

SOFAZ

- The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established in
- accordance with the decree of the President of the Republic of Azerbaijan dated
- December 29, 1999 “On Establishment of the State Oil Fund of the Republic
- of Azerbaijan.” Statutory Regulations of the State Oil Fund of the Republic of
- Azerbaijan were approved by the President of the Republic of Azerbaijan dated
- December 29, 2000. The cornerstone of the philosophy behind the Oil Fund was
- to ensure intergenerational equality of benefit with regard to the country’s oil
- wealth, whilst improving the economic well-being of the population today and
- safeguarding economic security for future generations

- The Fund's activity is directed toward the achievement of the
- following objectives: (i) preservation of macroeconomic stability, ensuring fiscal-tax discipline, decreasing dependence on oil revenues and stimulating development
- of the non-oil sector; (ii) taking into account that oil and gas are deployable resources ensuring intergenerational equality with regard to the country's oil wealth and to accumulate and preserve oil revenues for future generations; (iii)
- financing major national scale projects to support socio-economic progress.

- SOFAZ's activities in the field of assets accumulation and spending are
- overseen by a Supervisory Board. The Board is to review the Fund's draft annual
- budget, annual report and financial statements along with auditor's opinion and
- provide its comments. Members of the Supervisory Board are appointed by the
- President and represent mainly state bodies. In accordance with the presidential
- decree dated November 27, 2008, seven new members of the Supervisory Board
- were appointed. Prime Minister Arthur Rasizade was re-elected Chairman of the
- SOFAZ Supervisory Board. Civil society's participation in the management of
- SOFAZ hasn't been implemented yet.

- SOFAZ's daily management is vested with the Executive Director, appointed
- by and accountable to the President. SOFAZ's Executive Director as a chief
- executive officer is vested with the powers to be a legal representative of the
- Fund, organize and conduct business of the Fund including appointment and
- dismissal of employees, management and disbursement of the assets of the
- Fund in conformity with the rules and regulations approved by the President
- of Azerbaijan. The Executive Director is responsible for the preparation of the
- annual budget of SOFAZ, incorporating an annual program of the Fund's assets
- utilization, and its submission for the approval of the President of Azerbaijan.
- Regarding "Decree of the President of the Republic of Azerbaijan on
- establishment of the State Oil Fund of the Republic of Azerbaijan" (29.12.1999)
- SOFAZ fulfilled its operations through a special account of the National Bank.
- SOFAZ is accountable and responsible to the President of the Republic of
- Azerbaijan. The Fund is an extra-budgetary institution. The Fund is a legal entity and
- must have a settlement account and other accounts at banking institutions²

- Supervisory Board exercises general control over establishment and spending of
- the Fund's assets. **The main responsibility of the Fund is to ensure collection**
- **and effective management of foreign currency and other assets that are**
- **generated from the implementation of agreements signed in the field of**
- **oil and gas exploration, and development, as well as from the Fund's own**
- **activities, in the interest of citizens of the Republic of Azerbaijan and their**
- **future generations.** The Fund's assets form on the account of the following
- sources:
- - Revenues generated from implementing agreements on exploration,
- development and production sharing for oil and gas fields in the territory of
- Azerbaijan;
- - Net revenues from the sale of hydrocarbons falling to the share of Azerbaijan;
- - Oil and gas agreements' signature or performance bonuses paid by investors
- to the State Oil Company of the Azerbaijan Republic;
- - Acreage payments;
- - Dividends and profit participation revenues falling to the share of Azerbaijan;
- - Revenues generated from oil and gas passing over the territory of Azerbaijan;
- - Revenues generated from the transfer of assets from investors to the State
- Oil Company or within the framework of oil and gas agreements;
- - Revenues generated from the placement, management, sale or other
- utilization of the Fund's assets and revenues from asset revaluation and other
- related revenues;
- - Grant and other free aid, and other revenues and receipts in accordance
- with the legislation.

- The Fund's assets under management are placed in investment-grade rated
- banks and instruments. The Supervisory Board of the Fund determines rules for
- accounting and reporting the use of the Fund's assets. Utilization of the Fund's
- assets is carried out in accordance with main directions to be approved each year
- through Presidential Resolutions. The Fund's assets may be used for solving the
- most important nationwide problems, and for construction and reconstruction of
- strategically significant infrastructure facilities for the purpose of the country's
- socio-economic progress.

