

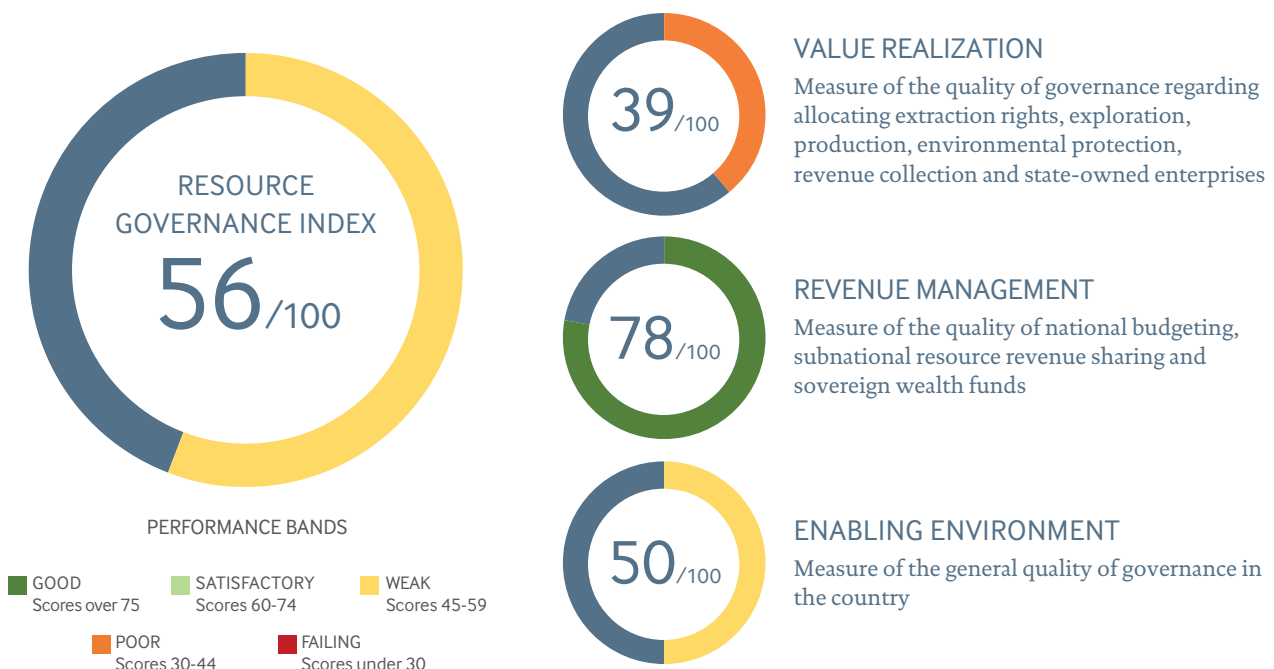
2021 Resource Governance Index Azerbaijan



Azerbaijan’s oil and gas sector scored 56 points out of 100 in the 2021 Resource Governance Index (RGI), up by nine points since the 2017 RGI. The country’s ability to realize value from the sector and its overall “enabling environment” deteriorated since the last assessment, but revenue management improved by 35 points and now places in the “good” performance band.

- Governance of licensing received a “failing” 11 points, due to a lack of rules and disclosures in the licensing process, as well issues regarding disclosure of officials’ financial interests and identification of the beneficial owners of companies involved in the sector.
- The governance of local impacts received a “failing” score, with issues both in terms of the laws and disclosures of environmental and social impact assessments and environmental mitigation plans.
- SOCAR, the state-owned oil producer, scored in the lower end of the “satisfactory” performance band, with commodity sales rules and disclosures especially problematic.
- The implementation of fiscal rules and their monitoring boosted the national budgeting subcomponent score by 37 points since the 2017 RGI.
- SOFAZ, the country’s sovereign wealth fund, received a “good” score due to improvements in both the legal framework and disclosures.

Azerbaijan oil and gas: 2021 Resource Governance Index and component scores



RESOURCE GOVERNANCE INDEX RESULTS SUMMARY

Azerbaijan's resource governance remains weak despite improvements in revenue management

Azerbaijan is a major crude oil producer with daily production reaching 775,000 barrels per day in 2019. The oil and gas sector plays a fundamental role in Azerbaijan's economy, accounting for over 90 percent of all merchandise export revenues in 2019.

