

State-Owned Oil Company Case Studies: SOCAR

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INTRODUCTION

State participation in oil and gas sector in Azerbaijan is implemented through SOCAR. Not only SOCAR is a state enterprise, but it is also country's largest company and tax-payer. Only in 2017 the company paid taxes in the amount of AZN1,511 billion and AZN155,984 million to State Budget and State Social Protection Fund. The share of company payments in total budget income and total tax incomes is 6%-8% and 15-17 accordingly. Company's total incomes exceed total budget incomes for 4 times. Thus disclosure of information on SOCAR's financial operations to public is essential and this research actually explored company's transparency and openness as well as its correspondence to contemporary management standards.

Throughout its production-sale chain SOCAR is vertically integrated company. Its operations include exploration, research and development, processing, transportation and retail sales of oil onshore and in Azerbaijan sector of the Caspian Sea. Besides its retail activities locally, SOCAR operates in Georgia, Romania, Switzerland and Ukraine. State holds 100 percent of SOCAR shares, thus supports the company financially and strategically. There have been large financial flows between the state and company throughout the years. The State financially supports capital increase, allocates subsidies, makes investments, provides with loans and tax breaks. SOCAR in its turn pays taxes and makes investments. Nevertheless there are no clear and precise rules regulating SOCAR's financial relations with the State. Existing regulations do not reflect specific approach between State and the company that has particular role in country economy.

Outcomes of this investigation show that company's governance system does not correspond to corporate governance principles, although latter has been declared by Company. Organization-legal structure of the Company is also not clear and contradicts with requirements of the Civil Code.

In some countries state enterprises are in the list of non-transparent and not accountable companies. It is said that lack of transparency may lead to decrease of incentives to operate for the sake of public welfare. SOCAR's position in NRG's Resource Governance Index (RGI) for 2017 was satisfactory, with 70 scores out of 100 possible. The company holds 10th place among 52 state oil and gas companies evaluated by the Index. The reason for good position of Company is related to disclosure of information according to EITI standards. EITI Standards require state and state companies to publish information on sales of goods, quasi-fiscal activities, joint ventures and subsidiaries, material payments of extractive companies to state enterprises and transfers between state companies and other state agencies¹. Although the country left EITI, Azerbaijan declared its intention to apply international transparency and accountability standard principles.

The first part of the research covers topics related to SOCAR's role in country economy, its mandate and relations with state, internal governance level and its correspondence with international standards, legal status, as well as transparency and accountability issues. The second part is about company performance, financial indicators, level of oil and gas production, including volume and export of goods from oil processing. The final part of the research is

¹ Natural Resource Charter Benchmarking Framework. https://resourcegovernance.org/sites/default/files/documents/precept_6_0.pdf

devoted to observed tendencies in company operations for last 10 years and recommendations for increasing effectiveness of governance, as well as achieving transparency and accountability.

Context and Background

SOCAR that integrated the Azerbaijan oil industry has long been known as “Azerneft”. Starting from 19th century it was subordinate to different organizations (Soviet of People's Commissars of the Azerbaijan SSR, the Supreme Economic Council of the USSR, Ministry of Heavy Industry of the USSR, People's Economic Council of Azerbaijan SSR) in the former USSR depending on its organizations' characteristics at different times and was known as “Azerneftkomite”, “Azerneftkombinat”, “Azerneftchikharma” Union and so forth. In 1954-1959, the Ministry of the Oil Industry of the Azerbaijan SSR and in 1965-1970, the Ministry of Oil Production Industry of the Azerbaijan SSR were established on the base of “Azerneft”. The organization was renamed “Azerneft” once again in August, 1970. In 1991, as the Azerbaijan Republic restored its independence, it was renamed as “Azerineft” State Concern according to the Decree of the President of the Azerbaijan Republic of December 3, 1991. On September 13, 1992, according to a Decree of the President of the Azerbaijan Republic, the State Oil Company of the Azerbaijan Republic was established on the grounds of the “Azerineft” State Concern and “Azerneftkimya” Production Association.

A number of changes have been made in SOCAR's structure since it was established. The Onshore and Offshore Oil and Gas Production Association were established in the structure of the State Oil Company. In 2003 “Azneft” Production Association was established by uniting the Onshore and Offshore Oil and Gas Production Associations.

The State Oil Company of the Azerbaijan Republic (SOCAR) is involved in exploring oil and gas fields, producing, processing, and transporting oil, gas, and gas condensate, marketing petroleum and petrochemical products in domestic and international markets, and supplying natural gas to industry and for the public needs in Azerbaijan. There are 3 production associations, 1 oil refinery and 1 gas processing plant, a Deep Water Plant, 2 trusts, 1 institution, 23 subdivisions as legal entities, 4 subdivisions as non-legal entities under SOCAR. Additionally, SOCAR has share in companies operating in various industries (insurance, construction, processing, shipbuilding, marketing, etc.) and currently there are 33 joint ventures operating with its participation².

SOCAR has established 5 Alliances with the participation of other companies. It includes “SOCAR HC Heavy Crane”, “SOCAR Maersk”, “SOCAR Optilan”, “SOCAR SCNBV”, “SOCAR TGP”.

SOCAR is Azerbaijan's most vertically integrated national oil and gas company engaged in production, transportation and processing operations on the Azerbaijan territory. SOCAR also owns significant shares in the BTC Pipeline that is the main export route for oil extracted from the Azeri-Chirag-Deepwater Gunashli (ACG) fields, in the ACG and Shahdeniz PSA including the SCP that is the main export route for the ACG and Shah Deniz fields and in a number of international pipelines. Additionally, SOCAR owns a controlling share in Petkim (51%), the only

² <http://www.socar.az/socar/az/company/about-socar/discover-socar>

petrochemical manufacturer in Turkey.³

Crude oil is produced in Azerbaijan since 1847 and SOCAR currently controls about 20% of Azerbaijan's crude oil production. In addition to its own production, the Company has linked many PSAs with international oil companies, including ACG PSA and Shah Deniz PSA, managed by BP. The company has 11,65% share in ACG PSA and 10% in the Shah Deniz PSA.

SOCAR's mission is to provide energy security of the Azerbaijan Republic, strategic interest on development of oil and gas, and petrochemical industry, support the increase of scientific and technical, economic and intellectual potential of Azerbaijan by addressing advanced and eco-friendly technologies, hold crucial position in regional and international energy projects, and maximize the profit from the sale of hydrocarbon reserves and derived products in the domestic and foreign markets. Company's vision is to become a vertically integrated international energy company resting upon advanced experience on operation efficiency, social and environmental responsibility. The company carries out ownership of all extracted hydrocarbons and their oil, petrochemical and gas products.

By the end of 2017, the statutory fund of SOCAR was 3036 million AZN and belongs to the state.⁴ According to the Charter of the Organization⁵, the company is not responsible for obligations of the state, nor is the State responsible for the Company's obligations, except as provided by the legislation. The property of the company carrying out commercial activity is made up of various sources, including state-owned property, income from commercial activities. The Company exercises its right to own, use and dispose of its property. After paying taxes to the state and other mandatory payments, SOCAR has the right to concentrate funds owned from the activities of itself and organizations belonging to its structure in centralized funds and issue an independent order over these funds.

Charter, amendments and changes to the Charter of SOCAR, its structure are being approved by the President of the Azerbaijan Republic.

The Charter and regulations of the Company's structure and competent administrative bodies (the Company's Board and Committees) are approved by the SOCAR's President.

At the same time, the bodies included to the structure of SOCAR are created, reorganized and liquidated in accordance with the structure established by the company's president. Relations between enterprises, organizations and other institutions created by the Company, including the transfer of property from the balance to the balance, the presentation of goods, works and services, and mutual settlements shall be carried out in accordance with the internal normative documents. Heads of the organizations included in the structure of the company and their deputies, as well as their chief accountants are appointed and dismissed by the Company President. According to the Charter, the implementation of the employer's functions with respect

³ SUSTAINABLE DEVELOPMENT REPORT – 2016. Pp. 12. <http://www.socar.az/socar/assets/documents/az/socar-annual-reports/davamli-inkisaf2016.pdf>

⁴ State Oil Company of the Azerbaijan Republic, International Financial Reporting Standards, Consolidated financial statements, December 31, 2017 - <http://www.socar.az/socar/assets/documents/az/socar-financial-reports/Maliyye.hesabat.2017.pdf>

⁵ Decree of the President of the Republic of Azerbaijan on “improvement of the structure of the State Oil Company of the Azerbaijan Republic” dated 24.01.2003 , № 844

to other employees of the company may be entrusted to the Personnel Management Committee established by the company's president.

I. **Accountability – to the state and to the public**

a. **Role and mandate:**

The state's participation in the oil and gas industry of Azerbaijan is being implemented through the State Oil Company of the Azerbaijan Republic (SOCAR). SOCAR operates both on the territory of the Azerbaijan Republic and on the international market in various fields of oil, gas and petrochemical industry. SOCAR carries out search, exploration, and development of oil and gas fields, extraction, processing, and transportation of oil, gas and gas condensate, and sale of oil, gas and petrochemical products in domestic and foreign markets. According to the results of 2016, the number of employees working at SOCAR was 50,933.⁶ For comparison, the number of BP Azerbaijan company employees was 3238, of which 2817 were local employees.⁷

SOCAR is a vertically integrated company throughout its production chain and mainly engaged in exploration, development, processing, transportation and retail operations on the land and in the Azerbaijani sector of the Caspian Sea. It also conducts retail activities in Georgia, Romania, Switzerland and Ukraine. According to the Charter, the mandate of the company is to ensure the efficient functioning and development of the oil, petrochemical and gas industry as a single complex, and the reliable provision of consumers' energy needs. SOCAR's commercial activities are directly specified in its Charter (1.2). At the same time, according to the Charter, making profit is considered one of the company's main goals. According to the Article 3.4 of the Charter, after paying taxes and other mandatory payments in accordance with the legislation, the Company has the *right to concentrate funds owned from the activities of itself and organizations belonged to its structure in centralized funds and make an independent order on these funds*. According to the SOCAR financial report, the retained earnings of the company by the end of 2017 amounted to 7357 million AZN.⁸ The decision on the future fate of this money belongs to the company itself.

There are quasi-fiscal activities reflecting the non-profit activities of SOCAR as a large state-owned enterprise. Quasi-fiscal expenditures are fiscal activities that are carried out by the state agencies on behalf of the government (which should actually be carried out by the relevant government agencies) and are not compensated for. Such expenditures are not related to the Charter costs of the Company.⁹

During the investigation of the state-owned quasi-fiscal activity that mentioned in the paragraph 6.b of the third requirement of the EITI Standard namely, the IMF's "Guide on Resource Revenue Transparency" approach is taken as a base. The latest report of Azerbaijan's

⁶ <http://www.socar.az/socar/en/news-and-media/news-archives/news-archives/2018/01>

⁷ <http://www.socar.az/socar/en/news-and-media/news-archives/news-archives/2018/01>

⁸ SOCAR, "Financial report 2017", "Report of Changes in Consolidated Capital", Pp. 7, <http://www.socar.az/socar/assets/documents/az/socar-financial-reports/Maliyye.hesabat.2017.pdf>

⁹ http://www.eiti.az/doc/2015/2015_EITI_report_published_aze_final.pdf

EIT Government Commission included data on 2 types of quasi-fiscal expenditure (energy carriers and quasi-fiscal activity in public spending) in the energy sector.

