

**DOCUMENT OF THE EUROPEAN BANK  
FOR RECONSTRUCTION AND DEVELOPMENT**

# **STRATEGY FOR AZERBAIJAN**

**As approved by the Board of Directors at its meeting on 17 May 2005**

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## EXECUTIVE SUMMARY

Azerbaijan is committed to the principles of Article 1 of the Agreement Establishing the Bank. However, the progress achieved in the implementation of the principles of multi-party democracy, pluralism and market economics has been slow and uneven, and many challenges remain. Although an improvement over previous elections, the Presidential elections of October 2003 failed to meet international standards for democratic elections. The OSCE and the Council of Europe urged the authorities to remedy the defects that became apparent during the electoral process. The parliamentary elections scheduled for November 2005 will be a significant opportunity for demonstrating progress in the proper functioning of democratic institutions.

Based largely on Foreign Direct Investment (FDI) in the oil sector and the consequential spill-over effects to the transport and construction sectors, Azerbaijan has, during the last few years, registered robust economic performance. With vigorous export growth in some sectors, most notably agriculture and chemicals, annual GDP growth since 2000 has averaged over 10%. Within the time span of this Country Strategy these growth rates could double.

During the current strategy period, the Government's economic policy mix has been broadly appropriate. To compensate for the greater liquidity in the system resulting from the capital inflows to the oil sector, the Government has progressively tightened its fiscal policy. Within this context, tax reforms have been successfully executed. Monetary policy, on the other hand, has been moderately lax, and the National Bank of Azerbaijan (NBA) has had difficulties sterilizing foreign exchange inflows for the purpose of minimising nominal exchange rate appreciation.

On the external side, annual current account deficits have averaged 30% of GDP. This, again, is due to substantial imports relating to the oil and gas sector. These imports have been largely financed with foreign investment, allowing public and publicly guaranteed external debt to be maintained at around 18% of GDP.

While the range of structural reforms undertaken by the Government to date has been limited, the pace with which these reforms are being introduced is quickening. Those reforms that have been implemented have generally been appropriate and timely. Examples include the new Banking System Law which is broadly in line with the Basel Core Principles, the new National Bank Law which includes the introduction of independent board members and the new Accounting Law which outlines a process for the introduction of International Financial Reporting Standards (IFRS). The recently adopted long-term oil revenue management strategy provides an appropriate framework for supporting macroeconomic stability. Institutional capacity building is needed in support of those structural reforms which have been introduced.

Within this policy environment, economic growth has been achieved without significant macroeconomic imbalances. Inflation has largely been under control and the exchange rate has shown remarkable stability. Starting with the 4<sup>th</sup> Quarter of 2004 and continuing in the 1<sup>st</sup> Quarter of 2005, however, inflationary pressures have begun to develop, particularly as the Government moves to bring gas and power prices closer to market levels. International reserves at the National Bank of Azerbaijan (NBA) and deposits in the State Oil Fund have been accumulating steadily.

The key challenges facing the Azerbaijan economy in the near and medium term remain substantial. In particular, achieving and maintaining the efficient and equitable management of oil and gas revenues and ensuring those revenues are used in support of economic diversification will be essential. Almost half of Azerbaijan's population lives below the national poverty line.

Ensuring development of an efficient and diversified employment base that is sustainable in the long-term will be critical to addressing this situation.

Indirect support of economic diversification, access to finance and expansion of the banking system into rural areas are the necessary preconditions to harness the job creation potential of small and medium-sized enterprises (SMEs). The investment climate has to be significantly improved to support private sector investment. At present corruption is widespread and pervasive, the banking sector is weak and undercapitalised, in most areas the regulatory environment is underdeveloped and inadequate and laws and regulations are often arbitrarily enforced. While the Government's recent actions are encouraging, substantial improvements and capacity building are still required in many areas.

As of end December 2004, the Bank had signed a total of 23 projects in Azerbaijan, amounting to EUR 459 million and covering a wide variety of sectors. Of these, 14 projects are in the private sector, representing 49.2 per cent of total commitments. Lessons learned include that the Bank's engagement in policy dialogue should remain focussed, should be closely co-ordinated with the international community and should be undertaken in the context of investment operations.

The EBRD's strategic approach will be to support economic diversification with the aim of poverty alleviation. In view of this strategic orientation and in response to Azerbaijan's status as an Early Transition Country (ETC), the EBRD's operational approach will continue to benefit from the resource commitment, operational flexibility and instruments provided through the ETC Initiative. Accordingly, the Bank's activities over the coming strategy period will focus primarily on support which targets the development of the private sector, including through an intensified policy dialogue with the authorities on improving the investment climate.