Governance of Azerbaijan's oil and gas sector scored 56 points in the 2021 RGI, up by nine points since the 2017 assessment. Revenue management improved by 35 points since the last assessment, driven by the adoption of fiscal rules and improvements in the legal framework of SOFAZ, the country's sovereign wealth fund. However, the value realization component deteriorated by 10 points, with the governance of licensing and local impacts receiving a "failing" score.

Azerbaijan oil and gas sector 2017 and 2021 Resource Governance Index scores

	2017 RGI Score	2021 RGI Score	Trend
RGI COMPOSITE SCORE	47	56	9
VALUE REALIZATION	49	39	-10
Licensing	28	11	-17
Taxation	59	56	-3
Local impact	38	28	-10
State-owned enterprises	70	60	-10
REVENUE MANAGEMENT	43	78	35
National budgeting	33	70	37
Subnational resource revenue sharing	.	.	.
Sovereign wealth funds	52	86	34
ENABLING ENVIRONMENT	49	50	1
Voice and accountability	15	13	-2
Government effectiveness	61	65	4
Regulatory quality	66	65	-1
Rule of law	54	52	-2
Control of corruption	37	38	1
Political stability and absence of violence	40	42	2
Open data	70	74	4
LAW	33	43	10
PRACTICE	58	51	-7
GAP (PRACTICE LESS LAW)	25	8	-17

VALUE REALIZATION

Azerbaijan's ability to realize value from the oil and gas sector has worsened

The licensing subcomponent was the weakest part of Azerbaijan's 2021 RGI assessment, scoring a "failing" 11 points. No rules govern either the pre- or post-licensing process, and the government has not disclosed the qualification criteria for companies to take part in licensing, the biddable terms, nor the rules governing the process itself (such as auction or negotiation rules). In terms of the post-licensing process, no laws mandate the disclosure of the license applicants, winners or the areas allocated. While some license winners were named after each production sharing agreement was approved by parliament, these disclosures were not comprehensive. The Extractive Transparency Commission, which maintained a cadaster of licenses, was abolished in July 2020, and the registry has not been updated since 2016; it does not include information on two agreements signed since then.

The rules and disclosures of officials' financial interests also remain inadequate. While Article 5.1 of the Law on Fighting Corruption requires public officials to disclose their financial holdings in companies to a government agency, these are not public disclosures, meaning that civil society oversight actors cannot review this information. No rules require the identification of the beneficial owners of extractive companies. Although Azerbaijan has committed to implement beneficial ownership disclosure laws as part of its Open Government Partnership (OGP) National Action Plan, no progress on this had been made during the RGI's assessment period, which ended in December 2020.

The governance of taxation scored 56 points in the 2021 RGI, placing in the "weak" performance band. The government has disclosed both oil production data (at the company level) and aggregate export value information as recently as 2020. Laws are also in place governing extractive sector taxation, with firm rules regarding income tax, royalty rates, withholding tax and production sharing agreements. Nonetheless, the legal framework lacks rules governing the tax authority itself. There is no obligation according to the tax code to audit extractive companies, and the state tax service itself is also not audited by an external body.

Azerbaijan ceased being a member of the Extractive Industries Transparency Initiative (EITI) in 2017, having then established its own standalone reporting process based on the EITI Standard. This new reporting process however lacks many advantages of the international initiative. Most importantly, the current reporting process is not a multi-stakeholder process, and civil society does not play a sufficiently important enough role. Another significant disadvantage is that the Azerbaijani reporting process is not dynamic enough and resembles regular state statistical reporting; it does not include such important elements as disclosure of beneficial ownership or a clear strategy for the implementation of best practices.

The Azerbaijani government is conducting consultations with NGOs and is discussing various aspects of the enabling environment for civil society activities. This is an encouraging development, but more robust improvements (see recommendations below) could ultimately lead to Azerbaijan being able to re-apply to EITI and maintain its standing with OGP.

