

Natural Resource Funds



Azerbaijan

State Oil Fund of the
Republic of Azerbaijan



Market Value

**State Oil Fund
of the Republic
of Azerbaijan**
\$34.7 billion

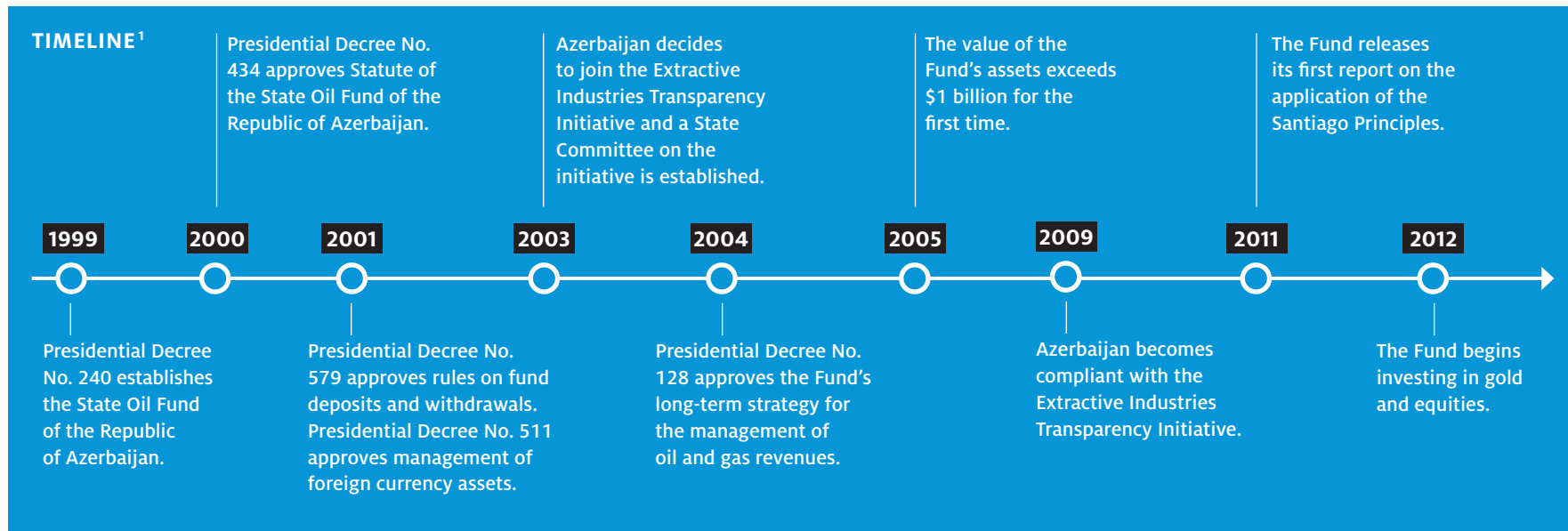


Good Governance Fundamentals	
Clear Deposit Rules	yes
Clear Withdrawal Rules	no
Clear Investment Rules	yes
Transparent	yes
Publicly Available Audits	yes
Effective Oversight	no

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.