The main operational objectives will be:

1. **Non-oil private sector development** – The Bank will contribute to the development of the non-oil sector by making direct debt and equity investments and via support to the financial sector. Micro-, small- and medium-sized enterprises are anticipated to be the primary target for these investments. The instruments, resources and programmes available under the ETC Initiative will be fully utilised in order to accentuate the Bank's engagement in these activities. The following sectors offer the greatest potential for non-oil private sector investments:

*Agribusiness* – The Bank will pursue opportunities in the areas of primary processing and packaging;

*Property and Tourism* – The economic growth which is expected to occur will increase demand for commercial office space. The Bank will seek to support investments in this sector as well as in the areas of commercial real estate and hospitality;

*Telecommunications* – The Government of Azerbaijan has begun the process of reforming the telecommunications sector in Azerbaijan. The Bank will continue its policy dialogue with the Government relating to the sector with a view to enabling investments; and

*General Industries* – The construction sector in Azerbaijan, continues to show strong growth, almost exclusively in Baku. The Bank will therefore seek to invest in both large and small projects in the building materials sector.

2. **Financial sector** – The weak financial sector in Azerbaijan represents a significant risk to Azerbaijan's economic prospects in the medium term. The Bank will be actively engaged in this sector at different levels. In particular the Bank will continue to play a leading role in the related policy dialogue. This dialogue will focus on improving the competitiveness and

consistency of regulation within the sector. The Bank will seek further opportunities for equity investment in the sector, particularly within the context of consolidations and mergers.

3. **Infrastructure** – Critical to the achievement of the Government’s economic development strategy is the creation of efficient infrastructure. The Bank will target improvements to the transportation network, with a particular focus on the development of strategic international transportation corridors. The Bank will also focus upon much needed improvements in the power sector. In transport commercialisation will be the centre of attention while in the power sector the focus will be on restructuring and regulatory and tariff reforms. While exploring investment opportunities in municipal and environmental infrastructure, the Bank will emphasise that its ability to move forward in this sector will require a strong commitment from counterparts to implement tariff and other project-related reforms.
4. **Natural resources** – Following the EBRD’s financings of the Azeri, Chirag and deepwater Guneshli Phase 1 (ACG), Baku-Tbilis-Ceyhan Pipeline (BTC), Shah Deniz and South Caucasus Gas Pipeline (SCP) projects, there continues to be potential in the sector for smaller investments in secondary and tertiary recovery projects. Therefore, the Bank’s focus within this sector will shift towards smaller on-shore projects. Additionally, there may be viable projects in the mining sector which the Bank will explore. These potential projects are normally located in particularly poor regions and local economic impacts could be significant.

As the Bank’s portfolio in Azerbaijan expands, these operational objectives will be complemented and reinforced by enhanced policy dialogue on the investment climate. In close co-ordination with the international community, the Bank will continue to play a leading role in seeking improvements to the investment climate. Within the context of the Bank’s existing and potential investments in key sectors, the policy dialogue will focus upon the regulatory environment and the arbitrary enforcements of laws and regulations.

The Bank will continue to ensure that all operations in Azerbaijan are subject to the Bank’s Environmental Policies and Procedures and incorporate, where appropriate, Environmental Action Plans. In the context of the ETC Initiative, the Bank will seek increased donor TC and investment grant co-financing to support the preparation or implementation of projects, for legal transition work, to sustain its policy dialogue with the authorities on the investment climate and to leverage the financial support it can provide in priority sectors.

I recommend that the Board of Directors approve this Country Strategy.

Jean Lemierre  
President

## 1. THE BANK'S PORTFOLIO

### 1.1 Overview of Bank Activities to Date

**Current Portfolio** - The Bank's levels of activities have increased markedly in Azerbaijan over the last two years with a sharply increased number of transactions being completed across a broad array of sectors. The natural resource sector represents the majority (73%) of the total business volume of EUR 239 million signed during the course of the previous Country Strategy. As at 31 December 2004, the Bank's total signed business volume in Azerbaijan amounted to EUR 459 million, with the natural resource sector representing 66% of the total. Annex 1 provides a summary of the Bank's operations in Azerbaijan to end 2004.