According to the Government's specific decisions the state budget, various state agencies and projects implemented by the government are being financed by SOCAR. These types of contributions and financing (in the form of payments to subcontractors of state departments) in 2017 amounted to 567 million and 89 million AZN. These funds were used primarily in the Azerbaijan Republic to repair and reconstruct new recreation, transport, education and medical infrastructure. In general, in the period from 2013 to 2017, SOCAR has invested 1890 million AZNs into state-funded projects and funds. **(Figure 1-1)**

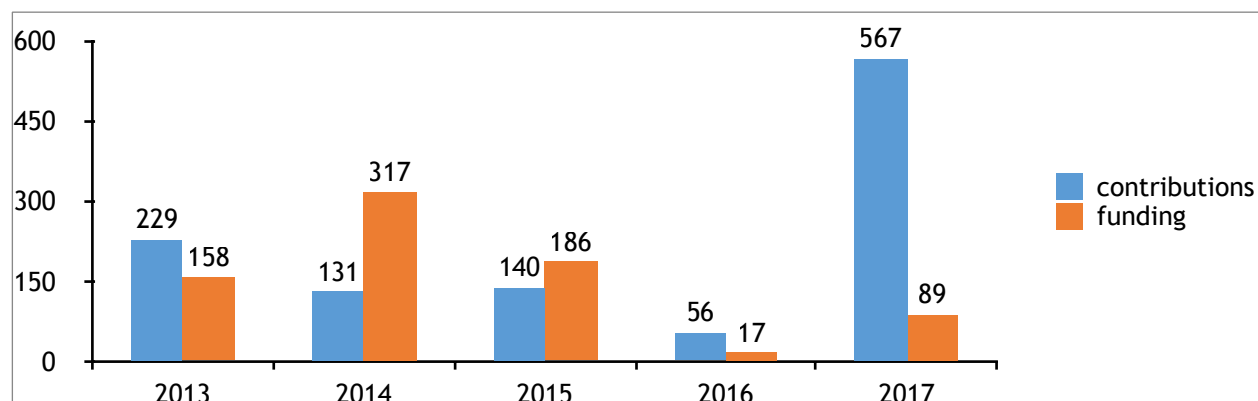


Figure 1-1. Contributions and funding from SOCAR, million AZN
Source: SOCAR's Financial reports

Funding for assets constructed by SOCAR amounted to 33 million AZN in 2013, 28 million AZN in 2014 and 13 million AZN in 2015.¹⁰ In 2016 and 2017 there was no funding from the assets transferred by SOCAR Group.

SOCAR's Charter stipulates participation of the Company in the provision of measures envisaged by the state-run socio-economic development programs however the rules of such participation have not been implemented by the Cabinet of Ministers or other government agencies. The issues of SOCAR's involvement in various programs, as a rule, are mentioned generally. The reports do not contain information on contracts between these agencies and SOCAR regarding the implementation of these works.

There are certain contradictions between SOCAR's commercial and non-commercial roles. The quasi-fiscal activity of the company's energy carriers is largely related to the production and processing of its products (natural gas) and is close to its core business. However, the company also performs activities that do not meet its mandate in areas not related to the sector (sports, health, education). While a number of documents adopted by the company have clarified certain aspects of social fiscal activity, there is still uncertainty in this area.

SOCAR does not have an accurate and clear system of regulation of financial relations with the state. The existing rules do not reflect a special approach to a state with a particular role in the country's economy and it can be said that it does not differ from the relationship between the state and the ordinary enterprise. Decision # 102 dated 09.06.2005 by

¹⁰ http://www.eiti.az/doc/2015/2015_EITI_report_published_aze_final.pdf

the Cabinet of Ministers "*On Income and Expenditure Estimates of Large State Taxpayers*" is the only document reflecting special relationships between SOCAR and the state on financial transfer. This decision regulates not fiscal transfer rules, but the proper accounting of SOCAR's tax payments to the state budget and subsidies from the state.

The resolution states that SOCAR, as a large state taxpayer, will submit the first quarterly revenues and expenditure estimates for the next year to the Commission, which is designed to prepare public budget and consolidated budget projects until July 1 of each year. Besides, in order to coordinate revenues and expenditure estimates of the next year and relevant investment programs it should be presented to the field Ministry, Ministry of Finance and Ministry of Economics by *December 1st of each year*. Then the company must approve its revenues and expenditure estimates with these agencies *until February 25 every year*. If revenues and expense estimates are not approved by this date, then from that time until the end of the period other costs should not allow more than 50% of actual expenditure for the relevant period of the previous year excluding SOCAR salary and its equivalent payments, allocations from the salary fund to the State Social Protection Fund, bank loans, tax and other compulsory payments.

According to the resolution, SOCAR reports on quarterly revenues and expenditure estimates approved as other major taxpayers should be submitted up to 45 days after each quarter to the Ministries of Finance and Economy and, respectively, the Ministry of Energy and the Ministry of Communications, High Technology and Transport. If SOCAR receipts in quarterly reports on the performance of budgets is *at least 20 per cent less than or equal to* the estimated indicators for the same period, then together with the report, the relevant authorities should be provided with justified information.

SOCAR occupies an important place in the economy of the Azerbaijan Republic as the largest company in the country. The company is the largest tax payer in Azerbaijan. The company has paid only 1.511 billion AZN to the state budget in 2017 and 155 million 984 thousand AZNs to the State Social Protection Fund.

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

Financial flow from state to SOCAR

Capital increase. The authorized capital of SOCAR increased by 1234 million AZN in 2017 reaching out to 3036 million AZN. The amount of *additional payments* to the authorized capital of SOCAR amounted to 2382 million AZN during 2017 and the amount of additional paid-in capital for the year ended December 31, 2017 amounted to 4541 million AZN¹¹. Earlier, by the Order of the Cabinet of Ministers dated December 26, 2016, 172 million 256 thousand AZN was directed to increase the authorized capital of SOCAR¹².

¹¹ SOCAR, "Financial report 2017", "Note 28, Authorized capital, additional paid-in capital and retained earnings"

¹² Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2016" and the annual report on state budget execution, Pp. 255. http://sai.gov.az/upload/files/ICRA-2016-SON_FINAL.pdf

SOCAR is expected to allocate 663.2 million AZN to increase its authorized capital as state support for the drilling of some oil fields (Umid, Garabagh and Babek fields) in the section of "Other branches of economic activity" of the state budget of 2018. Although these funds are not envisaged by the budget law for the relevant year, the amendments to the Law on the State Budget of the Azerbaijan Republic for 2018 have been made and it has been added to the expenditure on June 29, 2018¹³.

Subsidization. 250 million AZNs to the state budget in 2017 on deductions of the Central Bank's profits aimed at granting subsidies for covering the loss of natural gas produced by SOCAR for the low cost price in the domestic market (the price set by Tariff Council, primarily to the population) in the domestic market in 2016. At the same time, the company is expected to provide a subsidy of 300 million AZN in order to cover the loss caused to the sale of imported natural gas to "Azerenerji" Open Joint-Stock Company at a lower cost in the 2018 State Budget's "Other Areas of Economic Activity"¹⁴.

Investment. Projects involving SOCAR are funded entirely or partially by the state budget or investment-oriented funds allocated from the State Oil Fund. Southern Gas Corridor Closed Joint Stock Company (SGC CJSC) was established by SOCAR based on the Decree of the President of the Azerbaijan Republic dated February 25, 2014 with the authorised capital of 100 million USD and 51% of shares belong to state ownership and 49% belong to SOCAR. Under the order, the State Oil Fund has the right to finance the direct state-owned shares of SGC OJSC, as well as a long-term investment in the SGC OJSC with the requirement to repay the equity interest has been instructed to invest. In the period from 2014 to 2016, the State Oil Fund transferred 1232.1 million (1530.3 million AZN) USD to the Ministry of Economy to increase the authorized capital of the SGC OJSC. Funds for the project, which are scheduled for 2017, are not covered¹⁵.

Crediting. A total of 3141.5 million AZN credit line was opened to 16 customer companies in order to implement a number of projects by the Central Bank in 2015 on the basis of state guarantees within the framework of the State Investment Program. 60.2% of this amount or 1891.5 million AZN was invested by SOCAR¹⁶.

Tax incentives. By Decree of the Cabinet of Ministers of December 2, 2013, the excise rates of oil products, including gasoline and diesel have been increased. According to this decision, the excise rate of gasoline AI-95 was increased from 101% to 159%, excise rate was increased to 134% for both AI-92 (92%) and EI-80 (93%). Diesel growth was increased from

¹³ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2018" <http://sai.gov.az/upload/files/2018-DURUSTLESME-REY-FINAL.pdf>

¹⁴ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2018" <http://sai.gov.az/upload/files/2018-DURUSTLESME-REY-FINAL.pdf>

¹⁵ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2016" and the annual report on state budget execution, Pp. 212. http://sai.gov.az/upload/files/REY_ICRA2017_final.pdf

¹⁶ <http://sai.gov.az/upload/files/HP%202016%20fealiyyet.pdf>

24% to 57%. As a continuation of this increase, the price of fuel (gasoline, diesel), sold at the territory of the country since December 3, has been increased by the Tariff Council's decision. By the decision of the Cabinet of Ministers dated February 6, 2014 the next changes were made to this decision. Changes in the excise tax rates on 11 types of oil products produced and sold in the Azerbaijan Republic on the basis of the amendment were significantly reduced. For example, according to the amendment, the excise-tax on gasoline AI-95 was reduced from 159% to 64%, for AI-92 reduced from 134% to 65%, in AI-80 reduced from 134% to 66%. For diesel fuels this figure was reduced from 57% down to 18%. As a result of this decrease, the tax rates went lower than it was before to the final decrease. Although the tax rates that led to the fuel price increase were later reduced, it didn't affect the price. By the Government decision there was a gain of additional 30-60 % for each ton from the sale of various types of fuels produced by SOCAR. Government exempted the imported fuel from import duties for a certain period of time in order to regulate the price of fuel in the domestic market during that period by making changes to customs duties¹⁷. As a result of these concessions, SOCAR receives the tax incentives by importing a fuel to the country.