The 2021 RGI scored governance of environmental and social impacts scored as failing. While the 2019 Law on Environmental Impact Assessment mandates extractive companies to commission an assessment of impacts of operations on the environment (EIA), there is no corresponding requirement for social impact assessments. The law also doesn't oblige companies to publicly disclose EIAs, meaning that the public cannot interrogate the impact of the extractive sector on Azerbaijan's coastline, sea and overall biodiversity. The same applies for environmental mitigation plans; the law requires that extractive companies produce mitigation plans, but not that they disclose them publicly. While BP has disclosed the EIAs and SIAs regarding its own operations in Azerbaijan, other companies have not.

The law also doesn't specify procedures that govern the rehabilitation and closure of oil and gas operations. Additionally, there are no rules in the Land Code that determine the procedures to be taken regarding resettlement when oil and gas projects interfere with users' access to land. While there are rules on compensation, the law remains silent on resettlement provisions.

The governance of SOCAR, Azerbaijan's national oil company, regressed by 10 points since the 2017 RGI, now placing at the lower edge of the "satisfactory" performance band. There are however key areas where SOCAR's governance demonstrates signs of best practice. The company's financial statements were reviewed by an external auditor, and SOCAR published its annual report, balance sheet, cash flow statements, income statement and consolidated financial reports online for the year 2019, which included revenues transferred to the government. SOCAR also disclosed information about its joint ventures, including levels of ownership and costs and revenues.

Areas for improvement remain for SOCAR, especially regarding commodity sales. No rules mandate how SOCAR should select the buyers of its oil and gas, or at what price the commodities should be sold, and none require the public disclosure of this information. While SOCAR has disclosed the aggregate volume and value of its oil and gas sales in its 2019 annual report, there is no mention of the buyers nor the dates of sale. In line with best practice, SOCAR should publish information disaggregated to the level of each individual sale, including data on the volume, values, identity of the buyer and the date. The disclosure of this disaggregated information is important so that key stakeholders can interrogate SOCAR's performance, ensure that sales aren't made for political or nefarious reasons, and ensure that there is no tax or revenue leakage.

REVENUE MANAGEMENT

Improvements in national budgeting and the governance of SOFAZ drove score increases

Azerbaijan's score on the 2021 index's national budgeting subcomponent improved by 37 points since the 2017 RGI. The Azerbaijani government disclosed its budget and government expenditure for both the years 2019 and 2020, and the Ministry of Finance also published documents indicating both revenues derived from the oil and gas sector, as well as the forecast projections of oil revenues. This is a positive step, as it allows key stakeholders an understanding of what revenues might be obtained from the oil sector, and how they could factor into future budgets. Article 11-1 of the 2016 Law on Budget System (amended in 2018 and 2019) established firm numerical rules governing state expenditure for the upcoming years, specifying an upper limit on spending. The Chamber of Accounts is responsible for the monitoring of adherence. Positively, the government complied with the fiscal rules in the 2019 fiscal year, which was confirmed by the oversight body.

Major improvements were registered in the governance of SOFAZ, Azerbaijan's sovereign wealth fund, which with 86 points, placed in the "good" performance band. Rules governing the withdrawals of funds improved due to regulations passed in December 2018 and the Law on the Budget System specifies that both deposits and withdrawals are recorded in the annual budget and incorporated in the government's legal framework. SOFAZ also improved its reporting rules, with the Law on Accounting requiring the publication of an annual report, as well as yearly external financial auditing of SOFAZ's financial statements.

Azerbaijan can nevertheless improve SOFAZ's governance, as no legislation requires the parliament to review SOFAZ's annual financial reports. Article 12 of the Law on Budget Systems, which specifies all the documents and entities that must be reviewed, does not currently feature SOFAZ, and the fund's financial statements were not reviewed by parliament during the assessment period. Oversight by parliament is important as legislators can determine whether the fund's investment activities follow the set rules, and scrutinize the fund's financial health and management, providing a key measure of accountability.