**Table 1**  
Azerbaijan, Net Cumulative Business Volume by Industry  
(EUR million), 31 December 2004

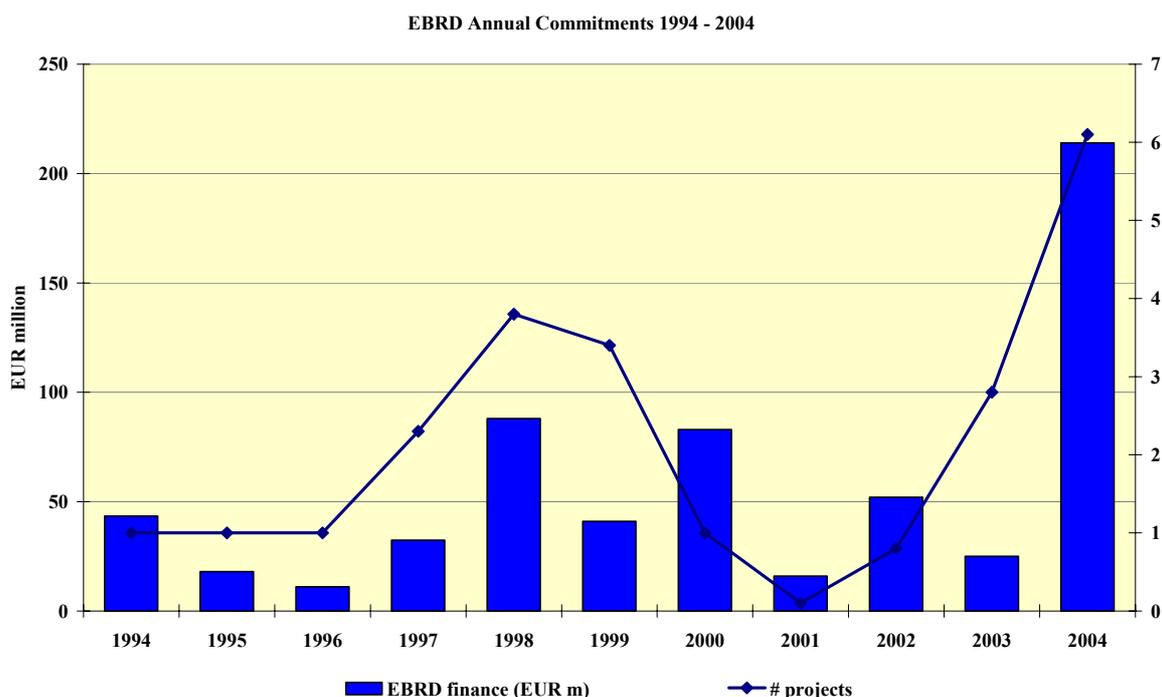
Sector Business Group	No. of Projects	Total Project Value (EUR mln)	EBRD Finance (EUR mln)
<b>Energy</b>			
Natural Resources	9	3,051	300
Power and Energy	2	90	55
<b>Sub-total Energy</b>	<b>11</b>	<b>3,141</b>	<b>355</b>
<b>Financial Institutions</b>			
Bank Equity		1	1
Bank Lending		11	10
Equity Funds		17	5
Small Business Finance		8	5
<b>Sub-total Financial Institutions</b>	<b>2</b>	<b>37</b>	<b>21</b>
<b>General Industry</b>			
General Industry	1	5	2
<b>Sub-total General Industry</b>	<b>1</b>	<b>5</b>	<b>2</b>
<b>Infrastructure</b>			
Municipal & Env Inf	1	80	17
Transport	4	78	55
<b>Sub-total Infrastructure</b>	<b>5</b>	<b>158</b>	<b>72</b>
<b>Specialised Industries</b>			
Agribusiness	2	6	5
Property and Tourism	1	5	4
<b>Sub-total Specialised Industries</b>	<b>3</b>	<b>11</b>	<b>9</b>
<b>TOTAL</b>	<b>22</b>	<b>3,353</b>	<b>459</b>
of which direct	20	2,143	372
of which regional	2	1,210	87
of which non-sovereign	15	3,104	332
of which sovereign	7	249	126
of which private	14	2,646	226

of which state	8	707	233
of which debt	21	3,303	443
of which equity	1	49	15
of which guarantee	0	1	1

Public sector investments in the power and transport sectors are the other noteworthy portfolio exposures, each representing approximately 12% of the portfolio.

Chart 1 (below) shows the number of projects signed in each year since 1994 and annual commitment levels. Generally, EBRD business levels have been relatively modest in Azerbaijan, reflecting a difficult climate for private sector investment and constrained sovereign debt capacity. The effect of the more recent, large oil and gas investment projects; a renewed commitment to reform from the newly appointed President; and of the implementation of new approaches under the ETC Initiative, resulted in a sharp turn around in this situation during 2004. During 2004, the Bank undertook six new transactions for a total amount of EUR 207 million in Azerbaijan.

Chart 1



**Portfolio Pipeline** – The portfolio pipeline for 2005 (summarised in Annex 2), while strong and well diversified across a variety of sectors, is weighted toward large public sector infrastructure projects. This recognises the need to create an economic foundation supporting stable and diversified private sector-led growth. The private sector pipeline is healthy in terms of numbers but, with a notable exception in the natural resource sector, the size of the projects is relatively small. Given that Government debt capacity will likely increase substantially as a result of increased oil revenues, thereby allowing much needed investment in public sector infrastructure, it is expected that the Bank’s portfolio of sovereign debt will increase over the timeframe of this Country Strategy.

## 1.2 Implementation of the Previous Country Strategy

Over the period of the previous Country Strategy, the Bank's activities in Azerbaijan were consistent with the declared objectives. However, while the Bank's activities in most sectors during that period had a meaningful transition impact, measured against the Bank's stated objectives, similar progress was not achieved in the financial sector.

***Direct financing and policy dialogue to improve investment climate.*** The Bank undertook a limited number of direct financings during the past two years. In December of 2003, a USD 20 million loan agreement was signed with the holding company of Groupe Castel's beer, wine and mineral water operations in Azerbaijan and other CIS countries. The funds have been used to restructure Castel's production and distribution capabilities throughout Russia and the Caucasus, as well as for selective development across the region. Together with co-financing from IFPT, a Canadian investment fund, the Bank provided USD 10.2 million in financing for the Landmark I and II office complexes in Baku. Tied to this financing was EUR 413,000 of TC funding provided by the Swiss Secretariat for Economic Affairs (SECO) for the development of a centralized Mortgage Registry in Azerbaijan. Late in 2004, the Bank signed agreements committing USD 5.7 million in debt and equity to M-Pro a small but dynamic dairy company.