SOCAR's allocations to the state

Budget payments. Budget revenues for SOCAR came up to 1317.5 million AZN which is higher than in 2016 (1240 million AZN) based on the fact that the oil price in the state budget of 2017 is 40 USD (25 USD in the state budget of 2016). These are consolidated taxes and other payments with State Oil Company along with Azerigas and Azerkimya state enterprises (excluding income tax for individuals). In 2017, 8% of the state budget *total revenues*, 16.7% of the state budget's *oil revenues* (7884 million AZN) and 73.9% of the *tax revenues* (1784 million AZN) collected from the oil sector came from SOCAR.¹⁸

SOCAR's budget payments have been increased to 1380 million AZN in the 2018 state budget.

¹⁷ <http://www.e-qanun.az/framework/36122>

¹⁸ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2017" and the annual report on state budget execution http://sai.gov.az/upload/files/REY_ICRA2017_final.pdf

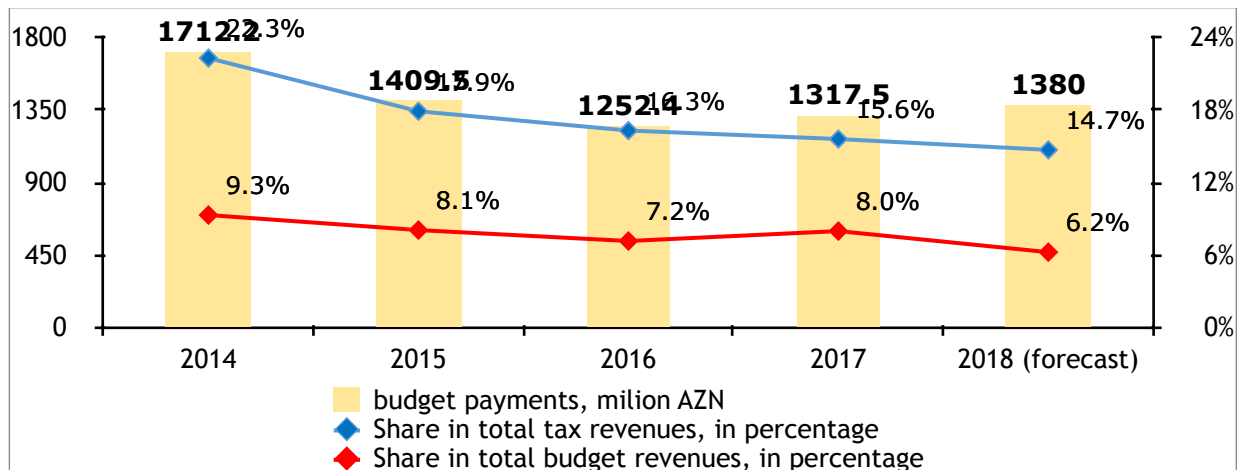


Figure 1-2. SOCAR's budget payments (2013-2018)
Source: Chamber of Accounts of the Azerbaijan Republic

2017 SOCAR's share in total state-owned taxpayers' budget payments reached 71.8% which was 8.0 points and 6.1 points higher when compared to 2015 and 2016. However, the forecast for the company in the amount of 1365 million AZN for 2017 was executed at the level of 96.5% (1317.5 million AZNs). Though the volume of income has decreased by 91.9 million AZN or 6.5% when compared to 2015, it was increased by 65.1 million AZN or 5.2% in comparison with 2016¹⁹.

Although SOCAR's payments to the budget in 2014-2016 have decreased from 1.71 billion down to 1.25 billion AZN due to the fall of crude oil prices in the world markets, the following years it demonstrated an upward trend and an increase of 1.38 billion manat in 2018. Despite the increase of tax payments in 2014-2018, the share of SOCAR's tax payments in total tax revenues decreased from 22.3% to 14.7%. **(Figure 1-2)**

Investment. In accordance with the relevant government decisions SOCAR periodically invests or finances the state budget, various state institutions and projects implemented by the state. Such direct money transfers made by SOCAR to the government in 2017 and particularly to the construction and maintenance of existing infrastructure in the Azerbaijan Republic, at the same time financing for the construction of new entertainment, transport, education and health infrastructure (as payments to subcontractors of state bodies) amounted to 567 million and 89 million AZN respectively²⁰. **(Figure 1-1)**

b. Corporate governance:

SOCAR is a state-owned company and 100% of its shares owned by the Azerbaijan Republic. The organizational legal form of the company is special and registered as a state-

¹⁹ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2017" and the annual report on state budget execution http://sai.gov.az/upload/files/REY_ICRA2017_final.pdf

²⁰ SOCAR, "Financial report 2017", "Note 28, Charter capital, additional paid-in capital and retained earnings" Pp. 69, <http://www.socar.az/socar/assets/documents/en/socar-financial-reports/2016.pdf>

owned enterprise. As a fully state-owned enterprise, SOCAR always receives government support.

The government has historically provided financial and strategic support to SOCAR, and plays a significant role in expanding operations, resources, production levels, transportation and processing networks of SOCAR.

Existing new management structure, including the new Charter of SOCAR has been approved with decree of the President of the Azerbaijan Republic on “improvement of the structure of the State Oil Company of the Azerbaijan Republic” dated 24.01.2003, № 844. According to the Charter, the structure of SOCAR includes the Management, Company Board and 5 Committees. Management of the Company category includes 13 persons, including the president, senior vice president and 11 vice presidents.

The vice-presidents have been identified in the following areas: Vice President for Geology and Geophysics; Vice president for field development; Vice president for economic affairs; Vice president for processing; Vice President for Investments and Marketing; Vice president for social affairs; Vice President for Ecology; Vice President for Personnel, Regime and IT; Vice president for strategic development; Vice President for oil, gas transportation and gas industry;

The president, senior vice president and vice presidents included in the Management of the Company are appointed and dismissed by the president of the Azerbaijan Republic in accordance with article 5.3 of the Charter. 11 of 13 individuals included in the company's management are members of the New Azerbaijan Party, a ruling political party.

The Charter does not provide any criteria for the knowledge and skills including age limits and work experience of senior executives. At the same time, there is no time limit for those who hold leading positions.

SOCAR's reports point out that²¹ the company implements a centralized management system based on Corporate Governance Principles, which consists of the Company's Board, Management and Committees. However, our research shows that SOCAR's management does not comply with corporate governance standards. The organizational-legal form of the company is also incomprehensible. However, all these issues are also reflected in international standards, including the "Guidelines for Corporate Governance of the Public-owned Companies", adopted by the Economic Development and Entrepreneurship countries in 2015²².

SOCAR's organizational-legal form as a commercial entity contradicts the requirements of the existing Civil Code. According to Article 64 of the Code it envisages economic partnerships and societies as a commercial organization. These entities are considered to be commercial entities with a Charter (joint) capital divided into shares of their founders (participants). According to the Code, when establishing economic partnerships and

²¹ <http://www.socar.az/socar/assets/documents/az/socar-annual-reports/davamli-inkisaf2014.pdf>

²² OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition https://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015-edition_9789264263680-ru

societies, the words "*limited liability company*" and "*stock company*" should be mentioned along with the name of the company.

SOCAR's organizational-legal status was stated as "state-owned company" in its company name. State registration of the company was carried out in 1992 on the grounds of existing legislation of that time. The existing Civil Code was adopted in 2000.

Although the Company's Charter was renewed in 2003, this fact was not taken into consideration. It is not clear which category the company belongs to - economic society or partnership. At least, the legislation requires to state of which category it belongs to.

Another problem is **the failure to apply corporate governance standards by SOCAR**. It is noted on the prospectus²³ paced by the company as an emitent posted on the Baku Stock Exchange that since Azerbaijan Republic does not have specific corporate governance standards, the forms of corporate governance are generally defined by the Civil Code and SOCAR's existing corporate governance bodies are constituted in accordance with the relevant legislation of the Azerbaijan Republic. The application of corporate governance standards in most of the company's statements is repeatedly emphasized. However, our research shows that the principles of governance do not fully comply with corporate governance standards, even with the requirements of the Code cited by the company. While the Code contains important elements of corporate governance, it cannot be found on SOCAR's management structure.

Let's analyze SOCAR management structure. According to the Charter, SOCAR's structure includes the management of the Company, the Company's Board, 5 Committees, Head offices, branches, representations and organizations (companies) that do not have the status of legal entity, as well as joint ventures and institutions.

The president of the Company along with the management of the company, affirms the structure and staff schedule of the Company's head office, approves the statutes of the structural divisions of the apparatus, appoints and dismisses the employees of the administration, applies encouragement and penalties. At the same time, appoints and dismisses the managers of the companies included in the structure of the company, their deputies and senior accountants, approves the Charter and Statutes of those agencies, determines the composition, rights and duties of the *Personnel Management Committee* that implements the functions of the employer.

According to Article 5.7 of the Charter, *the Company's Board (the CB)* is a collegial management body. The CB includes the company's president, vice presidents and other officials appointed by the president. The chairman of the company is chairing the meetings of the CB. The CB meeting is held no less than once a month and the extraordinary meeting is called only by the president of the company. Decisions are made by a simple majority of votes through open voting. When the votes are evenly divided, the vote of the chairman of the Council or of another acting member of the Council becomes decisive. The Regulation of the CB is approved by the President of SOCAR.

In addition, 5 committees are operating under SOCAR - *Audit, Risk Management, Procurement, Personnel Management, and Information Security Committees*.

²³ http://bfb.az/teqdimat/?s_issuer=5083

We could expect that the structure and Charter adopted in 2003 will be improved and adapted to the international corporate governance system. Unfortunately, the company's management does not fully comply with corporate governance standards and requirements of national legislation.

According to the civil Code, the supreme governing body of the companies is considered *the general meeting of their participants (shareholders)*. A GMP must be held at least annually. *The General Meeting* shall establish a *Board of Directors (or Supervisory Board)* and (or) *Audit Commission (Inspector)* for no more than 3 years. *The Board of Directors (supervisory board)* of the company exercises control over the general management and activities of the company within its authority. In addition, there may be a *collegial (board, directorate)* or an *executive (director, general director)* body of the Company. *The Executive Body* implements the current management of the Company's activities, reports before the *Board of Directors (the Supervisory Board)* and *the General Meeting of Shareholders*. Executive body is determined by *the Supervisory board* or by *the general meeting* if this authority has not been assigned to the supervisory board under the Charter.

At present, SOCAR management does not have a General Meeting and Supervisory board elected by the General Meeting. There is only Company Board available, which operates as a Board of Directors. Actually, the president of the country carries out the functions of the General Meeting and Supervisory board. The company does not have mutual control mechanisms, control is unilateral - by the president of the company to the structures under his/her disposal.

Currently, corporate governance standards operate in just two sectors in Azerbaijan - banking and household sectors.

