to keep them in line with world market prices, with that mechanism being implemented in 2004.

In trade and investment policy, accession to the **World Trade Organization** (WTO) is a high priority for our government. The government has contracted a diagnostic study of the investment environment by the Foreign Investment Advisory Service (FIAS), a joint IFC-World Bank facility. In consultation with the Fund and World Bank staffs, the Government intends to **revise the 1992 Law on Protection of Foreign Investments** along the lines recommended in the FIAS report. Also, to assist potential investors, and to help in conveying information to them regarding our efforts to improve governance and the business environment, as well as to give investors a channel to convey their concerns in this regard to the government, we have created an **Investment Council**.

ATTACHMENT : EXCEPTIONS OF AZERBAIJAN AS NOTIFIED IN THE “BLUE BOOK”

MEASURES

Land Code of the Azerbaijani Republic approved and enacted by the Law No. 695-IG of 25 June 1999; Chapter XII, Article 48(3), Article 49(4); Chapter XVIII, Article 88(4), Article 89(8).

SECTOR

National economy.

LEVEL OF GOVERNMENT

National.

DESCRIPTION

Foreigners and stateless persons, foreign legal persons, international associations and organizations and foreign states may only lease the plots of land in the Azerbaijani Republic.

Private property rights acquired by foreign legal and natural persons as a result of contracts of inheritance, gift or mortgage of land shall be alienated within one year in accordance with the legislation of the Azerbaijani Republic.

In case of failure to alienate private property rights for land of legal and natural persons in accordance with the legislation, a relevant executive authority or municipality shall implement a compulsory purchase of land under a procedure envisaged by this Code.

PHASE-OUT

Not plans at present.

MEASURES

Law on Privatisation of the State Property of 7 January 1993, Article 8, paragraph 1.

State Privatisation Program of the State Property in the Azerbaijani Republic for 1995-1998 as adopted by the Law No. 1120 of 29 September 1995, Annex 10(1).

SECTOR

National Economy.

LEVEL OF GOVERNMENT

National.

DESCRIPTION

Participation of foreign legal and natural persons in privatisation is only permitted in accordance with the legislation of the Azerbaijani Republic under the procedures established by the State Privatisation Program.

In accordance with the State Privatisation Program of the State Property in the Azerbaijani Republic for 1995-1998, the President of the Azerbaijani Republic, on the advice of the State Committee on Property, decides on the admission of foreign investors to participate in privatisation of facilities specified in Section 2 of Annex 1 to the Program when he decides on granting a permission to privatize these facilities and enterprises.

PHASE OUT

The adoption of the new State Privatisation Program of the State Property for future is expected soon.

MEASURES

State Privatisation Program of the State Property in the Azerbaijani Republic for 1995-1998 as adopted by the Law No. 1120 of 29 September 1995, Article 4(2).

SECTOR

National Economy.

LEVEL OF GOVERNMENT

National.

DESCRIPTION

A foreign investors' acquisition of privatisation vouchers (cheques), as well as shares of privatised enterprises, shall exclusively be upon redemption of State Privatisation Options.

An Option is a state security issued to bearer that gives its owner, a foreign investor, the following rights:

- to acquire privatisation vouchers (cheques) for consequent participation in privatisation;
- to acquire shares of privatised enterprises.

Utilization of privatisation vouchers (cheques) in the privatisation process by a foreign investor without Privatisation Options shall not be permitted.

PHASE OUT

No plans at present.