- The Oil Fund's budget is an annual financial program prepared in compliance
- with the legislation of Azerbaijan to ensure the implementation of the Oil Fund's
- objectives and functions and reflects the Oil Fund's revenues and expenditures. The
- preparation and execution of the Oil Fund's budget shall be based on the principle
- of the implementation of a coherent macroeconomic policy in Azerbaijan and the
- consolidation of revenues and expenditures of the consolidated government.
- Effecting of any expenditure on Oil Fund's assets extraneous from the Oil Fund's
- budget by the Oil Fund is inadmissible. Expenditures that can arise from the
- Oil Fund's assets' revaluation in the Oil Fund's reported currency (Azerbaijani
- manat) as well as expenditures in connection with payment of lawfully determined
- taxes and any other obligatory payments are not intended in the budget of the Oil
- Fund and are in fact reflected as extra-budgetary expenditures in the balance of
- the Oil Fund. Budget expenditures of the Oil Fund as well as financing lawfully
- determined taxes and any other extra-budgetary obligatory payments are effected
- on the Oil Fund's assets in the national currency of the Republic of Azerbaijan
- and foreign currency.

- A long-term strategy on management of oil and gas revenues, which covers
- the period 2005-2025, establishes the principles for the use of oil and gas
- revenues and medium-term expenditures policy for this period⁵. This strategy
- ensures the management of the revenues acquired from sale of natural gas and
- oil in conformity with the sources described below, accrued in the State Oil Fund
- of the Azerbaijan Republic, and in the state budget. The principles for long-term
- use of oil and gas revenues are as follows: when forecasting the amount of longterm
- expenditures from oil and gas revenues, the ‘constant real expenditures’
- principle shall be used as a basis and annual limits shall be set for these
- expenditures that are to be made within the period covered by the strategy; when
- incomes from oil and gas revenues peak, at least 25 percent of them is saved; the
- regulations adopted for spending oil and gas revenues shall remain unchanged
- during the effective period of the long-term strategy on management of oil and
- gas revenues and the expenditure limits projected on the basis of the constant
- real expenditures principle is observed; the volume of medium-term expenditures
- shall be determined based on the non-oil deficit (the difference between revenues
- and expenditures of the consolidated budget of the country, excluding the oil
- sector) and taking account of the long-term expenditure limit.

- The development of the non-oil sector based on the use of long-term oil and gas
- revenues will help in reducing the country's need for external borrowing. The
- strategy on use of oil and gas revenues includes the following objectives, while
- aiming at retaining macroeconomic stability:
 - - developing the non-oil sector, regions, SMEs;
 - - large-scale development of infrastructure; fulfillment of poverty reduction
 - measures and the solution of other social problems;
 - - stimulating the improvement of the intellectual, material, and technical base
 - of the economy; development of "human capital;"
 - - consolidating the defense capabilities of the country;
 - - executing projects relating to reconstruction activities in liberated territories
 - and the return of internally displaced persons to their native lands.

- But there are critics by EITI NGO Coalition that the main regulatory document should be law. ***Azerbaijani civil society groups have already prepared a draft law on SOFAZ.*** Regarding that draft law:
- “administration expenses of the Fund shall not be more than 5% of its annual revenue. It is impossible to substantiate the 5%, as the international standards contain the limit of 5% as an exceptional case. In my opinion, we may preserve 10% and not write any other figures here. The Fund shall be accountable and responsible to the Milli Mejlis of the Republic of Azerbaijan. The liquid funds of the Fund will be preserved in the highly rated and internationally recognized banks determined by the Supervision Board with the assets expressed mainly in US dollars, Euro, British pound sterling and Japanese yen and in other currencies not exceeding 10%. The assets preserved with any banks may not exceed 20% of the Fund’s liquid funds. 30% of the Fund’s annual revenues shall be allotted for collection purposes within each fiscal year. The Funds collection assignment assets are preserved for needs of the next generations, and excluding provisions contained in this law, it cannot be used for other goals. By release of the occupied Azerbaijani lands, approximately 50% of the Fund’s stocking assignment assets may be used for the purpose of financing of actions related to the reorganization of these territories and returning of refugees to their homeland. The Fund’s stocking assignment assets may be sued if the net revenues generated from sale of hydrocarbons falling to the share of the Azerbaijan Republic are less than those generated from placement and management of the Fund’s assets.