"Corporate Governance Standards in Banks" approved with Decision No 12/04 dated June 3, 2013 by the Board of Directors of the Central Bank of the Azerbaijan Republic²⁴. These standards have been prepared in accordance with the Basel Committee on Banking Supervision on "Corporate Governance Principles" taking into account international corporate governance practices. Another document is the "Azerbaijan Corporate Governance Standards" adopted by the Ministry of Economic Development (current Ministry of Economy) in 2011²⁵. SOCAR's management must be adapted to OECD's "Guiding principles of corporate governance in state-owned companies"²⁶ and Azerbaijan's corporate governance standards.

The audit activities at SOCAR are carried out by the Audit Committee established under the President of the Company. SOCAR's Audit Committee defines and implements internal audit policies and strategies. The Audit Committee has 3 members. These are the SOCAR vice presidents and the head of the Law department. The committee is headed by the vice-president

²⁴ <http://www.e-qanun.az/framework/25981>

²⁵ <http://economy.gov.az/article/korporativ-idar%C9%99etm%C9%99/21348>

²⁶ OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition https://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015-edition_9789264263680-ru

representing the Company's Board. However, according to Article 107 of the Civil Code, the Audit Committee is created and respected by the Board of directors (Supervisory board).

Apparently, in corporate standards internal audit divisions are not subject to the executive body (Management board), but to the *Board of directors (the Supervisory board)*.

The purpose of this subordination is to monitor the implementation process and to ensure transparency. In the example of SOCAR, the head of the executive body establishes and controls the internal control division. And there is no internal control over the executive body.

As a part of the fight against corruption in the transparent and professional management of companies, the conflict of interests of employees, especially managers, is always in focus, and companies adopt appropriate rules to prevent it.

Human capital development. SOCAR maintains the knowledge and skills of the staff in focus. Human resources management in the Company is centralized at SOCAR's head office. Human resources management of the Company is carried out by 3 main bodies (*Personnel Management Committee, Human Resources Department, Personnel Departments of Head offices and other organizations*):

Ethical behavior of employees. A number of standards that aim to combat corruption and prevent conflicts of interest have been approved by order no 108 dated 10.08.2012 of SOCAR president in the framework of the "*National Strategy for Increasing Transparency and Anti-Corruption*" approved by the Decree of the President of the Azerbaijan Republic on July 28, 2007.

In the "SOCAR Anti-Corruption Policy" standard, there are provisions to prevent corruption and to prevent conflicts of interest. In the same time, the Code of Business Ethics regulates the relationships between the employees, and between the Company and employees, as well as the ranking of the ethical principles that are of high importance for the Company, conflict of interests, labor health protection, the provision of equal opportunities.

c. Transparency and accountability:

In number of countries, state-owned companies are generally listed among non-transparent and non-accountable state-owned organizations. The lack of transparency may reduce the incentive for companies to work for the well-being of society. In this regard, EITI standards create good basis for state-owned companies to improve public disclosure practices by requesting governments and state-owned companies to report on their procurements, quasi-fiscal activities, joint ventures and associates, material payments to state agencies and transfers between state owned companies and other state agencies. In addition to these transparency requirements, other internal management mechanisms and procedures can improve accountability²⁷.

²⁷ Natural Resource Charter Benchmarking Framework. Precept 6: State-Owned Enterprises

According to NRG's 2017 annual Resource Governance Index (RGI),²⁸ the position of SOCAR, which collected 70 out of 100 possible points, is treated as satisfactory and ranked 10th among 52 oil and gas state companies evaluated by the Index. The good position of the company in the Index is due to compliance of information disclosure in accordance with EITI standards. EITI reports disclose detailed information on government payments, non-operating expenses, as well as barter operations, and also information about companies buying state's share of oil. However, the fact that Azerbaijan left the EITI Initiative, creates doubts about continuation of this kind of information disclosure practice.

In accordance with transition to International Financial Reporting Standards for Legal Entities, amendments requiring conduct of financial reporting by external auditor and publication of the auditor report were made to Azerbaijan legislation.

According to Article 12.3 of *the Law of Azerbaijan Republic "On Accounting"*

organizations with public significance and commercial organizations that conduct consolidated financial statements, as well as the *organizations*²⁹ referred to in Article 12.2 of this Law are required to:

- *post their annual financial reports and consolidated financial reports, together with an auditor's opinion in free access via web page or publish them;*
- *Provide free copy of annual financial reports and annual consolidated financial reports, together with auditor's opinion available to any person upon his/her request.*

As a result of the amendments to *the Charter of SOCAR* in 2014, publication of reports was included as a mandatory commitment. In accordance with Article 6.1-1 of the Charter, the consolidated financial reports of the Company, together with an auditor's report should be published no later than June 30th of next year after reporting year on the website and in periodicals. According to the same article, during the reporting period, SOCAR and its associates should submit reports to the Ministry of Finance of the Republic of Azerbaijan in case if they receive state guaranteed loans, or participate in projects related to spending of state debt, also if they receive subsidies, subventions, grants or budget allocations for implementation of particular roles.

According to Article 12.4 of *the Law of the Republic of Azerbaijan "On Accounting"*, the governing body determined by the Charter of accounting entity is responsible for preparation, presentation and publication of the financial statements and the consolidated financial statements that entity.

SOCAR shifted to international financial reporting standards since January 1, 2008. Since from 2009, the Company has been publishing financial statements prepared by an external

²⁸ <http://resourcegovernanceindex.org/country-profiles/AZE/oil-gas>

²⁹ Commercial organizations that are involved in projects on allocation of state guaranteed loans or state debt, as well as those receiving subsidies, subventions, grants or budget allocations for implementation of particular roles

audit company on its official website on annual base (*Consolidated Financial Statements based on International Financial Reporting Standards*)³⁰.

Along with the financial statements, the company regularly publishes its *Annual Report* (2004-2016) and *the Sustainability Report* (2011-2016)³¹. These reports are also prepared in printable format. The Sustainability Report provides information on all aspects of the company's sustainable development, as well as information about the Company's priorities and future plans. The annual report includes information on the Company's activities throughout the year (information on production, processing and sales, exploration and development of new deposits, projects involved, etc.). In contrast to the financial statements that are understandable for experts, annual and sustainable development reports are prepared in popular language and usually are quite understandable to citizens.

The legislative body, Milli Mejlis, has no authority to inspect and supervise the activities of SOCAR. SOCAR reports to the President of the Republic of Azerbaijan only. The Company does not therefore report on its activities to other bodies, including the parliament. In terms of legislation, the parliament has right to request certain information. According to Article 11 of *the Law on Status of the Members of the Azerbaijan Republic Parliament*, *MPs may enquire materials and information related to their mandate from central and local executive bodies, judicial bodies, local government bodies, the state companies, organizations*. The specified bodies shall provide required materials and documents to MPs within 10 days following requirements of the legislation of the Azerbaijani Republic on the state secret.

On the other hand, *Article 39 of the Internal Regulations of the Milli Majlis of the Republic of Azerbaijan* states that, *the Committee established by the parliament has the right to require documents and materials necessary for the preparation of draft laws and resolutions from the state and non-state enterprises, to invite their representatives (experts) to the meetings of the committee*.

The Chamber of Accounts, which is Milli Mejlis institution, has the authority to oversight SOCAR to some extent. Article 2.1 of *the Law on the Chamber of Accounts* includes authority to oversight the purposeful use of funds allocated from the state budget to legal entities and municipalities. However, there is no information available on the SOCAR's performance review, which received sufficient funds from the state each year.

Financial statements have been published on the company's website since 2009. So far published and audited reports cover 2009-2017. During this period, only one company, *Ernst and Young Holding*, carried out the audit. EY, headquartered in Central London, operates in more than 150 countries around the world. To note, the State Oil Fund has worked with 3 audit companies for the period of 2002-2015. These were *Ernst and Young Holding* (2002-2006, 2010-2012), *Deloitte and Touché* (2007 - 2009) and *PWC* (2013-2015).

In general, long-term business experience with single audit company has been widely distributed among state-owned post soviet companies. For example, *KazMunayGas* of

³⁰ <http://www.socar.az/socar/az/economics-and-statistics/economics-and-statistics/socar-reports>

³¹ <http://www.socar.az/socar/az/economics-and-statistics/economics-and-statistics/socar-reports>

Kazakhstan³² has worked with Ernst and Young Holding only and has entrusted company audit from 2005 till 2017s to this company. Russia's giant *Gasprom*³³ has partnered with PWC during 1998-2014 and FBK LLC during 2015-2017. Ukrainian company *Naftogas*³⁴ worked with 3 companies. In the early years of its activity it primarily used the services of local BDO LLC as an external auditor, (2001-2003, 2010-2011), then the company used the services of world-class companies such as Ernst and Young Holding (2004-2009) and Deloitte & Touché USC (2012-2017).

SOCAR publishes Azerbaijan version of its annual financial statements on the official website, which increases the accessibility of the interested persons to the report. However, the main problem is that the audit report remains difficult for ordinary citizens to understand. In order to make reports more understandable for civil society and media, it would make sense prepare “user friendly” version of the report. SOCAR could collaborate with specialized NGOs to contribute to this work.

Procurement in SOCAR is carried out based on internal normative documents within the legislation of the Republic of Azerbaijan. Number of normative documents were adopted with the order of the President of the Company dated July 31, 2009, No. 105 "On regulation of relations related to procurement of SOCAR". In accordance with the procurement concept, the Head Office carries out procurement transactions, including audit services, in accordance with the Charter and Regulations of SOCAR. Normative documents include procurement procedures, rules, templates, etc. related to procurement. However, local media never published information on selection of audit companies. Until now, SOCAR has used the services of only one audit company - Ernst and Young Holding.

³² http://www.kmg.kz/rus/investoram/finansovye_i_godovye_otcheti/

³³ <http://www.gazprom.ru/investors/disclosure/reports/2018/>

³⁴ <http://www.naftogaz.com/www/3/nakweben.nsf/0/C4775D2495121A4AC2257107003B5C8D?OpenDocument&Expand=1&>

II.

Company performance

SOCAR's goal is to become a vertically integrated international energy company resting upon advanced experience on operation efficiency, social and environmental responsibility. There is no separate development strategy that targets the Company's goals for the near and medium term in return for such an ambitious move.

The company's activity is multidimensional and have set many tasks before it: integration into the global energy security system, involvement of modern technologies, equipment and materials into the oil, gas and petrochemical industry of the Azerbaijan Republic, to become one of the world's leading companies, and so on. SOCAR is doing a lot of work in this direction. Modern technologies are being attracted, the human resource capacity is strengthened, the fields for production and sales are being created inside and outside the Azerbaijan Republic. Taking that SOCAR does not have Strategy, a single document reflecting its short and medium term goals and action plan to achieve them, it is difficult to forecast Company's role in energy sector in future and its intension to deal with other sectors.

