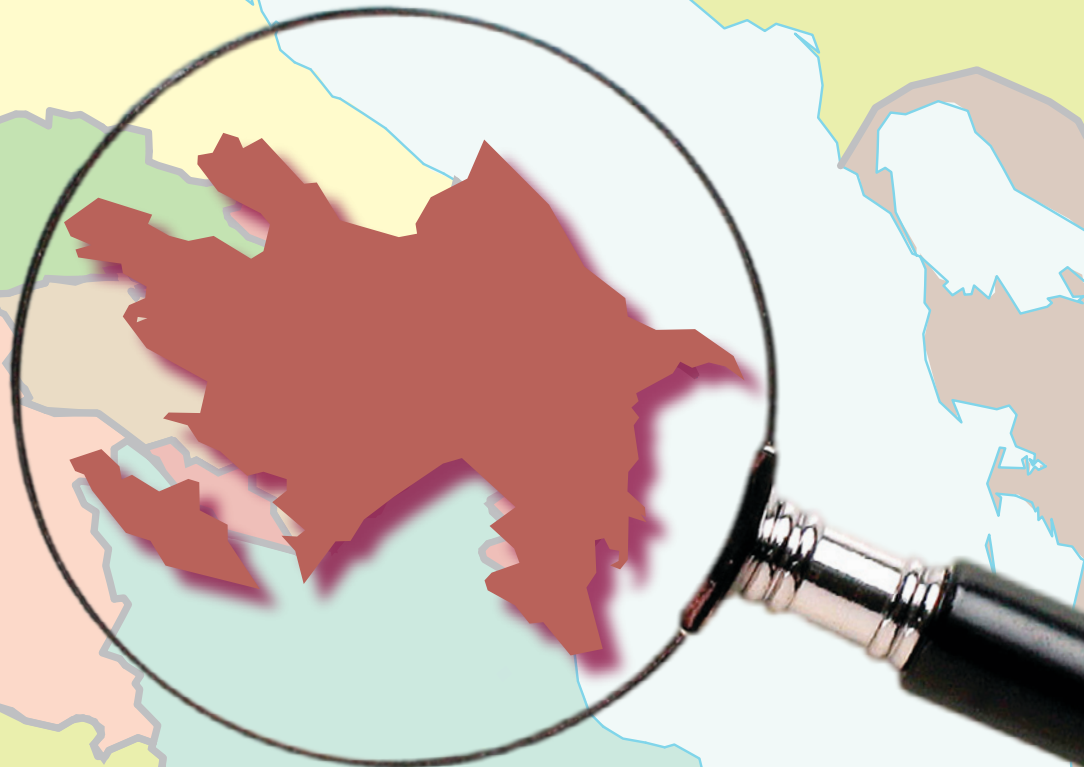




AZERBAIJAN

***FOLLOW-UP
IN-DEPTH REVIEW
of the Investment Climate
and Market Structure
in the Energy Sector***

ENERGY CHARTER



**Energy Charter Secretariat
2011**



Disclaimer

Information contained in this work has been obtained from sources believed to be reliable. However, neither the Energy Charter Secretariat nor its authors guarantee the accuracy or completeness of any information published herein, and neither the Energy Charter Secretariat nor its authors shall be responsible for any losses or damages arising from the use of this information or from any errors or omissions therein. This work is published with the understanding that the Energy Charter Secretariat and its authors are supplying the information, but are not attempting to render legal or other professional services.

© Energy Charter Secretariat, 2011
Boulevard de la Woluwe, 56
B-1200 Brussels, Belgium
ISBN: 978-905948-108-4 (English, PDF)

Reproduction of this work, save where otherwise stated, is authorised, provided the source is acknowledged. All rights otherwise reserved.

Table of Contents

1. INTRODUCTION.....	6
2. POLICY CONCLUSIONS ADOPTED BY THE ENERGY CHARTER CONFERENCE.....	7
3. MAIN FINDINGS OF THE SECRETARIAT	9
4. GENERAL INDICATORS	15
4.1. Size of the country, population and climate	15
4.2. State structure	17
4.3. Macroeconomic development.....	20
4.4. General energy policy of the country	26
5. LEGISLATIVE FRAMEWORK FOR ENERGY INVESTMENT	28
5.1. Legislation relevant to investment in the energy sector	28
5.1.1. Constitutional provisions.....	28
5.1.2. Establishment of enterprises (national and foreign companies).....	28
5.1.3. Foreign investment legislation	29
5.1.4. Legislation on land/immovable property/real estate	30
5.1.5. Competition legislation	31
5.1.6. Corporate taxation	32
5.1.7. Legislation regulating conditions for entry for foreigners.....	34
5.1.8. Foreign exchange and securities laws/regulations.....	35
5.1.9. Legislative basis regulating compensation for losses and expropriation.....	35
5.1.10. Legislative framework for privatisation	36
5.1.11. Legislation regulating the publishing of laws.....	37
5.1.12. Observance at sub-national levels	38
5.1.13. Intellectual property rights.....	38
5.2. Summary of laws/regulations for the energy sector	38
5.2.1. List of laws and regulations.....	39
5.2.2. Plans to amend legislation	39
5.3. Summary of participation in international organisations.....	40
5.4. Exceptions to national treatment	40
6. ENERGY SECTOR – SUPPLY AND DEMAND SIDE	42
6.1.1. Institutional structure.....	42
6.1.2. Supply and demand	43
6.1.3. Energy consumption by sectors.....	45
6.1.4. Energy prices, subsidies and plans for achieving market conditions	47
7. ENERGY MARKET STRUCTURE BY SECTORS	51
7.1. Oil Sector	51
7.1.1. Physical features	51
7.1.2. Oil storage	53
7.1.3. Crude oil supply infrastructure.....	54
7.1.4. Refining	56

7.1.5.	Oil exports	58
7.1.6.	Legislation specific to the sector	60
7.1.7.	Market structure monopolies	61
7.2.	Natural gas sector	63
7.2.1.	Physical features	63
7.2.2.	Natural gas exports	65
7.2.3.	Natural gas pipelines	65
7.2.4.	Gas storage	66
7.2.5.	Legislation specific to the natural gas sector	66
7.2.6.	Market structure monopolies	67
7.2.7.	Current opportunities for private investors.....	69
7.3.	Electricity sector	70
7.3.1.	Physical features	70
7.3.2.	Legislation specific to the electricity sector	75
7.3.3.	Market structure monopolies, privatisation	77
7.3.4.	Current opportunities for private investors.....	79
7.4.	RE Resources	79
7.4.1.	Legislation specific to RE sources	79
7.4.2.	Biomass	80
7.4.3.	Wind energy	81
7.4.4.	Solar energy	82
7.4.5.	Geothermal power	83
7.4.6.	Hydropower potential	84
7.5.	District heating sector	85
7.5.1.	General information.....	85
7.5.2.	Legislation specific to the heating sector	86
7.5.3.	Market structure monopolies	86
ANNEX 1	INTERNATIONAL AGREEMENTS FOR THE AVOIDANCE OF DOUBLE TAXATION	88
ANNEX 2	LIST OF BITS OF AZERBAIJAN	89
ANNEX 3	EXCEPTIONS TO NATIONAL TREATMENT	90

Table of Figures

Figure 1	Map of Azerbaijan	16
Figure 2	Structure of the judiciary system in Azerbaijan.....	19
Figure 3	Economic growth and inflation.....	21
Figure 4	Structure of the GDP for 2010	22
Figure 5	Foreign trade turnover of Azerbaijan (2009-2010).....	23
Figure 6	Main trade partners of Azerbaijan (trade turnover in 2010, US\$ millions).....	24
Figure 7	Structure of foreign investments by country for 2010	25
Figure 8	Investments in national economy, period 2004-2010 (Mln USD).....	25
Figure 9	Total energy supply of primary energy products, in percent	43
Figure 10	Primary energy consumption (million tons oil equivalent), 2000-2010	44

Figure 11	Prime energy demand growth (2005-2030)	45
Figure 12	Final consumption of energy products, in percent.....	46
Figure 13	Final energy consumption by economy sectors, in percent	47
Figure 15	Natural gas price for industrial users	49
Figure 16	Oil production in Azerbaijan (million tons), 1997-2009	51
Figure 17	Structure of Azeri-Chirag-Deepwater Gunashli (ACG)	52
Figure 18	ACG production profile	53
Figure 19	Export routes for oil and gas	54
Figure 20	BTC pipeline	55
Figure 21	Oil treatment at refineries, million tons, 2004-2009.....	56
Figure 22	System barrel diversification	58
Figure 23	System barrel trading	59
Figure 24	Share of SOCAR Trading in exports in %.....	59
Figure 25	Gas production in Azerbaijan (billion m3), 1997-2009	63
Figure 26	Shah-Deniz shareholder structure	64
Figure 27	Shah-Deniz production profile, 2008-2023	64
Figure 28	Gas production, transmission and distribution structure.....	68
Figure 29	Main electricity transmission network.....	73
Figure 30	Electricity production forecast for 2011-2015	74
Figure 31	Organisational structure of Azerenergy SC	78
Figure 32	Azerbaijan wind map	81
Figure 33	Solar direct normal insolation	83
Figure 34	Geothermal resources map of Azerbaijan.....	84

List of Tables

Table 1	General information about the Azerbaijan Republic	15
Table 2	Macroeconomic indicators of the Azerbaijan Republic.....	21
Table 3	Importance of the oil and gas sectors to the economy	22
Table 4	Overview of the energy data	44
Table 5	Electricity tariffs as of 6 January 2007	48
Table 6	Wholesale and retail prices for oil products.....	49
Table 7	Installed generation capacity of the Azerbaijan Republic	71
Table 8	Production of electricity, 2005-2010	74

1. INTRODUCTION

The Energy Charter Treaty (ECT) and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) were signed in December 1994 and entered into legal force in April 1998. The treaty was signed or acceded to by 51 states, the European Community and Euratom (the total number of its members is, therefore, 53).

The fundamental aim of the ECT is to strengthen the rule of law on energy issues, by creating a level playing field of rules to be observed by all participating governments, thereby mitigating risks associated with energy-related investment and trade.

The Azerbaijan Republic ratified the ECT and PEEREA on 2 December 1997. For Azerbaijan, the ECT entered into force on 16 April 1998. The ECT's trade provisions, which were initially based on the trading regime of the GATT, were modified by the adoption in April 1998 of a Trade Amendment to the Treaty. For Azerbaijan, the trade amendment entered into force on 21 January 2010 on a provisional basis.

In fulfilment of its commitments within the Energy Charter process, Azerbaijan presents this in-depth report on the investment climate and market structure (ICMS). The report covers the period 2005-2011 and is based on the latest publicly available data for the country.

Undertaken on a peer review basis, this report serves the purpose of information sharing and cooperation among the member states. The report contains updated information on the development of the national economy, basic statistics on foreign direct investments (FDIs), an in-depth analysis of the legal framework and a review of the investment climate and market structure in the energy sector of Azerbaijan.

The report is prepared by the Energy Charter Secretariat in close cooperation with the Ministry of Industry and Energy of Azerbaijan.

2. POLICY CONCLUSIONS ADOPTED BY THE ENERGY CHARTER CONFERENCE

The Energy Charter Investment Group reviewed country report of Azerbaijan at its meeting on 25 October 2011. It agreed upon a number of policy conclusions and recommendations with regard to the report that was subsequently adopted by the Charter Conference on 29 November 2011. These conclusions read as follows¹:

The Charter Conference,

Having heard the report from the Investment Group with respect to the Report on Investment Climate and Market Structure from Azerbaijan

NOTED

- a) *That the review has shown that Azerbaijan honours its commitments under the ECT and has undertaken broad reforms and investment policy measures towards improving legal frameworks for investors;*
- b) *In particular:*

- Took note that Azerbaijan has adopted an open door policy in the oil and gas sectors that has resulted in significant inflow of FDI in the energy sector. The development of oil and gas resources continues to drive the country's economic growth;
- Invited the Government to consider review and update of the existing "State Programme on development of fuel-energy complex of the Republic of Azerbaijan in 2005-2015". The revised programme could provide a medium and long term strategy for the development of the power sector and related environmental policies;
- Invited Azerbaijan to ratify the ECT Trade Amendment. Its ratification would allow the country to familiarise with the practices and disciplines that WTO membership entails, through application of its rules "by reference" to trade in energy materials and products and energy-related equipment;
- Took note with satisfaction that the Government is committed to further develop a network of oil and gas pipelines throughout the region to promote international trade and cooperation in the energy sector. New pipelines for export of natural gas are key for increasing the security of energy supply from Azerbaijan to the neighbouring countries as well as global energy markets;
- Welcomed the broad reforms to improve the investment climate. Priority to further reforms shall be given to streamlining procedures for construction permits, ensuring effective functioning of custom system, ensuring independence and competence of courts and judiciary system and continued efforts fighting against corruption;
- Invited to further develop legislation and regulations aimed at setting high standards of business conduct, transparency, corporate governance and environmental protection;

¹ Adopted at the 22nd Meeting of the Energy Charter Conference on 29 November 2011

- Invited to consider increasing competition in the electricity sector towards establishing an open and competitive energy market and creating a level playing field for local and foreign investors;
- Noted that Azerbaijan has successfully undertaken rehabilitation of power generation facilities in the electricity sector but rehabilitation of transmission and distribution networks remains a challenge. The sector will require substantial investments in the coming years where foreign investors could make contributions;
- Emphasized need to continue strengthening market-oriented energy policies and continued application of full cost recovery tariffs. Special consideration should be given to development of new tariff structure and methodology while also ensuring that social protection mechanisms for vulnerable segments of the population are in place;
- Noted that the Tariff Council of Azerbaijan acts as a regulatory body covering many economy sectors including the energy. In order to stimulate further development of the energy market it is advised to consider establishment of an independent state agency to regulate the energy sector in a fair, transparent and predictable manner;
- Underlined that the market for energy efficiency improvements and renewable energy sources is limited in its scope and does not seem to attract investors. The Government is advised to strengthen the existing legal, regulatory and institutional framework, and introduce incentive schemes to enhance energy security and reduce air pollution and contribute to climate change mitigation efforts;
- Draw attention to ecologic aspects in the energy sector. It is advised to continue work aimed at minimising, in an economically efficient manner, harmful environmental impacts arising from hydrocarbon production and consumption.

3. MAIN FINDINGS OF THE SECRETARIAT²

Investment climate and legislation

Strategic development of Azerbaijan's oil and gas resources continues to drive the country's economic growth. In 2010, share of oil sector in gross domestic product (GDP) was recorded at 48.5 per cent. The country has important oil, natural gas reserves while the high potential in renewable energy sources has not been fully estimated. In 2009, the President of Azerbaijan acknowledged that broader national economic development would continue to depend on the oil and gas sector for the next 10-20 years. The government is planning to stimulate the regional as well as non-oil economy development strategies which aim to diversify the economy. The energy sector has made strong contribution to the economic growth also through profit payments to the State Oil Fund (SOFAZ) which was established as an extra-budgetary fund to ensure macroeconomic stability, transparency in the management of oil revenue, and utilizing natural resources in a sustainable manner for the benefit of future generations. SOFAZ received the highest rating for transparency by the Sovereign Wealth Fund Institute in 2009.

Azerbaijan is not yet a member of World Trade Organization (WTO) though multilateral negotiations as one of the most important issues for accelerating the process of Azerbaijan's accession to WTO are continued. In Azerbaijan, export goods are not subject to any restrictions but regulations exist for the export of strategic commodities including electricity, oil and gas. The Energy Charter Treaty's amended trade regime represents an important milestone for Azerbaijan, though the country has not yet ratified the ECT Trade Amendment. Its ratification would allow the country to familiarise with the practices and disciplines that WTO membership entails, through application of its rules "by reference" to trade in energy materials and products and energy-related equipment.

Azerbaijan is leading foreign direct investment (FDI) in the region. The country has achieved gradual improvement in the overall legal framework for the investment activities with a number of regulations liberalizing investment climate. Azerbaijan has carried out strong legal reforms by adopting new Tax Code, Civil Code, Land Code, Labour Code, Customs Code, Foreign Exchange Law and Law on International Arbitration which altogether made the system significantly more transparent and friendly for local and foreign businesses. The government of Azerbaijan has made significant efforts to modernize and reform its economy. The country created a one-stop shop for company registration, cutting the number of procedures from thirteen to six and reducing the time required by half. In terms of registering property, a new unified property registry was introduced, reducing the number of procedures required to register property from seven to four. The tax burden was reduced by introducing an online filing and payment system with advanced accounting software for calculating taxes due. This saves more than five hundred hours a year on average in dealing with paperwork. Another important reform introduced in 2010 was to improve trading across the borders, the time required to clear goods and get them across borders was shortened by regrouping various agencies into a single customs service unit. In 2011, Azerbaijan improved access to

² These findings were submitted by the Energy Charter Secretariat to the regular session of the Investment Group on 25 October 2011.

finance by establishing an online platform, allowing financial institutions to provide information to, and retrieve it from, the public credit registry.

On the other hand, there are many areas in the business climate that require further improvements. Interviews with international organizations and investors operating in Azerbaijan have shown that Azerbaijan is still plagued by an arbitrary tax and customs administration. It was noted that the court system is suffering from lack of independence. It is also important to underline that there is limited competition due to existing monopolies in gas and electricity sectors. Another reported problem is corruption. In 2010, the global anticorruption watchdog Transparency International ranked Azerbaijan as 134 of 178 countries on its Corruption Perceptions Index. Azerbaijan shall continue to make progress in fighting corruption and needs to build its capacity and avoid widespread conflicts of interest. In this context it should be also underlined that Azerbaijan participates in the Extractive Industries Transparency Initiative (EITI). Azerbaijan has become the first ever country to successfully complete the validation process and obtain the EITI-compliant status.

Generally, the Azeri legislation establishes a very open regime for FDI. According to the legislation a foreign investor in Azerbaijan enjoys the non-discriminatory regime. Foreign investments are protected by certain guarantees including against adverse changes in legislation - the general rule is that legislation in force at time of making investment continues to apply to an individual investor for the subsequent ten years, notwithstanding any adverse change in law. The new Investment Bill currently under discussion in the Parliament is expected to reinforce existing guarantees as well as to introduce new legal instruments to protect foreign businesses.

Azerbaijan has a liberal exchange system and there are no restrictions on converting or transferring funds associated with an investment into freely usable currency at market rate. Azerbaijan has not yet developed effective incentives to attract foreign investment, other than those provided by Production Sharing Agreements (PSAs) in the oil and gas sector. It should be noted that specific legislation on special economic zones (SEZs) was created and passed by the Parliament on December 25, 2009. Nevertheless no SEZ has yet been established since then.

The review confirms that Azerbaijan maintains three exceptions to the principle of non-discriminatory treatment related to land and privatization. First exception states that foreigners cannot have private property rights for land but may lease the plots of land in the Republic of Azerbaijan. Second exception, in accordance with the State Privatisation Programme, the President of the Azerbaijan, on the advice of the State Committee on Property, decides on the admission of foreign investors to participate in privatisation which includes facilities and enterprises in the energy sector. Third exception requires that foreign investors must obtain a state security (an option) to have rights to acquire privatisation vouchers for consequent participation in privatisation and/or to acquire shares of privatised enterprises. An improvement to this exception is recent amendment of the privatization programme related to profits earned in Azerbaijan which are reinvested by foreign investors. Options are not required from foreign investors funding their participation in a privatization with net profits obtained in Azerbaijan.

It should be noted that although the privatization programme envisaged privatizing enterprises in the energy sector, no noticeable activities have taken place so far with the exception of two small privatized hydropower plants. The meetings with government

agencies and companies confirmed that there are no immediate plans to proceed with privatization and opening up of the state companies in oil, gas and electricity sectors. Certain stakeholders have noted that positive experiences of partnership with foreign investors in the oil and gas sector could be applied in the electricity sector which at present is dominated by the state electricity company.

Azerbaijan has attracted a large number of foreign investors to operate in oil fields in accordance with PSAs between the government and prominent western companies. The country's oil and gas policy enabled an extremely successful cooperation between multinationals and the government of a country in transition. The experience of the energy sector stimulated the government to open up its market for international business in the other sectors as well. It is important to note that, owing to the absence of any special legislation that covers the oil and gas industry and specifically addresses the need for sector growth, PSAs have been enacted into the legislative system of Azerbaijan as laws of the country. PSAs do not only constitute part of the legal system but more importantly also take precedence over the general legislation in the case of any discrepancy. To date more than 30 PSAs have been signed and adopted as the laws of Azerbaijan. Although the system of regulation of the industry through PSAs is in place and working effectively, the government continues improving the legislative base in the sector.

Azerbaijan has "State Programme on development of fuel-energy complex of the Republic of Azerbaijan in 2005-2015". Interviews with different stakeholders in the energy sector indicate that there is a need to review the programme in order to realign it to reflect the current developments. The revised programme could provide a medium and long term strategy for the development of power sector and related environmental policies.

Although Azerbaijan is rich in oil and gas, the government has recently started paying greater attention to developing of renewable energy. This is reflected by Azerbaijan's accession to International Renewable Energy Agency (IRENA) in June 2009, the presidential decree on the creation of a State Agency on Alternative and Renewable Energy Sources in July 2009, and the adoption of the State Programme on the use of alternative and renewable energy sources for 2004-13.

Azerbaijan has significantly improved its investment climate. According to the World Bank assessment in its report Doing Business 2011, Azerbaijan is now ranked 54 out of 183 economies in terms of the overall "Ease of Doing Business" evaluation. The ranking of Azerbaijan has been improving on many topics but there is need to continue reforms to further improve certain aspects, namely in the area of issuing construction permits where Azerbaijan is ranked 160 and paying taxes is ranked 103. It is reported that the average time needed to obtain a building permit in Azerbaijan is 207 days with 31 procedures to be completed in the authorization process. Further streamlining procedures on permits for construction shall be a priority which has a direct relevance to the energy sector. Another low ranking is 177 which relates to trading across borders in general economy sectors. However, it should be noted that export procedures of energy materials are much more streamlined and this ranking is not representative in the context of the energy sector.

Energy Market Structure

Oil sector and gas sectors

State Oil Company of Azerbaijan Republic (SOCAR) is involved in all aspects of the petroleum industry associated with prospecting, exploration and development of oil and gas fields, preparation for refinery and transportation of oil and gas condensate, oil-chemistry products in onshore and offshore areas of the Republic as well as sale of their derivatives in domestic and foreign markets. The SOCAR is able to meet demands of the Republic for oil and oil-chemistry products and export to international markets.

The state-owned Azerigaz OJSC is engaged in gas transportation, distribution, purchase and supply and manages access to transportation and distribution networks. In 2010, Azerigaz was integrated into the SOCAR structure. No gas market opening plan is envisaged in the legislative framework. Consumers cannot purchase natural gas directly from producers. Azerenergy (power utility company) procures natural gas for electric plants under a contractual framework.

No gas grid code has been adopted in Azerbaijan, but the existing Law on Gas Supply regulates the process of production, processing, transportation, storage, distribution, sale and use of all types of gas (including natural gas). There is no third party access to the pipeline network and access to the grid must be negotiated with Azerigaz.

According to the legislation, in cases where system (transportation and distribution) operators refuse to provide access to their systems, they must provide full substantiation for the reasons of such refusal.

The gas tariffs are approved by the Tariff Council and are mandatory for all entities in Azerbaijan. The Tariff Council regulates gas tariffs in accordance with its internal rules. All investments in the distribution network and in the gas-transportation system are implemented by Azerigaz. In accordance with “The State Programme for socio-economic development of regions of the Republic of Azerbaijan in 2009-2013”, Azerigaz carries out large scale rehabilitation of the infrastructure and works on gasification programme for residential communities.

In the recent past Azerbaijan used to import natural gas. At present Azerbaijan already exports gas to Georgia, Russia and Iran. Diversification of export routes has been top priority for the Government of Azerbaijan. The country celebrated the first oil for the Baku-Tbilisi-Ceyhan (BTC) pipeline in May 2005, and the official completion ceremony of this pipeline was held in Turkey in July 2006. Since then the BTC pipeline has been operational, with a maximum capacity of one million barrels per day. Furthermore in parallel with the BTC the Baku-Tbilisi-Erzurum gas export pipeline was commissioned in September 2006. In October 2008, the first tanker carrying oil from Kazakhstan’s Tengiz field departed for Azerbaijan. New pipeline and delivery route systems for natural gas through the southern corridor to Europe are currently being considered and negotiated. According to the SOCAR, Azerbaijan is practically ready to supply 2 billion cubic meters per year to Europe and 10 billion cubic meters in 2017. Authorities of Azerbaijan have recently been in talks with Turkish counterparts regarding gas transit which hopefully will open the route for Azeri gas to Europe. Azerbaijan is at present considering all the options to transport its gas to Europe including the Trans Adriatic pipeline, the Inter-connector Turkey-Greece-Italy, and the

Nabucco and White Stream projects, while work is also under way about the delivery of liquefied gas to Bulgaria and Romania. LNG supplies to Ukraine present another alternative to transit via Turkey and is being pursued by Azerbaijan.

Electricity sector

Azerbaijan's electricity sector is dominated by a vertically integrated monopoly operated by Azerenergy OJSC, a 100% state-owned enterprise. Azerenergy is engaged in the production, transmission, distribution, purchase and sale of electricity in Azerbaijan. The company is entitled to submit proposals for tariff increases and to take part in the tariff-regulation process, but the final decision making authority with regard to tariff determination in the electricity sector rests with the Tariff Council. Azeri legislation envisages unbundling in the electricity sector but this has not yet been implemented. Over the last years Azerenergy has managed to implement a large scale investment programme to fully upgrade and add new generation capacities. At present, all generation capacity in Azerbaijan uses natural gas a prime fuel for electricity generation. It was reported that the electricity supply has been improved. The company continues installation of smart pre-paid meters which significantly improved collection rates up to 100 per cent in several regions of the country.

The regulated entities are required to provide economic justification for the expenses which make up part of prices (tariffs). The calculated tariffs are reviewed by the Tariff Council and published upon approval. A uniform tariff for the residential use and other tariffs for commercial and industrial enterprises are in force. In legal terms foreign capital investment in energy assets/companies is permitted and not restricted. Investments in new generating capacities are encouraged, and long-term electricity procurement is guaranteed.

The government has established a medium-term tariff policy that incorporates a transition to full cost recovery for utility service providers with a 10% return on equity. This will enable the utilities to become financially self-sustaining. The Tariff Council chaired by the Minister of Economic Development determines the retail and wholesale tariffs as well as the gas and fuel supply prices. The Tariff Council has powers to set tariffs for any kind of renewable energy, but only wind energy and mini hydro power tariffs have been set. There is no difference in tariffs between cogeneration and traditional power systems. At present, a uniform tariff is applied. Ministry of Economy of Azerbaijan informed about ongoing discussion in the Tariff Council concerning possible adoption of support schemes for the development of renewable energy sector.

The Azeri electricity market has not opened yet and no formal opening timeframe has been envisaged. Legislation provides for principles of non-discriminatory access to network infrastructure, though this has not been implemented in practice due to the current market structure. All the parties requiring access to transmission and distribution networks are obliged by law to comply with the same technical specifications, without discrimination or preference for any one party over another. In cases where system (transmission and/or distribution) operators refuse to provide access to their systems, the operators are required to provide an explanation of the reasons for refusal.