SOFAZ's asset and revenue management

- SOFAZ's assets are managed in accordance with the “Rules for accumulation, investment and management of assets of the State Oil Fund of the Republic of Azerbaijan” (Investment Guidelines) approved by a presidential decree of June 19, 2001. According to these Rules the purpose of management of the Oil Fund's foreign currency assets is to hold foreign currency assets of the Oil Fund securely and to generate revenues by effective management. Outside the Republic of Azerbaijan, the current accounts of the Oil Fund should be opened with banks rated by reputable international rating agencies such as Standard & Poor's, Moody's and Fitch with a long-term credit rating not lower than: “AA-” as defined by Standard & Poor's or Fitch, or “Aa3” as defined by Moody's. The Fund's counterparts in international financial markets might be institutions with long term credit ratings not less than BBB (by Standard and Poor's), BBB (by Fitch) or Baa (by Moody's). The maximum weight of one financial institution or one investment in the investment portfolio of the Fund is set at 15% of the total amount of the investment portfolio (exceptions are central banks, custodian banks and external managers).

- 50% of the total amount of the investment portfolio of the Fund is to
- be invested in assets denominated in US Dollars, and 40% in assets denominated
- in Euro, 5% in assets denominated in GBP, whereas 5% of the total amount of the
- investment portfolio of the Fund is to be invested in assets denominated either in
- currencies of countries with long-term country ratings (sovereign debt) not less than
- the credit ratings A (Standard & Poor's, Fitch) or A2 (Moody's); in US Dollars
- or in US Dollars, Euro and GBP based on their respective weight. According to
- investment policy, up to 60% of the Fund's investment portfolio
- can be managed by external managers. The assets given to an external manager
- cannot exceed 15% of the total amount of the investment portfolio. SOFAZ's
- investment portfolio should not be invested in currency arbitrage, swaps, forwards
- and futures (except for the purpose of hedging or optimizing the currency
- composition of the investment portfolio and structure of the SOFAZ's assets),
- precious metals and stones, or real estate

- The main projects are financed by SOFAZ include: a) “State Program on
- education of Azerbaijani youth abroad in the years 2007-2015”; b)
- “Baku-Tbilisi-
- Kars New Railway” Project; c) constructing a water pipeline from
- Oguz-Gabala
- region to Baku city; d) reconstruction of the Samur-Absheron irrigation
- system; e)
- Formation of the statutory capital of Azerbaijan Investment Company; f)
- Settlement
- of the problems of refugees and internally displaced persons who were
- forced to
- flee their native lands as a result of Armenian invasion on the Nagorno
- Karabakh
- region of Azerbaijan; g) Baku-Tbilisi-Ceyhan Main Export Pipeline.

SOFAZ's relations with the state budget

- The revenues of the State Oil Fund of Azerbaijan Republic (SOFAZ) made up
- 8,176.7 million AZN and its expenses 5,294.5 million AZN in 2009. The incomes
- of the Fund were fulfilled by 97.8% and expenses by 99.5%. The greatest part
- of the Fund's income (93.4%) was provided by the profit table sale of oil and
- gas. It's probably impossible to evaluate the economic-budget model of recent
- years without the SOFAZ / state budget relationship. The transfers of the Oil
- Fund to the budget as of 2003 gave a start to this relationship. The growth of
- these transfers year by year and its budget share of almost 50% at the present
- considerably improve this relationship. Such a situation itself causes certain
- anxiety. Hence, the growth strengthens the dependence of the budget upon the
- oil fund and weakens its motivation for tax collections.