Despite these successes, it has in the past been difficult for the Bank to find projects of an acceptable size and risk profile. The introduction of the ETC Initiative, allowing the Bank to work with smaller clients, with higher risk profiles, has however substantially enhanced the Bank's ability to work with private sector businesses in Azerbaijan.

Outside of progress on oil revenue management, the policy dialogue undertaken by the EBRD to help improve Azerbaijan's investment climate has, to date, had only limited success. In particular, progress in eliminating corruption, in strengthening the regulatory environment and in addressing arbitrary enforcement of laws and regulations, has been disappointing. The legislative environment in the banking sector has been improved, but the undue dominance of state-owned banks continues to be a serious obstacle to economic growth.

***Building an effective and competitive financial sector.*** In 2003, the Bank made its first equity investment in an Azerbaijani commercial bank through a EUR 800,000 equity investment in Unibank. Unibank is one of five local banks which currently have SME credit lines under the EBRD's Azerbaijan Multi-Bank Framework project.

This facility, which provides credit lines to local banks for on-lending to small and medium enterprises (SMEs), has during the past two years increased the number of its intermediary banks from three to five. Additionally, the Bank signed two Trade Facilitation Programme (TFP) operations, bringing the total number of TFP facilities to five banks. A characteristic of the EBRD's debt facilities to Azerbaijan's banking sector has been their relatively small individual value, which reflects general undercapitalisation of the banking sector.

The Microfinance Bank of Azerbaijan (MFBA), in which the Bank has an equity interest, received a EUR 4.0 million loan for on-lending to micro-enterprises. To date, the MFBA has provided over 10,500 loans to micro- and small-enterprises (MSEs), totalling almost USD 25 million. With 3,500 outstanding loans, MFBA is currently averaging over 780 loans per month at an average size of approximately USD 2,800.

Significant resources have been applied by the Bank during the past two years to address the underlying issues related to the International Bank of Azerbaijan (IBA). The IBA continues to dominate the Azeri banking sector, maintaining a near monopoly over most government financial services, as well as most large corporate accounts. While much of this dominance can be attributed to the IBA's extensive branch and ATM networks, the IBA continues to pursue many practices which could be deemed anti-competitive. To date, the Bank's efforts to work with the Government, as the majority shareholder of IBA (50.2%), have not achieved any meaningful improvements to the situation.

Consequently, over the past year the EBRD has supported consolidations and mergers within the banking sector, thus promoting the emergence of healthy and dynamic mid-tier banks that are better equipped to compete effectively with IBA,

***Infrastructure projects.*** The Bank signed a EUR 30.5 million loan facility to finance the reconstruction of the Hajigabul – Kurdamir Road, part of the historic “Silk Road” trading route linking Asia and Europe. Many of the country's road networks have been neglected and resultant travel conditions have become a significant hindrance to trade. This project addresses these issues by reconstructing what is an important part of a trade route both within Azerbaijan and with its neighbours. Part of the loan is being used to promote institutional reform at the Ministry of Transport.

***Development of the oil and gas sector.*** The Bank has been active in the oil and gas sector since the previous Country Strategy was approved, with this increased activity reflecting meaningful progress on related governance and transparency issues. The Bank played a leading role in the financing of the BTC Oil Pipeline project and the associated ACG Phase 1 Oil Field Development project. These two projects, expanding the market for the natural resources of Azerbaijan, are critical building blocks for the potential economic development of the country. While the successful completion of these projects will not guarantee Azerbaijan's future economic prosperity, if properly managed, they can create a foundation for sustainable and diversified economic development of the country. The Bank also financed the participation of the State Oil Company of the Azerbaijan Republic (SOCAR) in the Shah Deniz Gas Field development project and the South Caucasus Gas Pipeline project. Significant conditionality was attached to these financings. This conditionality will support the move of SOCAR towards greater transparency and commercialisation.

Over the period of the previous Country Strategy, and in large part due to the Bank's activities within the sector, Azerbaijan has made real progress in developing the institutional framework for the responsible management of oil and gas revenues. Azerbaijan is playing a leading role in the Extractive Industries Transparency Initiative (EITI), SOCAR is in the midst of a restructuring and commercialisation exercise and the State Oil Fund continues to function in an increasingly transparent and open manner.

### **1.3 Transition Impact of the Bank's Portfolio and Lessons Learned**

The transition impact of the Bank's portfolio varies by sector. In the oil and gas sector, the Bank has had a significant direct and indirect impact. Led by the creation of the State Oil Fund in 2001, Azerbaijan has pursued a thoughtful approach to oil and gas revenue management. The mandate of the State Oil Fund is to “ensure inter-generational equality with regard to the country's oil wealth, all this whilst improving the economic well being of

the population today and safeguarding economic security for future generations". Since its foundation, the State Oil Fund has accumulated just under USD 1 billion and its management has been transparent and effective. Audited annual and quarterly financial statements are made public and are posted on the State Oil Fund's website ([www.oilfund.az](http://www.oilfund.az)).