Azerbaijan has no schemes of subsidies aimed to encourage energy efficiency and no specific obligations to purchase renewable energy. Moreover there is no established market for renewable energy. According to the legislation generating companies may sell energy in the wholesale market at the tariffs approved by the Tariff Council.

Azerbaijan faces serious environmental challenges. Over the many years Caspian petroleum and petrochemical industries have contributed to the existing air and water pollution problems. There is increasing understanding of this problem at the state level. A very good initiative is being undertaken by SOCAR that has established an ecological park to improve environment and clean up contaminated soil in some regions.

4. GENERAL INDICATORS

4.1. Size of the country, population and climate

Table 1 General information about the Azerbaijan Republic

Official name:	Azerbaijan Republic
Head of State	President: Ilham Aliyev (since October 2003)
Head of Government	Prime Minister: Artur Rasi-zadeh
Legislative body	Milli Majlis (National Assembly)
Capital	Baku
Major cities	Ganja, Sumgayit, Shemakhy, Sheky, Khankendy, Shusha
Total land area	86,600 km ²
Population	9.1 million
Labor force	4.31 million
Unemployment rate	6.2%
Literacy	98%
Official language	Azerbaijani
Independence declared	28 May 1918
Independence declared from USSR	18 October 1991
Religion	Islam 93.4%, Russian orthodox 2.5%, Georgian orthodox 0.18%, Judaism 0.11%, other 3.8%
Ethnic groups	Azeri 90.6%, Dagestani 2.2%, Russian 1.8%, Armenian 1.5%, other 3.9%
Currency	Azerbaijan Manat AZN (1AZN=1.15 Euro May 2011)
Time zone	GMT +3

Source: Central Bank and Ministry of Economic Development of Azerbaijan

The Azerbaijan Republic is in the South Caucasus, between longitudes 44° and 52° east and latitudes 38° and 42° north. Its territory is 86,600 square km. The country has a population of 9.1 million (1 January 2011) and it borders with Iran (765 km) and Turkey (13 km) to the south, Russia (390 km) to the north, Georgia (480 km) to the north-west and Armenia (1007 km) to the west. Azerbaijan is on the western coast of the Caspian Sea with a coastline of 713 km. and has been an important trade and transport point since the beginning of commerce along the Great Silk Road. Over half of its territory (59.9%) is mountains (foothills – 17.5%, mountains – 33% and high mountains – 9.4%) and the rest (40.1%) plains and lowlands. 27% of the territory is above 1,000 m, but 18% is below the level of the World Oceans.

Figure 1 Map of Azerbaijan³



Source: www.azembassy.be

Azerbaijan is surrounded by the Major Caucasus, Minor Caucasus and Talish mountain ranges. The Kur-Araz lowland is surrounded by these ranges.

In different parts of the country, the climate varies from arid to humid “subtropical”. Relief plays an important role in the distribution of these peculiarities. Nine out of eleven world climate types occur in Azerbaijan. Absolute height ranges between 4,466 m above sea level and 26 m below sea level. The Caspian Sea and the Black Sea play a significant role in the climate of the region. Azerbaijan has a mild winter with average monthly temperatures only falling below zero in the mountains. In spring, a rise in the temperature and length of the day is characteristic. This results in a warm soil surface in early spring, especially in the Kur-Araz lowland. Summers are hot and dry, with strong sunshine. In Absheron temperature ranges are between 23.4-25°C. Summer is cool in the mountains of the Lankaran zone, but hot in the plains. The hottest zone is the Kur-Araz lowland, where temperatures range between 24.8-26.5°C.

The territory of Azerbaijan consists of 66 rayons, 11 cities and one autonomous republic (Nakhchevan Autonomous Republic or Nakhchevan AR). The main cities are Baku, Ganja, Sumgayit, Shemakhy, Sheky, Khankendy and Shusha.

Azerbaijan is known as an oil and gas country throughout the world. Besides the major oil and gas deposits of Azerbaijan there are numerous mining sites for ferrous and nonferrous metals and construction materials. An area that must be specifically mentioned is the north-west of the country (Dashkesan, in particular). Major deposits of aluminium ore, iron ore and nonferrous metals and construction materials including gypsum, limestone and trim stone

³ The designations employed and the presentation of the material in this map do not imply the expression of any opinion whatsoever on the part of the Energy Charter Secretariat with respect to the delimitation of the frontiers or boundaries, or the authorities thereof.

scattered all over the country are of particular interest. Deposits of iodine, gold and other precious metals, mineral spring water, etc. also form part of the geology of Azerbaijan.

4.2. State structure

Constitution

Azerbaijan's first Constitution was adopted on 12 November 1995. Ever since then, Azerbaijan has celebrated the 2 November as Constitution Day. The Constitution of Azerbaijan was the basis of the country's foundation after the fall of the Soviet Union. The Constitution consists of five sections, 12 chapters and 158 articles. Amendments and additions to the constitution were first made via the referendum of 24 August 2002 and, more recently, of 18 March 2009.

Among the important amendments to the Constitution, one innovation was the change in Article 95 I (4), which provides that the Milli Majlis is now responsible for approving and terminating “intergovernmental agreements containing rules contrary to the laws of the Azerbaijan Republic”. Azerbaijani legislation distinguishes inter-state and inter-governmental treaties. The former are to be ratified by the Milli Majlis and the latter by the president. The purpose of the amendment is, therefore, to ensure that, if an intergovernmental treaty provides rules contrary to Azerbaijani law, it will have to be submitted to the Milli Majlis for ratification and not just to the president.

International treaties to which Azerbaijan is a party constitute an integral part of its legal system (Article 148, paragraph 2 of the Constitution). According to the Constitution of Azerbaijan (Article 151) whenever there is disagreement between normative-legal Acts in the legislative system of the Azerbaijan Republic (except for the Constitution of Azerbaijan and Acts accepted by way of referendum) and international agreements wherein the Azerbaijan Republic is one of the parties, the provisions of the international agreements shall prevail.

According to the law of the Azerbaijan Republic “On Investment Activity” (Article 22), if the international agreements of the Azerbaijan Republic establish rules other than those specified by the legislation of the Azerbaijan Republic, the international agreements are applied.

President

The executive power is held by the president of the Azerbaijan Republic. The president must be a citizen of Azerbaijan who has attended a higher-education institute, be at least 35 years of age, have been residing in Azerbaijan for not less than ten years, be eligible to vote and not have been charged with any grave crimes nor have any previous commitments to any other country.

The president is elected for the term of five years through common and direct voting. The president is the head of state according to the political system of the Azerbaijan Republic. He has the power to appoint and release the prime minister by agreement with the Milli Majlis. The president dismisses the Cabinet of Ministers and appoints and releases members of the Cabinet of Ministers, introduces the state budget in the Milli Majlis for approval, regulates the work of the government, presents the candidates for the positions of judges of the constitutional courts, the Supreme Court of the Azerbaijan Republic and the Court of Appeal

of the Azerbaijan Republic, appoints judges of other courts and appoints and releases the prosecutor general on the agreement of the Milli Majlis.

Milli Majlis (National Assembly)

The Milli Majlis of the Azerbaijan Republic is a unicameral (single-chamber) legislative body composed of 125 members elected for five-year terms through direct common voting. The Milli Majlis has the power to approve and regulate the state budget.

The Milli Majlis develops constitutional laws, Acts and orders on issues within its power. It approves the appointment of the prime minister and gives the vote of confidence to the Cabinet of Ministers. By introduction of the head of state it appoints judges for the Constitutional Court, Supreme Court and the Economic Court.

Under the Constitution of the Azerbaijan Republic, the Milli Majlis can dismiss the president by means of impeachment. Moreover, the Milli Majlis has the power to ratify and annul international contracts, appoint referendums and deal with the establishment of the Auditing Chamber. It has a scheduled activity for autumn and spring sessions.

The Milli Majlis ratifies production sharing agreements (PSAs) in the oil and gas sectors.

Government

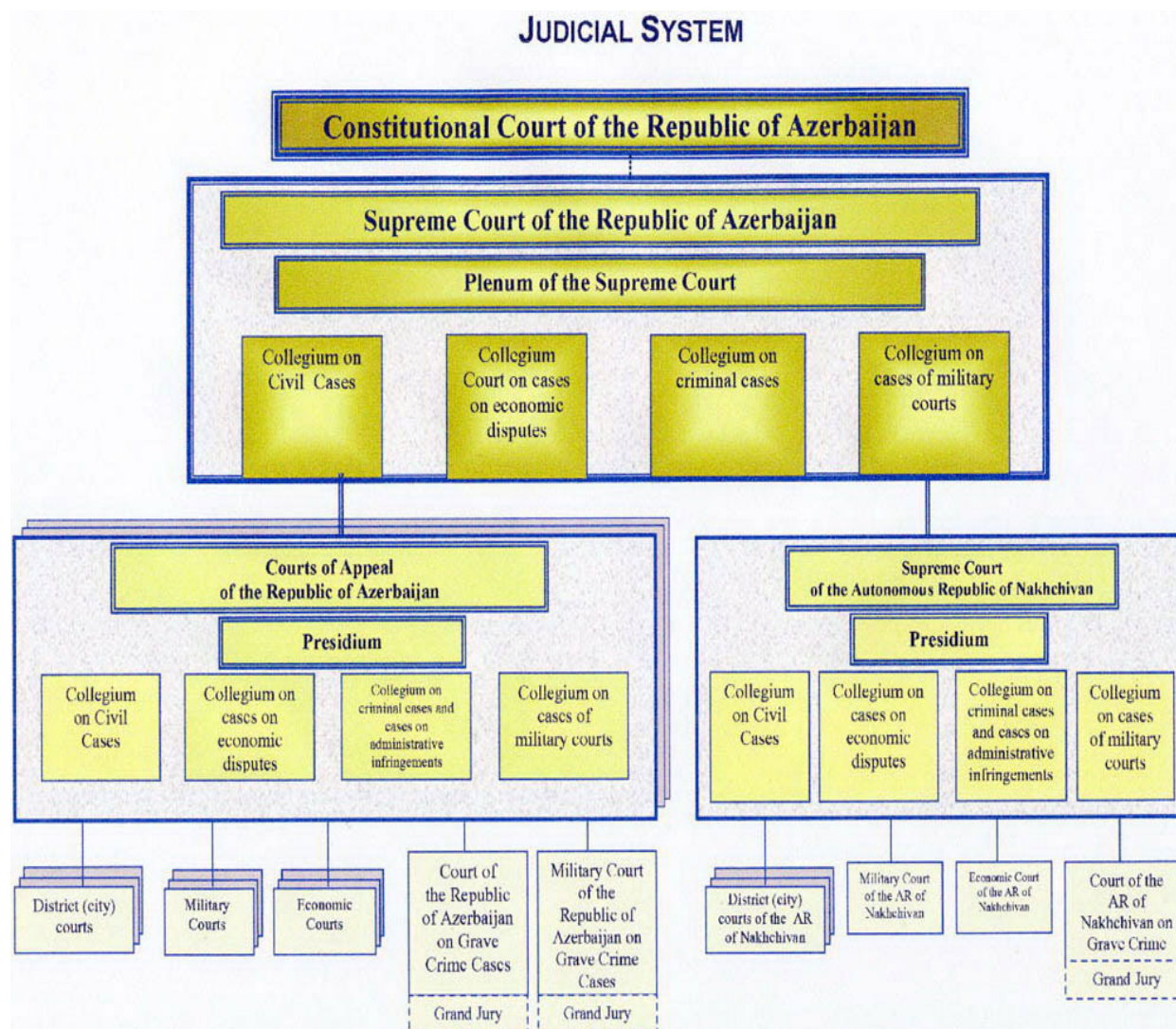
The government (Cabinet of Ministers) is subordinate to the president, who appoints the prime minister and cabinet subject to the approval by the Milli Majlis. The Cabinet of Ministers oversees the implementation of the state budget and financial, credit and monetary policies, as well as state social programmes. If the president retires or dies before the end of his term, new presidential elections are held within three months. During this period the prime minister takes over the presidential responsibilities. According to Article 105 of the Constitution of Azerbaijan, if the prime minister is incapable of doing so the chairman of the parliament shall take the position.

Judiciary

According to the Constitution of Azerbaijan, the judicial system of the Azerbaijan Republic consists of all the courts acting in the republic and these are united under the sole duties and organisational and activity principles of the judicial power.

The reform of the legal system has paved the way for setting up a new three-tier judiciary that is to be comprised of courts of first, appellate and cassation instances. The figure below shows the entire structure of the judiciary system in Azerbaijan.

Figure 2 Structure of the judiciary system in Azerbaijan



Source: Ministry of Justice of Azerbaijan

Judicial power rests on the Constitutional Court, Supreme Court, the Court of Appeal, common courts and other specialised courts of the country. Judicial power is exercised through civil and criminal courts and by other means determined by the law. Judges are independent and adhere only to the constitution and the laws of the Azerbaijan Republic and are not to be replaced throughout their term.

The Constitutional Court consists of nine judges, appointed by the Milli Majlis on the introduction of the president of the Azerbaijan Republic. The court is the highest constitutional justice body; it maintains the supremacy of the Constitution of Azerbaijan as well as of the rights and freedoms of everyone. On 23 December 2003, the parliament adopted the Law on the Constitutional Court within the framework of ongoing reforms, which provided for the right of citizens to apply directly to the Constitutional Court on matters related to their violated rights and freedoms.

The judicial reforms were continued by a presidential decree “On Modernization of the Judicial System” of 19 January 2006, which moved the reform onto the next level. According

to the decree, with a view to strengthening the effectiveness of the administration of justice, facilitating people's ability to apply to courts and developing the regions of the country, new courts, including new regional appellate courts, were established.

Furthermore, it provided for measures to be carried out in order to increase the number of judges and improve the courts functioning, to build up new legally established courts and to ameliorate the structure and operation of the judicial apparatus as well as to establish the Supreme School of Justice.

According to the Ministry of Justice of Azerbaijan, pursuant to a new judicial system, courts of appeal shall be operating in six regions of the country and, consequently, the current appeal and economic courts will cease to exist. The new courts of appeal, consisting of four collegiums (on civil cases, on criminal cases and cases on administrative infringements, on cases of military courts and on economic dispute cases) will operate subject to appropriate territorial jurisdiction.

According to the Law of the Azerbaijan Republic on Courts and Judges, district (city) courts shall try civil, criminal, administrative and other cases and economic courts shall try cases on economic disputes within their jurisdiction.

4.3. Macroeconomic development

Economic growth

The strategic development of Azerbaijan's oil and gas resources continues to drive the country's economic growth. In order to fully realise its huge economic potential, Azerbaijan will have to deal with a number of significant challenges. The results of unresolved conflict with Armenia, which occupies 20% of the territory of Azerbaijan, continue to put a heavy burden on the Azeri economy. Notwithstanding, Azerbaijan's economy has been growing for several years as a result of huge oil and gas exploration and production activities.

Azerbaijan's high economic growth during 2006-2008 was attributable to huge oil exports and these are continuing to grow, but some non-export sectors also featured double-digit growth, spurred by the growth in the construction, banking and real estate sectors. In 2009, economic growth remained above 9% even as oil prices moderated and growth in the construction sector cooled. The table below shows some key macroeconomic indicators for 2010.

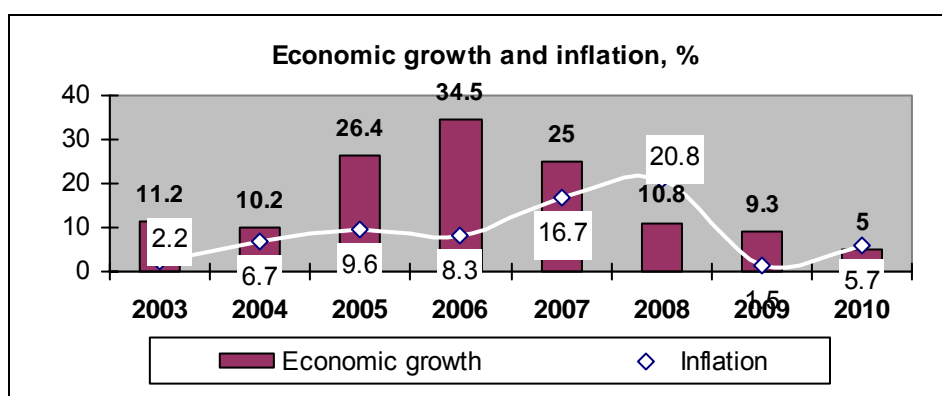
Table 2 Macroeconomic indicators of the Azerbaijan Republic

Indicators	unit	2010
Budget		
Revenues	USD	14.381 250
Expenditures	USD	15.344 125
GDP Per capita	USD	5797.8
GDP real growth rate	%	5.0
Share of oil sector in GDP	%	48.5
Inflation rate	%	5.7
External debt	USD	3 857.3
External debt/GDP	%	7.42
Industry	%	52.6
Agriculture	%	5.3
Construction	%	7.5
Trade	%	7.7
Transport	%	6.0
Communication	%	1.9
Social services	%	11.9
Taxes	%	7.1
Total Investments	USD	12 144
Growth rate	%	21.2
Domestic investments	USD	9136.6
Foreign investments	USD	3007.3

Source: Ministry of Economic Development of the Azerbaijan Republic

In 2010, economic growth slowed to 5.0%, although the impact of the global financial crisis was less severe than in many other countries in the region.

Figure 3 Economic growth and inflation



Source: Ministry of Economic Development of the Azerbaijan Republic

The above graph demonstrates a strong increase in economic growth from 2005-2006, which was caused by increased oil and gas production. In particular, the GDP growth was due to increased export volumes via the Baku-Tbilisi-Ceyhan (BTC) oil pipeline. From 2008, the

demand for oil began to reduce due to the global economic and financial crisis. This has resulted in a slowdown in GDP growth over the last three years.

With the growth in oil and gas production (with an increase of up to 50 million tons in 2010), the outlook for GDP growth is moderate. Growth in the non-oil economy in 2010 was driven largely by public investment, mainly in infrastructure projects that led to a 20.3% expansion in construction activity. The oil and gas sectors are very important to the economy of the country, which is demonstrated in the table below.

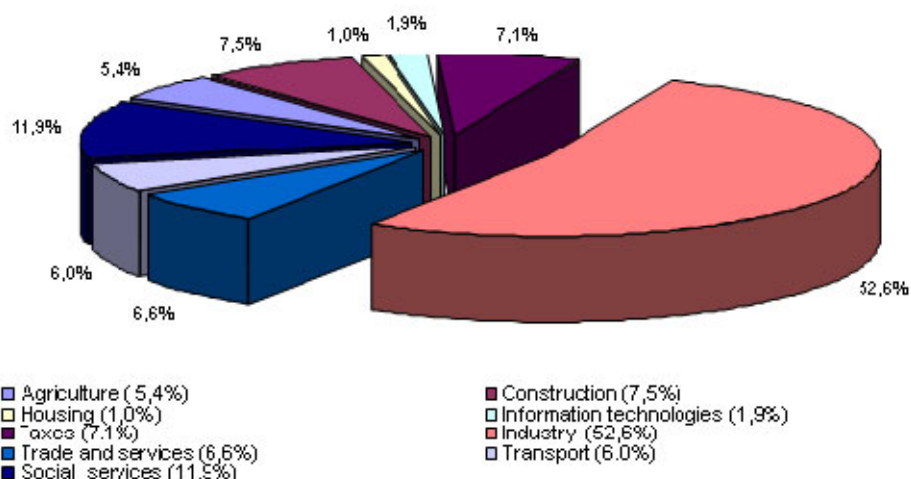
Table 3 Importance of the oil and gas sectors to the economy

	2003	2004	2005	2006	2007	2008	2009	2010
GDP Growth rate (%)	11.2	10.2	26.4	34.0	25.0	10.8	9.3	5.0
Share of oil and gas sectors in GDP (%)	30.1	31.3	44.1	53.8	55.9	54.1	47.0	48.5
Share of oil and gas sectors in industrial output (%)	62.1	61.6	75.0	82.8	85.7	89	74.0	75.7
Share of petroleum in gross export (%)	85.7	82.7	86.5	92.2	94.2	93.1	92.8	92.0
Share of oil and gas sectors in FDI (%)	98.5	97.5	94.2	90.3	90.1	83.9	82.0	81.8

Source: Ministry of Economic Development, State Statistical Committee of Azerbaijan

The graph below shows the structure of GDP in relation to different economy sectors.

Figure 4 Structure of the GDP for 2010



Source: Ministry of Economic Development of Azerbaijan

Resting mainly on the strength in oil pricing, the current account surplus was boosted to \$16.5 billion in 2010, about 31.9% of the GDP, from \$10.2 billion a year earlier. National gross reserves jumped by nearly 20% to \$6.4 billion at the end of 2010.

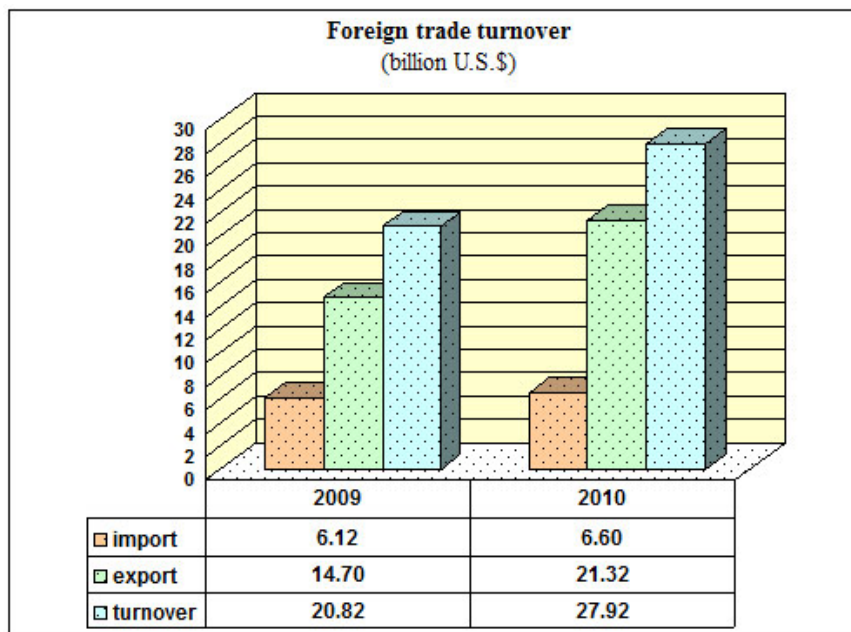
Trade including import and export

Since 1997 Azerbaijan has been in the process of negotiations about acceding to the World Trade Organisation (WTO). In such a context the government has undertaken a number of steps to liberalise foreign trade. The adoption of many WTO-compliant legal reforms has been a visible result of Azerbaijan's work to accede to the WTO. In particular, significant progress was made in 2008 when Azerbaijan was ranked number one reformer within the framework of the World Bank's (WB's) "Doing Business 2009" report.

The Ministry of Economic Development continues to lead the WTO accession process, and Azerbaijan held a WTO Working Party Meeting in Geneva in 2010, in addition to bilateral discussions with the US Trade Representative and the European Union (EU).

Import and export activities have been increasing over the last few years. According to the State Customs Committee (SCC) of the Azerbaijan Republic, in 2010 the foreign trade turnover increased by 34.10%, exports by 45.05% and imports by 7.8%, compared with in 2009. In monetary terms, the volume of the foreign trade turnover was US\$27.92 billion, the volume of imports was US\$6.6 billion and exports were US\$21.32 billion in 2010. The share of the energy resources, including oil, natural gas and refined products, was 94.1% in terms of export structure in 2010.

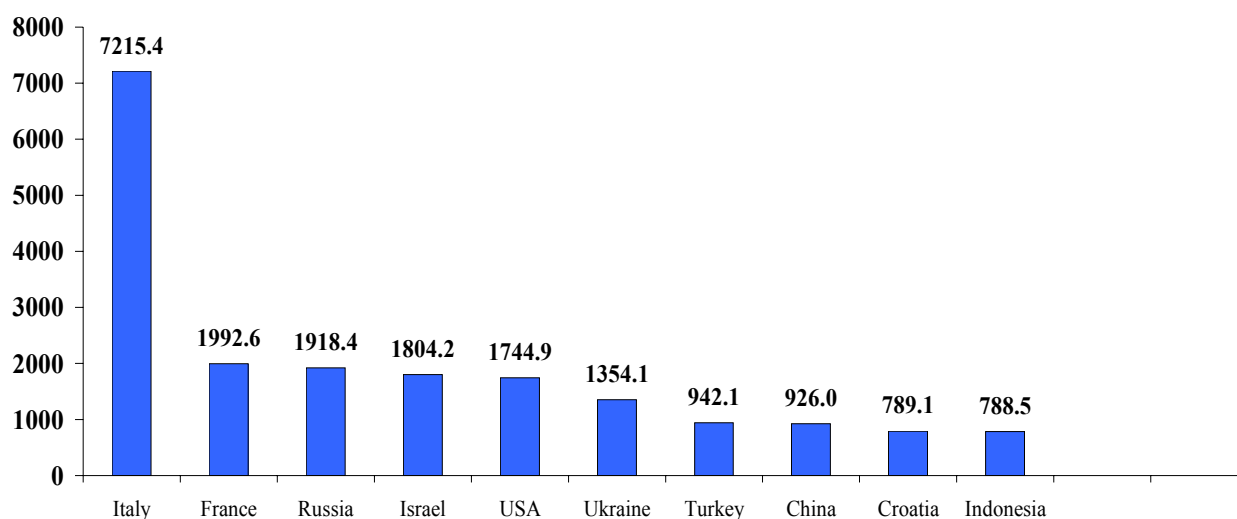
Figure 5 Foreign trade turnover of Azerbaijan (2009-2010)



Source: Azerbaijan SCC

Azerbaijan is developing trade relations with a number of countries. In 2010, there were trade operations with 147 countries. The EU has remained the major destination for the export of Azerbaijani goods. In the EU, the major trade partner of Azerbaijan is Italy, which is demonstrated in the graph below.

Figure 6 Main trade partners of Azerbaijan (trade turnover in 2010, US\$ millions)



Source: Ministry of Economic Development of Azerbaijan

FDI

As a result of the measures taken by the Government of Azerbaijan, the investment climate in the republic has become increasingly more favourable. Foreign investments have been growing since it gained independence. This is an important factor for the continuation of a stable social and economic development in the country.

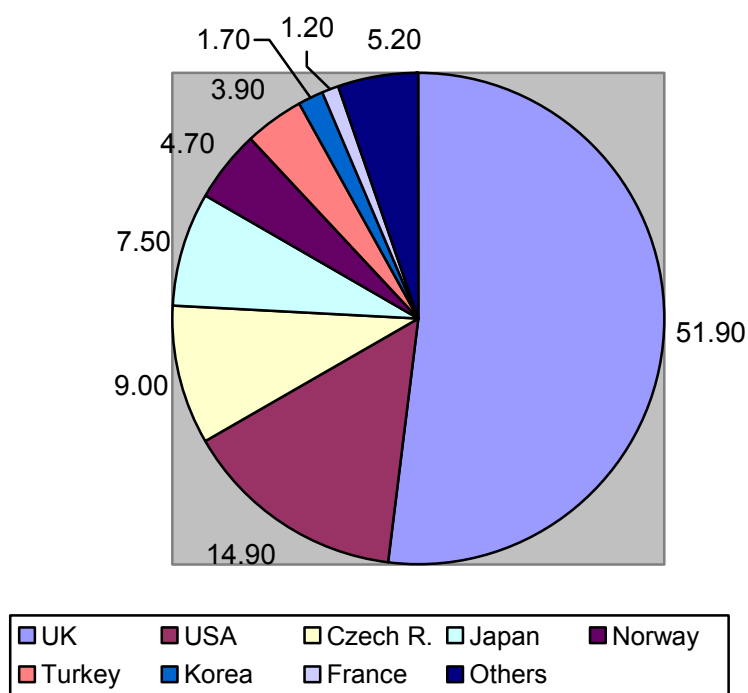
According to the State Statistical Committee of Azerbaijan, in 2010 a total of US\$17.4 billion in investment was attracted into the national economy, out of which US\$8.2 billion was in foreign investments. The UK had by far the highest share of investments with around 51.9%. Investments from the USA were 14.9%, the Czech Republic 9%, Japan 7.5%, Norway 4.7%, Turkey 3.9%, South Korea 1.7%, France 1.2%, and others 5.2%.