According to the company president's statement, SOCAR as the leading force of the energy strategy in Azerbaijan, has drawn up a long-term Complex Plan for Strategic Development from 2011 to 2025 as a logical continuation of the work done so far. The plan identifies and is purposefully executes development trends in all fields of activity of the Company, including exploration, development and production (*Upstream*), raw materials transportation (*Midstream*), processing, and sale of processed products (*Downstream*) and other types of service activities. Although the statement describes the existence of a Complex Plan, the Plan is not open to the public and its existence is questionable.

For comparison we should note that in 2018 Russia's *Gazprom* company has adopted a Strategy for 2018-2027 in the field of power generation³⁵. Kazakhstan's *KazMunayGas* company has a development Strategy until 2025.³⁶

In the 90s of the last century, the main goal of SOCAR was to ensure the sale of Azerbaijani oil out to the foreign markets and adopt modern technologies, however in the new century, especially in the second decade, it was to achieve the sale of Azerbaijani gas in European markets, to further increase its processing and sales opportunities.

The activity of SOCAR was to play a role in and contribute to the government's strategies. For example, in "*the State Program on the Development of the Fuel-Energy Complex (years of 2005-2015) of the Azerbaijan Republic*" the issues of intensification of exploitation of oil-fields under development in SOCAR, acceleration of application of modern mining-geophysical and oil-and-gas equipment into production are considered as the main tasks.

SOCAR is responsible for all produced hydrocarbons and oil, petrochemical and gas products derived from their processing. An average of 40 million tons of oil and 29 million cubic meters of gas are produced annually in Azerbaijan. In 2008-2017 there was a decline in oil production, despite the improvement in technological capacity of SOCAR and exploration of

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

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

new fields. The reason of decline is the decreasing oil capacity of the oil-well. In this period, the peak amount of oil produced by SOCAR was in 2008 (8.6 million tons). The record oil production (50.8 million tons) throughout the country was recorded however, in 2010, t. There was a tendency of decline in subsequent years and in 2017, it reached to the lowest level - to 7.4 million tons. Over the past 10 years, the company's oil production was decreased by 14.2%. The share of SOCAR in the total oil production in the country ranged between 16.7% and 19.8%. While the share of SOCAR in total oil production was decreased (16.7%) amidst increased overall production, in 2017 it was increased to 19.2%. **(Figure 2-1)**

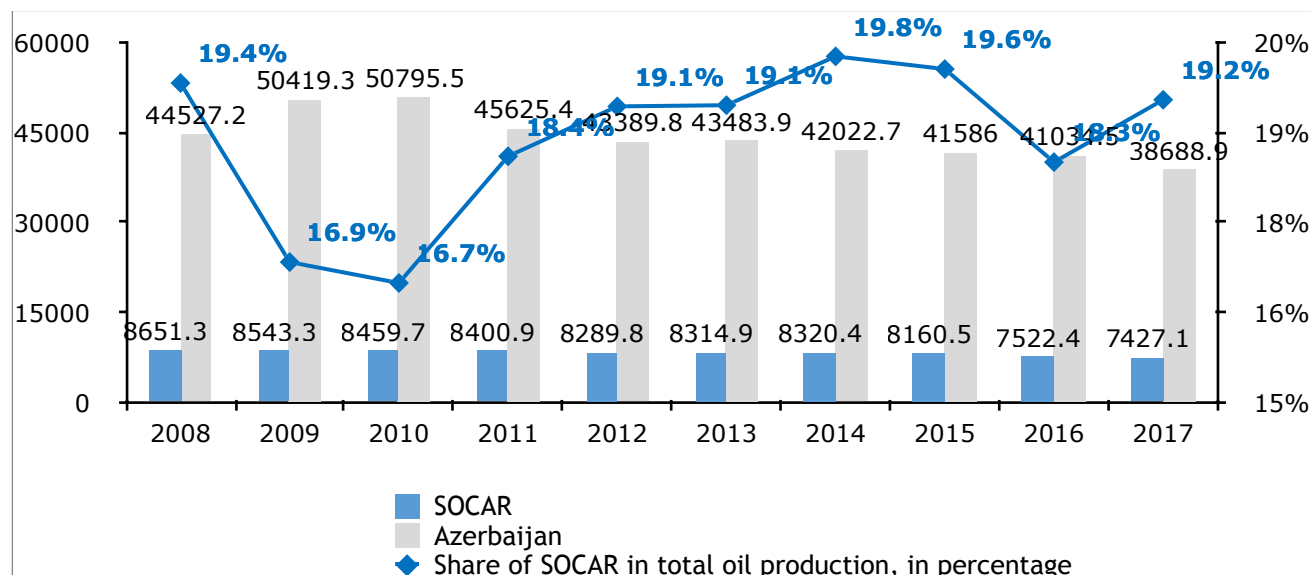


Figure 2-1. Annual oil production (2008-2017), thousand tons
Source: SOCAR

Along with the oil, gas production also declined. The company's gas production in 2008 was 7.75 billion cubic meters, but it decreased to 6.09 billion cubic meters in 2017. The decline in gas production in the past 10 years was 21.5%. Whereas, , the gas production in the country was mainly increasing in mentioned period (22.2%). The share of SOCAR in total gas production in the country fell from 33.1% to 21.3% during 2008-2017. The reason for this was increase in production throughout the country and the decrease in the company's own production. **(Figure 2-2)**

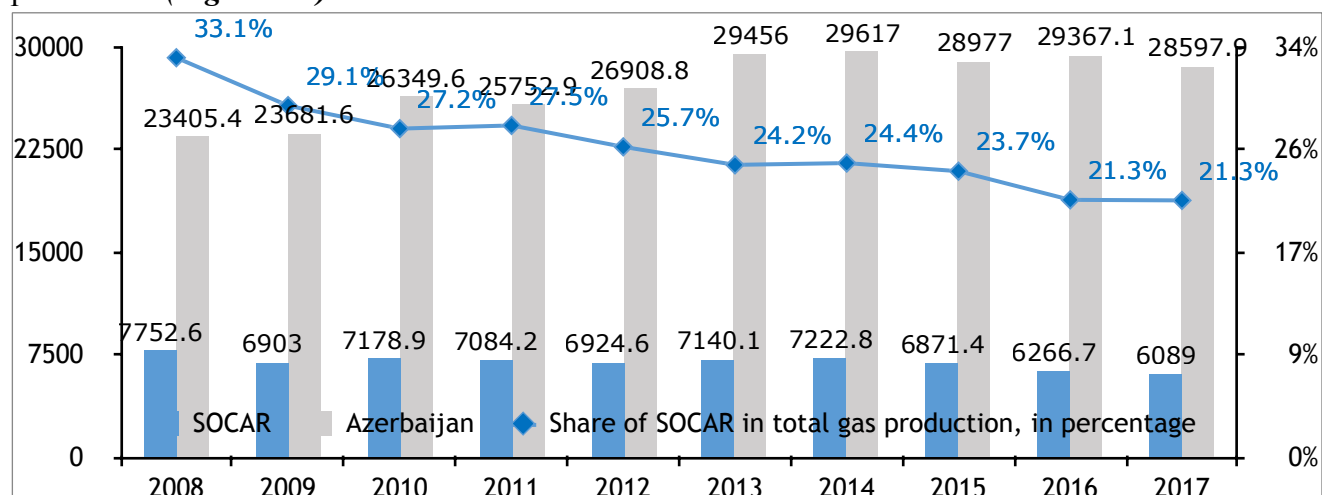


Figure 2-2. Annual gas production (2008-2017), million cubic meters

Source: SOCAR's annual reports

Expansion of SOCAR's activity fields and increase of oil prices has significantly increased the company assets in recent years. *Azeri Gas Production Union* in 2009 and *Azerikimya State Company* in 2010 were subordinated to SOCAR. Thus, the company has managed to maintain a value chain in the field of natural gas sales, as well as processing of oil products in chemistry industry.

Recently, SOCAR has increased its focus on natural gas transportation. The implementation of the Southern Gas Corridor project started in 2011 and documents on the construction of the Trans-Anatolian gas pipeline (TANAP) were signed as the initial stage of the project. The Southern Gas Corridor project, with planned investment of 45 billion USD involves 7 countries, 12 influential companies and 12 gas buyers. Four projects are being implemented for realization of the corridor: Full-scale development of the Shah Deniz field, South Caucasus Pipeline Expansion, TANAP and TAP pipeline construction.³⁷

After completing the Southern Gas Corridor project, annual transfer capacity will be 16 billion cubic meters at the first stage. The possibility of increasing this capacity up to 30 billion cubic meters in further periods was also taken into account. As company's CEO stated it was quite realistic to bring the total export potential of Azerbaijan up to 40 billion cubic meters by 2025. The company's target is to deliver the first natural gas from Shah Deniz-2 project to markets next year and complete this project by 2020.³⁸

SOCAR achieved 5 times increase of its assets during 2008-2017 by increasing its assets from 12.5 billion AZN to 61.4 billion AZN. Increase of both total capital and statutory capital affected increase of assets, but the main reason was liabilities. (**Figure 2-3**)

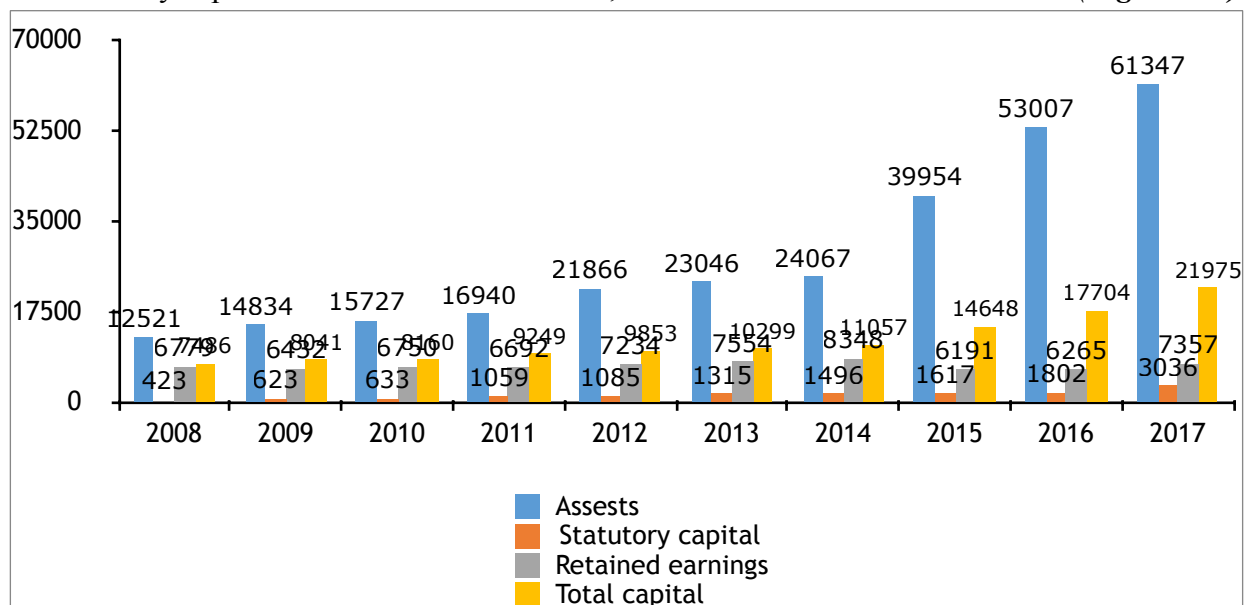


Figure 2-3. Financial indicators (2008-2017), million AZN

Source: SOCAR's finance reports

³⁷ SOCAR Annual report for 2015 http://www.socar.az/socar/assets/documents/en/socar-annual-reports/annual_report2015.pdf