Azerbaijan is also playing a leading part in EITI, having reached agreement with almost all foreign and local companies involved in the extractive industries and with a broad coalition of non-governmental organisations. This agreement resulted in the publishing of the world's first EITI Country Report in March of 2005. SOCAR has engaged United States Technical Development Assistance (USTDA)-funded consultants to prepare a commercialisation and restructuring plan and has undertaken a number of commitments to improve transparency and disclosure. The Bank has played an important role in these achievements both through conditionalities associated with the financing of the four major oil and gas projects and through a leading participation in the policy dialogue.

Institutional reform conditionality has been agreed as part of the Bank's financing of the Hajigabul – Kurdamir Road. The creation of the Ministry of Transport in 2003 was a significant first step towards the development of more rational management of the transport sector. Within the newly created Ministry, the Road Transport Services Department (RTSD), the entity through which the Silk Road is being executed, will seek to improve customer focus through, for example, the establishment of a "Roads Advisory Board". This Board will include representatives of various types of road users and will advise the RTSD on road policy and management. A second road project is now under preparation, with the Bank proposed for financing of a 60 kilometre section of the main route from Baku to Samur (at the Russian border). This project will seek to build on the transition objectives of the first project, by enhancing the efficiency of the road maintenance task. In the railway sector, a second project is under consideration to finance rolling stock and support commercialisation of the Azerbaijan State Railways.

The Bank's impact on the financial sector has been more limited. The Bank has concluded a significant number of successful operations in the sector and has a meaningful and positive impact - at the institutional level. However, at the level of Government policy in the sector, progress in reducing monopolisation and improving competition has been marginal. While the Bank expended considerable time and resources on the potential further privatisation of the International Bank of Azerbaijan (IBA), and while there seemed to be a desire at the highest levels of Government for the privatisation to occur, the IBA did not provide the Bank with the information needed to move forward.

The EBRD's Post Evaluation Department (PED) has noted the following lessons learned in their recent Evaluation of the Country Strategy for Azerbaijan:

***War, peace, and transition.*** When a country at early stages of transition is considerably slowed down by war and shortages in the supply of essential utilities, the preconditions for generating transition impact are not present. The first strategic priorities should be reconstruction, alleviation of shortages and job creation. When a minimum of market conditions are met, then the strategies should attempt to move from infrastructure and natural resource investments to more direct private sector development activities.

***Low income and transition.*** Although poverty alleviation is clearly not within the EBRD formal mandate, the poverty reality in ETCs cannot be ignored, since it matters when

identifying the segments of the society that carry the cost of adjustments towards the market economy and the potential purchase power to develop the economy. Among the various paths to transition, those tending to alleviate poverty should be preferable, to ensure minimum welfare that will provide enough social safety for durable transition. This approach also requires coordination with other members of the international community, who set poverty alleviation as their primary goal. Although the Bank's strategies do not aim at poverty alleviation, they should be consistent with the private sector development component of poverty alleviation strategies prepared by the Government with the assistance of the international community.

**Regional development within a country** should be encouraged via provision of microfinance. A Bank supported microfinance bank is creating regional branches and training more loan officers. Regional development calls for better infrastructure networks at that level: roads, power, and water supply. The EBRD could be more involved in supporting regional objectives in clustering investment programmes, or some of their components, at regional level.

**Selecting key sectors.** In post conflict economies, when multiple objectives are to be reached simultaneously in a wide range of areas, such as transition impact, cross border links, reconstruction, and private sector development for job creation, strategies should continuously focus on the few sectors that are well positioned in the economy that can fulfil multiple goals. Agribusiness could be one of them.

**Microfinance.** When strategies are pursuing both post conflict recovery objectives and transition impact, and intend to achieve desired levels of employment and income generation, they should promote appropriate financial instruments, relying more on microfinance programmes, through existing commercial banks (in downscaling from SME to micro) and non- bank financial institutions.

**Role of technical cooperation.** In the past, when institutional reforms were associated with a project in the utilities and infrastructure sectors, a restructuring and commercialisation plan was often condensed into one package and supervisory authorities could not implement it straight away for lack of political willingness or institutional capability. In the future, a TC grant aiming at supporting the institution building of a large company could precede the lending phase, to pave the way for reforms associated with future operations. The same approach could be applied to the industrial sector for large scale restructuring and privatisation.

**Policy dialogue and donor coordination.** When sectoral reforms require many difficult policy changes, the dialogue should be steady and carried in close co-operation with other international and bilateral institutions within a formal framework where the Government and the private sector can fully participate. A poverty reduction strategy framework could make a good forum for public and private sector reforms.