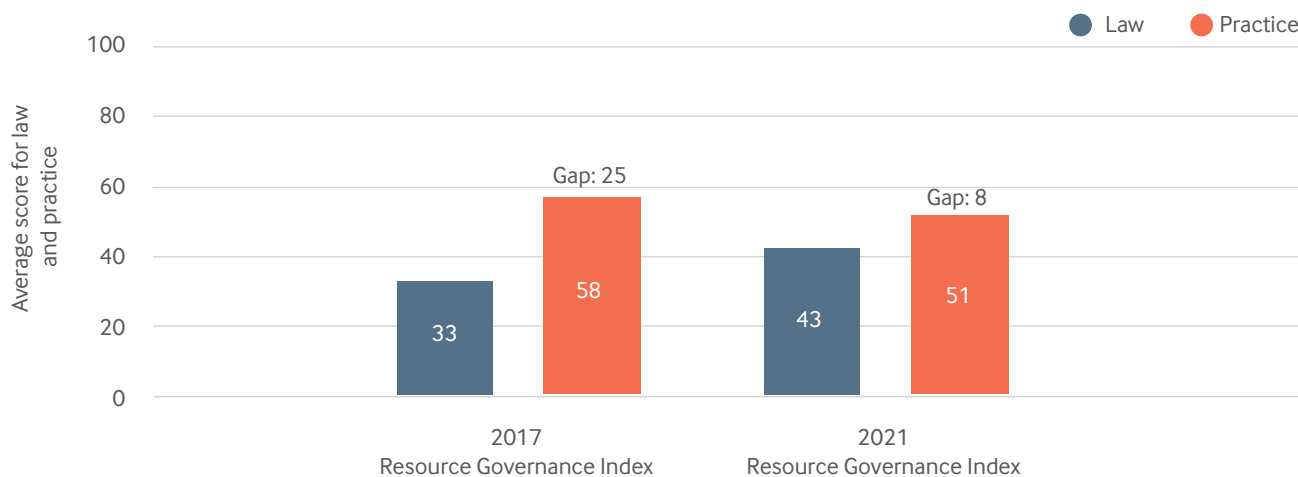
LAW AND PRACTICE SCORES

Azerbaijan's legal framework requires strengthening

In both the 2017 and 2021 RGIs, Azerbaijan's oil and gas sector scored higher on disclosures and implementation than it did on the strength of its legal framework—this means that good practices are not encoded in law, which creates the risk that authorities may abandon the practices. While the law scores increased from the 33 to 43 between the 2017 and 2021 RGI, practice scores deteriorated from 58 to 51, during the same time period.

The law score increases were mostly found in revenue management, where new laws regarding fiscal rules and rules regulating the sovereign wealth fund improved the robustness of the legal framework.

Evolution of the gap between law and practice in Azerbaijan's oil and gas sector



RECOMMENDATIONS



NRGI recommends the following courses of action to improve oil and gas governance in Azerbaijan:

1. **The Cabinet of Ministers** should ensure that despite leaving the EITI in 2017, Azerbaijan continues to disclose information on the extractive sector, and should push for best practice in this regard. This also means continuing engagement with civil society actors and working on strengthening beneficial ownership disclosures.
2. **SOCAR** should publish information on its commodity sales, ensuring the disclosure of sales volumes and values, and the identities of the buyers of its oil.
3. **SOFAZ** should continue with the promising progress made on disclosures, and should be used as a benchmark for other Azerbaijani government institutions.
4. **The Ministry of Ecology and Natural Resources** should pass laws mandating public disclosure of environmental impact assessments and should introduce stricter rules and monitoring systems to ensure a holistic approach to mitigating the environmental risks of the extractive sector.
5. **The Ministry of Energy** should play a key role in revamping the existing regulations to make them more transparent and accountable.

What is the Resource Governance Index?

The 2021 RGI assesses how 18 resource-rich countries govern their oil, gas and mineral wealth. The index composite score is made up of three components. Two measure key characteristics of the extractives sector – value realization and revenue management – and a third captures the broader context of governance — the enabling environment. These three overarching dimensions of governance consist of 14 subcomponents, which comprise 51 indicators, which are calculated by aggregating 136 questions.

Independent researchers, overseen by NRGI, in each of the 18 countries completed a questionnaire to gather primary data on value realization and revenue management. For the third component, the RGI draws on external data from over 20 international organizations. The assessment covers the period 2019-2020. For more information on the index and how it was constructed, review the RGI Method Paper.