A list of bilateral investment agreements are given in Annex 2.

According to Article 42, the Law on the Protection of Foreign Investments states that disputes or disagreements arising between foreign investors and enterprises with foreign investments and the state bodies of the Azerbaijan Republic, enterprises, public organisations and other legal entities of the Azerbaijan Republic, disputes and disagreements between participants of the enterprises with foreign investments and such enterprises themselves are to be settled in the law courts of the Azerbaijan Republic or, on agreement between the parties, in the courts of arbitration, including those abroad, in cases stipulated by legislative Acts of the Azerbaijan Republic in special bodies involved in the settlement of disputes.

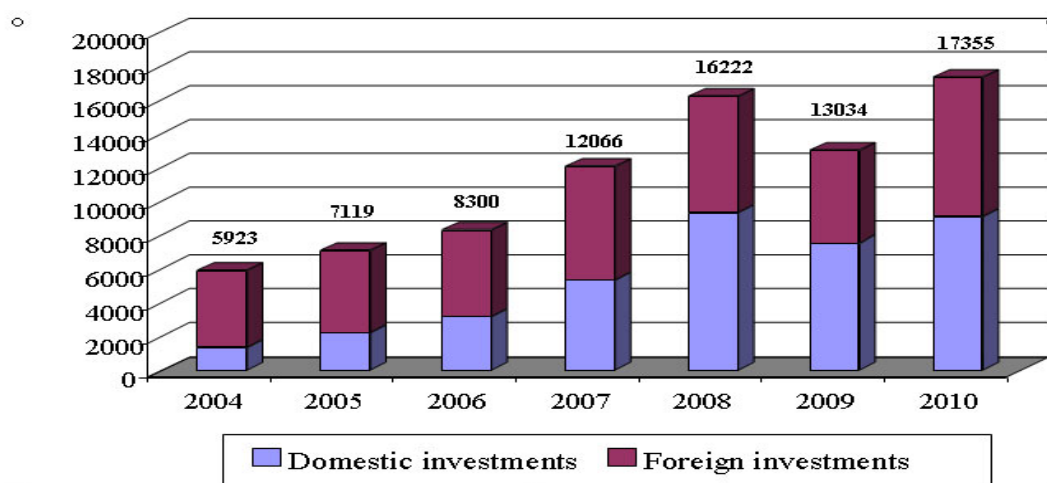
There is no special export credit agency operating in Azerbaijan. Under the Ministry of Economic Development, the Azerbaijan Export and Investment Promotion Agency deals with export promotion activities such as improving the legislative framework and preparing investment plans and programmes for investors as well as editing regular information sources.

Figure 7 Structure of foreign investments by country for 2010



Source: Ministry of Economic Development, State Statistical Committee

Figure 8 Investments in national economy, period 2004-2010 (Mln USD)



Source: Ministry of Economic Development of Azerbaijan

It is estimated that the total amount of investment in energy sector in Azerbaijan since independence has amounted to around \$96.3 billion. Production increases from the Azeri-Chirag- Guneshli (ACG) oil field, along with the projected start of production for the Shah Deniz natural gas field, will translate into about \$58 billion in investment needs.⁴

Free economic zones (FEZs)

⁴ Asian Development Bank, Outlook for Asia and the Pacific, 2009

The government passed a law to establish FEZs in 2009. It was announced that there will be an FEZ near a new Caspian port, and this should be completed in the near future. Azerbaijan's Cabinet of Ministers has approved simplified rules for customs controls, customs checkpoints, customs clearance of goods and the crossing of vehicles and individuals at the boundaries of FEZs. According to the rules, customs checkpoints may be established in the FEZs by the SCC. For these purposes, electronic control and declarations may be used. Under the new rules, goods imported into and exported from the FEZs are not subject to import duties and VAT, or customs duties and taxes (excluding excise duty). However, up to date there is no operational FEZ in the country.

4.4. General energy policy of the country

In 2005, the Government of Azerbaijan adopted the State Programme for the Development of the Fuel and Energy Sector (2005-2015), which identifies and sets development targets for the various sub-sectors within the energy sector.

The overall goal of the state programme has been to fully meet the demand for electric power from domestic resources and satisfy the demand for the energy services of the population and the economy through the continued development of the energy sector.

The specific objectives of the state programme are as follows:

- to determine the priority development targets for Azerbaijan's fuel and energy sector in compliance with the best practices and standards of the modern world;
- to implement appropriate scientific and institutional actions aimed at enhancing the operating effectiveness of the various industries within the fuel and energy sector;
- to ensure the implementation of appropriate technology measures for the improved production, processing, transportation, storage, accounting and consumption of energy resources;
- to help enable an environment for sound competition in the fuel and energy sector;
- to increase the volume of investments drawn for the development of the fuel and energy sector;
- to ensure environmental safety in the fuel and energy sector;
- to ensure a more successful collection of fuel and energy (electricity and natural gas) bills.

The state programme has a specific action plan of activities to be implemented in each sub-sector from 2005-2015.

The implementation of the energy strategy of Azerbaijan has also been successful by focusing on the following directions:

1. increasing the production of energy resources;
2. ensuring Azerbaijan's access to the global markets of energy sources through the attraction of international oil companies, foreign business circles and large investments in oil and gas projects;
3. establishing export pipelines to ensure the delivery of Azeri oil products to the global markets;

4. accumulating and increasing incomes from oil for future generations, and their utilisation for the present generation, considering the social needs of the country, and its economic prosperity and development requirements; and
5. importing modern techniques and technology.

Azerbaijan is also stepping up efforts to develop its renewable energy (RE) sources. These efforts are part of a long-term energy policy that envisages a leading role for Azerbaijan in green energy. In this regard the “State Programme on the Use of Alternative and Renewable Energy Resources in Azerbaijan” was adopted in 2004. The energy statistics and data are organised by the State Statistical Committee.

The objective of the state programme is to promote power generation from renewable and environmentally sound sources and to more efficiently utilise hydrocarbon energy sources.

The major tasks of the state programme include the following:

- to define the potential of alternative (renewable) energy sources for electric power generation;
- to raise the efficiency of the utilisation of the country’s energy sources by developing RE sources; to ensure the creation of additional jobs by developing new energy production;
- to increase the energy production capacities through the development of alternative energy sources and thereby ensuring the energy security of the country.

In 2009, the government established the State Agency on Alternative and Renewable Energy Resources.

According to Decree No. 187, on 15 October 2005, of the Cabinet of Ministers of the Azerbaijan Republic, imports of wind appliances and their parts are free from customs duties and VAT. There is still not another incentive in Azerbaijan. Questions relating to obligations, targets and statistics are not available.

5. LEGISLATIVE FRAMEWORK FOR ENERGY INVESTMENT

5.1. Legislation relevant to investment in the energy sector

5.1.1. Constitutional provisions

According to Article 151 of the Constitution of Azerbaijan, whenever there is disagreement between normative-legal Acts in the legislative system of the Azerbaijan Republic (except for the Constitution of the Azerbaijan Republic and Acts accepted by way of referendum) and international agreements wherein the Azerbaijan Republic is one of the parties, the provisions of international agreements shall dominate.

According to Article 69 of the constitution, foreign citizens and stateless persons staying in the Azerbaijan Republic may enjoy all rights and must fulfil all obligations just as citizens of the Azerbaijan Republic do if not otherwise specified by legislation or international agreements to which the Azerbaijan Republic is one of the parties.

5.1.2. Establishment of enterprises (national and foreign companies)

Azerbaijan has two major laws regulating foreign investments, which are the Law on the Protection of Foreign Investments (15 January 1992, No. 52) and the Law on Investment Activity (13 January 1995, No. 952).

Generally, there is no difference between the establishment of enterprises with foreign capital and those with local capital. Azerbaijani law recognizes the following types of commercial legal entities (commercial legal entities are defined as those operating for profit).

- General partnership (GP)
- Limited partnership (LP)
- Limited liability company (LLC)
- Additional liability company (ALC)
- Joint-stock company (open or closed JSC)
- Cooperatives.

LLCs and JSCs are the most popular choices of legal entities. Under the Law of the Azerbaijan Republic on the Protection of Foreign Investments, foreign investments in Azerbaijan may take any of the following forms:

- participation in enterprises and organisations jointly established with Azerbaijani legal entities and citizens;
- establishment of enterprises that are wholly owned by foreign investors;
- purchase of enterprises, property, buildings, structures, shares, bonds, securities, etc., subject to Azerbaijani laws governing foreign ownership;
- acquisition of proprietary rights to use land and other natural resources;

- conclusion of agreements with Azerbaijani legal entities and citizens providing for other forms of foreign investment.

According to Article 7 of the Law on the Protection of Foreign Investments, legislative Acts of the Azerbaijan Republic might determine territories whereon the activity of the enterprise with foreign investments is restricted or prohibited from the point of view of defence, national security, protection of the environment and population.

According to Article 5 of the Law on the Protection of Foreign Investments, the legal regime of foreign investments and also the activity of foreign investors in connection with their implementation might not be more favourable than the regime for property, proprietary rights and also the investing activity of legal entities and citizens of the Azerbaijan Republic, except in cases envisaged by the present law.

All companies operating in Azerbaijan need to be registered. Without formal registration, a company may not carry out business in Azerbaijan (for example, maintain a bank account, clear goods through customs, etc.). As a part of the ongoing business law reforms, a “One Window” principle was introduced from 1 January 2008. Registration procedures involving several governmental bodies (for example, the Ministry of Justice, tax authorities, the State Social Insurance Fund and the State Statistical Committee) have been eliminated, obligating businesses to only register with the Tax Ministry. Azerbaijan is a party to the Hague Convention on Abolishing the Requirement of Legalisation for Foreign Public Documents and thus does not require legalisation of documents produced from and executed in the Hague Convention’s signatory countries. The established period for state registration with the Tax Ministry is officially set at three days for commercial organisations.⁵

5.1.3. Foreign investment legislation

Azerbaijani legislation establishes a very open national regime for FDI, which means that FDI are welcome in any sectors where the local investor is allowed to invest. There are no special permits or specific registration requirements for foreign investment. A foreign investor in Azerbaijan benefits a non-discrimination regime.

According to Article 2 of the Law on the Protection of Foreign Investments, the following persons and entities might be foreign investors in the Azerbaijan Republic:

- a) foreign legal entities;
- b) foreign citizens, stateless citizens and citizens of the Azerbaijan Republic permanently living abroad, if they have been registered as participants of economic activity in the country of their citizenship or permanent residency;
- c) foreign states; and
- d) international organisations.

According to Article 3 of the Law on the Protection of Foreign Investments, foreign investments might be represented by any kind of property and proprietary rights, including right to the results of intellectual activity and other immaterial rights being contributed by

⁵ PWC Azerbaijan, Doing Business and Investing in Azerbaijan, 2011 edition

foreign investors to the objects of business activity and other kinds of activity with the objective of obtaining the profits.

Foreign investors might make investments in the territory of the Azerbaijan Republic by the way of the following:

- a) participation in enterprises and organisations established together with the legal entities and citizens of the Azerbaijan Republic on the basis of sharing;
- b) establishment of enterprises completely belonging to foreign investors;
- c) purchase of enterprises, proprietary complexes, buildings, structures, shares in enterprises, other shares, bonds, securities and also other property that, according to the legislation of the Azerbaijan Republic, might belong to foreign investors;
- d) acquisition of rights for the use of land and other natural resources and also other proprietary rights; and
- e) conclusion of agreements with legal entities and citizens of the Azerbaijan Republic providing for other forms of the realisation of foreign investments.

Foreign investments are protected by certain guarantees provided by the government and legislation, including guarantees against adverse changes in legislation — the general rule is that the legislation in force at the time of making an investment continues to apply to individual investors for the subsequent ten years, notwithstanding any adverse change in law.

According to Article 6 of the Law on the Protection of Foreign Investments, enterprises with foreign investments might carry out any kind of activity if they have not been prohibited by legislative Acts of the Azerbaijan Republic. Some kinds of activity (following the regulations of the Cabinet of Ministers of the Azerbaijan Republic) might be accomplished by the enterprises with foreign investments only after obtaining special permits (licences).

5.1.4. Legislation on land/immovable property/real estate

Legislation regulating land rights in Azerbaijan consists of the Civil Code, the Land Code of the Azerbaijan Republic, dated 2 June 1999 (the Land Code), the Law on Land Reform, dated 16 July 1996 (the Land Reform Law), the Law on Land Lease, dated 17 March 1999 (the Land Lease Law), the Law on the Land Market, dated 7 May 1999 (the Land Market Law) and other legislative Acts. Land rights are also regulated by the relevant provisions of the Civil Code. Azerbaijani law provides for the following basic rights over land:

- ownership;
- lease; and
- use of land.

Real estate in Azerbaijani legislation is described as “immovable property”. Pursuant to the Law on the State Register of Immovable Property (the State Registration Law), the creation of rights in property (ownership and other rights), transfers and termination of rights are subject to state registration with the register of immovable property.

As a general rule, the registration of property rights over immovable property shall be accomplished within 20 days. The State Registration Law contains special provisions in respect of the registration of certain rights in immovable property.

- Ownership and other property rights regarding the unfinished construction of immovable property can be registered in advance;
- Property rights regarding individual apartments in unfinished buildings or non-residential properties and mortgages thereon can also be registered in advance; and
- In the event immovable property is leased or given for use for a period exceeding 11 months, such a right shall be registered by either party of a lease or use agreement.

The concept of ownership in Azerbaijan includes the right to exercise possession, the right to use/benefit and the right to dispose of the land (transfer ownership or other rights over land to third parties). It should be noted that the right of ownership of land is a privilege of (I) the Azerbaijan Republic, (II) municipalities and (III) Azerbaijani individuals and legal entities.

Foreigners (individuals and legal entities) and stateless individuals may not own land in Azerbaijan and may not be granted purchase options on leases. However, international organisations, foreign legal entities and foreign citizens and states may lease land in Azerbaijan.

Foreigners who acquire right of ownership of land through general legal procedures such as the enforcement of security interest, grant or succession shall dispose of their ownership (for example, through a sale) within one year; otherwise, the land shall be acquired by the state or relevant municipality. There is no legal limitation for the ownership of buildings, constructions, etc. by foreign individuals and legal subjects.

Temporary land use rights are granted for up to 99 years and may be extended by the parties. A perpetual land use right is granted for an indefinite period. The holder of such a right is liable only for the land tax for land use.

Perpetual and temporary land use rights are granted by the state and municipalities only in exceptional circumstances to a limited number of persons listed in the Land Code. Landowners may grant perpetual or temporary land use rights under an agreement with the land user. Land use terms are defined by an agreement between the landowner and the land user.

Land lease is the use of land for a definite period, for a charge. Leases are concluded for a period agreed by the parties. Rent payments for the lease of privately held land parcels are freely negotiable.

Rent payments for state or municipally owned land parcels are determined according to market conditions, but cannot be less than specified statutory rents. With regard to agricultural land, discounts from statutory rents are available depending on market conditions in the agricultural sector.⁶

5.1.5. Competition legislation

Azerbaijan is still in transition from a command economy to a full-fledged market economy. Monopolies, price setting and state subsidies still remain as part of the domestic economy.

⁶ Azerbaijan Export and Investment Promotion Foundation, Doing Business in Azerbaijan, 2009

Competition issues, generally in business activities, and particularly in trade and foreign investment in the territory of Azerbaijan are primarily regulated by four main laws.

- Law No. 526 on Antimonopoly Activities, passed in 1993, subsequently amended in 1997, 2001 and 2002;
- Law on the Protection of Consumer Rights, passed in 1995;
- Law No. 1049 on Unfair Competition, passed in 1995; and
- Law No. 590 on Natural Monopolies, passed in 1998 and amended in 2001.

At the lower levels of the economy (small enterprises, factories and retail), the market economy is fully established and developed. At higher levels, such as large factories, wholesale trade, construction, energy and mining industries, monopolies still exist and prevent the development of market-based competition. In the energy sector, the state-owned company the State Oil Company of the Azerbaijan Republic (SOCAR) is a monopoly that proposes prices for goods and services that are the subjects of review and approval by the Tariff Council.

5.1.6. Corporate taxation

Azerbaijan currently has three different tax regimes for the energy sector.

1. Statutory tax regime;
2. PSA; and
3. Host government agreement (HGA).

Most major oil companies operating in Azerbaijan under oil and gas contracts are party to special PSAs. While in other countries PSAs are a type of contract, all PSAs in force in Azerbaijan have the power of law and have a higher legal status than other current laws of the Azerbaijan Republic.

While PSAs are an integral part of Azeri legislation, their interaction with existing Azeri laws and regulations can be complex. Within each PSA, there is a separate section on taxation, which is supplemented with protocols that are intended to clarify and set up the procedures for implementing the PSAs' provisions.

PSA tax regime

Up to June 2011, Azerbaijan had 33 ratified PSAs (including inactive/terminated PSAs), with an exclusive tax regime for each one.

The PSA tax regimes are applicable to each contractor party (signatory to the PSA), the operating company and the subcontractors. In addition, tax protocols that provide guidance on paying taxes and filing reports are negotiated with the Azerbaijani government.

The PSAs ratified by the Milli Majlis and granted the force of law have their own separate tax regime in Azerbaijan. Foreign companies operating as PSA subcontractors in Azerbaijan are referred to as foreign subcontractors (FSCs), and are subject to a simplified tax regime

(withholding of tax in place of the profit tax). This simplified corporate income tax regime does not apply to Azerbaijani legal entity subcontractors.

The HGAs are exclusively for the BTC and South Caucasus pipelines. The statutory tax regime applies to all legal entities (both local and foreign) with the exception of those that are governed by a PSA or HGA, each of which has its own tax rule.

The PSA/HGA tax regimes also generally apply to relevant oil operating companies, foreign investors serving as contractor parties and all Foreign Service companies working with such parties.

Statutory tax regime

Azerbaijan amended the Tax Code in 2001, which introduced 220 new articles and abolished a number of old tax laws. All foreign legal entities doing business in Azerbaijan through a “permanent establishment” must register with the tax authorities regardless of whether their activities are subject to profit taxation.

The tax registration of a representative office or a branch should take place within one month from the start of operations. The termination of a representative office’s or a branch’s activities should be reported to the authorities one month before the cessation of operations.

Profit tax

The Tax Code applies the same tax rate and principles of taxation to all types of legal entities with a registered presence in Azerbaijan. All those who pay profit tax are legal entities (including foreign legal entities) engaged in business activity in Azerbaijan.

Profit tax is computed on the basis of an enterprise’s taxable profit. It is generally determined on the basis of gross realisation (receipts), minus deductible expenses, which are defined as any costs related to generating profits.

According to the Law on the Protection of Foreign Investments, foreign investors can establish enterprises that completely belong to foreign investors (Article 3).

Dividend withholding tax

The 10% dividend withholding tax applies to both domestic and foreign shareholders and is levied in the currency in which the dividend is paid. Double taxation treaties (DTT) may reduce the rate at which the dividend tax applies.

Other withholding taxes

Foreign legal entities without a permanent presence in Azerbaijan are subject to the withholding tax on income, which is derived from the following sources.

- Interest – 10%;
- Rent and royalty – 14%;
- Freight income – 6%;
- Telecommunication services – 6%;

- Financial leasing and insurance payments – 4%;
- Other income – 10%.

From January 2010, individuals are exempt from personal income tax on interest from bank deposits and dividends for a period of three years.

Value added tax (VAT)

Generally, VAT is charged at the rate of 18% for each taxable operation and for the value of each taxable import. From January 2010, legal entities with taxable transactions exceeding an annual threshold of 150,000 AZN (new Azerbaijani manat) (approximately US\$187,000) and individuals with an annual turnover of more than 90,000 AZN (approximately US\$112,000) must register as VAT payers. Other companies carrying out business activity in Azerbaijan may register voluntarily. Only registered VAT payers may charge VAT and claim credit for input VAT.

Mining tax

Legal entities and individuals involved in the exploration of minerals in Azerbaijan are obliged to pay the mining tax. The rate depends on the type of mineral extracted and varies from 3% to 26% of its total wholesale price.

FSC tax

FSCs are subject to the withholding tax (from 5% to 8%, depending on the PSA regime) on the gross payments received for goods and services supplied within Azerbaijan.

The withholding tax satisfies all FSC tax obligations. The only exception is personal income tax for FSC employees. Personal income tax for FSC employees may be subject to the tax residency and tax deduction benefits.

Some PSAs envisage the application of the statutory profit tax regime for FSCs during the PSAs' development and production period.⁷

5.1.7. Legislation regulating conditions for entry for foreigners

Foreign employees who are employed by enterprises (affiliates or representative offices) operating in Azerbaijan are subject to Azerbaijan's Labour and Employment Law, except for those working in enterprises, branches or representative offices located in Azerbaijan under employment contracts concluded with a foreign person or a legal entity in a foreign state.

Foreign nationals wishing to work in Azerbaijan are required to register at their place of residence and obtain work permits. Work permits are issued by the Ministry of Labour and Social Protection of the Population. A work permit may be issued for up to one year and may be extended up to four times. Therefore, the cumulative maximum duration of a single work permit is five consecutive years.

⁷ PWC Azerbaijan, Doing Business and Investing in Azerbaijan, 2011 edition

Heads of representative offices and branches of foreign legal entities and their deputies are not required to obtain work permits in Azerbaijan.

The main legislation in this field is the Law on Exit from, and Entry in to the Country and on Passports (Baku, 14 June 1994, No. 813).

A “one-stop shop” system was applied at the State Migration Service beginning 1 July 2009. According to a presidential decree dated 4 March 2009, foreigners and people without citizenship arriving in Azerbaijan should be granted legal residence and work permits according to the single-window principle within seven days of application. The fee to acquire a one-year licence for a migrant worker is equal to 1,000 AZN (approximately US\$1,250).

5.1.8. Foreign exchange and securities laws/regulations

Foreign exchange transactions are governed by the Law on Currency Regulation of 21 October 1994. The Central Bank of Azerbaijan sets the foreign exchange policy and issues regulations related to foreign exchange controls.

Azerbaijan has a liberal exchange system. There are no restrictions on converting or transferring funds associated with an investment into freely usable currency and at a legal, market-clearing rate. Conversion is carried out through the Baku Interbank Currency Exchange Market and the Organised 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 and there are no difficulties in making a foreign currency exchange.

The Azerbaijani manat is the legal currency of the Azerbaijan Republic. Payment for all goods, work and services sold in Azerbaijan must be made in manats except where the payer holds a special licence issued by the Central Bank of Azerbaijan.

Foreign exchange regulations allow residents and non-residents to transfer foreign currency from Azerbaijan.

In January 2006, Azerbaijan denominated its currency into the AZN, which is pegged to the US dollar by the CBA’s monetary policy. Currently, the exchange rate is 0.8 AZN = US\$1.

5.1.9. Legislative basis regulating compensation for losses and expropriation

The Law on the Protection of Foreign Investments (Baku, 15 January 1992, No. 57) protects foreign investors against nationalisation or expropriation of property, except where national interests are endangered. Compensation shall be “prompt, effective and adequate”. In particular the law provides for the following:

- guarantee against nationalisation and requisition — foreign investments are not subject to nationalisation (except in cases of harm to the population and state) and requisition (except in cases of natural disasters, epidemics, accidents and emergencies);

- foreign investors are guaranteed immediate, adequate and effective compensation in cases of nationalisation and requisition. Compensation should be commensurate with the amount of the investment at the time of nationalisation or requisition, payable in foreign currency, and this may be freely transferred abroad;
- guarantee of compensation of damages — foreign investors are entitled to compensation for damages, including lost profits, incurred as a result of unlawful acts of state authorities; and
- guarantee of repatriation of profits — foreign investors are entitled to repatriate profits derived from foreign investments subject to the payment of applicable taxes and duties.

Nationalisation of property can take place only when it is authorised by parliamentary resolution, although there have been no cases of nationalisation or requisition against foreign firms in Azerbaijan. Requisition by a decision of the Cabinet of Ministers is possible in the event of natural disasters, epidemics or other extraordinary situations.

5.1.10. Legislative framework for privatisation

The privatisation process in Azerbaijan occurred in two stages, the first from 1995 to 1998, which was extended, however, until the adoption of the Second Programme of the Privatisation of State Property of the Azerbaijan Republic (the Second Privatisation Programme) in 2000.

This first wave of privatisation allowed four methods for the privatisation of state-owned property: first is the privatisation of small enterprises; second is the privatisation of medium- and large-scale enterprises; third is the privatisation of banks (which, however, were later excluded from the scope of the programme); and fourth is the sale of shares in specialised investment funds (this latter method did not develop into an effective privatisation tool).

The programme introduced privatisation checks (vouchers) that could be sold or redeemed in exchange for assets subject to privatisation. All privatised medium- and large-scale enterprises (except those already existing as JSCs) were to be restructured into JSCs, the shares of which were to be distributed through discount sales to employees of privatised enterprises, voucher auctions, investment tenders or cash auctions.

While the first privatisation programme did not fully achieve its objectives, the Law on the Privatisation of State Property (the Privatization Law) came into effect on 11 August 2000 and the Second Privatisation Programme on 12 August 2000. Together, these allowed the privatisation of some large-scale enterprises and “strategic units” in the telecommunications, chemical and petrochemical and metallurgy sectors.

While the new programme introduced certain new methods of privatisation (such as “special project” privatisation designed to attract strategic investors), it retained the principal methods as provided under the first programme, including voucher auctions and tenders. The validity of the vouchers ended on 1 January 2011. Under the general principles of the Privatisation Law, all state-owned property (except certain categories prohibited by law) may be privatised. Property that may not be privatised includes subsoil reserves, military facilities, certain entities and organisations funded by the state budget, other units of state importance and certain public facilities.

The main authority responsible for the implementation of the Second Privatisation Programme and coordination of the activities of other authorities related to privatisation is the State Committee for the Management of State Property.

According to the Second Privatisation Programme, the most significant state assets are privatised on the decision of the president, who is also responsible for the approval of foreign investors' participation in such privatisation. Other properties subject to privatisation are privatised on the decision of the State Committee for the Management of State Property.

Specific conditions may apply to foreign investors regarding participation under privatisation tenders. If foreign investors participate in privatisation by reinvesting funds earned in Azerbaijan prior to participation in auction and investment tenders, they must submit to the State Committee for the Management of State Property a statement approved by the tax authorities on such funds.

The Second Privatisation Programme retained a provision from the previous programme pursuant to which foreign investors are allowed to participate in privatisation by means of a special instrument called an option. An option is a registered non-documentary security.

The programme slightly modified regulations concerning the requirement for options where profits obtained in Azerbaijan are reinvested by foreign investors. Options are not required from foreign investors funding their participation in privatisation with net profits obtained in Azerbaijan.