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

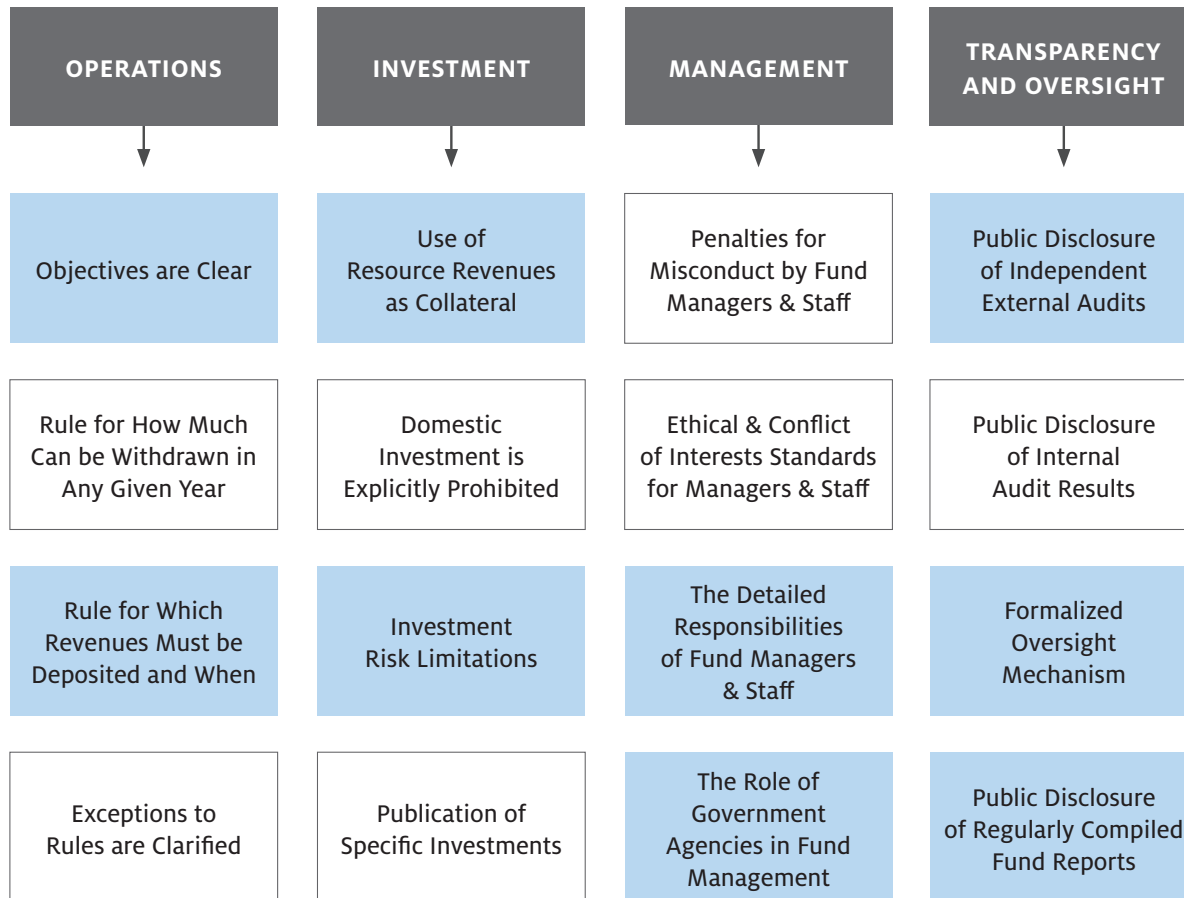
- Preserve macroeconomic stability by decreasing dependence on oil revenues and stimulate the development of the non-oil sector.
- Accumulate and preserve revenues for future generations.
- Finance major national projects for socio-economic development.

Good Governance Standards and Gaps in Regulation

Each box represents a regulatory standard essential for promoting consistent use of and safeguarding resource revenues. White boxes highlight regulatory gaps in fund governance.

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Good Governance Standards Met



Presence of Regulation
 Absence of Regulation

Operational Laws, Rules and Policies

Withdrawals are made arbitrarily and vary from year to year.

Fund Deposit Rules

The following revenue streams are deposited into the State Oil Fund:⁵

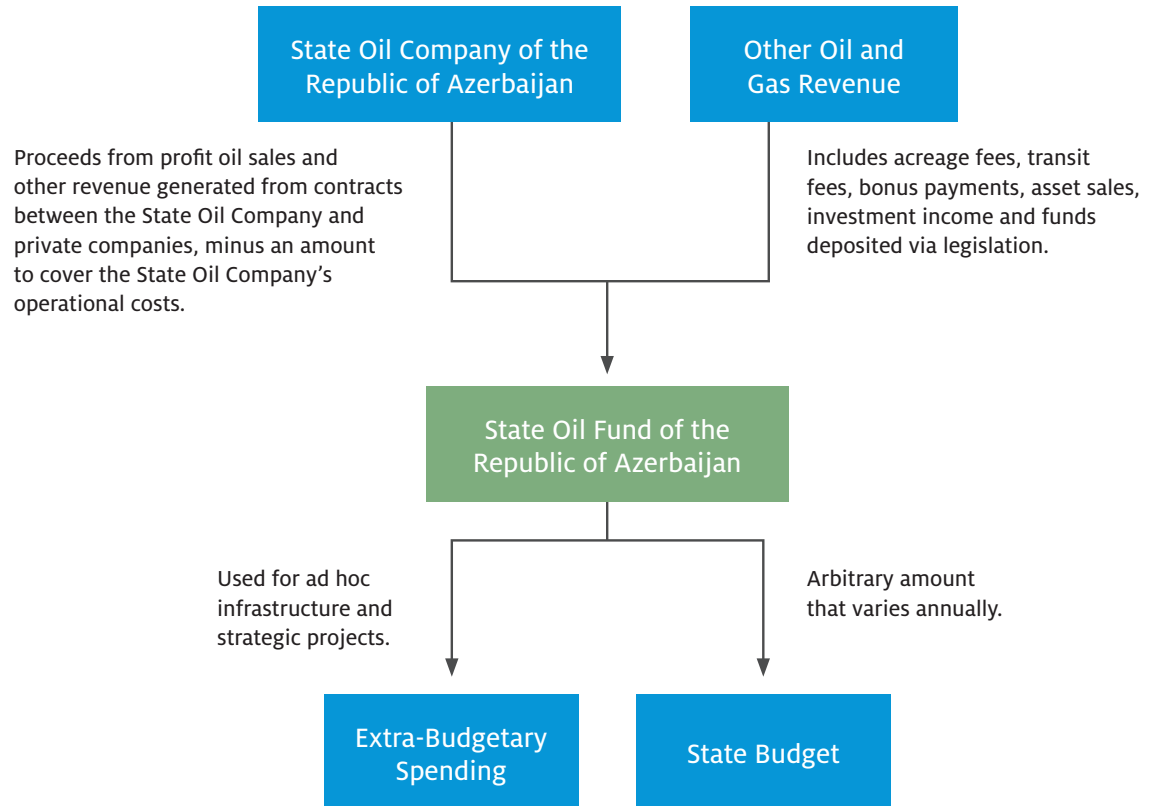
- Revenues generated from any agreements on exploration, development and production-sharing of Azerbaijani oil and gas fields with the State Oil Company of the Republic of Azerbaijan (SOCAR).
- Net revenues from the Republic of Azerbaijan's share of oil and gas sales, minus fees and expenses.
- Bonuses 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 Rules⁶

