Azerbaijan

State Oil Fund of the Republic of Azerbaijan
Synopsis

Market Value

State Oil Fund of the Republic of Azerbaijan
$34.7 billion

Good Governance Fundamentals

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<td>Clear Deposit Rules</td>
<td>yes</td>
</tr>
<tr>
<td>Clear Withdrawal Rules</td>
<td>no</td>
</tr>
<tr>
<td>Clear Investment Rules</td>
<td>yes</td>
</tr>
<tr>
<td>Transparent</td>
<td>yes</td>
</tr>
<tr>
<td>Publicly Available Audits</td>
<td>yes</td>
</tr>
<tr>
<td>Effective Oversight</td>
<td>no</td>
</tr>
</tbody>
</table>

Fund Highlights

- The State Oil Fund was established in 1999 and began operating in 2001.

- Lack of withdrawal rules, extra-budgetary spending directly by the Fund and lack of independent oversight are the Fund’s most significant governance challenges.

- A significant amount of information is available on Fund investments.

- The State Oil Fund limits investment risk through strict target asset allocation.

- A Supervisory Board oversees Fund activities on behalf of the President.
AZERBAIJAN

Timeline and Fund Objectives

**Fund Inception**

- The State Oil Fund of the Republic of Azerbaijan was established by **Presidential Decree No. 240** on December 29, 1999.²

- The Fund began operating in 2001.³

**Fund Objectives**

The Fund has three objectives:⁴

- Preserve macroeconomic stability by decreasing dependence on oil revenues and stimulate the development of the non-oil sector.

- Accumulate and preserve revenues for future generations.

- Finance major national projects for socio-economic development.
Each box represents a regulatory standard essential for promoting consistent use of and safeguarding resource revenues. White boxes highlight regulatory gaps in fund governance.

### Good Governance Standards and Gaps in Regulation

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<tr>
<td>Objectives are Clear</td>
<td>Use of Resource Revenues as Collateral</td>
<td>Penalties for Misconduct by Fund Managers &amp; Staff</td>
<td>Public Disclosure of Independent External Audits</td>
</tr>
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<td>Rule for How Much Can be Withdrawn in Any Given Year</td>
<td>Domestic Investment is Explicitly Prohibited</td>
<td>Ethical &amp; Conflict of Interests Standards for Managers &amp; Staff</td>
<td>Public Disclosure of Internal Audit Results</td>
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<td>Rule for Which Revenues Must be Deposited and When</td>
<td>Investment Risk Limitations</td>
<td>The Detailed Responsibilities of Fund Managers &amp; Staff</td>
<td>Formalized Oversight Mechanism</td>
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<td>Exceptions to Rules are Clarified</td>
<td>Publication of Specific Investments</td>
<td>The Role of Government Agencies in Fund Management</td>
<td>Public Disclosure of Regularly Compiled Fund Reports</td>
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</table>

### Good Governance Standards Met

- Presence of Regulation
- Absence of Regulation
AZERBAIJAN Natural Resource Funds

September 2013

Operational Laws, Rules and Policies

Fund Deposit Rules

The following revenue streams are deposited into the State Oil Fund:

- Revenues generated from any agreements on exploration, development and production-sharing of Azerbaijani oil and gas fields with the State Oil Company of the Republic of Azerbaijan (SOCAR).
- Net revenues from the Republic of Azerbaijan’s share of oil and gas sales, minus fees and expenses.
- Bonuses and acreage payments to SOCAR.
- Revenues generated from the transport of oil and gas through pipelines on Azerbaijani territory.
- Dividends and investment income.
- Grants, aid and funds appropriated to the State Oil Fund through legislation.

Fund Withdrawal Rules

- There are no clear rules on withdrawal amounts or timing. Withdrawals are made arbitrarily and vary from year to year.
- The State Oil Fund not only transfers funds to the state budget but also makes payments directly to specific projects set forth by the President of the Republic of Azerbaijan, mainly strategically significant infrastructure such as a transboundary water pipeline and railway.
- The Fund’s assets may not be used as collateral for government borrowing. Lending to government bodies or private enterprises is prohibited.

Withdrawals are made arbitrarily and vary from year to year.
Operational Laws, Rules and Policies

Flow of Funds

**State Oil Company of the Republic of Azerbaijan**
- Proceeds from profit oil sales and other revenue generated from contracts between the State Oil Company and private companies, minus an amount to cover the State Oil Company’s operational costs.

**Other Oil and Gas Revenue**
- Includes acreage fees, transit fees, bonus payments, asset sales, investment income and funds deposited via legislation.