The Second Privatisation Programme and related Acts do not require the use of options on secondary stock or commodity markets.

It is important to note that according to Action Plan 2011-15 approved by the president for the implementation of the State Programme of Poverty Reduction and Sustainable Development 2008-15 (adopted by Decree #3043 from 15 September 2008) the country will begin privatisation of enterprises in the fuel and energy sector.

The action plan prescribes the State Committee for Property Affairs and the MIE to consultations in 2011-15 on the privatisation of enterprises in electric power, oil and gas industries, based on sales of oil and petroleum products.

Other than in the energy sector, privatisation in the sectors for telecommunications, mechanical engineering, the chemical industry, tourism, agriculture, construction and public utilities will also continue during the above indicated period.

5.1.11. Legislation regulating the publishing of laws

According to the Constitution of the Azerbaijan Republic, the laws and decisions of the Milli Majlis (parliament) and decrees and orders of the president of the Azerbaijan Republic come into force from the day of publication. If a different order is not envisaged in the decrees and orders of the Cabinet of Ministers they come into force after the day of their publication.

All these legal acts are published in the newspaper *Azerbaijan*. The newspaper officially belongs to the Milli Majlis of the Azerbaijan Republic.

In addition some branches of the government have their own official newspapers or journals.⁸

5.1.12. Observance at sub-national levels

According to the Constitution of the Azerbaijan Republic, the Nakhchevan AR is an autonomous state within the Azerbaijan Republic and the Constitution of the Azerbaijan Republic, laws of the Azerbaijan Republic, decrees of the president of the Azerbaijan Republic and decrees of the Cabinet of Ministers of the Azerbaijan Republic are obligatory on the territory of Nakhchevan AR.

5.1.13. Intellectual property rights

Under the existing legislation of Azerbaijan, the Cabinet of Ministers is empowered to authorise various state agencies to register and protect intellectual property rights in respective areas.

The State Agency for Standardisation, Metrology and Patents is responsible for the issuance of patents and trademark registration. There is also the State Copyright Agency, which is responsible for the registration of the copyrights.

The maximum duration of protection is different according to the copyright object. The main legislative Act is the Law of the Azerbaijan Republic on Copyright and Related Rights (the Copyright Law) (No. 115-IQ, approved on 5 June 1996).

Violations of intellectual property rights carry civil, criminal, and administrative liability. The Copyright Law protects works of science, literature and the arts (copyrights) as well as stage productions, phonograms of radio or cable broadcasts and computer programs and databases (allied rights).

Azerbaijan is a party to several international agreements concerning the protection of intellectual property, including the Convention Establishing the World Intellectual Property Organisations, the Paris Convention for the Protection of Industrial Property, the Madrid Agreement Concerning the International Registration of Trade Marks, the Madrid Protocol, the Patent Cooperation Treaty, the Eurasian Patent Convention, the Performances and Phonograms Treaty of the World Intellectual Property Organisations and the Copyright Treaty of the World Intellectual Property Organisations.⁹

5.2. Summary of laws/regulations for the energy sector

⁸ <http://www.nyulawglobal.org/globalex/azerbaijan.htm>

⁹ Legal Framework for Doing Business in Azerbaijan, AZPROMO

5.2.1. List of laws and regulations

Since gaining independence in 1991, Azerbaijan has gradually set up a legal framework for developing a free market economy and attracting foreign investments in the energy sector.

The National Assembly adopted a number of 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 (amendments and additions to the constitution were first made via the referendum of 24 August 2002 and more recently 18 March 2009)
- Tax Code of the Azerbaijani Republic (Baku, 11 July 2000)
- Law on Entrepreneurial Activities (Baku, 15 December 1992, No. 405)
- 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 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; (Baku, 10 June 1997, No. 311-IQ)
- The Law on Exit from, and Entry in to the Country and on Passports (Baku, 14 June 1994, No. 813)
- The Law on the Legal Status of Foreign Citizens and Stateless Persons (Baku, 13 March 1996)
- The Law on the State Procurement (Baku, 27 December 2001, No. 245-IIQ)
- The Law on Privatization of the State Property (16 May 2000, No. 878-IQ)
- Decree of the President “On Strengthening the Financial Discipline in the Energy Sector (25 March 2002, No. 893)
- The Law on Energy (Baku, 24 November 1998, No. 541-IQ)
- The Law on Electricity (Baku, 13 June 1998, No. 723)
- The Law on Subsoil (Baku, 13 February 1998, No. 439-IG)
- The Law on Environment Protection (Baku, 4 August 1999, No. 173)
- The Law on the Use of Energy Resources (Baku, 30 May 1996)
- The Law on Environmental Security (Baku, 4 August 1999, No. 172)
- The Law on Power Plants and Heat Generation Plants (Baku, 28 December 1999, No. 84-IG)
- The Law on Gas Supply (Baku, 30 June 1998, No. 513-IG)
- Tax Code of the Azerbaijani Republic (Baku, 11 July 2000)
- The Law on the Use of Energy Resources (Baku, 30 May 1996).

5.2.2. Plans to amend legislation

In the framework of its European Neighbourhood Policy, Azerbaijan and the European Community concluded a partnership and cooperation agreement (PCA) in 1999. In support of the implementation of this PCA and according to the National Indicative Programme (NIP) for 2007-2010 the Azerbaijani MIE and the German Federal Ministry of Economics and Technology (BMWi) have concluded a so-called twinning contract on the “Legal Approximation and Structural Reform in the Energy Sector of Azerbaijan”. The project has developed the draft texts of new legislation as follows.

- Law on Gas Provision
- Law on Electricity
- Grid Code Electricity
- Grid Code Gas
- Action plan for electricity and gas sector restructuring.

It is expected that after necessary internal consultation procedures the new laws and the legal documents will be accepted by the Azerbaijan government.

5.3. Summary of participation in international organisations

Up to date Azerbaijan has diplomatic relations with 158 countries.

Azerbaijan has concluded more than 37 bilateral investment treaties (BITs) on the mutual protection of investments and several more treaties are currently under negotiation. The list of all BITs is in Annex 2.

Azerbaijan is a member of more than 38 international and regional organisations including the Energy Charter (April 1998), UN (March 1992), Council of Europe (March 2001), OSCE (January 1992), CIS (September 1993), Organisation of the Islamic Conference (1992), Council of Europe (2001), ECO (1992), Organisation of the Black Sea Economic Cooperation (1992), European Bank of Reconstruction and Development (1992), WB (1992), UNESCO, UNICEF, World Health Organisation, International Federation of the Red Cross and Red Crescent (IFRCRC), Interpol, International Olympic Committee, etc.

Azerbaijan is a party to the ICSID Convention and a number of bilateral investment protection treaties.

Since 2000, Azerbaijan has been a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

5.4. Exceptions to national treatment

Azerbaijan currently maintains three exceptions to the non-discrimination principle in the “Blue Book” of the Energy Charter. The exceptions relate to the acquisition of real estate by foreigners and participation of foreign investors in privatisation. A short summary of the exceptions is presented below and a full text is given in Annex 3.

Land/real estate

In accordance with the Land Code of the Azerbaijani Republic approved and enacted by Law No. 695-IG of 25 June 1999, foreigners and stateless persons, foreign legal persons, international associations and organisations and foreign states may only lease plots of land in the Azerbaijani Republic.

Private property rights acquired by foreign legal and natural persons as a result of contracts of inheritance, gifts or mortgaging 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 the 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.

Privatisation

In accordance with the Law on Privatisation of State Property of 7 January 1993 and the State Privatisation Programme of State Property in the Azerbaijani Republic 2008, the president of the Azerbaijani Republic, on the advice of the State Committee on Property, decides on the admission of foreign investors into the programme to participate in the privatisation of facilities specified in section 2 of Annex 1 when he decides to grant permission to privatise these facilities and enterprises.

Another exception related to foreign investors' acquisition of privatisation vouchers (cheques), as well as shares of privatised enterprises, shall be exclusively upon the redemption of state privatisation options.

One option is state security issued to the bearer, which 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.

The utilisation of privatisation vouchers (cheques) in the privatisation process by a foreign investor without privatisation options shall not be permitted.

The Second Privatisation Programme slightly modifies regulations concerning the requirement for options where profits obtained in Azerbaijan are reinvested by foreign investors. Options are not required from foreign investors funding their participation in a privatisation with net profits obtained in Azerbaijan.

6. ENERGY SECTOR – SUPPLY AND DEMAND SIDE

6.1.1. Institutional structure

The MIE of the Azerbaijan Republic is the central executive and policy making institution in the energy sector of Azerbaijan. MIE works very closely with the Ministry of Economic Development of the Azerbaijan Republic, SOCAR, Azerenergy OSC (a state-owned electricity company) and other related organisations.

The Ministry of Economic Development of the Azerbaijan Republic is the central executive institution in charge of economic development, state investments, economic relations, foreign investments, sustainable development and business promotion activities as well as of the development of the energy sector in Azerbaijan.

SOCAR is Azerbaijan's state-owned oil and natural gas company. The company is responsible for producing oil and natural gas in Azerbaijan, operating the country's two refineries, running the country's pipeline system and managing the country's oil and natural gas imports and exports. Although the MIE handles exports as well as exploration and production agreements with foreign companies, SOCAR is party to all of the international consortia developing oil and gas projects in Azerbaijan. On its own, SOCAR produces about 20% of Azerbaijan's total output with the rest (about 80%) being produced by the Azerbaijan International Operating Company (AIOC), which consists of major oil and gas companies that operate in the oil and gas sector of Azerbaijan.

Azerenerji JSC is state-owned company. Azerenerji is responsible for producing electric and thermal energy. The company has a monopoly position in the market. The company is responsible for the transmission and distribution of electricity in the country, except the distribution business in the capital, Baku.

The Tariff Council is a regulatory body and acts pursuant to authority granted to it by presidential decree (26 December 2005), the Regulations on the Tariff (Price) Council and the Resolution by the Cabinet of Ministers (9 March 2006). The Tariff Council establishes the tariff methodology, approves the tariff level proposed by regulated companies (including but not limited to energy), proposes changes to the legal framework as it relates to pricing and settles disputes over price regulation and tariff application. It is an executive authority, guided by the constitution, laws presidential decrees and executive orders, the Cabinet of Ministers' enactments and resolutions and existing international agreements. It may act upon its own initiative within its tariff jurisdiction.

The state regulation as regards the safe use of nuclear energy and ionising radiation and the safe management of radioactive waste is implemented by the Ministry of Emergency Situations (MES). The ministry is the central executive authority established in 2006 and has wide competences in the field of emergency situations as well as the safe transportation and utilisation of nuclear waste.

The Ministry of Transportation and relevant administrations regulate oil transportation by sea, rail and road, excluding pipelines. The issue of safety during the transportation of oil is regulated largely by the MES.

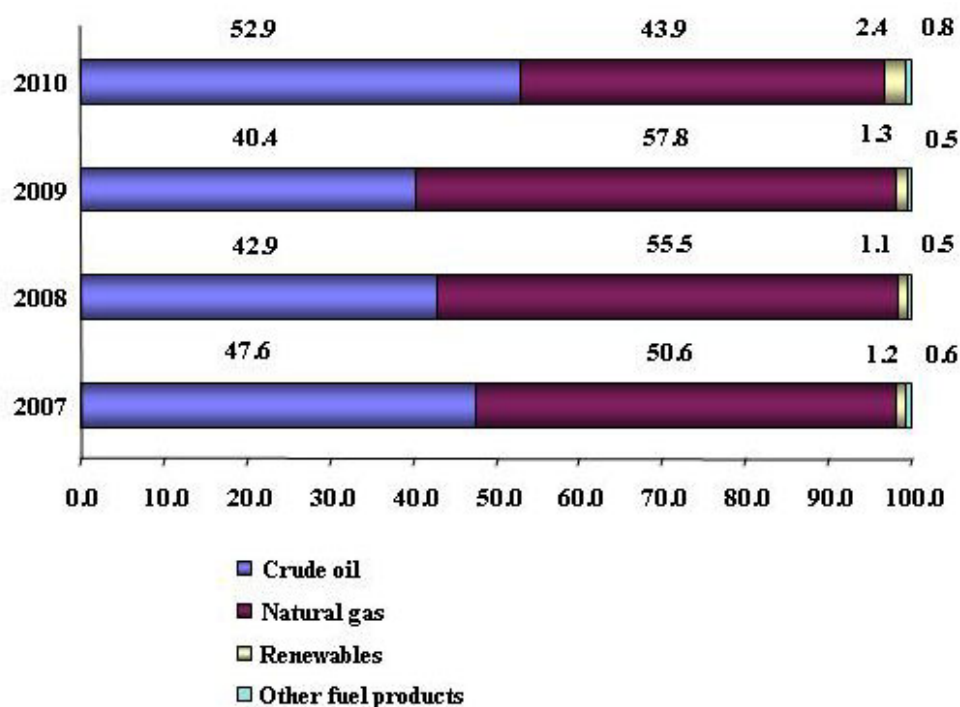
The State Oil Fund of the Azerbaijan Republic (SOFAZ) was established in accordance with Decree of the President of the Azerbaijan Republic #240, dated 29 December 1999, "On the Establishment of the State Oil Fund of the Azerbaijan Republic". The fund was established to ensure intergenerational equality of benefit with regard to the country's oil wealth, whilst improving the economic well-being of the population and safeguarding economic security for future generations. The fund's activity is directed to the achievement of the following objectives:

- preserving macroeconomic stability, ensuring fiscal-tax discipline, decreasing dependence on oil revenues and stimulating development of the non-oil sector;
- ensuring intergenerational equality with regard to the country's oil wealth and accumulating and preserving oil revenues for future generations; and
- financing major national projects to support socio-economic progress.

6.1.2. Supply and demand

At the present time, Azerbaijan provides 100% of its gross energy consumption through domestic production. The country does not depend on foreign resources in the energy sector. Azerbaijan exports oil, natural gas and electricity. The structure of prime energy supply is presented in the graph below.

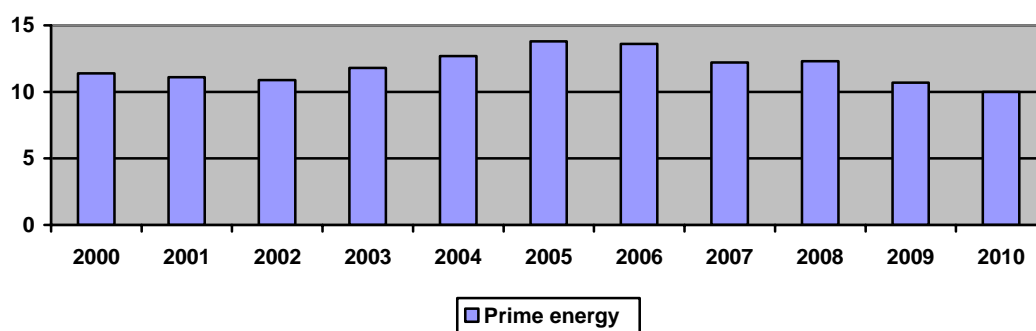
Figure 9 Total energy supply of primary energy products, in percent



Source: Ministry of Industry and Energy, 2011

In 2000, Azerbaijan consumed 11.4 million tons of oil equivalent. From 2000 to 2005, the primary energy consumption increased, reaching 13.8 million tons of oil equivalents in 2005. Since then the consumption has been steadily decreasing down to 10.0 million tons of oil equivalent in 2010. The total primary energy consumption in Azerbaijan for the years 2000-2010 is presented in the graph below.

Figure 10 Primary energy consumption (million tons oil equivalent), 2000-2010



Source: BP Statistical Review of World Energy, June 2011

Presently, hydrocarbons are produced by 58 oil and gas fields, out of which 41 sites are onshore and 17 sites are offshore. It is estimated that 1656.9 million tons of oil and condensate and 570.2 billion m³ (bcm) of natural gas have been produced from these fields from the start and up to 2010.

Only in 2009 were 50.4 million tons of oil and condensate and 23.6 bcm of gas produced in Azerbaijan. Out of this overall amount SOCAR produced 8.5 million tons of oil and condensate and 6.9 (bcm) of gas. The remaining 40.2 million tons of oil and 10.5 bcm of gas were produced at the Azeri-Chirag-Gunashli field, which is operated by the AIOC (including 3.9 bcm of gas from GCA for SOCAR), 1.6 million tons of condensate and 6.2 bcm of gas at the Shahdaniz field (including 0.8 bcm of gas from the Shahdaniz field for SOCAR), 1.2 million tons of oil and condensate and 0.1 bcm of gas from onshore joint ventures and operating companies.¹⁰

Table 4 Overview of the energy data

Energy Overview	
Proven Oil Reserves (January 1, 2010)	7 billion barrels
Oil Production (2010)	50.8 million tones/year
Oil Consumption (2010)	1.17 million barrels per day
Crude Oil Distillation Capacity (2010)	399 thousand barrels per day
Proven Natural Gas Reserves (January 1, 2010)	2,0 trillion cubic meters
Natural Gas Production (2010)	26.3 billion cubic meter
Natural Gas Consumption (2010)	7.2 billion cubic meter
Electricity Installed Capacity (2010)	6.4 GWt
Electricity Production (2010)	18.4 billion kilowatt hours
Electricity Consumption (2010)	14.5 billion kilowatt hours
Major Oil/Gas Ports	Baku, Sangachal (BTC)

Source: Ministry of Economy of Azerbaijan, American Energy Information Administration

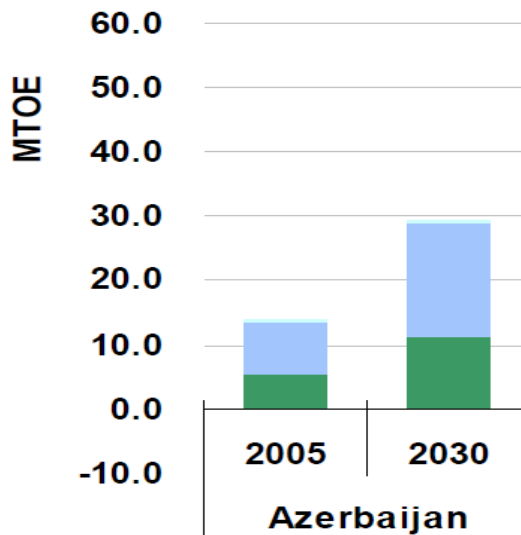
Azerbaijan's primary energy demand is projected to increase from 13.9 Mtoe in 2005 to 29.5 Mtoe in 2030, growing by 3.1% per year. It is estimated that nearly 60% of the energy mix will be dominated by natural gas, which is mainly used for power generation.

The second largest share of the energy mix will be provided by oil, which is mainly used in the transport sector. It is projected that Azerbaijan will experience growth in the energy

¹⁰ SOCAR Annual Report, 2009

extracting industry but, on the other hand, development will be led by the service sectors, which would result in a relatively slow growth in energy demand compared with the GDP growth. In terms of per capita energy demand, Azerbaijan will reach 3.07 toe in 2030, increasing from 1.66 Toe in 2005.

Figure 11 Prime energy demand growth (2005-2030)

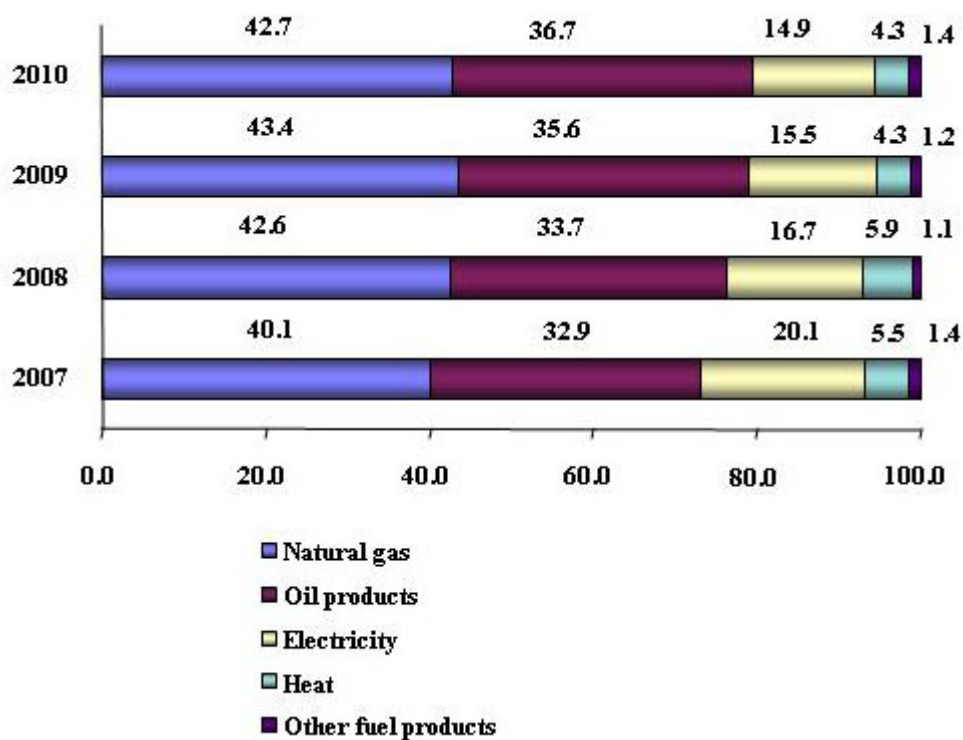


Source: Asian Development Bank, Energy Outlook for Asia and the Pacific, 2009

6.1.3. Energy consumption by sectors

Azerbaijan has a diverse prime energy supply in terms of different fuels. As of 2010, the pattern of energy consumption by different energy products shows that the share of natural gas has been increasing up to 42.7% in 2010 from 40.1% in 2007. This development is due to the increasing consumption of natural gas by power stations and the ongoing gasification programme extended to new residential and commercial customers. The second-largest share of energy product consumption belongs to oil products, which have increased from 32.9 % from 2007 up to 36.7 % in 2010. Electricity consumption fell from 20.1 % in 2007 down to 14.9% in 2010 due to the implementation of a metering programme and switching from electricity to gas heating in the residential sector.

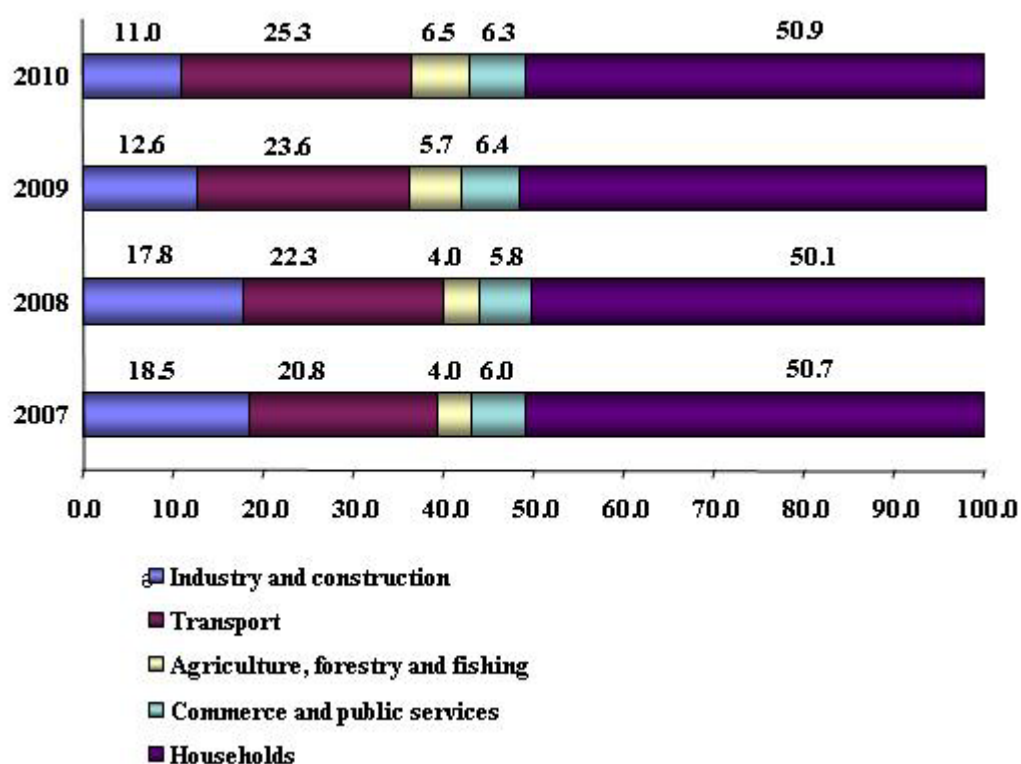
Figure 12 Final consumption of energy products, in percent



Source: Ministry of Industry and Energy, 2011

As of 2010, the household sector has the highest share of the final energy consumption in Azerbaijan (50.9%). The transport sector has the second highest share (25.3 %). The share in the final consumption of the industrial sector has been falling over the last several years and reached 11.0 % in 2010.

Figure 13 Final energy consumption by economy sectors, in percent



Source: Ministry of Industry and Energy, 2011

Azerbaijan is a relatively small energy consumer in terms of both total consumption and consumption per head. The Economist Intelligence Unit estimates consumption per capita at 1.53 tons oil equivalent (toe) in 2010. The country is a net exporter of oil and was a net importer of natural gas until 2007. A large gas field development (Shah Deniz) and infrastructure investment contributed to substantial gas exports. Despite being a small consumer, Azerbaijan has a high level of energy intensity (energy required to generate one unit of GDP), indicating energy inefficiency and an economy with a relatively small tertiary sector. For 2010, the country's energy intensity is estimated at 489.8 toe/GDP in US\$ at 2005 prices; in comparison, the US energy intensity is estimated at 168.6 toe/GDP in US\$ at 2005 prices.

6.1.4. Energy prices, subsidies and plans for achieving market conditions

The government has established a medium-term tariff policy that incorporates a transition to full cost recovery for utility service providers with a 10% return to equity. This will enable utilities to become financially self-sustaining. The Tariff Council chaired by the Minister of Economic Development determines the retail and wholesale tariffs on energy products and services. The council meets each quarterly.

Electricity

The electricity tariff was increased in January 2007 from US \$0.024 per kWh to US \$0.075 per kWh for the first time since 1997. Subsidies to energy utilities were in the order of about \$320 million in 2006 and these decreased to zero from 2007.¹¹

The collection of utility payments has been substantially improved from around 53% in 2007 to 73% in 2009 and 90% in 2010.

The regulated entities are required to provide economic substantiation of the expenses that are part of prices (tariffs). The calculated tariffs are reviewed by the Tariff Council and published upon approval. A uniform tariff for the population and other tariffs for commercial and industrial enterprises are in force. The following types of tariffs exist in the electricity sector:

- tariffs for the purchase of electricity from producers
- wholesale electricity sale tariffs
- retail electricity sale tariffs
- export and import electricity tariffs.

Tariffs are calculated on a cost-benefit basis, using reports for previous years and actual data, as well as forecasted data, taking into account estimations by the utility companies.