### **Overall Assessment and Rating**

PED has rated the past country strategies in Azerbaijan as follows:

<b>Main Components</b>	<b>Rating</b>
Relevance of stated priorities	<b>Good</b>
Strategy implementation	Satisfactory
Transition impact	Satisfactory
Coordination with other IFIs and Donors	Good

#### **1.4 Portfolio Ratio and Quality**

Investments in the private sector of Azerbaijan represent 49.2 % of the Bank's portfolio in the country. However, non-sovereign financing constituted 72.3 % of the portfolio. The Bank's financing of state-owned SOCAR's participation in the Shah Deniz and South Caucasus Pipeline projects has been structured on commercial terms, not backed by the Government's financial guarantee.

Substantial diversification of income and production source within Azerbaijan will be a necessary condition for ensuring that the EBRD's portfolio, in the medium term, achieves a clearly dominant private sector character. Taking account of this and of the structure of the current project pipeline, it is envisaged that the private sector content of the Bank's portfolio will be 60 percent or greater from around the end of 2006.

## **2. OPERATIONAL ENVIRONMENT**

### **2.1.1 The General Reform Environment**

Azerbaijan has an important geo-strategic position as a gateway from Central Asia to Europe. Due to its location in the South Caucasus bordering Georgia, Armenia, Turkey, Russia and Iran and also due to major investments of international oil companies, Azerbaijan is bound to consider many interests in domestic policy making. Annex 3 provides a detailed assessment of the political situation in Azerbaijan, in the context of Article 1 of the Agreement Establishing the Bank

There was sizeable progress in transition to a market economy, but transition towards a more civil society (e.g. democracy, pluralism, respect for human rights and freedom of the press) did not match progress on the economic side. Progress in implementation of the principles of multi-party democracy, pluralism and market economy has been slow and uneven, and major challenges remain. Although an improvement over previous elections, the presidential elections of October 2003 failed to meet international standards for democratic elections and the OSCE and the Council of Europe urged the authorities to remedy the defects that became apparent during the electoral process. The parliamentary elections scheduled for November 2005 will be a significant opportunity for demonstrating proper functioning of democratic institutions.

Many challenges remain in the areas of implementing the rule of law, maintaining freedom of the media and ensuring respect for human rights. The progress in these areas has been slow, although formal commitments regarding ratification of international treaties have been honoured. Corruption remains a serious problem. According to Transparency International's Corruption Perception Index 2004, Azerbaijan ranked 140<sup>th</sup> amongst 145 countries in terms of perceived level of corruption. Amongst the EBRD's countries of operation, Azerbaijan ranked 27<sup>th</sup> out of 27 countries. In a resource-rich country like Azerbaijan, revenue reporting is vital for fighting corruption. Azerbaijan is actively supporting the UK Government's Extractive Industries Transparency Initiative (EITI) and has begun to publicly disclose both Government and Corporate EITI reports. While there are some weaknesses in these early reports, they do mark an important new phase in public disclosure and transparency.

The Nagorno-Karabakh conflict remains unresolved and is a cause of serious concern given its domestic, regional and international consequences. However, the continuing dialogue between the Presidents of Azerbaijan and Armenia is a positive signal. With hundreds of thousands of people displaced, many of whom continue to live in very harsh conditions as a result of the conflict, a final settlement is of great social, political and economic importance.

### **2.1.2 Social Conditions**

Despite recent high economic growth, and growing energy resources, Azerbaijan has a high incidence of poverty. According to SPPRED, in 2002, about 46.7 per cent of population lived below the minimum living standards, (official minimum consumption basket is AZM 175,000 per month which is equivalent to about USD 25). Azerbaijan's GDP per capita, at about USD 1041 in 2004, is among the lowest in transition countries. About 8.8 per cent of population live below the extreme poverty line of less than 18 dollar per month. Due to low earnings in the formal economy and worse employment opportunities, the level of poverty is slightly higher in urban than rural areas (47.8 per cent in urban areas and 45.4 per cent in

rural areas), with Baku having the largest share of poor population (21 per cent). However, rural poverty is related to lack of financial resources and accessibility to basic services due to underdeveloped infrastructure and unreliable supply of energy and gas. Children under 15 and households with three or more children are the most vulnerable groups. Azerbaijan has currently 1 million refugees and IDPs (12 per cent of the population). After 15 years, the majority of IDPs are still living in unsuitable conditions (special camps or unfinished buildings in Baku and other big cities) and the unemployment rate is high among them.

Similar to other CIS countries, Azerbaijan inherited from the Soviet period, a widespread education system. According to the 1999 census data, at least 97.5 per cent of population above 15 years old have completed primary school education and about 52 per cent have completed secondary education. However, there is a need to improve the quality and access to basic education recognised in the SPPRED. Improvement of teaching quality is expected to be achieved by increasing their wages and putting in place a performance linked bonus system.

The healthcare system in Azerbaijan has suffered from low investments (budget health expenditure was only 1.1 per cent of GDP in 2003) and large incidence of informal payments caused by low real wages in the sector. Access to health care services for the poor is difficult due to lack of financial means. SPPRED also recognises the urgent need for improvement in the quality and access to basic health services.