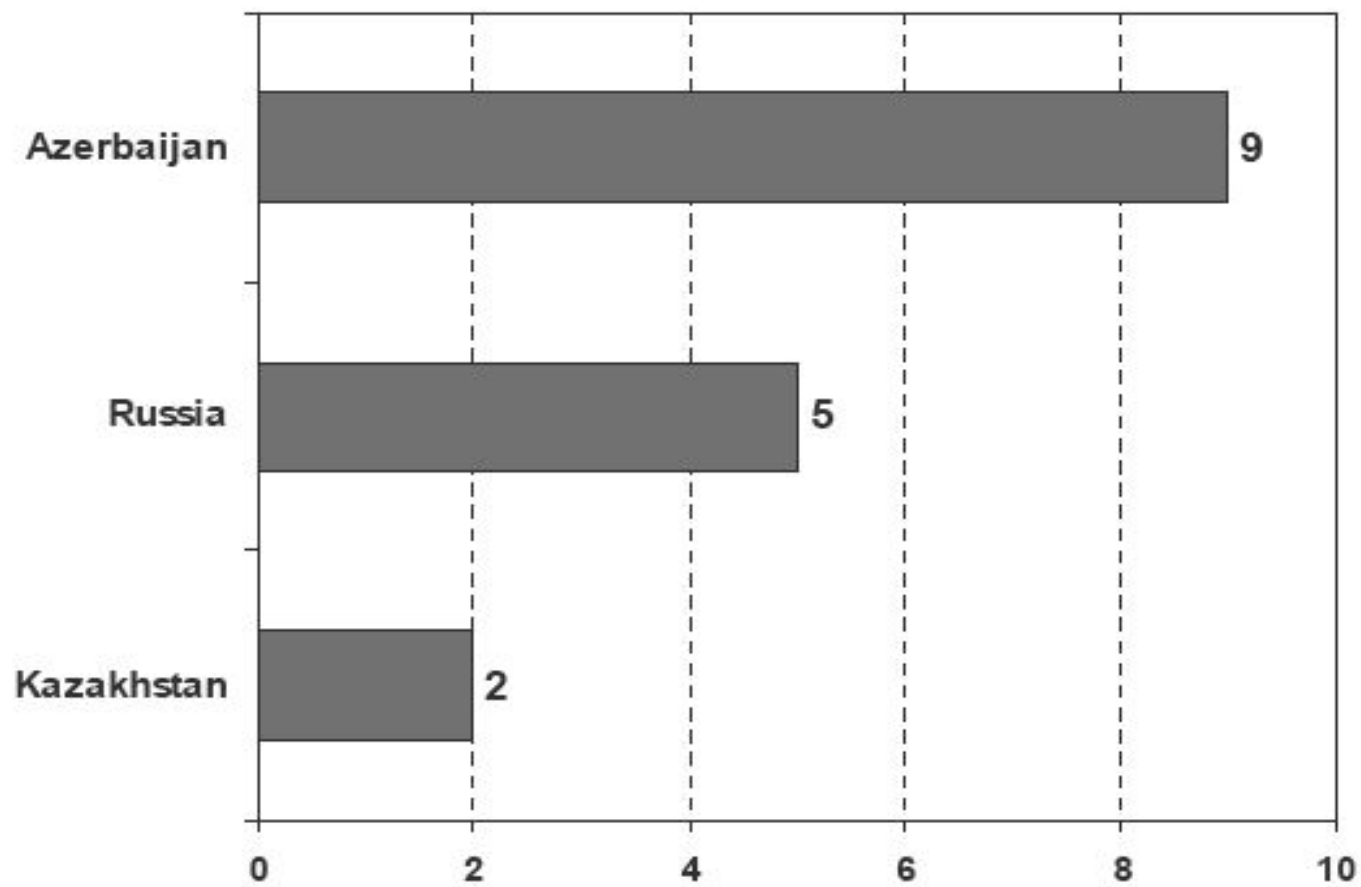
- Since the establishment of SOFAZ, its revenues amounted to \$40 billion, \$20 billion of which has been spent. Half of SOFAZ's revenues were maintained for future generations in accordance with SOFAZ's total strategy. SOFAZ's income from bonuses hit 0.8 million manat, from dividends on the Baku-Tbilisi-Ceyhan oil pipeline - 156.8 million, from transit payments -- 8.9 million manat in 2009. About 25 percent of revenues in the oil fund must be kept in accordance with the strategy of a long-term oil revenue management, approved by the president in 2004. So far, Azerbaijan has gained about \$40 billion from oil revenues, and half of these funds - about \$20 billion - is stored in the SOFAZ. Given the fact that in the next 15 years, oil revenues amount to about \$200 billion, then if SOFAZ will save half of these revenues, the country will have revenues of \$100 billion. Due to increased revenues from management of Fund's assets, in the future, the level of transfers to the public budget can remain at current levels due to revenues from asset management. SOFAZ has received \$1 billion from the asset management up to now. With a minimum profitability on assets placed at 5 percent, after 15 years we can reach the level of \$6 billion income from asset management per year. If we continue to adhere to these principles and criteria, after some time the government of Azerbaijan will be able to keep a constant level of transfers at the expense of revenues only from the management at current levels.