- 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.

Operational Laws, Rules and Policies

Flow of Funds



Investment Laws, Rules and Policies

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 Allocation¹¹

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

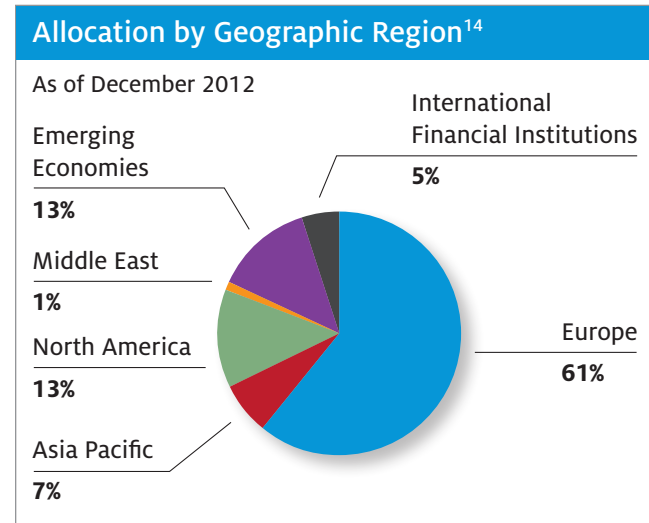
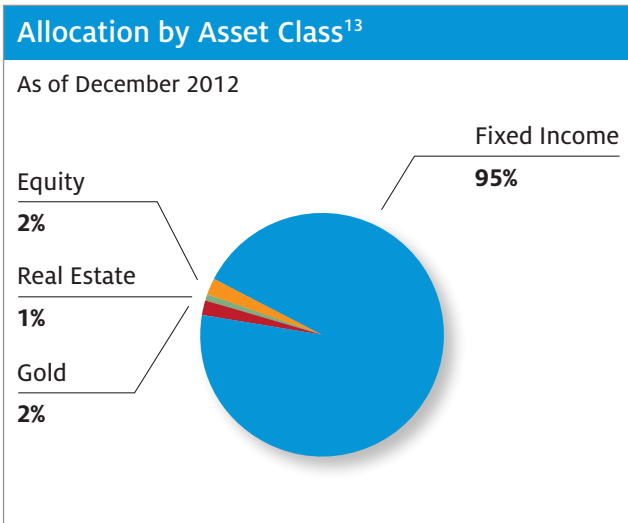
The Fund's target allocation also stipulates that assets be invested in the following currencies:

- 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's¹²

Policy on In-State Investments

Fund assets can be invested in infrastructure and socio-economic development projects within Azerbaijan.