### **2.1.3 The Legal Environment**

The pace of legislative activity in Azerbaijan has slowed during the last two years. However, there have been a number of significant legal reforms during 2004, such as a new Banking Law, and the accession to the Convention on Criminal Prosecution of Corruption and to the Convention on Civil Responsibility for Corruption. In addition, an Anticorruption Act was passed in 2004 and entered into effect in 2005. Despite these and prior reforms, Azerbaijan continues to face considerable challenges to bring its legal environment to the minimum standards upon which a successful transition to a market-based economy depends.

In general, the view of the Bank, based on its research and its own experience as an investor, is that the commercial laws of Azerbaijan provide a basic framework within which investment and business activities can be undertaken. However, the analysis conducted by the Bank in relation to key commercial laws which are instrumental for the improvement of the investment climate in the country has shown that the local legislation needs to be substantially improved. For example, legislation on corporate governance and on capital markets was found to be in “*very low compliance*” with international standards, whereas insolvency legislation scored “*low compliance*” with such standards. Legislation on secured transactions is riddled with confusion as the different applicable provisions lack coordination among themselves. Furthermore, a general problem that Azerbaijan shares with other transition countries is its failure to achieve a fair and adequate enforcement of existing laws and regulations, as a result of, among other things, a poorly functioning judiciary. Annex 4 provides a more detailed assessment of Azerbaijan’s progress in legal reform.

In the future, Azerbaijan will continue to be challenged to improve its commercial laws in order to adjust to generally accepted internationally standards, and to make these laws fully effective and implemented through the strengthening of its court system.

#### **2.1.4 Environmental Issues**

During the next two years, the Bank will continue to take account of potential environmental impacts associated with the Bank's extensive involvement in the natural resources sector in Azerbaijan and the Caspian region in general. In addition the Bank will endeavour to focus upon institutional capacity building in discussion with the competent authorities. In the natural resources sector, the large projects with which EBRD is involved have a strict environmental compliance and monitoring regime summarised on the project websites. In addition, an Independent Environmental Consultant has been retained to monitor compliance with project commitments. This monitoring occurs quarterly, and results of this are also made available to the general public through the internet.

In terms of capacity building, EBRD is currently implementing its Technical Cooperation initiative aimed at developing Azerbaijan's National Oil Spill Contingency Plan in line with relevant international conventions. EBRD and the Ministry of the Ecology and Natural Resources of Azerbaijan, the Beneficiary of the project, are currently in the process of organising a round table with the participation of governmental departments, state-owned oil and shipping industry and international operators present in Azerbaijan to discuss and develop the structure, composition and functions of the future National Oil Spill Planning Committee. It is expected that a draft National Oil Spill Contingency Plan will be presented to stakeholders in a formal workshop to be held in August 2005 in Baku.

In order to support regional efforts for environmental preservation of the Caspian Sea, from 2001 to 2003, the Bank worked with the United Nations Economic Commission for Europe (UNECE), the United Nations Environment Programme (UNEP), the Caspian Environment Programme (CEP) and the five littoral states of the Caspian (Azerbaijan, the Islamic Republic of Iran, Kazakhstan, Russia, Turkmenistan) to develop guidelines and procedures for projects with transboundary impacts. A second phase of the project is currently being discussed by UNEP, which would involve training of local environmental authorities and involvement of NGOs. In November 2004, Representatives of CEP and bilateral and multilateral organizations including EBRD and the World Bank, business and NGOs gathered for the Caspian Environment Program Investment and Donor's Forum and discussed investment and technical assistance priorities in Baku. The Bank will continue its support for the regional effort in co-operation with other international and bilateral organizations.

In consideration of the above issues and the role other IFIs and partners are playing, EBRD will pursue three main approaches with respect to environmental issues. Firstly robust environmental monitoring and enforcement of environmental requirements on existing projects. Secondly new projects in Azerbaijan will continue to be subject to the Bank's Environmental Procedures and Public Information Policy and incorporate, where appropriate, EAPs into the legal documentation in order to address issues raised during due diligence, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects. Thirdly, the Bank will work with other international organisations and government agencies as appropriate to strengthen Azerbaijan's capacities with respect to environmental management. Annex 5 provides further details of the Bank's Environmental Assessment and Response.

## **2.2 PROGRESS IN TRANSITION AND THE ECONOMY'S RESPONSE**

### **2.2.1 Macroeconomic Conditions for Bank Operations**

Economic performance has been strong during the three years since the last country strategy, with real GDP growth rates averaging 10 per cent annually. The strong performance has been mainly based on oil exports and oil-related foreign direct investment, with spill over effects on transport and construction. While both the agriculture and chemical sectors have also grown strongly, the economy continues to be highly dependent on oil and gas-related activity. In 2004 extraction and processing are estimated to have contributed more than 30 per cent of GDP. The State Oil Fund increased its assets by USD 155 million during 2004, reaching USD 970 million by the end of the year.