³⁸ SOCAR Annual report for 2016 http://www.socar.az/socar/assets/documents/en/socar-annual-reports/annual_report2016.pdf

Over the past 10 years *the total capital* of the company increased from 7.5 billion to 22 billion manat. Despite this increase, the share of total capital in assets decreased from 59.8% to 35.8%. The share of the funds attracted by the company (trade and other payables, short-term and long-term debt liabilities, etc.) were increased. During the reporting period, *the Statutory capital* increased from 422.7 million AZN to 3 billion AZN. The increase of statutory capital was mainly due to the funds allocated from the state budget. **(Figure 2-3)**

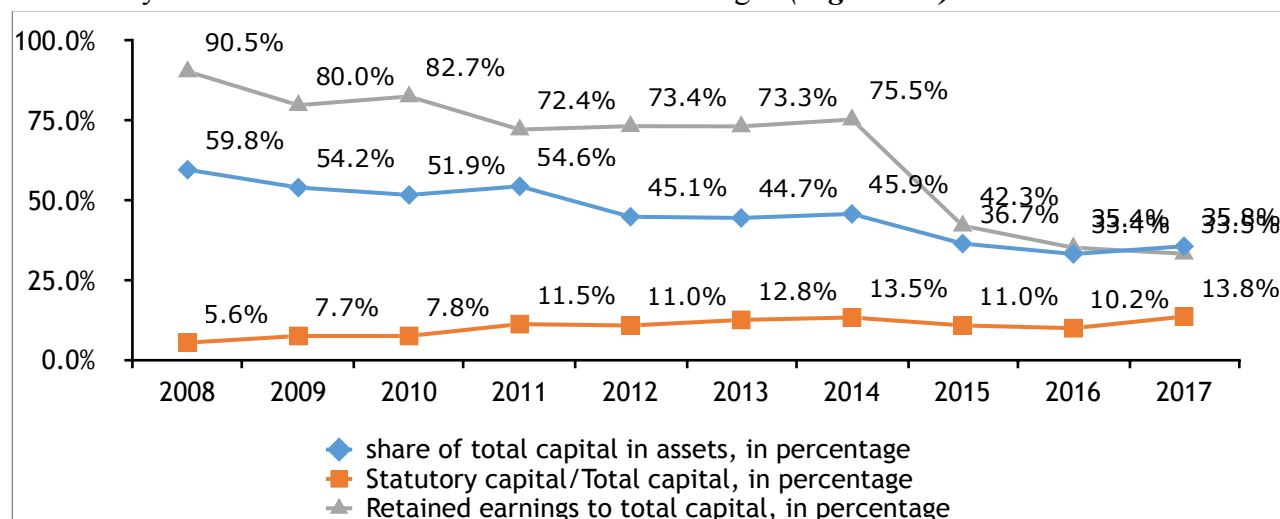


Figure 2-4. Financial indicators (2008-2017)

Source: SOCAR’s finance reports

The volume of retained earnings of SOCAR varies between 6-8 billion AZN per year. If in 2008 90.5% of company’s capital was formed on the account of retained earnings, this figure dropped to 33.5% by the end of 2017. The share of statutory capital meanwhile increased from 5.6% to 13.8%. **(Figure 3-4)**

As a result of implemented measures, the depth of oil processing at SOCAR increased to 89.5% in 2016, while it was 53.3% in 2001. However, since 2014 (93.4%), tendency for decline has been observed.

Analysis of SOCAR’s annual reports shows that, along with oil and gas production, there has also been decline in oil processing. During 2008-2016, the total volume of oil processing was decreased by 18.2% which meant drop to 6009.4 million tons from 7348 million tons. The highest level of oil processing during this period was recorded in 2008. The amount of processing was increased to 6740.5 million tons when global oil prices began to decline in 2014, then it decreased again. **(Figure 2-5)**

Decrease also occurred as a result of oil processing in obtained products. The volume of light color products produced in 2008-2016 was dropped by 20.3%, gasoline dropped by 17.3%, diesel fuel - by 22.3%, jet fuel - by 20%, stove black oil - by 64.2%, bitumen - by 18.7%, lubricants dropped by 81.5%. The only increase was in liquefied gas (2.5%) and oil coke (22.3%). From 2014, SOCAR has started to acquire vacuum gas oil during processing. If the volume of gas extracted in 2014 was 578.5 million tons, then in 2016 it has dropped to 365 million tons. **(Figure 2-5)**

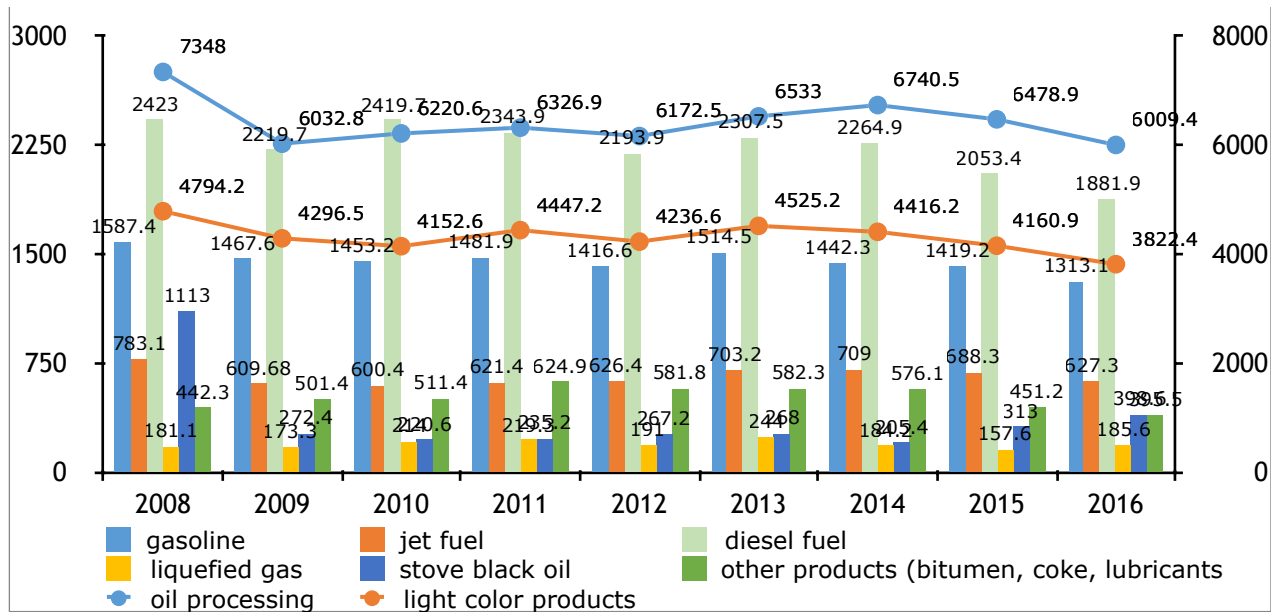


Figure 2-5. Dynamics of oil processing and products of processing (2008-2016)

Source: SOCAR's finance reports

The oil processing products produced by SOCAR over the past 10 years are more targeted to the domestic market. While exporting 44.8% of oil products in 2008, the share of exports fell by 27% in 2016. The highest level of the company's sales in the domestic market in 2013 were 74%. Approximately 60-70% of exported oil products are diesel fuel and oil coke. Unlike oil products of SOCAR, the sale of petrochemical products was mainly carried out at foreign markets. Approximately 80-85% of these products were for export. The share of exports approached 90% in 2014. However, the share of export has declined in 2014-2016 and fell down to 85.7% in 2016. (Figure 2-5)

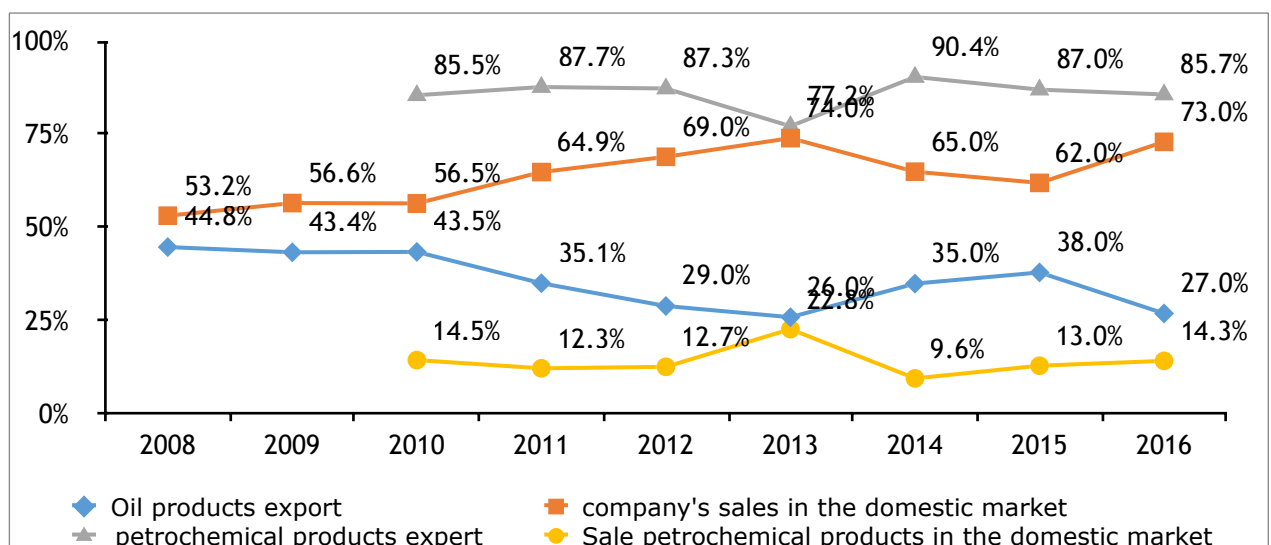


Figure 2-6. Export dynamics of oil and petrochemical products (2008-2016)

Source: SOCAR's finance reports

SOCAR's *total revenues* increased to 92.6 billion AZN by the end of 2017, while it was a total of 4.7 billion AZN in 2008. The major part of revenues is derived from crude oil sales. The rise in crude oil prices in the world markets has led to a significant increase in annual revenues. For this reason, despite the decline in crude oil production, its share in total revenues increased from 23.8% in 2008 to 61% in 2017. Over the last 10 years, annual revenue from crude oil sales has increased from 1.1 billion to 56.6 billion AZN. During this period, its annual revenue from the sale of natural gas increased by 2.7 billion AZN compared to 2008 (515 million AZN)³⁹.