Table 5 Electricity tariffs as of 6 January 2007

No	Services	Tariffs 1 kWh per USD cent
	Wholesale tariffs	
1	“Azerenergy”'s production	5,2
2.	Small hydropower stations	3,1
3	Wind Energy	5,7
	Retail tariffs	
4	All consumers	7,0
	Transit tariffs	
5.	Transit of electricity	0,3

Source: Tariff (Price) Council of the Azerbaijan Republic

Natural gas

Prices for services for the pipeline transportation, storage and distribution of natural gas are determined by the Tariff Council (TC), and approved by the Ministry of Economic Development and the Ministry of Finance. The tariffs are determined by the TC on the basis of proposals submitted by the utility companies. In the natural gas sector, Azerbaijan has separate tariffs for the following:

- wholesale purchase of natural gas

¹¹ Report of the Janub Gas Fired Power Plant Project

- retail sale of natural gas to end consumers
- transportation of natural gas.

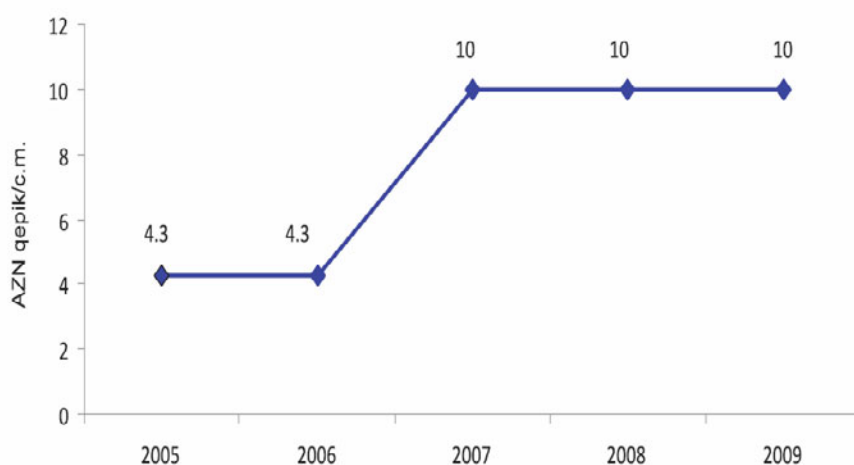
Regulated entities must submit the following data to the TC:

- reference on substantiation of prices and on the need to revise them
- calculation of cost prices of the entity's goods and services
- expense items for the last two years and the last reporting period
- projected costs, breakdown of expenses related to production (services) and profit
- taxes and other payments
- breakdown of payables and receivables
- auditor's opinion on the entity's activities
- comparative table of new and existing prices.

The TC's decision is communicated to the public through the press.

As of July 2009 the TC approved natural gas tariffs for residents and industry at 100 AZN (\$125/1000 m³). The graph below shows the evolution of the natural gas price from 2005 up to 2009.

Figure 14 Natural gas price for industrial users



Note: the prices are given above in Azerbaijani manats. The exchange rate used for this report is \$1=0.808 manats

*Source: T C of Azerbaijan
Oil products*

The prices of oil products are regulated in similar way to that described above for natural gas. There are different tariffs for each oil product in Azerbaijan. According to the TC resolution on the regulation of oil products in the republic, as of 6 January 2007, the prices of oil and oil products increased. The current wholesale and retail prices are given in the table below.

Table 6 Wholesale and retail prices for oil products

No	Name of the Products	Wholesale prices in manats	Retail prices in manats

		1 ton	1 ton	1 liter
1.	Petroleum AI-95	736,00	786,00	0,60
2.	Petroleum AI-92	670,00	720,50	0,55
3.	Petroleum AI-80	670,00	720,50	0,55
4.	Diesel	485,00	535,50	0,45
5.	Reactive motor oil	307,00		
6.	Naphtha	210,00		
7.	Liquid gas (Butane – buntline and Propane – propylene constraints)	230,00		
8.	Gas petroleum	210,00		
9.	Motor oil DT-36	200,00		
10.	Motor oil DT-20	250,00		
11.	Black oil	100,00		
12.	Motor oil M-12VB, M-14V2	726,00	776,30	0,70
13.	Industrial oils İ-12A, İ-20V, İ-40A, İ-8B1, İ-30V	560,00	609,95	0,55
14.	Turbine oils T-22, T-30, T-46	505,00	554,50	0,50
15.	Transformation oils T-1500	615,00	665,40	0,60
16.	Other type oils AK-15, S-11, XM-6, K-12, K-19, VM-4	450,00	499,80	0,42
17.	Bitumen BN-60/90, BNB-60/70	160,00		
18.	Bitumen MQO	95,00		
19.	Bitumen BNV, rubrics A-30, BNB- 70/30, BNB-85/25	250,00		

Note: Prices are given in Azerbaijan manats (1EUR=1.12 AZN)

Source: TCI

7. ENERGY MARKET STRUCTURE BY SECTORS

7.1. Oil Sector

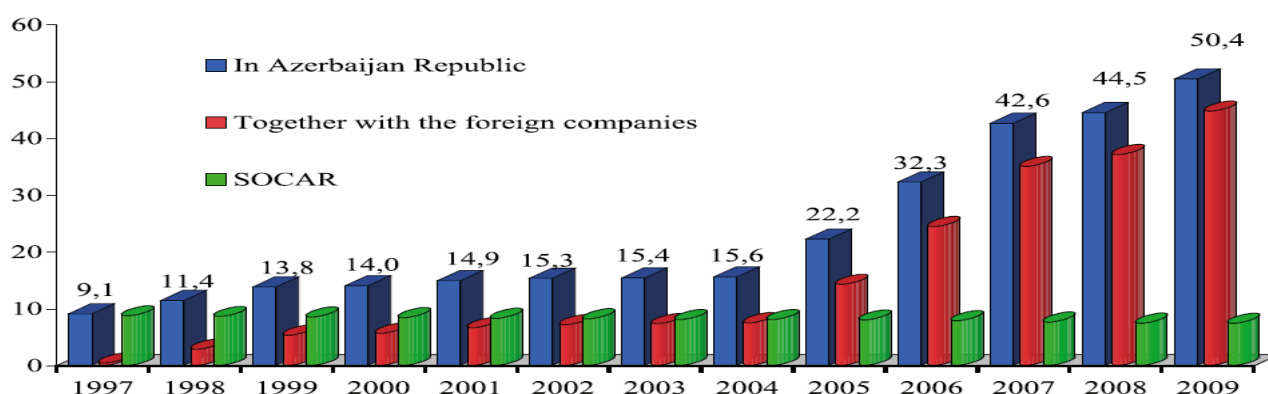
7.1.1. Physical features

Exploration and production

SOCAR is Azerbaijan's state-owned oil and Natural Gas Company and is responsible for producing oil and natural gas, operating the country's two refineries, running the country's pipeline system and managing the country's oil and natural gas imports and exports. The MIE and SOCAR work together on exports as well as exploration and production agreements with foreign companies. SOCAR is party to all of the international consortia developing oil and gas projects in Azerbaijan. On its own, SOCAR produces about 20% of Azerbaijan's total output, with the rest (about 80%) being produced by the AIOC.

The graph below shows oil production from 1997 up to 2009. According to the MIE of Azerbaijan some 50.8 million tons of crude oil were produced in 2010 and there are plans to increase output to between 60 million tons and 65 million tons of crude oil a year by 2015.

Figure 15 Oil production in Azerbaijan (million tons), 1997-2009



Source: SOCAR Annual Report, 2009

In 2010, Azerbaijan had an estimated 7 billion barrels of crude oil reserves. The main oil reserves are located offshore in the Caspian Sea, particularly the ACG field, which is estimated to have accounted for over 80% of the total oil output in Azerbaijan in 2010.

The government awarded the AIOC a PSA for the ACG block in 1994, when the “Contract of the Century” was signed with major oil companies representing eight countries. The fields are estimated to hold 6.5 billion barrels (890 million tons) of crude oil and currently produce around 800,000 barrels per day (bpd) (40 million tons per year). Most of this is exported via the 1.2 million bpd (60 million tons per year) BTC pipeline to the Mediterranean Sea.

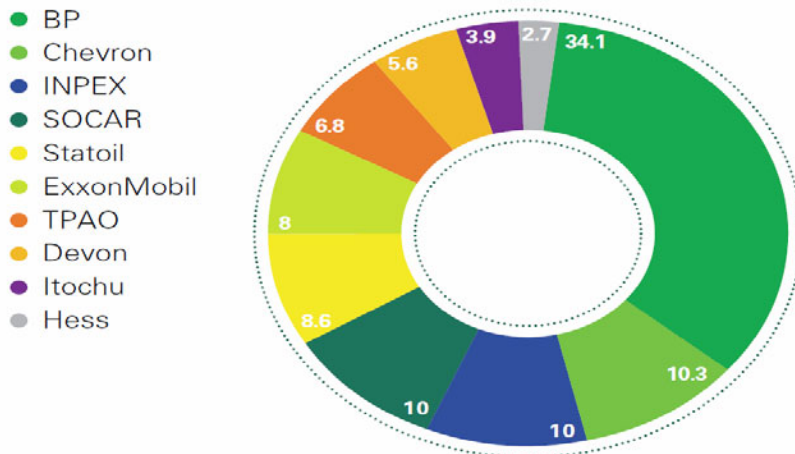
The AIOC is a consortium of ten petroleum companies that have signed extraction contracts with Azerbaijan. The AIOC is led by British Petroleum (BP) and among its members are

large international companies, namely Chevron, Statoil, Türkiye Petrolleri, ExxonMobil and SOCAR. The AIOC has made significant direct investments in the ACG as well as the construction of the BTC pipeline.

Among the major producers there is the Azeri-Chirag-Deepwater Gunashli (ACG) project, for which full field development was conducted from August 2001. In February 2005, oil production began from the Central Azeri Platform – Phase 1, as part of the ACG Full Field Development. In addition, West Azeri and East Azeri production began in December 2005 and October 2006 respectively as part of Phase 2, followed by Deepwater Gunashli as Phase 3 in April 2008.

ACG’s participating interests are as follows: BP (operator – 34.1%), Chevron (10.3%), SOCAR (10%), INPEX (10%), Statoil (8.6%), ExxonMobil (8%), Türkiye Petrolleri Anonim Ortaklığı (TPAO) (6.8%), Devon (5.6%), ITOCHU (3.9%) and Hess (2.7%).

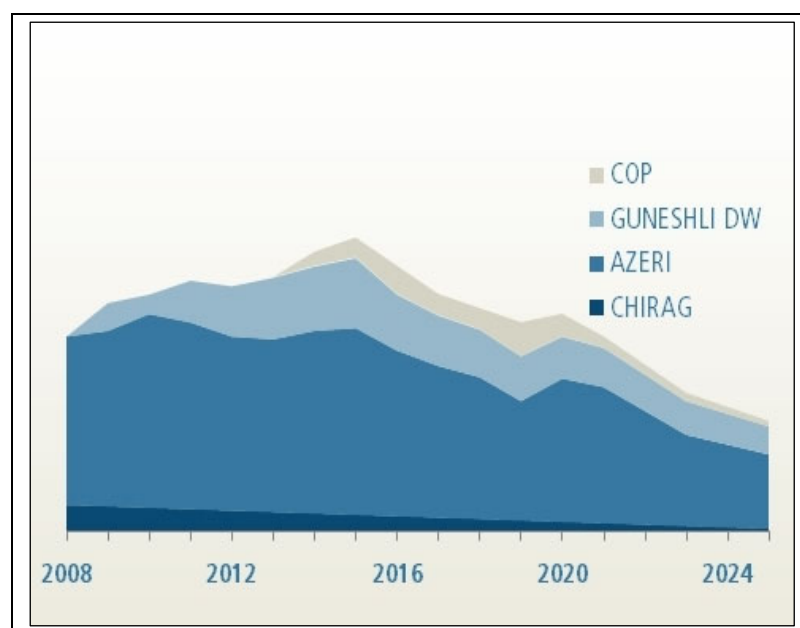
Figure 16 Structure of Azeri-Chirag-Deepwater Gunashli (ACG)



Source: BP Sustainability Report, 2009

In 2010 ACG produced on average 823,100 bpd (300.4 million barrels or 40.6 million tons) from the Chirag, Central Azeri, West Azeri, East Azeri and Deepwater Gunashli platforms.

Figure 17 ACG production profile



Source: SOCAR Trading

In October 2010, BP and SOCAR signed a new PSA on the joint exploration and development of the Shafag-Asiman structure in the Azerbaijan sector of the Caspian Sea. The block lies some 125 km (78 miles) to the South-East of Baku. It covers an area of some 1100 square km and has never been explored before. It is located in a deepwater section of about 650-800 m with a reservoir depth of about 7000 m.

There are number of perspective fields in Azerbaijan, such as Muradkhanly, Kyursangy, Kurovdagh, Gobustan and Inam. These fields are under development and it is expected that new exploration fields will positive contribute to increasing the oil production of the country.

It is estimated that Azerbaijan will see a substantial increase in oil production, mainly from the ACG field in the Caspian Sea, reaching 1.4 million bpd in 2015. Meanwhile, production will moderately decline thereafter, reaching 1.26 million bpd in 2030. Through the BTC pipeline, much of the produced oil (at a peak in 2015; this was more than five times bigger than the domestic demand) will be dedicated to exports.¹²

7.1.2. Oil storage

One of the world's largest integrated oil and gas processing terminals is located 55 km south of Baku; the Sangachal terminal is a vital link in Azerbaijan's oil and gas industry.

The terminal covers an area of 500 square km and consists of two main parts: the Early Oil Project (EOP) and Sangachal Terminal Expansion Programme (STEP).

The terminal receives processes, stores and exports crude oil and gas produced from the Azerbaijan's offshore oilfields in the Caspian Sea. Treated crude oil and gas at the terminal

¹² Asian Development Bank, Energy Outlook for Asia and the Pacific, 2009

are pumped to storage tanks and finally pumped to export pipelines for onward shipment to the world's markets. Below is a short outline of historical events related to the terminal.

- EOP construction started – May 1996
- EOP construction ended – October 1997
- Early oil reaches Sangachal – 25 December 1997
- STEP expansion works started – February 2002
- First oil from Central Azeri reached Sangachal – February 2005.

The EOP terminal houses four crude oil storage tanks (25,500 cubic m each) and can process, store and export in excess of 6 million tons of crude oil per year.

STEP is the part of the terminal that has been expanded to receive, store and process oil from the Azeri and Deepwater Gunashli sections of the ACG field and gas from the Shah Deniz field. It houses a number of facilities including three crude oil storage tanks with 880,000 barrels capacity each.

The Sangachal terminal also hosts two critical facilities for the BTC oil pipeline: the head pump station and the control room. The latter monitors the entire pipeline and can detect problems and isolate the necessary pipeline sections across all three countries. BP is the operator of the terminal.

7.1.3. Crude oil supply infrastructure

Figure 18 Export routes for oil and gas



Source: SOCAR Trading
[BTC oil pipeline](#)

The BTC pipeline is operated by a special company formed by the investors of this pipeline. The construction and operation of the pipeline is governed by the relevant inter-government (Azerbaijan, Georgia and Turkey) and host government agreements. Cross-border transportation other than through the BTC pipeline is governed by the relevant inter-

governmental and inter-agency agreements, which normally include the interested oil concessionaires.

The BTC pipeline is one of the great engineering endeavours of the new millennium. The BTC oil export pipeline transports crude oil from offshore oil fields in the Caspian Sea to the Turkish coast of the Mediterranean, from where the crude is further shipped via tankers to European markets. The pipeline starts from the Sangachal terminal near Baku and runs through Azerbaijan, continuing via Georgia and Turkey to the Ceyhan marine terminal on the Turkish coast of the Mediterranean. The pipeline, which is buried along its entire length, is 1,768 km in total length: 443 km is in Azerbaijan, 249 km in Georgia and 1,076 km in Turkey. The diameter of the pipeline is 42 inches throughout most of Azerbaijan and Turkey. In Georgia the pipeline diameter is 46 inches. The pipeline diameter reduces to 34 inches for the last downhill section to the Ceyhan Marine terminal in Turkey. The pipeline's throughput capacity is one million barrels of oil per day.

The Baku-Tbilisi-Ceyhan Pipeline Company (BTC Co) is responsible for the construction and operation of the whole pipeline. It is an incorporated joint venture company made up of 11 shareholders and managed by BP, its largest shareholder. The linefill of the BTC pipeline started on 10 May 2005 and oil first reached the Ceyhan terminal on 28 May 2006. Approximately 10 million barrels of oil were required to fill the line. The first tanker of crude oil that had travelled through the line was exported on 4 June 2006. About 200 million tons of oil have been delivered through the BTC pipeline since it started operation.

Figure 19 BTC pipeline



Source: <http://defense-update.com>

Baku-Supsa oil pipeline

The Western Route Export pipeline (WREP) for oil transports crude oil from offshore oil fields in the Caspian Sea to the Black Sea, from where the crude is further shipped via tankers through the Bosphorus to European markets.

The pipeline begins at the Sangachal terminal near Baku and travels through Azerbaijan and Georgia to the Supsa terminal on the Georgian coast of the Black Sea. The length of this pipeline is 833 km.

The AIOC owns and operates the pipeline on behalf of SOCAR, the state oil company of Azerbaijan, and its shareholders. WREP has been in operation since February 1999.

Throughout 2007 WREP was shut down to permit extensive repair and replacement work to take place. The programme included section replacements in Georgia (Zestaphoni re-route) and Azerbaijan (the Kura River, west crossing). The work was completed in the first quarter of 2008. During the shutdown other routes were used to deliver oil to world markets, so ensuring there was no impact on demand or ACG production.

Baku-Novorossiysk oil pipeline

The Baku-Novorossiysk pipeline (also known as the Northern Route export pipeline and Northern Early oil pipeline) is a 1,330-km oil pipeline that runs from the Sangachal terminal near Baku to the Novorossiysk terminal on the Black Sea coast in Russia. The Azerbaijani section of the pipeline is operated by SOCAR) and the Russian section is operated by Transneft. The pipeline's capacity is 100,000 bpd and 2.25 million tons of Azeri oil was transported in 2010 (NK s-265). Access to the pipeline is within Azerbaijan's competency. In coordination with its Russian counterpart (Transneft), oil is transported to Novorossiysk, where it is mixed with lower-quality Kazakh and Russian oil shipped by the Caspian Pipeline Consortium.

Other means of transportation

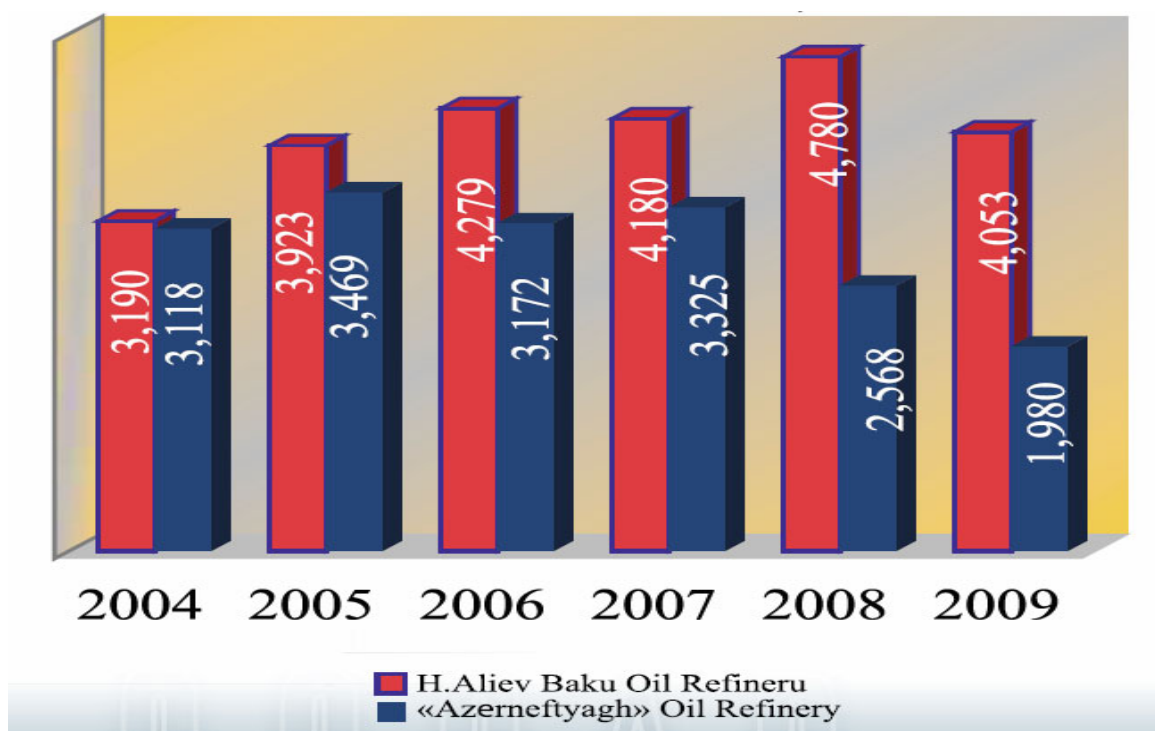
The majority of the transportation of oil by sea is operated by the state shipping company. The state railway company manages oil transportation by railway. Some private companies are involved in the operation and ownership of marine tankers, freight forwarding and oil terminals.¹³

7.1.4. Refining

There are two oil refining plants in Azerbaijan, namely the Baku oil refining plant named after H. Aliyev and the Azerneftiyag oil refining plant that are owned and operated by SOCAR. The main products of the plants are gasoline, straight-run gasoline, jet engine fuel, kerosene, diesel oil, communal stove fuel, stove black oil, oil asphalt, petroleum coke, lubricating oils and liquefied gas.

Figure 20 Oil treatment at refineries, million tons, 2004-2009

¹³ Getting the Deal Through – Oil Regulation 2009, Baker and McKenzie – CIS Limited



Source: SOCAR Annual Report, 2009

Products manufactured in oil refineries meet the domestic demand fully and are exported to foreign countries in some volume. The graph above shows that in 2009 the refineries produced more than 6 million tons of oil products. Out of this amount 227,184 tons of motor petrol, 1,434,962 tons of diesel, 271,727 tons of aircraft fuel and 34,497 tons of furnace fuel oil were exported. The enhancement of quality indices as well as of processing depth is in focus continuously. The processing depth was raised from 80.37% to 91.63% in 2010. The updating of the capabilities of petrol production technology within the refinery complex is regularly reviewed.

Fuel types produced in the refineries have been fully adjusted to the EURO-2 standard. The necessary improvement actions related to transition to the EURO-3 standard have been performed well. SOCAR has initiated a programme to upgrade and construct new oil-gas refinery/processing plants. As part of the reform process and according to a decree dated 2 April 2010 from the president of the Azerbaijan Republic, “Azerikimya” State Company was handed over to the subordination of SOCAR. It is considered that such reform will create wider opportunities to enhance the efficiency of the oil-gas processing and petroleum chemistry industry, to strengthen the competitiveness of the manufactured products, to attract significant investments for the construction of modern complexes in compliance with international experience and to improve the environment.

SOCAR has also acquired the “Petkim” Petroleum Chemistry Company in Turkey and ensured a reliable supply of raw materials. SOCAR has approved and confirmed a feasibility study for a new oil refinery plant to be constructed and attached to it. In addition, there is broad cooperation between the Petkim company and the petroleum chemistry complex in Sumgayit.

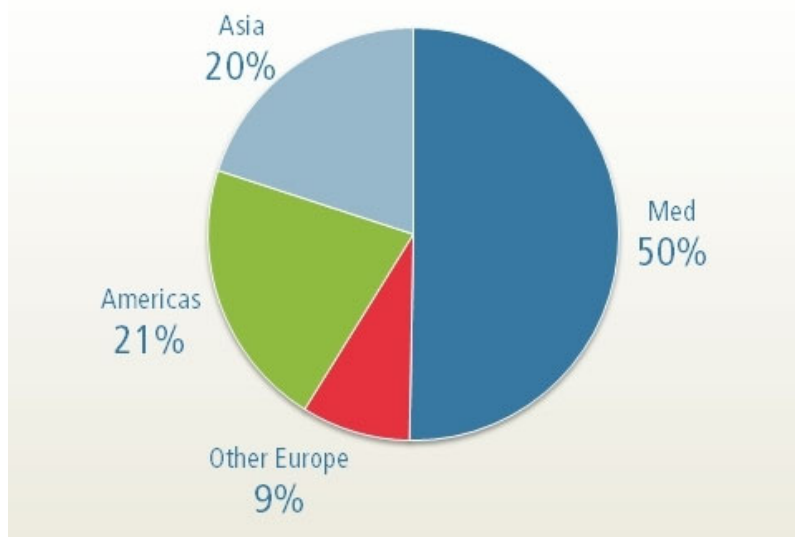
7.1.5. Oil exports

SOCAR Trading is the international marketing and development arm of SOCAR. Until the establishment of the company, oil volumes were marketed FOB Ceyhan mainly to international trading and supply companies. In 2008, SOCAR Trading was set up in order to deliver these volumes directly to end-users worldwide.

SOCAR Trading markets the bulk of SOCAR's crude oil export volumes from Ceyhan. The company trades significant volumes of third-party crude and oil products and assists its parent company with international investments in logistics and downstream. Since it shipped its first cargo in April 2008, SOCAR Trading has successfully optimised and diversified the SOCAR barrel among end-users across Europe, Asia and the Americas.

SOCAR Trading has also leveraged its system barrel successfully to access significant third-party crude and product volumes, processing operations and investments in oil logistics, which is demonstrated by the graph below.

Figure 21 System barrel diversification

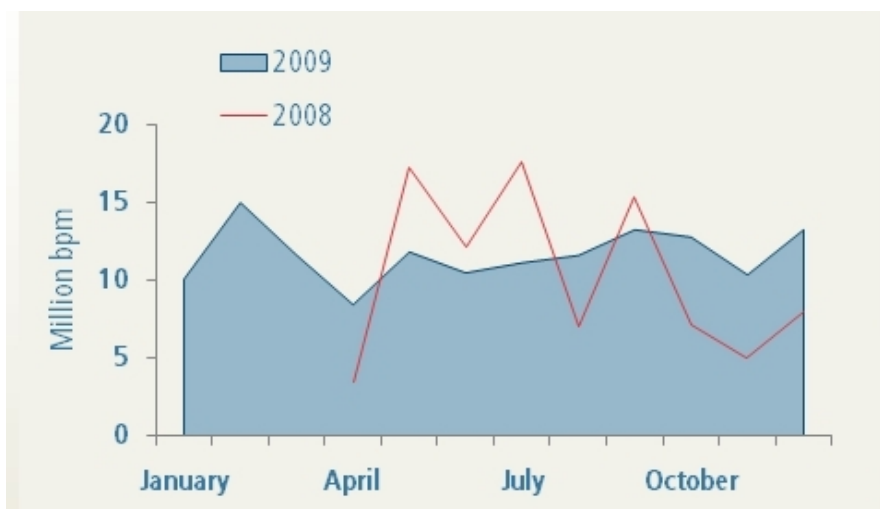


Source: SOCAR Trading

Third-party business makes up more than one third of SOCAR Trading's activities. SOCAR Trading markets around 70-80% of Azerbaijan's 1 million bpd of oil production by SOCAR.