SOFAZ's transparency and accountability

- SOFAZ represents Azerbaijan in the Extractive Industries Transparency Initiative (EITI). Thus, the country has the opportunity to become the first full EITI member. Additionally, one of the priorities for SOFAZ is to assist other countries in the EITI. Kazakhstan, Yemen, Mongolia, Nigeria and other countries have applied to Azerbaijan in this connection. EITI unites 26 members. Azerbaijan has an opportunity to further improve the extractive industry accountability system.
- The multi-stakeholders group (consisting of SOFAZ and foreign companies) and the NGO Coalition have held meetings to discuss possible changes and improvements in EITI. EITI includes all extractive industries. Accountability covers not only the oil-and-gas industry, but also all types of extractive industries. In line with queue principles, companies involved in extractive industries will pay for the audit. Deloitte developed the 10th EITI report on 2008 outcomes.

- As an independent auditing and financial control body, The Chamber of
- Accounts must inform the society about the results of the budgetary expenditure
- checkups in accordance with Clause 6.0.3 of the national law on the Main
- Principles of Information. International tools have also been developed to measure accountability and
- transparency of sovereign wealth funds, including SOFAZ. One of them is the
- Linaburg-Maduell Transparency Index which was developed at the Sovereign
- Wealth Fund Institute by Carl Linaburg and Michael Maduell. The Linaburg-
- Maduell transparency index is a method of rating transparency in respect to
- sovereign wealth funds. Pertaining to government-owned investment vehicles,
- where there have been concerns of unethical agendas, calls have been made to
- the larger “opaque” or non-transparent funds to show their intentions.

Linaburg-Maduell Transparency Index (score)



This index is based on ten essential principles that depict sovereign wealth fund transparency to the public. The following principles each add one point of transparency to the index rating. The index is an ongoing project of the Sovereign Wealth Fund Institute. The minimum rating a fund can receive is a 1; however, the Sovereign Wealth Fund Institute recommends a minimum rating of 8 in order to claim adequate transparency. Transparency ratings may change as funds release additional information. There are different levels of depth in regards to each principle; judgment of these principles is left to the discretion of the Sovereign Wealth Fund Institute. Principles of the Linaburg -Maduell Transparency Index are the following: the fund provides history including the reason for creation, origins of wealth, and government ownership structure; the fund provides up-to-date independently audited annual reports; the fund provides ownership percentage of company holdings, and geographic locations of holdings; the fund provides total portfolio market value, returns, and management compensation; fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines; fund provides clear strategies and objectives; if applicable, the fund clearly identifies subsidiaries and contact information; if applicable, the fund identifies external managers; the fund manages its own web site; the fund provides a main office location address and contact information such as telephone and fax.

SOFAZ and civil society

- there is an exigency for mutual cooperation of the Fund with
- the civil sector in organization of monitoring of investment projects in the domestic
- economy financed by the Fund. There are many gaps and even legislative cases
- in this area. For example, the civil sector still doesn't have a clear answer to the
- question of which authority is responsible for efficient and transparent spending
- of funds for Oguz-Gabala-Baku water supply system and other similar projects.
- According to the Order dated February 24, 2006, № 42 "Azersu" Joint Stock
- Company was entrusted with construction, management and implementation
- of customer's functions for "Oguz-Gabala-Baku" WSS project by the Cabinet of
- Ministers of Azerbaijan Republic. In January 01, 2010 SOFAZ appropriated funds
- totaling 547.4 million manat and an additional 200 million this year for financing
- the project. Repeated requests to the Fund about enabling monitoring of this
- expensive project yield no positive results. The standard answer of management
- is that the Fund is not responsible for the target and the transparent use of funds
- in these projects, so it is better to appeal to public operators, in this case the state
- water company Azersu. Obviously, this answer can't suit an NGO. It is also clear
- that the promotion of NGOs in monitoring is in the interests of the Fund also,
- which is high in the ratings of good and transparent governance and tries to hold
- this position.