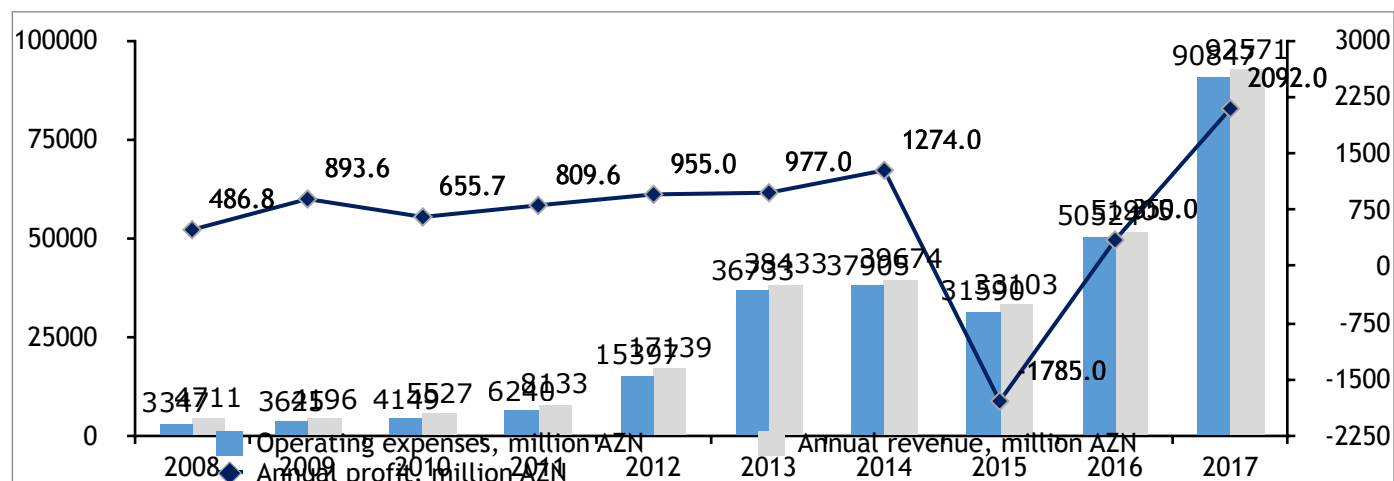


Figure 2-7. Dynamics of capital and operating expenses 2008-2017

Source: SOCAR's finance reports

Increased range of goods produced, transported and sold by the company increased costs, along with revenues. Operating expenses increased from 3.3 billion AZN in 2008 to 90.9 billion AZN in 2017. (*Figure 2-7*)

Main reason beyond SOCAR's increased income was expansion of its sales and distribution operations. The Company has actively dealt with sales and distribution of oil products within country and abroad (Switzerland, Georgia, Romania, UAE) in recent years. The share of mentioned income source in total company incomes increased for 3 times during 2015-2017. The Company received most of its income as a result of operations in Switzerland. In 2017 Company received income in the amount of AZN78.6 billion through SOCAR Trading and SOCAR Energy Switzerland companies established in Switzerland, which comprised 85 percent of company's consolidated incomes. This indicator was 78 percent and 72 percent in 2016 and 2015 accordingly.⁴⁰

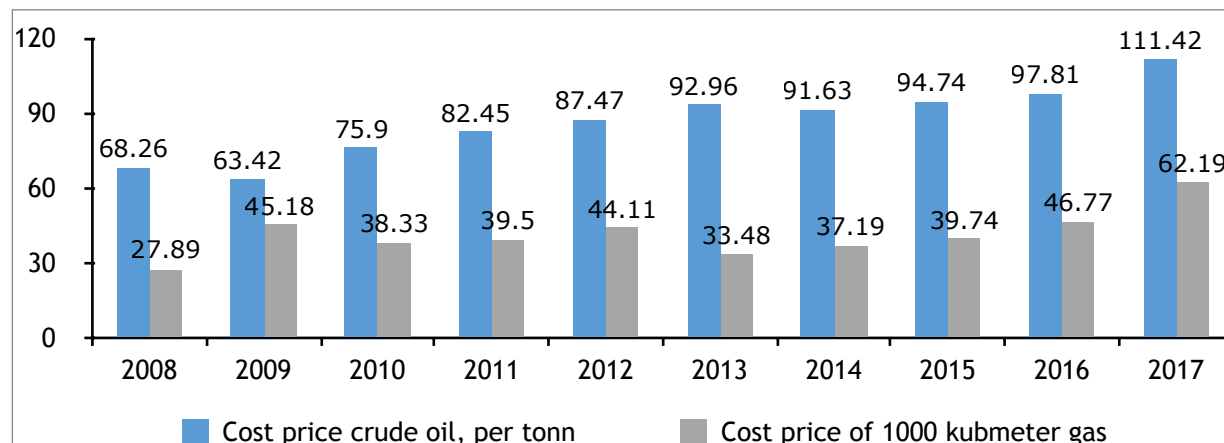
SOCAR Trading established in Geneva in 2008 deals with sales of Azerbaijan oil as well as oil and oil products of third parties. Company offices are located in Geneva (headquarter), Singapore, Dubai, London, Houston and Calgary. SOCAR Energy Switzerland (SES) deals with whole and retail sale of oil products in Switzerland market. In 2012, based on agreement signed

³⁹ SOCAR's Financial Report for 2017, page 72

⁴⁰ SOCAR's financial reports, 2015-2017

between SOCAR and “ExxonMobil”, company obtained actives of “Esso Switzerland”. At present there are 167 petrol stations with SOCAR brand in Switzerland.

Annual reports of SOCAR show, the costs of crude oil and gas produced by company increased by 63.2 percent and 123 percent accordingly in last 10 years. While in 2008 the production cost of 1 ton of crude oil was AZN68.3, by the end of 2017 this number reached AZN111.4. During mentioned period the production cost of a thousand cubic meters of natural gas increased from AZN 27.9 to AZN 62.2 from **(Graphic 2-8)**



Graphic 2-8. Dynamics of production cost of crude oil and gas, 2008-2017

Source: Annual reports of SOCAR

The company has managed to increase its annual profit year by year. The Company increased its annual profit to 2 billion AZN in 2017 while it was 486.8 million AZN in 2008. In 2015 the company faced loss in the amount of 1.8 billion AZN, which was due to the sharp decline in oil prices in the world markets and the devaluation of the national currency alongside with this decline.

The company was able to enter the world energy market through its offices in more than 10 countries in last 10 years, through its joint ventures in Turkey, Georgia, Ukraine and other countries. SOCAR has entered the Georgian market since 2006. Since 2006, it has started to sell oil through its Energy Georgia subsidiary, and since 2008, it has started to sell gas through its SOCAR Georgia Gas subsidiary. Entering the Turkish market in 2008 it obtained controlling share of Petkim, the largest petrochemical company in Turkey, within the SOCAR-Turcas-Injaz alliance and took over the management of the company.

Petkim products provide 25-27% of Turkish market. This indicator is expected to reach 40%. One of the targets of SOCAR is to turn Petkim into a large logistics center, one of the Turkey’s largest and Europe's leading production complexes. In 2011, construction began in Turkey and amounted to \$ 6.3 billion. STAR oil refinery plant in Turkey that has been under construction since 2011 with 6.3 billion USD investment will start operating in the fourth quarter of 2018.

SOCAR has pursued a policy of increasing oil processing in the domestic market. In 2012, SOCAR started construction of *Nitrogen fertilizer - carbamide plant in Sumgait*. The construction of the plant is within "State Program on Reliable Food Provision of population of

the Republic of Azerbaijan for 2008-2015". In 2014, SOCAR Polymer LLC and Italy's Maire Tecnimont S.p.A. signed a cooperation agreement on the construction of Polypropylene plant within the Sumgait Chemical Technology Park project.

Despite the fact that SOCAR is the largest company in the country, the Company is implementing the policy of reducing the number of employees within its cost optimization measures. In 2008, the number of employees in the Company and its subsidiaries was 64,794 while their number in 2016 fell by 21.4% to 50,933. The average annual income per employee was 72,707 AZN in 2008, and increased to 1.8 million AZN in 2016.

The main final products of the State Oil Company are oil, gas and oil products. 85-90% of oil products cost are related to purchase of crude oil. In 2009, the production cost of oil per tone was 76.53 AZN, while in 2016 it increased to 97.81 AZN.

In recent years SOCAR has faced a number of problems and the government has always supported the company in solving these problems. By the end of 2014, another oil price declines in the global commodity markets has forced the states which economies depend on oil revenues to face with precarious conditions. The price of Brent crude oil dropped by 2 times to 56 USD at the end of that year per barrel which was about 115 USD per barrel in June 2014. The downfall continued in the coming months and the oil price dropped up to 29 USD at the beginning of 2016⁴¹. The drop in oil prices in such a short time has created concerns for the economy of Azerbaijan like other oil countries. Reduction of oil revenues to the end of 2014 has increased the pressure on the national currency. The sharp decline in currency reserves forced the government to double its devaluation in 2015. As a result of 2 sharp devaluations, the AZN lost 49% of its value against the dollar. The decline in oil and gas prices in the world markets and consequently the devaluation and macroeconomic stability in the country have created the following problems for SOCAR.

- **Drop of oil and gas prices in the world markets resulted in a reduction of SOCAR's annual revenues and profit.** In 2015, the company's annual revenue decreased by 16.6% from 39.1 billion AZN to 33.1 billion AZN. Reduce of revenues negatively affected company profit as well. In 2015, for the first time in last 10 years the company faced loss (1.8 billion USD). The rise in oil prices in 2016 increased company's annual revenues and profit again. *(Figure3-5.)*
- **The company's credit rating was deteriorated.** International rating agency Standard & Poor's confirmed the long-term credit rating of the State Oil Company of Azerbaijan (SOCAR) on December 4, 2015 at "BB +" level. This information was published by Fins.az with reference to the agency. Forecasted rating however changed from "Stable" to "negative". The agency stated that SOCAR is connected to the state and the rating of

⁴¹ Bloomberg . <https://www.bloomberg.com/quote/CO1:COM>

this company will continue to weaken as the sovereign rating of Azerbaijan drops⁴². Moody's agency downgraded SOCAR's rating in 2016⁴³.