Investment Laws, Rules and Policies



Management and Accountability

Management and internal accountability

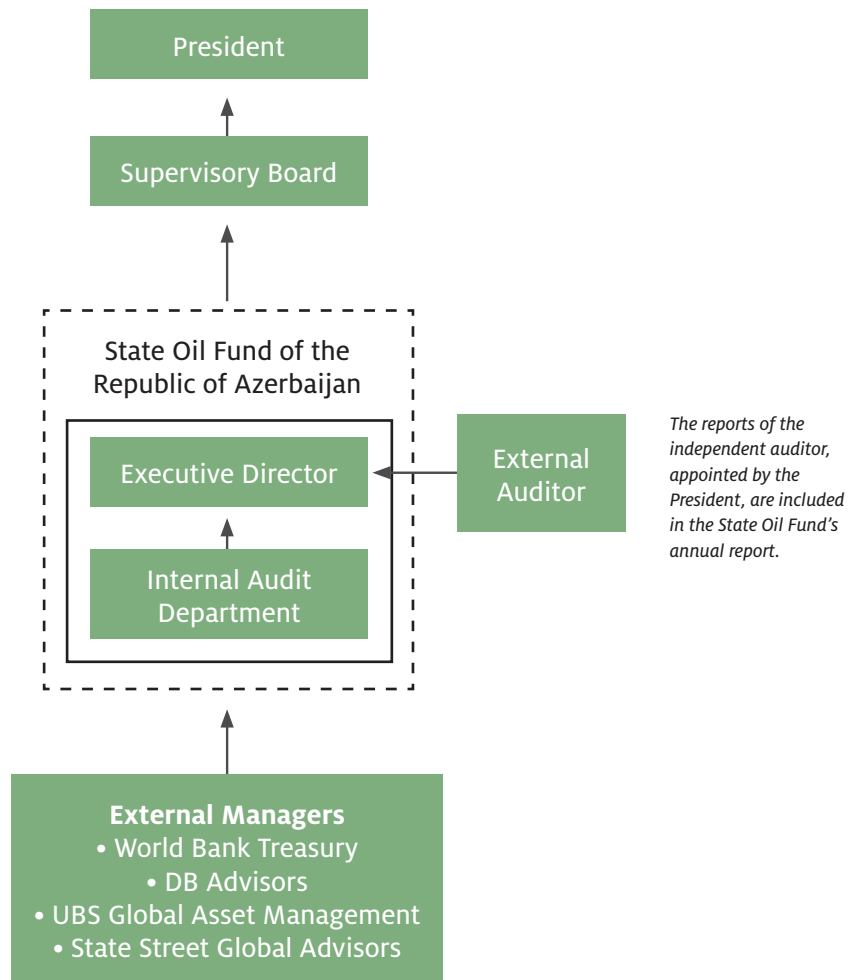
The Fund was established through a Presidential decree. The President also has ultimate oversight of the Fund.

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.

External accountability



Oversight and Safeguards

While much information on Fund activities is available, oversight bodies in Azerbaijan are generally not independent, limiting the usefulness of this information for promoting good governance.

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 monitor 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:

When or how often Fund reports are published and made publicly available	yes	
Which individuals or organizations are responsible for publishing Fund reports	yes	
Size of the Fund(s)	yes	
Deposit and withdrawal amounts	yes	
Returns on investments	yes	
Detailed asset allocation – geographic location	yes	
Detailed asset allocation – asset class	yes	
Detailed asset allocation – specific assets		no
Natural resource prices and other fiscal assumptions used to calculate deposit and withdrawal amounts allowed under fiscal rules		no

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

<http://www.oilfund.az/uploads/ferman1en.pdf>

Statute of the State Oil Fund of the Republic of Azerbaijan

<http://www.oilfund.az/uploads/status.pdf>

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

http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf

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

<http://www.oilfund.az/uploads/4-eng-programofrevenues.pdf>

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

<http://www.oilfund.az/uploads/5-eng-long-term.pdf>

1. http://www.oilfund.az/en_US/about_found/history/xronologiya.asp
2. Decree of the President of the Republic of Azerbaijan on the Establishment of the State Oil Fund of the Republic of Azerbaijan No. 240. Available at: <http://www.oilfund.az/uploads/ferman1en.pdf>
3. Rules on Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan. Available at: http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf
4. http://www.oilfund.az/en_US/about_found/meqsed-ve-felsefe.asp
5. Statute of the State Oil Fund of the Republic of Azerbaijan Article 3. Available at: <http://www.oilfund.az/uploads/status.pdf>
6. Statute of the State Oil Fund of the Republic of Azerbaijan Article 4. Available at: <http://www.oilfund.az/uploads/status.pdf>
7. Rules on Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan Section 3.1.2. Available at: http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf
8. Investment Policy of the State Oil Fund of the Republic of Azerbaijan for the Year 2013 Section 1.1. Available at: http://www.oilfund.az/uploads/Inv_policy1.pdf
9. Rules on Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan Section 3.3. Available at: http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf
10. Rules on Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan Section 3.1.3. Available at: http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf
11. Investment Policy of the State Oil Fund of the Republic of Azerbaijan for the Year 2013 Section 1.2.2 and 1.2.3. Available at: http://www.oilfund.az/uploads/Inv_policy1.pdf
12. Rules on Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan Section 2.2.1. Available at: http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf
13. Annual Report 2012 State Oil Fund of the Republic of Azerbaijan p. 37. Available at: http://www.oilfund.az/uploads/annual_2012en.pdf
14. Annual Report 2012 State Oil Fund of the Republic of Azerbaijan p. 39. Available at: http://www.oilfund.az/uploads/annual_2012en.pdf