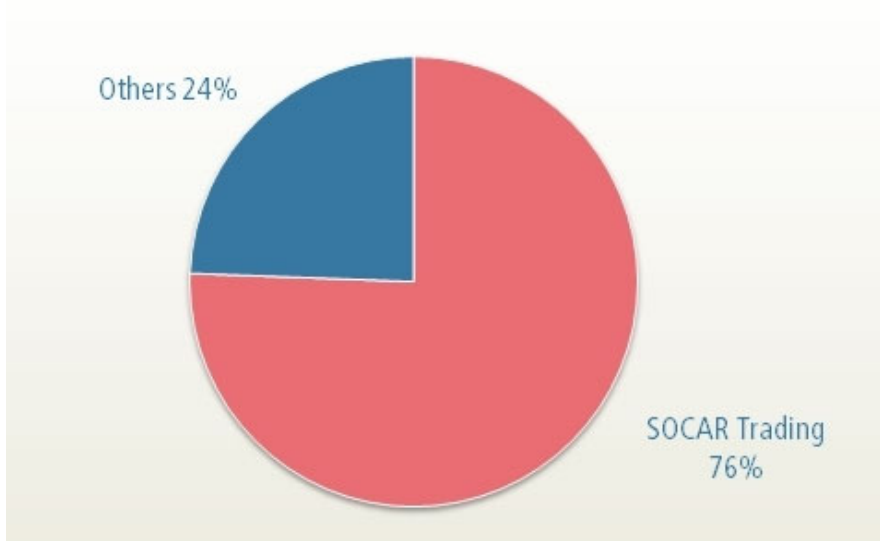
SOCAR is confident of starting oil deliveries to several East European countries in the near future. There are ongoing talks on oil supplies with officials from the Czech Republic, Slovakia, Hungary and the SOCAR trading company in Europe. The company already has the technical capability to deliver oil to Eastern Europe. Oil exports to the three countries could flow through the southern branches of the Druzhba pipeline, which runs through Ukraine. Azerbaijan already exports oil to Ukraine and Belarus using the Odessa-Brody pipeline. Azerbaijan could export some 5 million tons (36.5 million barrels) of oil to the three Eastern European countries.

Figure 22 System barrel trading



Source: SOCAR Trading

Figure 23 Share of SOCAR Trading in exports in %



Source: SOCAR Trading

According to the Central Bank of Azerbaijan, the exporting of fuels and energy products totalled \$8.199 billion against \$25.107 billion in 2010 and \$19.969 billion in 2009.

Oil export proceeds reached \$7.8 in the first quarter of 2011, \$7.5 billion from crude oil exports and \$30.365 billion from petroleum products. The AIOC provided oil export for \$7.1 billion and the other producers for \$372.4 million, including SOCAR for \$359.8 million and condensate from Shah Deniz gas field for \$12.6 million.

Last year oil exports amounted to \$23.8 billion: \$22.3 billion from exports of crude oil and \$1.571 billion from petroleum products. The AIOC made oil exports worth of some \$21 billion and other producers' exports amounted to \$1.3 billion; this included SOCAR, who

produced oil worth \$1.162 billion and the Shah Deniz gas field, which produced condensate worth \$126.3 million.

7.1.6. Legislation specific to the sector

The legal framework for the regulation of oil and gas in Azerbaijan was established with the adoption of the law on subsoil (the Subsoil Law), No. 439-IQ, dated 13 February 1998, and Law No. 541-IQ on energy, dated 24 November 1998 (the Energy Law). Prior to this, Azerbaijan adopted Law No. 94-IQ on the use of energy resources (the Energy Resources Law) on 30 May 1996.

The Subsoil Law governs the exploration, use, protection, safety and supervision over the use of subsoil reserves including, but not limited to, oil located both within Azerbaijan and on the Azerbaijani sector of the continental shelf of the Caspian Sea.

Under the Subsoil Law, no person or legal entity may engage in oil or gas exploration and production without a licence. The Subsoil Law further provides that a production licence must be issued for a particular subsoil block.

The Energy Law provides that the production rights for a specified block are granted exclusively on the basis of an “energy contract”.

The Energy Resources Law sets forth the social, economic and legal bases of state policy in the area of energy resource use.

Concessions/licences regimes

It is important to recall that, on 28 March 2000, the president of Azerbaijan issued Decree No. 310 on Measures to Improve the Issuance of Special Permits (licences) for Certain Types of Business Activities in Azerbaijan, as subsequently amended. Under the decree the production and processing of oil can only be conducted by state enterprises or JSCs in which the controlling stake belongs to the state.

Under the Subsoil Law, the right to engage in subsoil exploration and extraction activities may be granted pursuant to a special permit (licence) to Azerbaijani citizens and entities as well as to foreign individuals and legal entities.

Licences are awarded by tender, auction or, in exceptional cases, negotiation. Tenders may be open or closed, and licences under the Subsoil Law are available to foreign investors in the areas of exploration or production or both. An exploratory geological structure may be granted to several subsoil users (for different minerals and resources).

Under the Subsoil Law, an exploration licence may be issued for a term of up to five years and a production licence for up to 25 years.

According to the Subsoil Law, licences for combined exploration and production are given for 25 years and may be extend up to 30 years. An extension may be granted for a term

agreed between the subsoil user and the licensing authority. In addition, an existing licence holder has a pre-emptive right to obtain an extension.¹⁴

In accordance with Presidential Decree No. 404 on 15 May 2006, the MIE participates in the preparation and implementation of state policy in the areas of the production, transportation and processing of oil. The ministry in cooperation with SOCAR has the mandate to prepare, negotiate, execute and oversee the implementation of PSA or other agreements on behalf of the state with respect to the development of hydrocarbon reserves in Azerbaijan.

In the absence of specific legislation related to PSAs, concessions and petroleum law, every oil concession in the form of a PSA — a prevailing form of the oil concession in Azerbaijan — is legally approved according to the law of Azerbaijan by the parliament.

As a practical matter, a memorandum of understanding for a particular field or block shall be signed by SOCAR and an interested investor.

After the preliminary deal between SOCAR and the investor, the president reviews and authorises SOCAR to finalise negotiations over the field or block.

The signed agreement is then presented to the legislature for legal approval and to be signed by the president afterwards.

Most PSAs have been concluded for similar terms as provided for in the Subsoil Law with regard to licences with the maximum term of 30 years.

Following the first legal approval of a PSA, most subsequent oil deals (more than 30) have been concluded as PSAs.

Oil pipeline/transit regulations

Pursuant to Presidential Decree No. 782 on the Improvement of the Rules for the Issuance of Licences (special permits) for Certain Types of Activity, dated 2 September 2002, the international, inter-city and intra-city transportation of goods by means of water, air and motor transport is subject to licensing by the Ministry of Transportation.

The transportation of hazardous substances must be authorised by the MES.

7.1.7. Market structure monopolies

SOCAR was established by presidential decree on 13 September 1992 in accordance with Azerbaijani legislation and is domiciled in the Azerbaijan Republic. In order to improve its operational efficiency SOCAR has been restructured several times and now is comprised of 19 business units each with their particular areas of business. SOCAR and the business units are involved in upstream, midstream and downstream operations. SOCAR's main functions pertain to managing the extraction, refining and transportation of oil, gas and gas condensates, and the sale of gas and oil and gas products. SOCAR is 100% owned by the government of the Azerbaijan Republic.

¹⁴ Subsoil Law of the Azerbaijan Republic, No. 439-IQ, 13 February 1998

On 1 July 2009, SOCAR acquired 100% of the share capital of the Azerigas Closed Joint Stock Company (Azerigas CJSC), a monopolist gas utility company in the Azerbaijan Republic. Following this acquisition, Azerigas CJSC was transformed into the Azerigas Production Union (Azerigas PU) within the SOCAR structure. SOCAR is responsible for producing oil and natural gas in Azerbaijan, operating the country's two refineries, running the country's pipeline system and managing the country's oil and natural gas imports and exports. SOCAR is party to all of the international consortia developing oil and gas projects in Azerbaijan.

With regard to upstream operation, SOCAR fulfils two main roles: not only does it invest, execute and operate upstream operations as the state oil company, but it also manages and markets the state share of the oil proceeds on the part of the Azerbaijan Republic. Thus SOCAR owns varying shares in Azerbaijan's oil fields and projects, has a range of upstream departments to conduct geology and geophysics, engineering, construction and hydrocarbons production, and exports some 70-80% of Azerbaijan's crude oil.

As the state oil company for a major oil producing country, SOCAR's up- and midstream activities have traditionally dominated its asset base. SOCAR also owns and operates Azerbaijan's two legacy refineries with a processing capacity of 400,000 bpd and has been expanding in several other downstream areas in recent years.

This will continue with the construction of several new refineries, in Azerbaijan and the surrounding region, as well as possible large downstream acquisitions in Europe and beyond. SOCAR is rapidly building a branded retail station network in Azerbaijan, Georgia and Ukraine, and has made significant investments in petrochemicals, product logistics and downstream gas assets in Turkey and Georgia as well as at home.

The AIOC is a consortium of ten petroleum companies that have signed extraction contracts with Azerbaijan (BP being the biggest). The AIOC and SOCAR are dealing with all cross-border issues.

The AIOC made significant investments, contributing to the construction of the South Caucasus pipeline and the BTC pipeline, and are currently discussing the construction of a Trans-Caspian oil pipeline between Kazakhstan and Azerbaijan. The extraction of oil from the ACG fields and natural gas from Shah Deniz has been possible through FDI in this consortium. These companies include the following.

- BP (UK)
- Chevron (USA)
- Devon Energy (USA)
- Statoil (Norway)
- TPAO (Turkey)
- Amerada Hess (USA)
- SOCAR (Azerbaijan)
- ExxonMobil (USA)
- INPEX (Japan)
- ITOCHU (Japan).

In 2011, SOCAR enlarged its stake in the AIOC, the BP-led group that is developing the offshore Azeri-Chirag- Guneshli (ACG) oilfields in the Caspian. BP Azerbaijan had sold part of its share in the AIOC to SOCAR's affiliate in the consortium, AzACG. The state-owned firm arranged the purchase through the issue of a US\$485 million bond on the domestic market. The new shareholder structure in the AIOC is as follows: BP Azerbaijan, with 35.83%; SOCAR (AzACG), 11.64%; Chevron, 11.27%; Inpex, 10.96%; Statoil, 8.56%; Exxon, 8%; Turkish Petroleum, 6.75%; Itochu, 4.3%; and Hess, 2.72%.

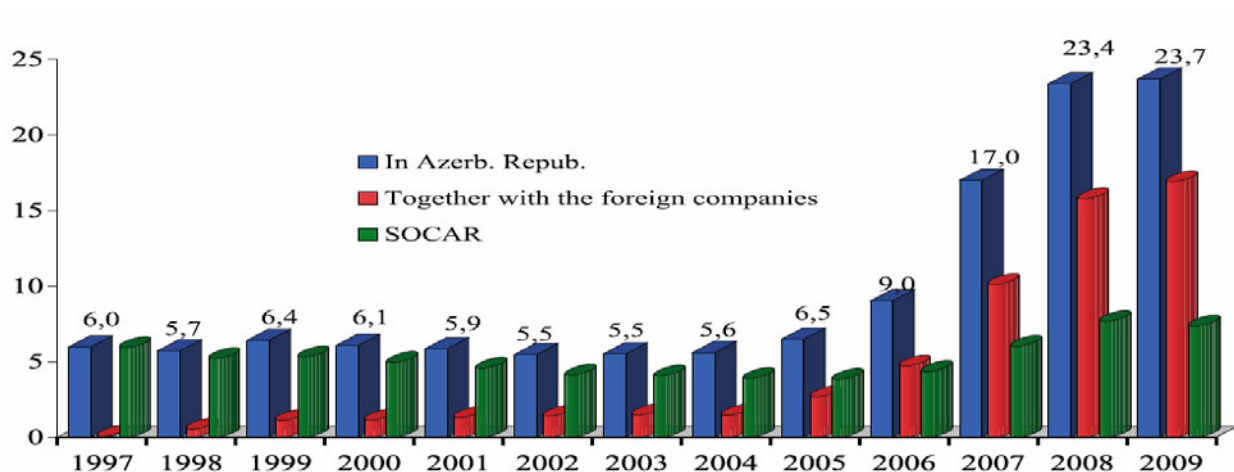
7.2. Natural gas sector

7.2.1. Physical features

Exploration and production

The gas sector plays a key role in the economy of Azerbaijan. The graph below shows that natural gas production in Azerbaijan started to increase sharply from 2005 to 2009, from 6.5 billion m³ up to 23.7 billion m³.

Figure 24 Gas production in Azerbaijan (billion m³), 1997-2009

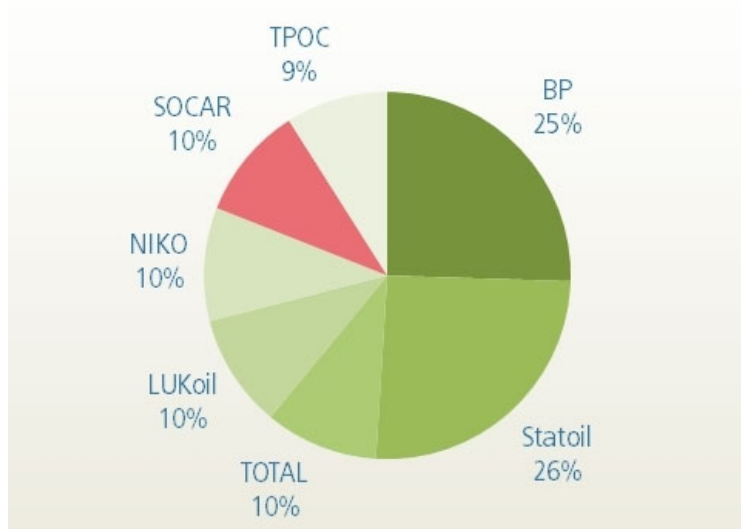


Source: SOCAR Annual Report, 2009

In 2010, Azerbaijan produced 26.3 billion cubic m of natural gas. Almost all of Azerbaijan's natural gas is produced from offshore fields. The country's leading natural gas field is the Shah-Deniz natural gas and condensate field, which began production in 2006.

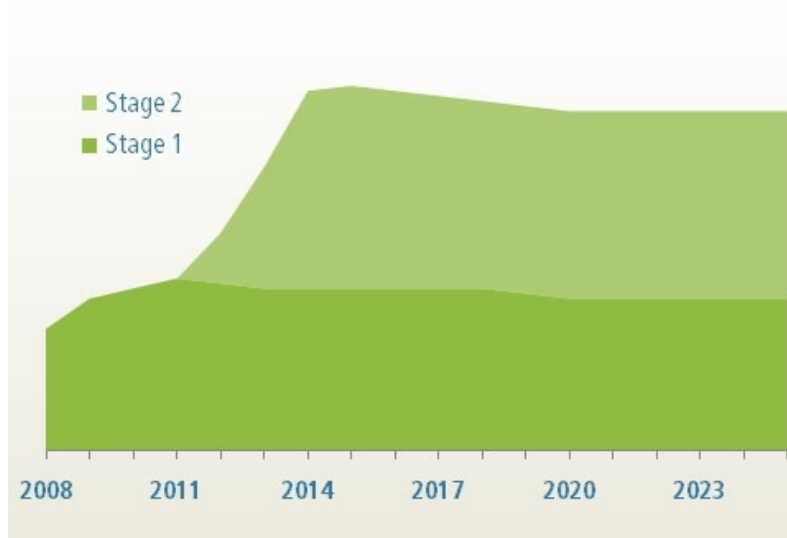
The Shah-Deniz deepwater gas field is the ninth largest gas field in the world and has reserves of around 1.2 trillion cubic m. It is situated in the south of the Caspian Sea, off the Azerbaijan shore, approximately 70 km south-east of Baku, the capital of the Azerbaijan Republic. It has been in operation since the end of 2006 through a PSA ratified in 1996 by a consortium of companies consisting of the lead operator, BP, (25.25%), Statoil (25.5%), SOCAR, Lukoil of Russia, Total of France, NICO of Iran (10% each) and TPAO of Turkey (9%). The graph below shows the rounded-off shareholder structure for Shah-Deniz.

Figure 25 Shah-Deniz shareholder structure



Source: SOCAR Trading

Figure 26 Shah-Deniz production profile, 2008-2023



Source: SOCAR Trading

Phase 1 of the Shah-Deniz field’s development was completed in 2006 and includes a fixed offshore platform, two subsea pipelines to bring the hydrocarbons ashore and a new onshore gas-processing terminal adjacent to the existing oil terminal at Sangachal near Baku. The Shah-Deniz consortium’s members (most of whom are also members of the AIOC) began producing natural gas for export during the spring of 2007.

During 2010 the field produced about 6.9 billion cubic m (more than 243.4 billion cubic feet) of gas and 1.9 million tons (14.7 million barrels) of condensate or about 19 million cubic m of gas per day (67 million standard cubic feet per day) and about 40,200 barrels of condensate per day.

In terms of the future outlook for gas production and exports it should be noted that BP and its partners in the Shah Deniz field have been in negotiations with three consortia — Nabucco

Gas pipeline (NGP), Interconnector-Turkey-Greece-Italy (ITGI) and Trans Adriatic pipeline (TAP) — for some time. SOCAR is also involved in the talks, primarily as a representative of the Azerbaijani government but also as a shareholder in the Shah Deniz project. The three pipeline groups competing for supplies of natural gas from Azerbaijan's Shah Deniz Phase 2 (SD2) field have been asked by BP, the operator of the project, to submit their final transport tariff cost estimates by 1 October 2011. The Shah Deniz consortium is expected to make its final investment decision (FID) on SD2 in early 2013. This project will boost the Shah Deniz field's output by 16 bcm per year, of which 6 bcm per year has already been promised to Turkey.

7.2.2. Natural gas exports

Azerbaijan has been a net exporter of natural gas since 2007 and, first of all, this was due to the Shah Deniz field. In 2010, Azerbaijan's natural gas production reached around 26.30 bcm. In 2010, Azerbaijan exported around 6.4 bcm to Turkey, Georgia 0.3 bcm, Russia 1 bcm and Iran 0.1 bcm.

According to the SCC, for January-June 2011, the country's gas exports totalled 4.066 bcm (including 403.1 million m³ in June versus 490.45 million m³ in May, 820.77 million m³ in April and 921.6 million m³ in March).

According to cargo customs entries, 2.082 billion m³ of gas for \$373.987 million were registered (including 184.420 m³ for \$46.742 million in June). This average export price for June reached \$253.45 per 1,000 m³ and for January-June this was \$179.62.

A record export volume of 307.97 million m³ for \$54.765 million was registered in April 2010. Last year the average export price made \$60.94 per 1,000 m³ in 2009 and gas exports totalled 671.7 million m³ for \$125.3 million, at the average price of \$186.57 per 1,000 m³.

In 2008, the country exported 369.788 million m³ of natural gas for \$73.87 million at the price of \$199.77 per 1,000 m³ versus \$197.67 per 1,000 m³ in 2007.

The above data only takes into account the country's own exports not the reported details of gas exports by international contractors from the Shah Deniz field.

It is important to note that under the Joint Declaration on the Southern Gas Corridor signed in Baku, Azerbaijan has committed to supplying substantial volumes of natural gas (about 10 bcm per year) over the long term to the EU. The document also calls for Azerbaijan to play the role of transit country for Central Asian gas. The joint declaration was signed by José Manuel Barroso, the president of the European Commission, and Ilham Aliyev, the president of Azerbaijan. The joint declaration is an important step towards the realisation of the EU's Southern Corridor project and the diversification of European energy supplies.

7.2.3. Natural gas pipelines

South Caucasus pipeline (SCP)

The main conduit for Azerbaijan's natural gas exports is the SCP, also known as the Baku-Tbilisi-Erzurum pipeline (BTE), which runs parallel to the BTC oil pipeline. The pipeline

began exporting in 2007, and has the capacity to transport about 8.8 bcm of natural gas. The Shah-Deniz consortium owns and operates the pipeline.

Gazi-Mammed-Mozdok pipeline

On 14 October 2009, Russia's Energy Company, Gazprom, and SOCAR signed a contract to supply Azerbaijan's gas to the Russian North Caucasus region from the beginning of 2010. The agreement is very flexible and specifies only the minimum amount of supplies, which is a mere 0.5 bcm per year. Partners expect that Russia will buy as much gas as Azerbaijan can sell.

Transportation is organised through the gas pipeline Gazi-Mammed-Mozdok, which was used for supplies of Russian gas to Azerbaijan only three years ago. The capacity of this pipeline is about 7 bcm per year. Baku and Moscow have determined the volume of gas to be bought by Russia as 1 bcm in 2010 and 2 bcm in 2011.

Baku-Astara pipeline

Due to tensions between Azerbaijan and Armenia, in late 2006 Azerbaijan began a swap deal with Iran, which provides natural gas to Azerbaijan's geographically separate Nakhchivan exclave. Azerbaijan ships natural gas into Iran via the Baku-Astara pipeline and Iran then delivers the gas via a new 30-mile pipeline into the exclave. Iran receives a 15% commission on transit fees. In early 2010, Iran and Azerbaijan signed an additional gas supply deal for increased volumes of gas from Azerbaijan to be delivered to Iran for its own consumption, and volumes are likely to increase with the renovation of the pipeline and upgrades to the Astara gas compressor.

7.2.4. Gas storage

Azerbaijan has two existing underground gas storage (UGS) facilities, both located in the Absheron Peninsula, at Garadag and Galmaz, 20 km and 75 km respectively to the south-west of Baku. Gas is supplied from a high-pressure Gazi-Mammad-Baku pipeline by two branch lines: one is 18 km long, 720 mm going to the Galmaz UGS, and the other is 720 mm, which goes to the Garadag UGS through the Garadag gas processing plant.

The Galmaz UGS began operation in 1976 and was the first UGS to be developed in the South Caucasus region. It is a sandstone reservoir with relatively dry gas, very little condensate content and no significant water content.

Two blocks of the first and second productive horizons were converted into gas storage. The Garadag UGS has also been developed in the depleted gas/condensate Garadag field, which comprises two reservoirs. The small one was converted into gas storage and began operation in 1986. The total design storage capacity is around 1.5 bcm: 1.2 at Galmaz and 0.3 at Garadag. The daily injection and withdrawal rates were on average at 10 million cm/day in Galmaz and 2.5 million cm/day in Garadag.

7.2.5. Legislation specific to the natural gas sector

The Law on Gas Supply (Baku, June 30, 1998, No. 513-IG) was passed on 30 June 1998. The law regulates the process of the production, processing, transportation, storage, distribution, sale and use of all types of gas (including natural gas). No grid code has been adopted in Azerbaijan.

The Subsoil Law sets forth the principles of exploration, extraction, production, use, protection and safety supervision over subsoil reserves, including gas, located both within Azerbaijan and its portion of the Caspian sector.

The Energy Law covers the regulation of the exploration, exploitation, production, processing, storage, transportation, distribution and use of all “energy materials and products”, including gas. Essentially, the Energy Law is an “umbrella” law for power regulations.

Each person intending to engage in activities related to energy must obtain, prior to commencing such an activity, a special authorisation from the MIE on the basis of an energy contract or application to such a ministry.

The Energy Law describes in detail the procedure for the conclusion of an energy contract and its terms and conditions. The Law on Natural Monopolies governs relations between natural monopoly entities, consumers and state bodies in relevant commodity markets. The provisions of the law apply, inter alia, to entities engaged in the pipeline transportation, storage and distribution of natural gas, since such activities are carried out by natural monopoly entities. The matters relating to the efficient and effective use of energy carriers, including gas, during production, processing, exploitation, transportation and distribution are covered by the Energy Use Law.

In addition, PSAs concluded between the government of Azerbaijan and international energy companies on the production of oil and gas shall also be taken into account. The transportation of natural gas produced in Azerbaijan through the territory of third countries is governed by international agreements.

Pursuant to the state programme on the development of the fuel-energy complex in Azerbaijan, governmental policy for the domestic natural gas sector for 2005 to 2015 aimed at achieving better supply to satisfy the needs of the population and the economy through the development of the natural gas sector, specifically through the creation of a robust competition environment, an increase in investments attracted to the field, environmental safety and the application of progressive technological measures to the production, processing, transportation, storage and consumption of natural gas.

7.2.6. Market structure monopolies

The state-owned Azerigas Stock Company was closed down and placed under the control of SOCAR by a presidential decree "On Improvement of Management Mechanisms in Oil and Gas Industry" dated 1 July 2009.

SOCAR re-named it the Azerigaz Production Unit, which is the monopolist gas supplier in the country. The Azerigas Production Unit carries out the preservation, processing, transportation, distribution and sale of natural gas within the Azerbaijan Republic. At the

same time, the production unit deals with the transportation of natural gas produced by SOCAR to Iran and Georgia.

At the present time, there are no official plans for opening a gas sector on the distribution side, and nor have there being any in the past. Consumers cannot purchase natural gas directly from producers such as the AIOC. Azerenergy procures natural gas for electric plants under a contract agreement from SOCAR.

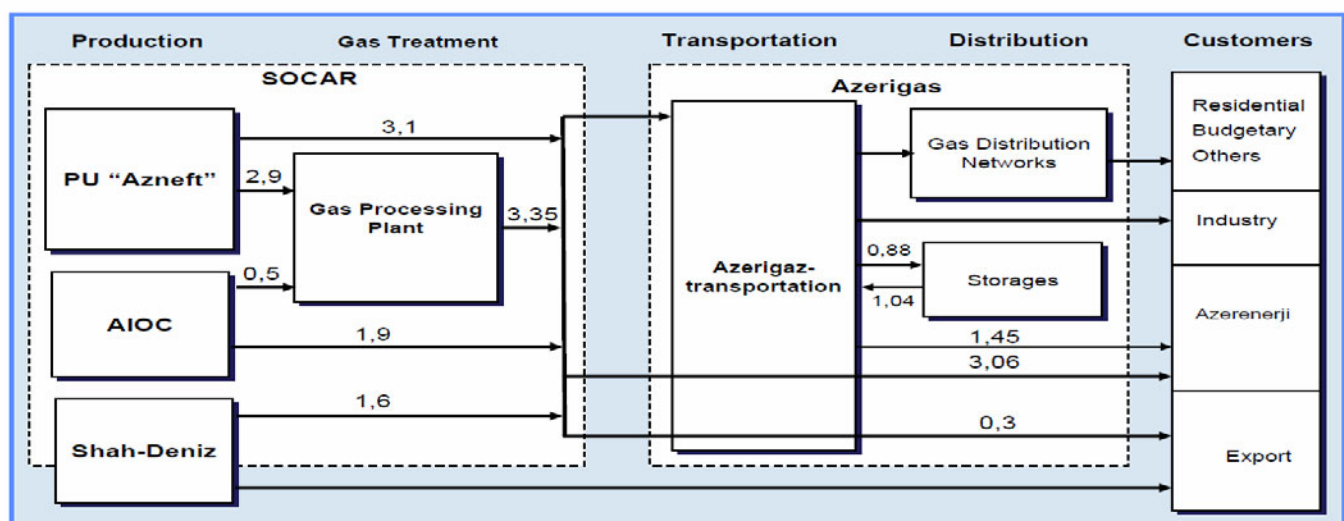
There is no third-party access; access to the grid must be negotiated with Azerigaz. As with electricity, in cases where system (transportation and distribution) operators refuse to provide access to their systems, they must provide full substantiation of the reasons for such a refusal.

The pipeline transportation and storage of natural gas are natural monopoly activities in Azerbaijan. Azerigaz is responsible for the transportation and storage of natural gas. In order to engage in the provision of gas transportation services, and the construction of UGS facilities and their exploitation, contractors must conclude an energy contract with a relevant body. Currently, Azerigaznagl, a division of Azerigaz, carries out the transportation of gas by main transmission pipelines. The regional transportation and supply of gas is organised by Azerigaz through its regional divisions.