**State Oil Fund of the Republic of Azerbaijan**
- Used for ad hoc infrastructure and strategic projects.

**Extra-Budgetary Spending**
- Arbitrary amount that varies annually.

**State Budget**
Investment Authority

The Fund’s Executive Director determines investment policy, guided by the opinion of the Fund’s Supervisory Board. The investment policy is then approved by the President of the Republic of Azerbaijan.\(^7\)

Investment Objectives

The Fund’s goal is to maximize returns while minimizing the probability of substantial losses.\(^8\)

Investment Strategy

The following assets are permissible for investment:\(^9\)

- Cash deposits in central banks, commercial banks and other financial institutions
- Debt obligations of governments, international financial organizations and other institutions with at least a BBB- or Baa3 credit rating
- Equity
- Mutual and alternative investment funds
- Gold
- Real estate
- Non-investment grade debt obligations as long as they have a credit rating of at least BB- or Ba3

The Fund utilizes external investment managers, which must meet the following requirements:\(^10\)

- Parent company has at least a BBB- or Baa3 rating from Standard & Poor’s, Fitch or Moody’s
- Minimum of five years of experience in managing financial assets
- Experienced in managing assets equal to or exceeding $1 billion

Investment Allocation\(^11\)

According to the 2013 investment policy, the Fund’s target asset allocation is the following:

- Minimum 85 percent debt obligations and money market instruments
- Up to 5 percent equity
- Up to 5 percent real estate
- Up to 5 percent gold

The Fund’s target allocation also stipulates that assets be invested in the following currencies:

- 50 percent U.S. dollar
- 40 percent euro
- 5 percent pound sterling
- 5 percent in the currency of any G7 country, member of the European Monetary Union, Russia, Turkey or any country with a sovereign debt rating of at least an A from Standard & Poor’s or Fitch and an A2 from Moody’s\(^12\)

Policy on In-State Investments

Fund assets can be invested in infrastructure and socio-economic development projects within Azerbaijan.
Investment Laws, Rules and Policies

Allocation by Asset Class\textsuperscript{13}

As of December 2012

- Equity: 2%
- Real Estate: 1%
- Gold: 2%
- Fixed Income: 95%

Allocation by Geographic Region\textsuperscript{14}

As of December 2012

- Emerging Economies: 13%
- Middle East: 1%
- North America: 13%
- Asia Pacific: 7%
- Europe: 61%
- International Financial Institutions: 5%
Management and Accountability

Management and internal accountability

The Fund was established through a Presidential decree. The President also has ultimate oversight of the Fund.

A Supervisory Board is appointed by the President. It supervises the Fund’s activities and consists of government ministers and members of Parliament.

The State Oil Fund is headed by an Executive Director who is appointed by the President to carry out operational management of the Fund. The Internal Audit Department reports to the Executive Director.

External managers are limited to managing 60% of the Fund’s assets.

The reports of the independent auditor, appointed by the President, are included in the State Oil Fund’s annual report.
Oversight and Safeguards

Oversight Mechanisms

- Finances are subject to regular and comprehensive internal audits.

- The Supervisory Board, consisting of representatives from both the executive and the legislature, is appointed by the President to oversee the State Oil Fund’s activities. It reviews the Fund’s annual budget, annual reports, financial statements and audits.

- Fund finances are subject to a regular and independent external audit that meets international standards.

- Funds are managed separately from the country’s international reserves.

Common Oversight Mechanisms or Safeguards Not Present in Azerbaijan

- Parliament has no formal fund oversight role and lacks independence from the executive branch.

- International oversight institutions, such as the World Bank or the International Monetary Fund, do not routinely monitors Fund management.

- De facto constraints on civil society organizations to advocate freely limit their ability to provide citizen oversight of Fund activities.
### Transparency Laws, Rules and Policies

There is public disclosure of the following:

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>When or how often Fund reports are published and made publicly available</td>
<td>yes</td>
</tr>
<tr>
<td>Which individuals or organizations are responsible for publishing Fund reports</td>
<td>yes</td>
</tr>
<tr>
<td>Size of the Fund(s)</td>
<td>yes</td>
</tr>
<tr>
<td>Deposit and withdrawal amounts</td>
<td>yes</td>
</tr>
<tr>
<td>Returns on investments</td>
<td>yes</td>
</tr>
<tr>
<td>Detailed asset allocation – geographic location</td>
<td>yes</td>
</tr>
<tr>
<td>Detailed asset allocation – asset class</td>
<td>yes</td>
</tr>
<tr>
<td>Detailed asset allocation – specific assets</td>
<td>no</td>
</tr>
<tr>
<td>Natural resource prices and other fiscal assumptions used to calculate deposit and withdrawal amounts allowed under fiscal rules</td>
<td>no</td>
</tr>
</tbody>
</table>
Annex:
List of Applicable Laws

Decree of the President of the Republic of Azerbaijan on Establishment of the State Oil Fund of the Republic of Azerbaijan

Statute of the State Oil Fund of the Republic of Azerbaijan

Rules on management of foreign currency assets of the State Oil Fund of the Republic of Azerbaijan

Rules on the preparation and execution of the annual program of revenues and expenditures (budget) of the State Oil Fund of the Republic of Azerbaijan

Long-term strategy on the management of oil and gas revenues
Endnotes