- **As a result of devaluation, foreign debt in foreign currency increased drastically when exchanged to national currency.** 80% of SOCAR's total debt was attracted in foreign currency, at the same time, most of the capital expenditures were made in foreign currency. As a result of devaluation foreign debt grew up by twice when exchanged to AZN. Since SOCAR's activities mainly focus on the domestic market, revenues are in national currency. Thus though there wasn't significant change in revenues, its costs and liabilities increased drastically because of exchange rate difference⁴⁴.

In order to save SOCAR in this difficult situation the government has provided the company with different types of support.

In order to increase its revenues, SOCAR increased the wholesale and retail prices of its products domestically. By Decision No 16, dated November 28, 2016 the Tariff Council raised per ton price for the jet fuel produced by SOCAR from 338.2 AZN to 415.95 AZN, and tariffs for furnace oils from 69.94 to 185.13 AZN.

According to the *Tariff Council's* Decision no.18, dated November 28, 2016, SOCAR's sales price for natural gas was also increased. Now population pays 10 gepiks for up to 1,700 m³ of annual consumption, and 20 gepiks for the part of consumption that is more than 1,500 m³. Before the increase, 10 gepiks per cubic meter were paid irrespective to the amount of consumed gas. At the same time, the tariff for 1 cubic meter of gas for the non-population group was made 20 gepiks (this figure was same as for population group before the increase). By the same decree the sales price for natural gas distributors was changed from 42 AZN to 75 AZN and the sales price for energy producing companies consuming natural gas by connecting to main gas pipelines was increased from 80 AZN to 120 AZN. On the basis of Tariff Council's decision no. 16, dated July 14, 2017, in-company tariff for car fuel (AI-92) refined by SOCAR increased from 411.91 AZN to 619.36 AZN per ton.

According to the *Cabinet of Ministers' Decision no 90, dated March 31, 2014* the List of goods (works, services) prices (tariffs) regulated by the state was amended and the imported automobile fuel 95 and higher which is in line with the Euro 5 requirements and environmental norms was excluded from this list. After the Decree, starting from March 27, 2014, SOCAR was able to sell the same kind of fuel obtained abroad in local market for higher price.

Company's capitalization was supported. The charter capital of SOCAR increased by 1234 million AZN in 2017 and reached 3036 million AZN. Additional payments for SOCAR's

⁴² https://www.standardandpoors.com/ru_RU/web/guest/article/-/view/type/HTML/id/1775232

⁴³ https://www.moodys.com/research/Moodys-Downgrade-of-Azerbaijan-is-credit-negative-for-SOCAR--PR_343742

⁴⁴ https://www.standardandpoors.com/ru_RU/web/guest/article/-/view/type/HTML/id/1775232

charter capital by state in 2017 totaled 2382 million AZN and the amount of additional paid-in capital for the year ended December 31, 2017 amounted 4541 million AZN⁴⁵. SOCAR is expected to receive 663.2 million AZN allocation from state budget to increase its charter capital as state support for the development of some oil fields (Umid, Garabagh and Babek fields).⁴⁶

The service provided to the population was subsidized. In 2017 SOCAR was allocated subsidy in the amount of 250 million manats to cover loss caused by the sale of natural gas to population for less than its cost price in 2016. In 2018 the company will be allocated subsidy in the amount of 300 million manat to cover the loss caused by the sale of imported natural gas to “Azerenerji” Open Joint-Stock Company at a lower cost price.⁴⁷

Moreover, in 2015 SOCAR received a *credit* from Central Bank in amount of 1891.5 million manat under state guarantee to implement a number of projects within of the State Investment Program.⁴⁸ In order to regulate price for fuel in domestic market, the government periodically exempts imported fuel from import duties for a certain period of time by making changes to customs duties⁴⁹. As a result of these concessions, SOCAR, importing fuel to the country, receives tax incentives.

Perspective problems for SOCAR could be increase of its foreign debt and decrease of demand for oil and gas products in world commodity markets as a result of *alternative energy development*, as well as diminished interest to sales of gas through pipelines resulted by increase of the share of compressed gas sale. As of December 31, 2017, SOCAR's total debt was estimated at 15511 million AZN. 5998 million manat of this amount is short-term debt liabilities, and 9513 million manat is long-term debt liabilities.⁵⁰ Yet, In 2008 the company's total debt was 2110.9 million AZN. Short-term debt liabilities amounted to 386.4 million AZN in the same year, while the long-term debt liabilities were 1724.5 million AZN.⁵¹ In 2008-2017, the company's debt obligations increased for more than 7 times. The reason for increase is the fact that the company has been actively involved in foreign borrowing, but also increase of AZN value of debts borrowed in foreign currency after 2015 devaluation.

⁴⁵ SOCAR, “Financial report 2017”, “Note 28, Charter capital, additional paid-in capital and retained earnings”

⁴⁶ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2018" <http://sai.gov.az/upload/files/2018-DURUSTLESME-REY-FINAL.pdf>

⁴⁷ Opinion of the Chamber of Accounts of the Republic of Azerbaijan about the draft law of the Republic of Azerbaijan "On Execution of the State Budget of the Republic of Azerbaijan for 2018" <http://sai.gov.az/upload/files/2018-DURUSTLESME-REY-FINAL.pdf>

⁴⁸ <http://sai.gov.az/upload/files/HP%202016%20fealiyyet.pdf>

⁴⁹ <http://www.e-qanun.az/framework/36122>

⁵⁰ SOCAR, Financial Report 2017, Debt Liabilities, Pp. 64-65

⁵¹ SOCAR, Financial Report 2009, Debt Liabilities, Pp. 46-47

III.

Recommendations and follow-up.

Operation of SOCAR which is the state-owned company engaged in exploration and development of oil and gas fields in the territory of Azerbaijan, oil, gas and gas condensate production, processing and transportation, sale oil and petrochemical products, natural gas in domestic and foreign markets has always been in the spotlight of society and has led to various discussions. Civil society, including the media, face difficulties to obtain necessary information from this institution. The company does not seem interested in being open to the public despite its financial and operational reporting. News and especially information on sales on the official website has recently been decreased. . Reports on financial and program activities of the Company's joint ventures and subsidiaries are not available.

SOCAR, being the largest company in Azerbaijan, is also the largest taxpayer and largest employer. The company has enough social responsibility.

During the research process, the following trends have been observed over the last 10 years of SOCAR activities:

- *SOCAR is growing rapidly and along with the oil sector it is getting into non-oil sector and thus becomes a major risk for the country's economy as whole*
- *Debt obligations which surplus the state's foreign debts continue to grow and their return creates danger for the stability at country's currency market*
- *Medium and long term Strategy document that defines the vision and goals of the company and envisages its development does not exist in the background of rapid change in energy sector of the world and increasing share of renewable energy*
- *The Company emphasizing the application of corporate governance systems in its reports has a management that does not comply with corporate governance standards*
- *There is no mechanism for controlling company's activities by the parliament*
- *There are no clear, accurate norms regulating the financial flows between the company and the state*

Although the country left EITI international initiative Azerbaijan declared on application of international standards of transparency and accountability in extractive industry and in this regard the President of the country signed the Decree dated April 5, 2017 "On Additional Measures to Increase Transparency and Accountability in the Extractive Sector". According to the Decree, for the application of transparency and accountability standards in the extractive industry a number of international principles, including accountability of government in front of citizens regarding revenues from extractive sector, promoting transparency and accountability standards in public and private sectors and public relations, ensuring transparency in state and private companies operating in the extractive industry, as well as strengthening public finance management and accountability, should be referred to. In order to ensure transparency and accountability in the extractive industry of the Republic of Azerbaijan, the Extractive Industries Transparency Commission was established.

It is important for SOCAR to adapt best international practices in the light of international initiatives and local transparency initiatives that refer to international practices. These practices should be based on transparency and accountability, good governance, and openness to the public.

Given all this, it would be expedient to take the following steps to improve the efficiency of management in SOCAR's activities, to achieve transparency and accountability:

1. Defining upcoming goals and specification of action framework of the Company

- 1.1. Development of single Development Strategy of the Company for medium (5 years) and long-term (15-20 years) period
- 1.2. Preventing SOCAR from growing much and having "Too big to fail" status and eliminating its horizontal and vertical monopoly position to create a competitive environment in the market.
- 1.3. ***Limiting horizontal integration goals of the Company.*** For this purpose, it would make sense to separate the Azerkimya Production Union from the Company and making it an independent company.
- 1.4. ***Limiting vertical integration goals of the Company.*** To separate the AzeriGas Production Union that sells natural gas to the population and non-population groups locally from SOCAR and making it an independent agency to ensure enhanced mutual control and transparency between production subject and sales subject .

2. Specification of the Company's organizational and legal structure and application of corporate governance standards in management

- 2.1. Transition from the existing status of "state enterprise" to the status of a joint-stock company with household subject form and shares owned by state.
- 2.2. ***Application of corporate governance standards of the Company.*** For this purpose, amendments to the company Charter should be made, the management structure should be changed and the existing Company Council should be liquidated. Instead, the Supervisory Board (or the Board of Directors) responsible for strategic management and appointed by the President of the country should be established. The Supervisory Board (or the Board of Directors) in its turn appoints director and employees of the Executive body - the Management Board and the Audit Committee.
- 2.3. To include the requirements in the Charter on competence of the chair and members of the Management Structures (the Supervisory Board, the Board, the Audit Committee).

3. Making changes to related legislation on accurate and clear frames of transparency and accountability commitments

- 3.1. The transparency and accountability of extractive industry companies, including SOCAR should be mentioned in the “National Action Plan on the Promotion of the Open Government” which covers years of 2019-2021.
- 3.2. Changes to the “Law on Access to Information” on inclusion of SOCAR into the Information holder category (Article 9) should be made and the financial and operational information related to the company's activities should be included to the list of open information (Article 29).

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

5. Improvement of the company’s procurement standards and ensuring procedure for transparent selection of an independent external auditor that audits its performance

6. In order to increase the efficiency of its quasi-fiscal activities SOCAR is recommended to:

SOCAR:

- 6.1. To investigate effects of compulsory submission of oil, gas and oil products to domestic consumers at a price lower than world market price, on company’s financial state and identify its quantitative and qualitative impacts;
- 6.2. To conclude contracts with relevant state agencies on all implemented by the company social activities (projects) that are not in its direct competence, but are implemented as its participation in separate state programs ;
- 6.3. Reflect its annual expenses in the company's annual report on all social activities, including those in sport.

Government:

- 6.4. To implement complex measures in order to reduce SOCAR's quasi-fiscal activity (*for example, in the direction of approximation of domestic sales prices of oil products and gas to world market prices, or covering the loss faced by the company where these products are traded in lower than market prices*);
- 6.5. To develop and approve the cases for participation of SOCAR in government programs that are not directly related to its functions and rules for Company’s involvement in such projects;
- 6.6. To take measures to eliminate the cases of SOCAR’s involvement in the implementation of social activities that are under the competence of separate state agencies.