The local distribution of natural gas is provided by Azerigaz and its regional divisions. Gas is distributed to consumers by Azerigaz to the regional gas departments, which are responsible for distributing gas to their local divisions, which in turn supply consumers. The entire gas distribution network of Azerbaijan is operated by SOCAR. Moreover, the Gas Supply Law does not contain any requirements or procedures for the operation of a private gas distribution network. The law allows third parties to operate the gas distribution network owned by Azerigaz on the basis of a contract signed between the operator and SOCAR. Access to the natural gas distribution grid is organised in accordance with the Rules on General Terms of Gas Supply by Gas Distributors. All investments in the distribution network and in the gas-transportation system are implemented by SOCAR.

The graph below shows the natural gas market organisation in Azerbaijan.

Figure 27 Gas production, transmission and distribution structure



Source: <http://www.narucpartnerships.org/>

Regulation of liquefied natural gas (LNG)

Currently, LNG is produced by the oil processing plant owned by SOCAR and, thereafter, it is delivered to a gas processing plant owned by Azturkgaz Joint Venture, where it is put into gas-cylinders. The amount of LNG produced by these two plants does not have a significant stake in the natural gas sector of Azerbaijan. The construction and operation of LNG facilities is regulated by the Gas Supply Law and Energy Law.

In addition, under the Energy Law, the obtaining of a special authorisation from the MIE is required in order to engage in the processing of natural gas. Additional authorisations will be required under the Law on Technical Safety, since LNG facilities are considered to be potentially dangerous facilities. Azeri legislation generally regulates the prices for natural gas sold to all types of consumers, including LNG producers.

7.2.7. Current opportunities for private investors

Umid perspective structure

On 24 November 2010, the Azerbaijani state oil company SOCAR announced the discovery of the largest gas field in Azerbaijan after the giant Shah Deniz deposit in the Caspian Sea. This offshore field is named Umid.

The Umid structure is deep — approximately 6,500 m below the seabed. The platform from which the wells are drilled stands in some 60 m of water; it is located around 70 km south of Baku and 40 km from the shore. So far, data from the well shows that the Umid deposit contains 200-250 bcm of gas at the lowest estimation, which could rise as more wells (up to nine are planned) are drilled in the deposit. Apart from gas itself, it is estimated that Umid will also produce 30-40 million tons of gas condensate. The production of such associated liquids has been of significant benefit in the development of the Shah Deniz field.

This makes Umid the second largest gas field to be discovered in Azerbaijan since it gained independence in late 1991. Reserves of this size could push Azerbaijan's proven gas reserves up to around 2 trillion cubic m.

E&P activities were carried by SOCAR. The estimated reserves of the Umid field are 200-250 bcm. However, there is not any information about the development cost.

Azerbaijan-Georgia-Romania Interconnector (AGRI) project

In 2010, Azerbaijan, Georgia and Romania agreed to jointly develop an LNG project, designated as the AGRI project.

AGRI envisages transporting Azerbaijani gas by pipeline to Georgia's Black Sea coast, liquefying it there, shipping the liquefied product by tankers to Romania's coast and delivering the re-gasified product into Romania's pipeline system and onward to EU territory.

The project involves the construction of a liquefaction plant and LNG export terminal for Azeri gas in Georgia, as well as an import terminal with a re-gasification plant in Romania. The suggested coastal locations are Kulevi, the site of the Azerbaijani-owned oil export terminal in Georgia, and Constanta, the largest Black Sea port, in Romania. With the Romania-Hungary pipeline interconnection, Arad-Szeged, soon due to become operational, AGRI can open the way for Azerbaijani gas exports into Central Europe.

Preliminary estimates of the investment costs vary from \$2 billion to \$5 billion. The duration of construction work is estimated to be four years. According to some preliminary assessments, AGRI can bring at least 7 bcm of natural gas into Europe.

SOCAR, the Georgian Oil and Gas Corporation, the Romgaz Company of Romania and the MVM company of Hungary are participating in the project. Three options are to be considered for exporting gas via the AGRI project: exporting 2 bcm/year, 5 bcm/year and 8 bcm/year.

New LNG and oil transportation project with Ukraine

In 2011, at the World Economic Forum in Davos, the government delegations from Azerbaijan and Ukraine signed a memorandum on LNG and crude oil deliveries. The document covers shipments of LNG produced from Azerbaijani gas to Ukraine and Azerbaijani oil transportation through the Odessa-Brody pipeline. The memorandum provides for Azerbaijan to deliver the equivalent of 2 billion m³ of gas in LNG form to Ukraine in 2014. Another 5 bcm will be supplied in 2015. The oil transportation agreement signed in Davos states that Azerbaijan should pump up to 4 million tons (80,000 bpd) of crude through the Odessa-Brody pipeline in 2011. The Odessa-Brody pipeline has a design capacity of 14 million tons per year (280,000 bpd). It has never worked at full capacity since its launch in 2002.

7.3. Electricity sector

7.3.1. Physical features

The power sector, along with the oil and gas sectors, has a leading role in the economy of Azerbaijan and is important to the development of the economy. Azerbaijan is fully electrified, and electrical power is the third most utilised energy source (first is natural gas and second is oil) for domestic and industrial use. The development of the power sector is a top policy priority for the government.

The Azerbaijan power system is the oldest and most developed in the South Caucasus. It has an installed generating capacity of about 6,400 MW, to which thermal power stations contribute 5,400 MW and hydropower stations make up 1,000 MW.

Before the collapse of the Soviet Union, the Azerbaijan power system was an integral part of the united power system of Transcaucasia, which was connected with the united power system of the Soviet Union. After the collapse, the Azerbaijan power system was consequently separated from the other Transcaucasian republics and linked only with the North Caucasus of the Russian Federation.

Currently, 80% of Azerbaijan's generating power is located in the west. However, 70% of the power consumption takes place in the east, north-east and south-east. Therefore, fuel is transported hundreds of kilometres from the Absheron Peninsula to the thermal power stations Azerbaijan GRES and Ali Bayramli GRES. The energy produced is then transmitted to the Absheron Peninsula and from there is distributed to the northern and southern regions.

Generation capacities

In 2000, Azerbaijan had 5,127 MW of installed capacity. The table below shows detailed information on how much new generation capacity has been added each particular year from 2000 up to 2010. At present, Azerbaijan has an installed capacity of around 6,373 MW, consisting of thermo-power plants, hydroelectric plants and so-called modular plants, all of which are owned by the state.

Table 7 Installed generation capacity of the Azerbaijan Republic

#	Name of the Power Plant	2000	2001	2002	2006	2007	2008	2009	2010
1	Azerbaijan TPP (1981)	2,400							
2	Shirvan TPP (1962)	1050							
3	Janub PP								
4	Shimal PP 1954/2002)	150		400			-150		
5	Baku TPP	53.3	53.3						
6	Sumgayit TPP-2 (1960)	420		-420					
7	Sumgayit PP (2010)							525	
8	Baku Module PP					104.4			
9	Astara Module PP				87				
10	Sheki Module PP				87				
11	Khachmaz Module PP				87				
12	Shahdag (Guba) Module PP							104.4	
13	Sangachal Module PP						300		
14	Mingechevir HPS (1953)	401.6							
15	Varvara HPS (1956)	16.5							
16	Shamkir HPS (1982)	380							
17	Yenikend HPS (2000)	150							
Total :		5021	5075	5055	5316	5420	5570	6200	6200
18	Nakhichevan TPS(1993)	84			60				
19	Nakhichevan Module				87				
20	Araz HPS (1970)	22							
21	Vaykhir HPS				4,5				
Total Republic:		5127.4			5402.2	5593.6	5743.6	6373.0	6373.0

Source: MIE of Azerbaijan

In 2009, Azerenergy completed a 104.4-MW thermal power station in Guba, in the north-east of the country. The station consists of 12 turbines with an individual capacity of 87 MW and generates 700 million kWh of electricity each year. The power station supplies the Guba and Gusar districts, and also provides electricity to the Shahdag tourist complex.

In addition, large-capacity thermal power plants are being built (one with a capacity of 760 MW in Alibairamly and another with a 712 MW capacity in the settlement of Aliat), and a project is underway to build a network of small hydro- and wind power stations.

Azerenergy plans to put into operation a new power plant with a capacity of 780 MW in Shirvan, on the Kura River during 2011. The Canub plant will replace the existing infrastructure at Shirvan. The Asian Development Bank (ADB) has provided loans and technical assistance to the project.

There are also two small hydroelectric plants and one small wind energy plant that are run by the private sector.

Azerenergy is pursuing plans to develop the country's generation capacity because most of its generation units are outdated and expensive to run. International donors — the European Bank for Reconstruction and Development (EBRD), Islamic Development Bank and WB — have financed several projects to restore the existing power plants and build new capacities.

Transmission system

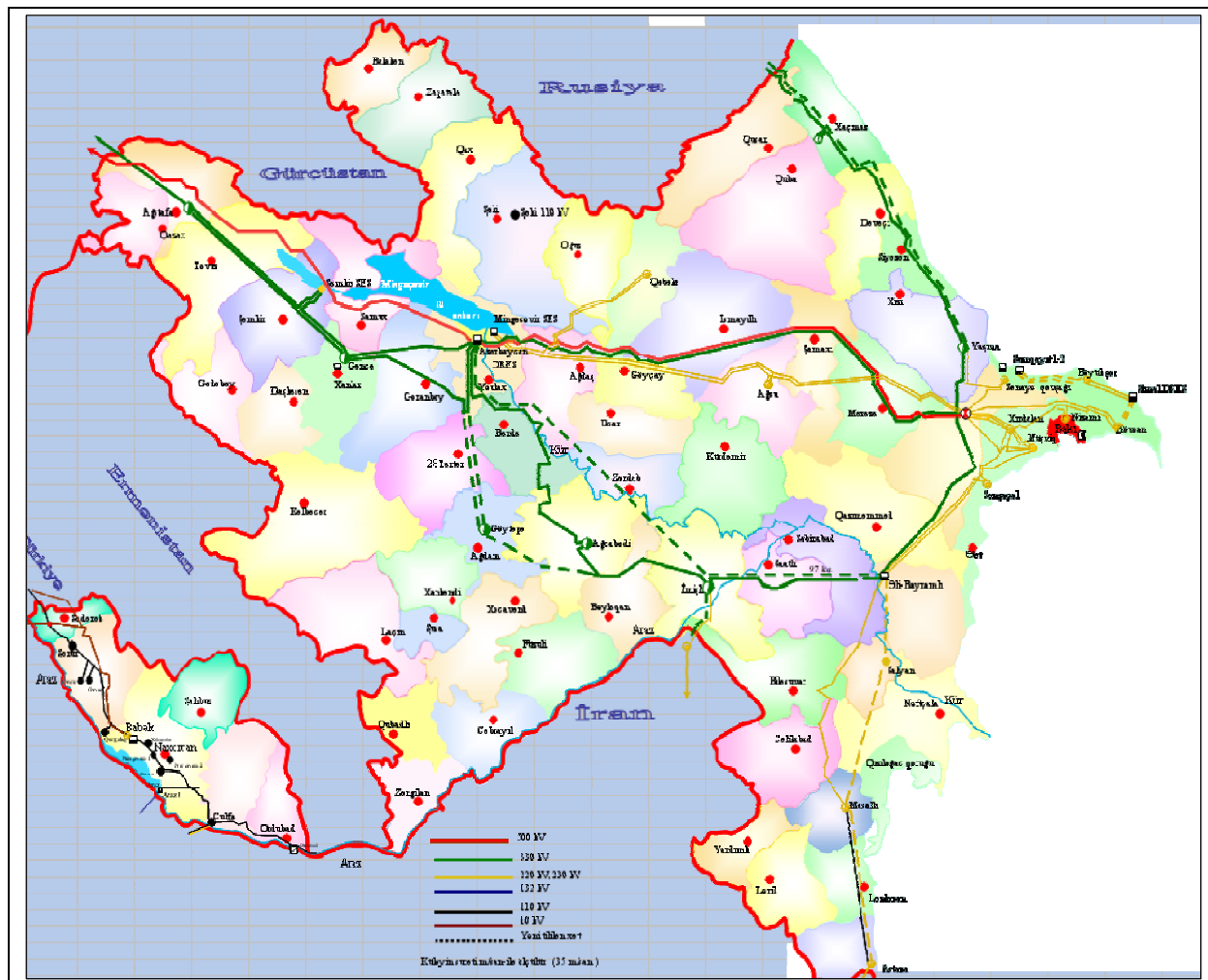
Azerbaijan's electricity grid is not connected to the Central Asian integrated system. Within the country, all cities and villages are grid-connected and electrified. Almost all customers are metered. Single circuit transmission lines are mainly used in Azerbaijan. Most of the electricity grid is old and needs to be renovated. A new 220 kV transmission line in the south of Azerbaijan and the 330-kV Khachmaz substation in the north have been constructed. New projects such as a 330-kV transmission line from the centre to the south (over a length of about 150 km) and another one, a 220-kV double-circuit transmission line from Mingachevir to Absheron (255 km from west to east), were recently completed. It is estimated that losses in the transmission system are currently 3.7% and in the distribution system losses are 14.7%.¹⁵

The power system incorporates electric transmission and distribution networks with a voltage of 0.4-500 kV. The total extent of transmission lines is more than 110,000 km. The substations of step-down transformers have a total capacity of more than 13,500 MVA.

The state-owned company Azerenergy owns all of the high voltage transmission lines in Azerbaijan and also controls the dispatching of the high voltage grid. The transmission grid voltages are 500 kV, 330 kV, 220 kV and 110 kV.

¹⁵ GTZ Report, Renewable Energies in Central Asia, 2009

Figure 28 Main electricity transmission network



Source: Azerenergy OSC

Azerbaijan’s power system is capable of satisfying electricity demand on its own but the structure of the grid network forces it to import some electricity from Russia, Iran and Georgia. Azerbaijan also imports electricity from Turkey to supply the Nakhchevan AR.

Azerbaijan’s power system has transmission lines with a voltage of 330 kV for linking with the united power system of the Russian Federation and the power system of Georgia. Transmission lines of 230 kV are used for the link with the Islamic Republic of Iran, through which the importing and exporting of electricity are carried out.

Azerbaijan currently has the following interconnections with its neighbours.

- Georgia: one 330-kV line, one 110-kV line and there exist plans to build a 500-kV line, although the realism of these plans are uncertain;
- Russia: one 330-kV line, with another 330-kV line planned;
- Armenia: formerly one 330-kV line, one 220-kV line, and three 110-kV lines, all of which have been out of use since the Nagorno-Karabakh dispute;
- Iran: two 154-kV lines to Nakhchivan, one 132-kV line between Parsabad (Iran) and Imishli and one 132-kV line at Astara;

- Turkey: one 110-kV line and one 220-230-kV line via Iran (both to Nakhchivan).

There is also the possibility of some export capacity via Georgia, which is likely to be increased in the event of a planned 500-kV line between this country and Turkey.

As a result of the Armenian-Azerbaijan conflict, Nakhchevan's energy system is disconnected from the republic. Since 1990, Nakhchevan AR permanently faces a deficit of energy, mainly covered through purchasing from Iran and Turkey. To resolve this problem, it is expedient to construct some small hydropower stations on the mountain rivers of the region. There is also need to construct Ordubad Hydro power station (HPS) with a capacity up to 36.6 MW which would have average energy production up to 190 million kWh on the river of Araks. Another HPS on the Arapchay irrigation water reservoir HPS with a capacity 12 MW and one more HPS on the Vaikhir irrigation water reservoir with a capacity up to 4.7 MW.

Electricity production, consumption and production forecasting

Electricity generation and consumption in Azerbaijan have both remained fairly flat for several years now. Most of the generation is from thermal-electric power plants fuelled by either oil or natural gas. An historical summary of electricity generation and consumption in Azerbaijan is shown in the table below.

Table 8 Production of electricity, 2005-2010

Indicators	Unit	2005	2006	2007	2008	2009	2010
Production of electricity	mln. kw/h	22,872	24,543	21,415	21,173	18,581	18,428
Consumption of electricity	mln. kw/h	20,043	21,655	18,176	17,884	14,499	14,502

Source: State Statistical Committee of the Azerbaijan Republic

In 2010, generation reached 18.43 billion kWh while electricity consumption was 14.50 billion kWh. Total exports were 0.392 billion kWh and imports 0.083 billion kWh in 2010. It is assumed that remaining balance is energy losses.

The greatest demand for electricity is observed during the winter months. The increased use of electricity for heating is due to the deterioration of central heating systems.

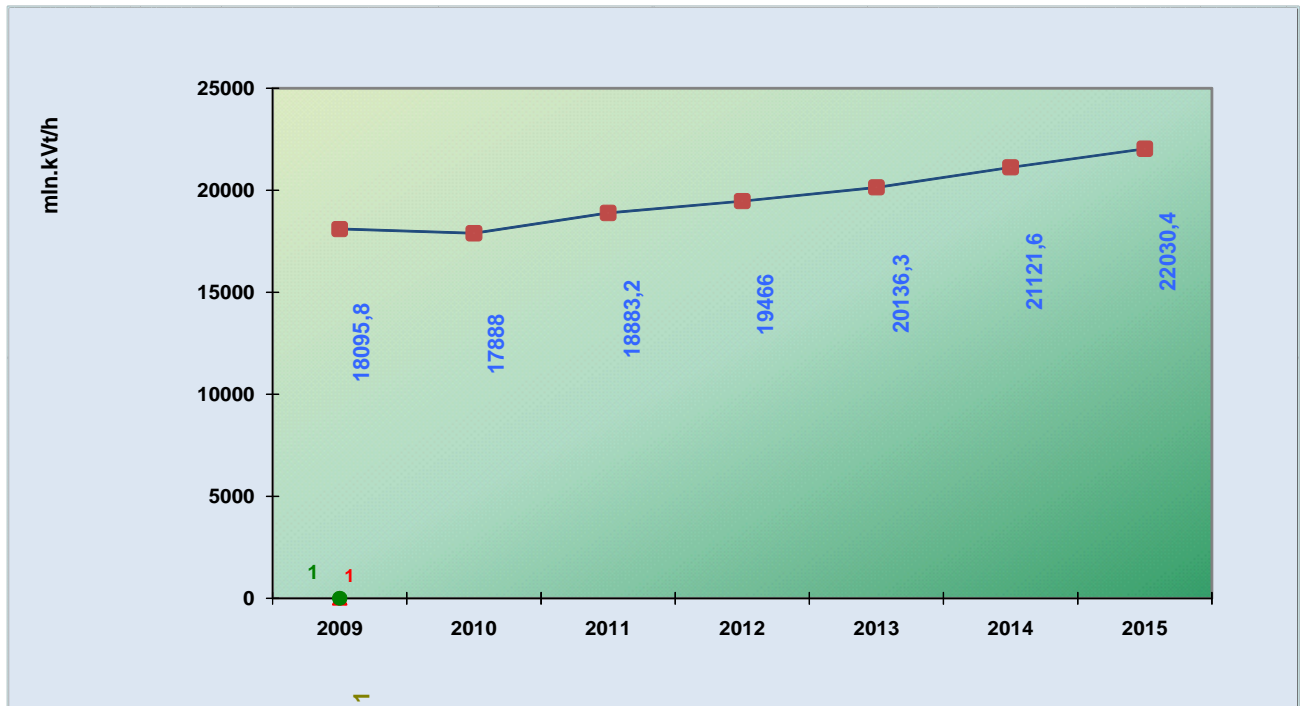
The table above shows that the consumption trend was reversed in 2007 and continued to decline up to 2010. The main reason for the fall in demand appears to be substantial rises in tariffs in January 2007, coupled with the implementation of the government's policy to install meters and increased bill collection. For example, in particular districts where meters were installed, power consumption reportedly fell by 20-25%. A further factor is the gasification programme, which allows switching from electricity to natural gas for heating.

It is estimated that Azerbaijan's electricity generation is likely to increase at the highest annual growth rate of 4.2% between 2005 and 2030.

Figure 29 Electricity production forecast for 2011-2015

Electricity production forecast for 2011 - 2015 by Azerenergy OSC

Years	2009	2010	2011	2012	2013	2014	2015
Electricity production, mln. kVth	18 095,8	17 888,0	18 883,2	19 466,0	20 136,3	21 121,6	22 030,4



Source: Azerenergy OSC, 2011

Electricity imports and exports

According to the SCC, in 2010 the country exported 392 million kWh for \$15.26 million and imported 83.9 million kWh for \$3.68 million. The export price of electricity for the reported term was \$0.0389 per kWh and the import price was \$0.0439.

In 2009, the country exported 710.4 million kWh of power for \$27.939 million and imported 133.9 million kWh for \$5.126 million.

In 2008, exports totalled 808.8 million kWh for \$27.357 million and imports made 266.5 million kWh for \$10.5 million. As a comparison, in 2007 Azerbaijan exported 443.3 million kWh of power for \$9.666 million and imported 773.7 million kWh for \$23.4 million.

Azerenergy is working on creating an energy corridor, Azerbaijan-Georgia-Turkey, in order to realise the export potential. It is planned that from mid-2012 Azerbaijani electric power will be supplied to the market of Turkey and its exports to European countries will begin.

7.3.2. Legislation specific to the electricity sector

The main legislative acts regulating the power sector are the Energy Resources Law, dated 30 March 1996, the Law on Electrical Energy (the Electricity Law), dated 13 June 1998, and the Law on Electricity and Heat Power Stations (the Power Station Law), dated 28 December

1999. To satisfy the public's need for electricity and gas, the government adopted the State Programme on the Development of Fuel-Energetic Complex of Azerbaijan (2005-2015). To address the growing global concerns over air-polluting emissions, in 2004, the president approved the "State Programme on the Use of Alternative and Renewable Energy Sources in Azerbaijan Republic".

According to the Electricity Law, the energy system of the Azerbaijan Republic should make provision for the following.

- The State Electrical Enterprise operates transmission lines of more than 110 kV, dispatching centres and energy production enterprises;
- The State Electrical Enterprise purchases energy produced by independent energy producers for its further transportation through its transmission network, and conducts interstate energy exchanges;
- Energy suppliers, which purchase electricity from the State Electrical Enterprise or other independent energy producers and sell it to consumers;
- Independent energy producers, which are economically and organisationally independent legal entities and are not part of the common state electrical energy system. These producers generate energy and supply it to consumers directly through their own distribution networks or via the State Electrical Enterprise or energy suppliers. These entities may also export their power.

As a general rule, special permission to carry out activities in the power sector is granted, and the contractors determined, on a competitive basis. The Electricity Law requires that individuals and legal entities obtain special permission for conducting activities in the generation, transportation and distribution of electricity if not otherwise determined by law. The law provides that in certain cases permission may be issued without a tender on the decision of the MIE.

The Electricity Law also provides that high-voltage installations cannot be constructed and put into operation without prior special permission unless otherwise provided by law. All power projects and production, technological processes, services, facilities and devices connected with or related to the use of energy resources and their production, transmission and consumption are subject to mandatory certification, that is, confirmation of compliance with ecological, sanitary, fire, construction and health and safety standards. In addition, major projects as defined in the Energy Resources Law require a feasibility study by the state commission created for such purposes.

According to the Electricity Law, electricity is supplied under agreements between consumers and energy suppliers. Agreements on the sale and purchase, transportation and exchange of electricity and heat must comply with the rules on the use of electricity.

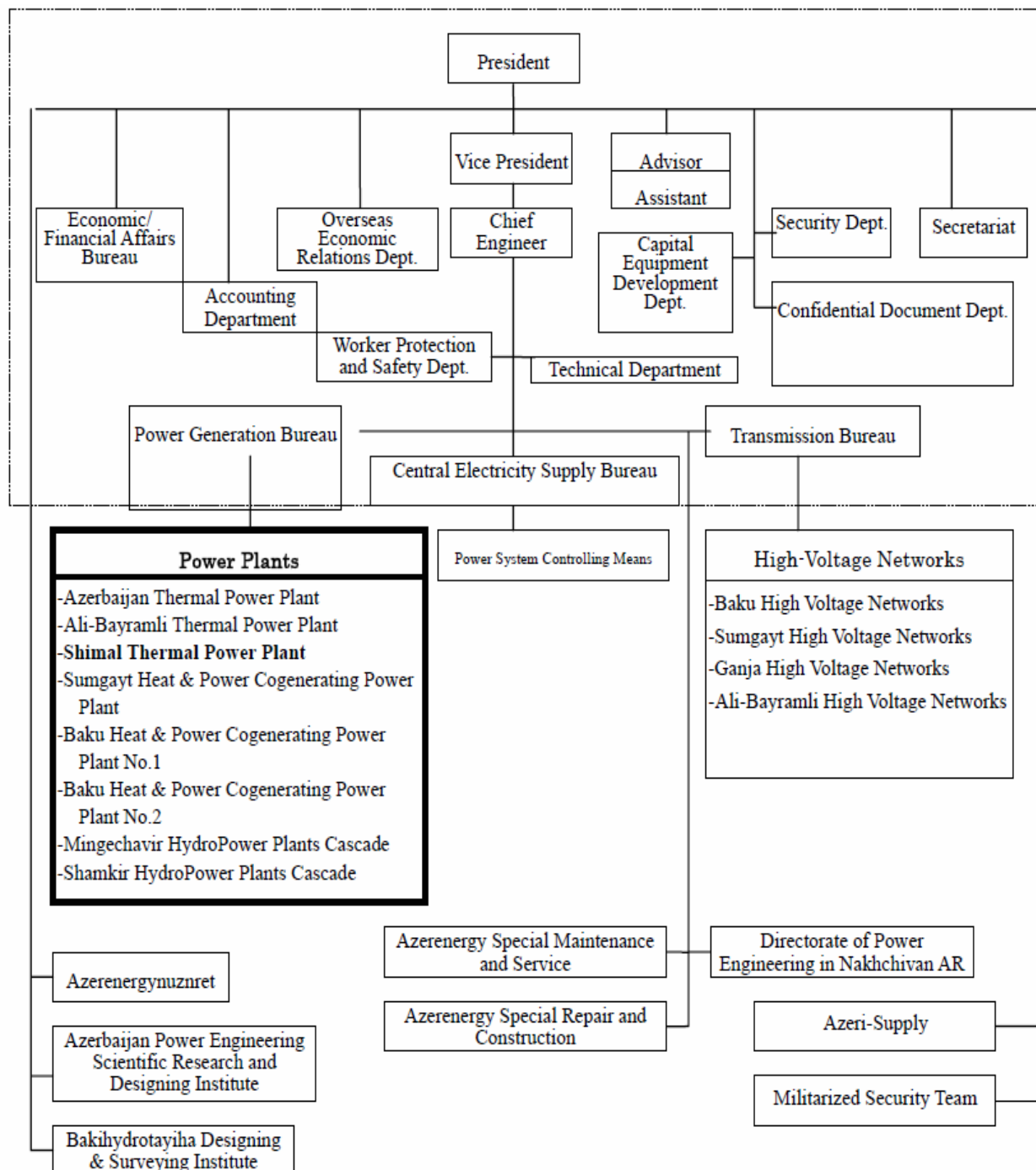
Energy consumption is subject to mandatory metering. The procedure for disconnecting consumers from the network (or the termination of the power supply) is regulated by the rules on the use of electricity, as well as by agreements with consumers.

7.3.3. Market structure monopolies, privatisation

Azerbaijan's electricity sector is dominated by a vertically integrated company, Azerenergy OJSC, which is a 100% state-owned enterprise. Azerenergy was established by Executive Order of the President No. 423 of 17 June 1996. Azerenergy OJSC produces, transports, distributes and sells electricity throughout the whole country, except in the city of Baku where the electricity distribution is performed by Bakuelektrikshebeke (Bakuelectricnetwork) SC.

Azerenergy is entitled to submit proposals on tariff increases and to take part in the tariff regulation process, but the final authority with regard to tariff determination in the electricity sector lies with the Tariff Council.

Figure 30 Organisational structure of Azerenergy SC



Source: Ministry of Energy and Industry

Azerbaijan’s legislation neither requires transmission and distribution to be separated from generation nor envisages the presence of a separate transmission system operator and distribution system operator. Accounting, functional and/or managerial disaggregation has not been accomplished or envisaged by legislation. Nonetheless, partial disaggregation has occurred: some mini-power plants have been privatised and one independent regional distribution company has been created.

The involvement of new private generating enterprises (mini-power plants) in the electricity sector is minor thus far though additional investment in new generating capacities and transmission/distribution operations is a medium-term policy objective.

The Azerbaijani electricity market has not yet opened and no formal opening time frame has been envisaged. Legislation provides for the principles of non-discriminatory access to the network infrastructure, though this has not been implemented in practice due to the market structure.

A new grid code has been developed in Azerbaijan in the framework of an EU-supported twinning project. It is expected that the new grid code will enter into force after the completion of internal procedures.

Access to, and proper investments in, the network are guaranteed by the Electricity Law. There are no access tariffs for generation/retailing and transmission/distribution. All the parties requiring access to transmission and distribution networks are obliged by law to comply with the same technical specifications, without discrimination or preference for any one party over another.

7.3.4. Current opportunities for private investors

Foreign capital investment in energy assets/companies is permitted and not restricted. Although there are no independent power producers (except two small hydropower stations and a wind farm), in general, investments in new generating capacities are encouraged and long-term electricity procurement is guaranteed.

Azerbaijan's power network is in need of rehabilitation and upgrading. Three key priority areas have been identified by international institutions: (i) the rehabilitation of the power grid to improve the power supply quality and loss reduction; (ii) the development of RE; and (iii) the improvement of demand-side energy efficiency and energy conservation. A comprehensive roadmap for investment in the sector is being developed with ADB assistance. Private investors can explore suitable investment projects through both public and private sector operations.

7.4. RE Resources

7.4.1. Legislation specific to RE sources

Azerbaijan's energy production is currently largely reliant on the exploitation of the country's hydrocarbon reserves but nevertheless the development of RE is also one of the government's strategic priorities. The state programme on the "Use of Alternative and Renewable Energy Resources in the Azerbaijan Republic" was approved by the decree of the president of the Azerbaijan Republic on 21 October, 2004. The programme stipulates conducting feasibility studies in the field of RE, mainly focusing on hydro and wind projects. Since 2004, very few activities involving RE were implemented due to limited funding. In order to progress further the government established the State Agency on Alternative and Renewable Energy Sources

(SAARES) under the MIE in 2009. It serves as the principal regulatory institution in the sphere of alternative and RE in the Azerbaijan Republic.

In spring 2011, SAARES in cooperation with UNDP launched a new project on “Promoting the Development of Sustainable Energy in Azerbaijan”. This project became possible with the financial support of €500,000 provided by the European Commission and \$790,000 contributed by the Government of Norway. This project aims to assist the Government of Azerbaijan to overcome barriers to the development of Renewable Energy Sources (RES) by reviewing and amending existing legal and institutional frameworks. These objectives will also be achieved through the training and education provided for target groups and beneficiaries on sustainable energy, by assessing the potential for renewable power in Azerbaijan, particularly in remote and rural areas, by identifying which types of RE are economic or economic with a minimal subsidy in each economic zone within the country, by building and analysing the economy of one small hydropower station in Azerbaijan and by preparing at least one investment project for each type of RE.

7.4.2. Biomass

The rapid development of the industrial, agricultural and social service fields in Azerbaijan opens new opportunities for energy production by using biomass. The area covered by forests in the country amounts to 14,400 square km, equivalent to 15% of the overall territory. It is estimated that more than 2 million tons of solid domestic and production wastes are disposed of at waste polygons every year.

There are significant agricultural operations in the country that could provide residues for biomass combustion or gasification, as well as wastes for biogas production from animal manures. There may also be potential for methane production from landfills. The following sources of biomass are available:

- forestry and wood processing wastes
- combustible industrial wastes
- agriculture and organic substance wastes
- waste from cities.

It may be affirmed that the Azerbaijan Republic has significant biomass potential for the production of energy due to developed agriculture, especially livestock farming, substantial forestry and waste processing potential.

At present, there is a large project (€346 million) in the implementation phase on waste processing. It is called the “Baku city waste to energy plant”, the implementation of which was awarded to the French firm CNIM (Constructions Industrielles de la Mediterranee) in December 2008, within the framework of “the Comprehensive Action Plan about the improvement of ecological situation in the Azerbaijan Republic for 2006-2010”.

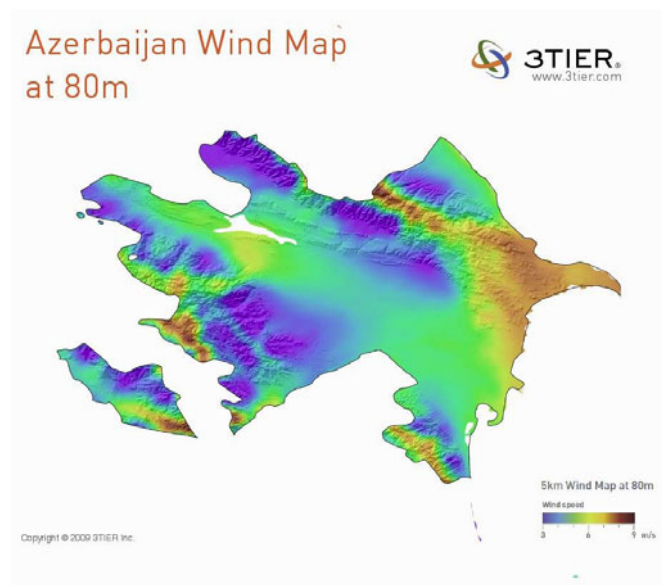
Recently, a tender has been announced to install a substation to transmit electricity to the grid produced at the planned Balakhani waste to energy facility. The Ministry of Economic Development of the Azerbaijan Republic invited tenders for the installation of auxiliaries and a 15/110-kV substation to transmit electricity produced at the municipal solid waste incineration plant to the state energy system.

As a design, build and operate (DBO) 20-year contract, the resulting facility will end up with a capacity of 500,000 tons of municipal solid waste per year, comprising two incineration lines, each line with a capacity of 250,000 tons. It is hoped that over 231 million kWh/year of electricity will be produced from the facility, which is expected to be completed by the end of 2012. The plant has a multilevel environmental protection mechanism and will operate according to the strictest environmental requirements of the EU and Azerbaijan.

7.4.3. Wind energy

The geographical location of the Azerbaijan Republic pre-defines the high level of the wind energy potential. The Greater Caucasus is the natural barrier preventing the penetration of cold air masses from the north and north-east. Skirting this barrier, cold air masses rush towards the Absheron Peninsula and Caspian lowland. The Kur-Araz lowland between three mountain ridges, especially the part that is located closer to the Caspian Sea, is also suffering the impact from the wind. The average annual wind velocity is 7 m/s (on the Absheron Peninsula). The wind velocity in zones adjacent to this zone is 6.5 and 4 m/s and isolines to the south limit the zone where the average annual wind velocity is ≥ 4 m/s.

Figure 31 Azerbaijan wind map



Source: www.3tier.com

It may be stated that a zone around the Caspian Sea has high wind energy characteristics. Investigations into wind potential have continued over the last several years to mainly evaluate possibilities for the utilisation of wind energy to produce electric energy and for the exposure of perspective sites for placing wind-mill electric generating plants (WEP). It is reported that an average annual wind velocity is 7.7 m/s all over the Absheron Peninsula and, therefore, the installation of wind-mill energy units in this zone is suitable.

High average annual wind velocities create the pre-requisites for the efficient utilisation of wind power, especially in cases when a power supply system with power reservation is needed. Working in parallel with the main power supply system of Azerbaijan, these units will increase its power provision and allow significant fuel saving. It was identified that 5.105 billion kWh of electric energy on average may be produced by WEUs installed at a height of

40 m and 6.222 billion kWh at a height of 80 m respectively, during the year (April 1999-March 2000).¹⁶

Historically, wind energy has long been used in Azerbaijan at a community level. Many simple wind-mill electric motors have been used on individual farms for irrigation purposes in a number of regions in the country. With a small capacity and simple design these units were widely used by the population.

The first large-scale wind power turbines were installed based on the cooperation of the German company Energy Competence Centre GmbH (ECC) from Berlin and the Azerbaijan company Caspian Technology Company. The operation of the first wind energy turbine began in March 2009. In Yeni Yashma, the Khizi region, the pilot project consisting of two turbines, VESTAS V52, each with 850 kW of power was connected to the grid. There are plans for this project to expand, in the form of a German joint-venture, with partial funding from a German bank and guarantees from the International Bank of Azerbaijan. The project could expand this facility to a wind park of 40-MW capacity. This would mainly serve the Sumgait area under a special tariff negotiated with the tariff authority. Eventually, the holding company envisages this park expanding to a possible 250-MW capacity (Sumgait uses about 500 MW daily. The tariffs for wind energy production were developed by the TC which may apply different tariffs to different projects depending on negotiations).

There is another project between Tomen Company (Japan) and Azerbaijan Scientific-Research Energy and Power Design Institute, which has installed two wind towers of 30 m and 40 m and confirmed that the annual average wind speed is 7.9-8.1 m/sec in Absheron. The company had also prepared a feasibility study for the installation of a 30 MW wind power plant in the Gorbustan region — this is now under consideration.

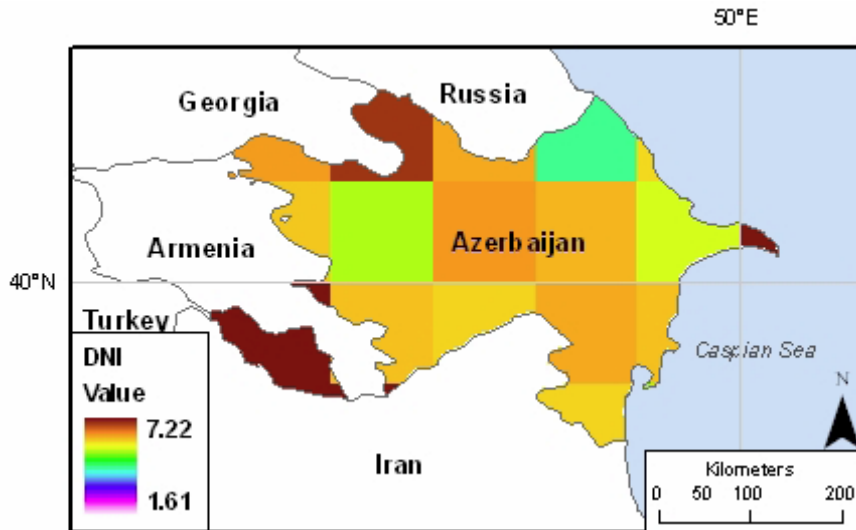
7.4.4. Solar energy

Azerbaijan has no large-scale solar power capacities although the solar energy potential is very high due to the favourable climatic conditions. The MIE has plans commissioning solar stations in the Absheron Peninsular, as well as the Nakhchivan AR and Mil-Mughan region.

The solar energy resource potential is high throughout practically the entire territory of the republic. It is especially high in the areas of Apsheron and Nakhchevan. The figure below displays the direct normal irradiation values for Azerbaijan.

¹⁶ Promotion of Renewable Energy, Energy Efficiency and Greenhouse Gas Abatement (PREGA), Azerbaijan Country Report

Figure 32 Solar direct normal insolation

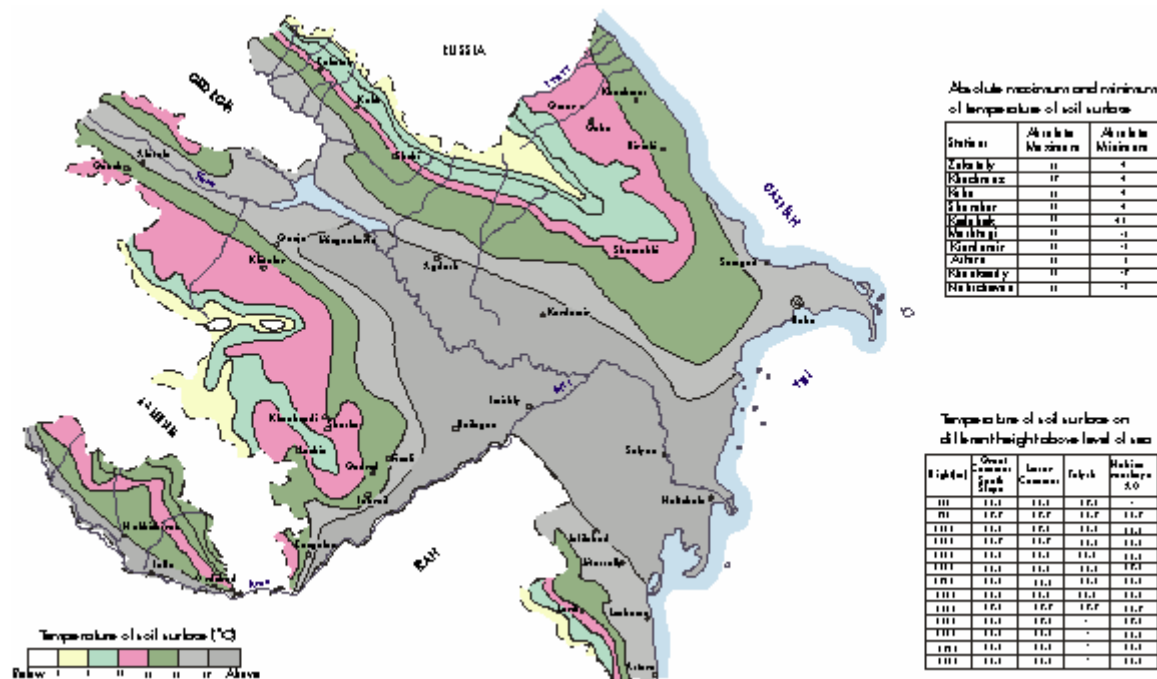


Source: www.3tier.com

7.4.5. Geothermal power

Azerbaijan has not utilised its geothermal power potential although the country is rich in thermal waters. They are usually found in the Great Caucasus and the Minor Caucasus, the Absheron Peninsula, the Talish mountain-row zone, the Kur lowland and the Caspian-Guba area. The exploitation of thermal waters in noted areas would partially cover the domestic and other heat energy needs. In addition, the potential exists for using thermal energy to heat extensive greenhouses.

Figure 33 Geothermal resources map of Azerbaijan



Source: www.3tier.com

The exploration and evaluation activities in Azerbaijan indicate a high potential for geothermal development. Prospective sources are recommended for therapeutic baths and industrial and energy applications.

Currently, Azerbaijan has no geothermal power plants. The use of thermal waters for greenhouse heating in the Lenkoran region, Kura side zone (Djarly, Muradkhanly, Sor-Sor), Gandja, and Yalama-Khudat regions are found to be promising. The high mineral content of these waters (more than 15 g/l) is typical.

The production capacity of the Lenkoran, Massaly and Astara regions is estimated to be about 25,000 m³ a day. Wells have produced water with wellhead temperatures of 40°C and rates of 40 l/s. The geothermal resources of Azerbaijan are represented by thermal water of low and middle temperatures (35-650°C).

Inflows of thermal water have been obtained with temperatures of 600°C from exploration oil wells at Absheron Peninsula.¹⁷

7.4.6. Hydropower potential

The installed generation capacity of hydropower plants (HPPs) in Azerbaijan is around 1000 MW. In 2010, these stations produced 3.4 billion kWh. It is equal to 18% of the total energy production of the country.

¹⁷ <http://ebrdrenewables.com/sites/renew/countries/azerbaijan/profile.aspx>, 1 August 2011

The development of small HPPs is the most promising component in the RE sector. The region between the Great and Minor Caucasus is rich in mountain streams and lakes. With a number of HPPs installed, this RE source is already being used. According to statements from the MIE, negotiations are currently underway to increase their number. Under existing conditions, it is technically and economically feasible to develop a vast potential of small rivers and use drops on the irrigation canals and water releases from reservoirs, which will permit the construction of small HPPs.

Azerenergy OJSC has prepared a programme on hydropower development, including small hydropower. Prospective sites where HPPs can be constructed have been identified. The total capacity is estimated to be more than 1,300 MW. Two new projects have recently been started, namely the Sheki and Mughan HPPs.

AzerEnergy OJSC has announced that hundreds of small hydropower stations will be built in the republic in the coming years. One of the priority projects is a 1.7-MW station to be set up on the Istisu that will generate 2.5 million kWh of electricity a year. To keep the station running, the water from the Istisu will be supplied to the station through pipes at high pressure from a distance of 2 km. A water-intake facility, hydroelectric units, a 10-kV substation and power lines will be built at the new station.

There are opportunities for the construction of small HPPs with an estimated production at 3.2 billion kWh per year. The construction of small hydropower stations will improve power supply in the remote areas in the country.¹⁸

Over the last several years the UNDP has promoted the development of hydropower with a project during 2007-2010 that had a budget of \$1.5M, provided by Norway. There are few HPPs in the country that are operated by private owners.

7.5. District heating sector

7.5.1. General information

By 1990, the district heat supply system of Azerbaijan, comprising several thermal stations and central distribution systems, provided almost all public and administrative buildings and residences with heating and hot water.

Over the last two decades the district heating systems of Azerbaijan have faced financial and technical problems, largely due to limited financing and lack of a policy framework and regulations. Azerbaijan's district heating sector has not seen major investments over the past 20 years. Today most of the central heating systems are in a bad condition; they are poorly maintained and obsolete, and require considerable modernisation.

In Azerbaijan, the central district heating systems were equipped with large central heavy fuel oil and natural gas-fired boilers that provided pressurised hot water. The basic resources for heat production in Azerbaijan are natural gas and heavy fuel oil.

¹⁸ UNDP, "Legal and policy modifications in the Azerbaijan energy legislation", 2010

The heating systems have transmission and distribution networks that were built during the Soviet period. Transmission pipelines are owned by the Ministry of Communal Services and distribution pipelines are owned by communal enterprises.

At present, centralised heating is used primarily in the capital. Some regions of Baku are supplied by industrial heat sources.

Decentralised heating is organised as individual heating (for a building) and private or autonomous heating (for an apartment or a house). Natural gas is the preferred fuel. Small-scale decentralised heating is used mostly in rural areas but lately there have been some projects on private heating system installation in multi-storey buildings in the cities. At present, there are many cases of switching from centralised to decentralised heating sources because of the continuing deterioration of the centralised heat supply.

7.5.2. Legislation specific to the heating sector

The following legislation is relevant for the developing of the heat supply sector in Azerbaijan.

- The Law “On Power Plants and Heat Generation Plants” (Baku, December 28, 1999, No. 84-IG);
- Presidential decree on improving management in the field of the heating supply of the Azerbaijan Republic (8 June 2006, No. 847);
- Energy Use Law (30 May 1996);
- Law on Electro Energy (13 April 1998);
- Energy Law (24 November 1998);
- State programme on the development of the fuel-energy complex of the Azerbaijan Republic in 2005-2015 (14 February 2005); and
- State programme on the use of alternative and RE resources in Azerbaijan (21 October 2004).

In 2009, the State Programme on the Socio-Economic Development of Regions for 2009-2013 years was prepared that envisaged various activities involving the rehabilitation and modernisation of heating systems in many region of Azerbaijan.

7.5.3. Market structure monopolies

The central body of executive power in heat supply is Azeristiliktechizat SC. The state-owned company was established by the presidential decree on improving management in the field of the heating supply of the Azerbaijan Republic (on 8 June 2006, No. 847). According to the decree the company has to provide heating services for education, health and other social institutions and public buildings as well as to the population.

Since its foundation Azeristiliktechizat SC has been involved in certain activities for improving heat supply. The construction of new boilers, the renovation and modernisation of old facilities and increasing the number of clients and consumers are the main achievements of the company.

Azeristiliktechizat SC is preparing a new programme on the development of heating systems in Baku city and settlements.

In the forthcoming period, investments are also necessary in the development of district heating, in accordance with the growth of consumption and the expansion of thermal networks. Consumption measuring will be also introduced and corresponding equipment will be installed with newly connected users. Furthermore, it is planned that infrastructure and management improvement projects will be implemented in the near future.

ANNEX 1 INTERNATIONAL AGREEMENTS FOR THE AVOIDANCE OF DOUBLE TAXATION

№–	State	Signature date	Coming into force date	Application date
1	Austria	04.07.2000	23.02.2001	01.01.2002
2	Belarus	08.08.2001	29.04.2002	01.01.2003
3	Belgium	18.05.2004	12.08.2006	01.01.2007
4	Bulgaria	12.11.2007	25.11.2008	01.01.2009
5	China	17.03.2005	17.08.2005	01.01.2006
6	Czech Republic	24.11.2005	16.06.2006	01.01.2007
7	Estonia	30.10.2007	27.11.2008	01.01.2009
8	Finland	29.09.2005	29.11.2006	01.01.2007
9	France	20.12.2001	01.10.2005	01.01.2006
10	Georgia	18.02.1997	01.12.1997	01.01.1998
11	Germany	25.08.2004	28.12.2005	01.01.2006
12	Greece	16.02.2009	XXX	01.01.2011
13	Hungary	18.02.2008	15.12.2008	01.01.2009
14	Iran	10.03.2009	25.01.2010	01.01.2011
15	Islamic Republic of Pakistan	10.04.1996	XXX	XXX
16	Italy	21.07.2004	XXX	01.01.2011
17	Japan	30.05.2005	11.04.2008	28.12.1991
18	Canada	07.09.2004	23.01.2006	01.01.2007
19	Kazakhstan	16.09.1996	07.05.1997	01.01.1998
20	Korea	19.05.2008	25.11.2008	01.01.2009
21	Kuwait	10.02.2009	XXX	XXX
22	Latvia	03.10.2005	19.04.2006	01.01.2007
23	Lithuania	02.04.2004	13.11.2004	01.01.2005
24	Luxemburg	16.06.2006	02.07.2009	01.01.2010
25	Moldova	27.11.1997	28.01.1999	01.01.2000
26	Nederland	22.09.2008	18.12.2009	01.01.2010
27	Norway	24.04.1996	19.09.1996	01.01.1997
28	Poland	26.08.1997	20.01.2005	01.01.2006
29	Qatar	28.08.2007	11.03.2008	01.01.2009
30	Romania	29.10.2002	29.01.2004	01.01.2005
31	Russian Federation	03.07.1997	03.07.1998	01.01.1999
32	Serbia	13.05.2010	XXX	XXX
33	Switzerland	23.02.2006	13.07.2007	01.01.2008
34	Tajikistan	13.08.2007	11.02.2008	01.01.2009
35	Jordan	05.05.2008	XXX	XXX
36	Turkey	09.02.1994	01.09.1997	01.01.1998
37	Ukraine	30.07.1999	03.07.2000	01.01.2011
38	United Arab Emirates	20.11.2006	25.07.2007	01.01.2008
39	United Kingdom	23.02.1994	29.09.1995	18.10.1991
40	Uzbekistan	27.05.1996	02.11.1996	01.01.1997

Source: Ministry of Taxes of Azerbaijan, 1 August 2011

ANNEX 2 LIST OF BITS OF AZERBAIJAN

№	Country	Date of signature	Ratification date
1	Austria	4 July 2000	24 October 2000
2	Belgium-Luxembourg Economic Union	18 May 2004	26 October 2004
3	Belarus	3 June 2010	30 September 2010
4	Bulgaria	7 October 2004	1 March 2005
5	China	8 March 1994	-
6	Croatia	02 October 2007	1 February 2008
7	Egypt	24 October 2002	13 May 2003
8	Estonia	7 April 2010	8 June 2010
9	Finland	26 February 2003	13 May 2003
10	France	1 September 1998	27 November 1998
11	Georgia	8 March 1996	19 April 1996
12	Germany	22 December 1995	25 June 1996
13	Greece	21 June 2004	26 October 2004
14	Hungary	18 May 2007	1 October 2007
15	Iran	28 October 1996	1 December 1998
16	Israel	20 February 2007	1 October 2007
17	Italy	25 September 1997	17 February 1998
18	Jordan	5 May 2008	2 October 2008
19	Kazakhstan	16 September 1996	15 November 1996
20	Korea	23 April 2007	1 October 2007
21	Kuwait	10 February 2009	28 April 2009
22	Kirgizstan	23 April 1997	26 June 1997
23	Latvia	3 October 2005	1 March 2006
24	Lithuania	8 June 2006	10 April 2007
25	Lebanon	11 February 1998	4 December 1998
26	Moldova	27 November 1997	8 December 1998
27	Norway	25 September 1996	-
28	Pakistan	9 October 1995	12 March 1996
29	Poland	26 August 1997	13 February 1998
30	Qatar	28 August 2007	19 October 2007
31	Romania	29 October 2002	5 December 2003
32	Saudi Arabia	10 March 2005	10 May 2005
33	Syria	8 July 2009	30 September 2009
34	Switzerland	23 February 2006	10 April 2007
35	Tajikistan	15 March 2007	5 June 2007
36	Turkey	9 February 1994	14 June 1994
37	UAE	20 November 2006	10 April 2007
38	Ukraine	25 March 1997	6 June 1997
39	UK	4 January 1996	15 March 1996
40	USA	1 August 1997	14 April 1998
41	Uzbekistan	27 May 1996	16 July 1996

Source: Azerbaijan Export and Investment Promotion Foundation (AZPROMO), 1 August 2011

ANNEX 3 EXCEPTIONS TO NATIONAL TREATMENT

COUNTRY: AZERBAIJAN

MEASURES

The Land Code of the Azerbaijani Republic approved and enacted by 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 organisations and foreign states may only lease plots of land in the Azerbaijani Republic.

Private property rights acquired by foreign legal and natural persons as a result of contracts of inheritance, gifts 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

No plans at present

OTHER EXCEPTIONS

None

COUNTRY: AZERBAIJAN

MEASURES

Law on Privatisation of the State Property of 7 January 1993, Article 8, paragraph 1
Second State Privatisation Programme of the State Property in the Azerbaijani Republic 2000

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 Programme.

In accordance with the State Privatisation Programme 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 the privatisation of facilities specified in Section 2 of Annex 1 to the programme when he decides to grant permission to privatise these facilities and enterprises.

PHASE-OUT

No plans at present

OTHER EXCEPTIONS

None

COUNTRY: AZERBAIJAN

MEASURES

Second State Privatisation Programme of the State Property in the Azerbaijani Republic 2000

SECTOR

National Economy

LEVEL OF GOVERNMENT

National

DESCRIPTION

A foreign investor's 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 a 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.

Utilisation of privatisation vouchers (cheques) in the privatisation process by a foreign investor without privatisation options shall not be permitted.

The Second Privatisation Programme slightly modified regulations concerning the requirement for options where profits obtained in Azerbaijan are reinvested by foreign investors. Options are not required from foreign investors funding their participation in privatisation with net profits obtained in Azerbaijan.

PHASE-OUT

No plans at present

OTHER EXCEPTIONS

None