At the same time, expansion has been achieved with low inflation and a stable exchange rate. To date, the National Bank of Azerbaijan (NBA) has been effective in using the exchange rate as a nominal anchor, both to maintain a low inflation rate and to protect the competitiveness of the non-oil sector. However, with the increase in foreign exchange inflows in 2004, the NBA lacked the instruments to simultaneously avoid recurrent appreciation of the manat and absorb part of the excess liquidity. This structural problem was compounded by the authorities' decision to repeatedly increase public sector wages throughout the year and by the need to progressively align domestic energy prices with international ones. As a result, the inflation rate at the end of the year increased to 10.5 per cent, up from 3.6 per cent in 2003. With the expected increase in foreign exchange inflows, NBA will target inflation while permitting real appreciation to take place via a nominal one.

Government finances remain strong. Fiscal policy was tightened in 2004, compared to the slightly expansionary bias previously registered. Revenues were higher, and expenditures lower, than initially forecasted. Overall, a consolidated general government surplus of 0.8 per cent of GDP is estimated for 2004 (and a non-oil deficit of approximately 9.7 per cent of GDP). Consistent with structural reforms already introduced, fiscal and quasi-fiscal energy subsidies have been progressively reduced. As Azerbaijan is entering a period of substantial fiscal revenues from the oil-related projects, the 2005 budget targets a non-oil deficit of 10.4 per cent of GDP, roughly equivalent to a 2.2 per cent consolidated government budget surplus.

Since the last country strategy Azerbaijan's current account has been registering high and recurrent deficits. The current account deficit was an estimated 27 per cent of GDP in 2004. However, these external imbalances stem from the substantial imports of capital goods and services required for the completion of the major hydrocarbon projects – the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, Shah Deniz gas condensate development and South Caucasus gas pipeline. The deficit been financed almost entirely through foreign direct investment. . The combination of a reduction in import spending and the anticipated surge of oil revenues should bring the deficit to around 7 per cent of GDP in 2005. The public and publicly-guaranteed external debt-to-GDP ratio remained at about 19 per cent in 2004 and is expected to decline to 18 per cent in 2005.

Structural reforms accelerated in the second half of 2004, after a period of a slowdown. Both the banking system and the accounting laws have been broadly re-designed according to international principles. The new National Bank Law strengthens the role of Azerbaijan

National Bank in corporate governance and supervision as well as its independence. Finally, the recently introduced long-term oil revenue management strategy, which complements a substantial use of oil wealth and growth in non-oil sectors, should help to attain macroeconomic stability and intergenerational equity.

Corruption remains a significant deterrent to investment. The recently approved anti-corruption law, in effect since 1 January 2005, defines corruption and assigns responsibilities to government bodies for tackling it. In this regard, transparency improvements in, and the restructuring of, the State Oil Company remain key challenges. Positive steps have however been taken to increase the transparency of resource revenues. Azerbaijan was the first country under the Extractive Industry Transparency Initiative to submit an international audited progress report. The country's programme with the IMF remains on-track. The fourth review under the three-year Poverty Reduction and Growth Facility was completed in December. 2004.

### **2.2.2 Transition Success and Transition Challenges**

At the time of the previous Country Strategy, Azerbaijan faced many challenges to its transition process. Against the background of the high poverty level in Azerbaijan, it was crucial to ensure the continuing support of the population for the transition process. In this context it was considered critical for the country's social stability and sustainable economic development that the substantial state revenues accumulating in the State Oil Fund, which was established in co-operation with the IMF and the World Bank in 2001, were transparently managed and effectively utilized.

In addition, with the implementation of large-scale oil and gas projects, the country faced the challenge of ensuring broad-based economic growth. A major obstacle to the development of the so-called non-oil sector has been and continues to be the challenging business environment. The most pressing investment climate issues are widespread corruption, an inadequate legal/regulatory environment, arbitrary enforcement of laws and regulations by law enforcement agencies as well as the judiciary, an underdeveloped infrastructure and lack of access to financing.

In the previous Country Strategy, four key transition challenges were identified:

***Fighting poverty and achieving balanced economic growth*** - The first annual report of Azerbaijan's State Program for Poverty Reduction and Economic Development (SPPRED), which reflected extensive consultation with civil society, was completed in May 2004. While some progress has been made in alleviating poverty and reducing the disparities in income distribution, combating poverty remains a key challenge in Azerbaijan. The EBRD's explicit role in respect to the achievement of the SPPRED objectives was limited to institution building in the banking sector and support for the improvement of transportation corridors within Azerbaijan. Despite this limited direct role, the EBRD was an important interlocutor in the development and implementation of the SPPRED.

***Improving the investment climate*** - Corruption continues to be the most significant impediment to economic development in Azerbaijan. The Government has recently introduced a Law on Fighting Corruption and an Anti-Corruption Decree but there are concerns about the Government's capacity and commitment to implement these new laws. There remains an urgent need to make progress on the separation of commercial

and regulatory functions of public enterprises and ministries. Strengthening the rule of law requires improvements in the selection and training of the judiciary and the functioning of the courts. The reduction of red tape and progress on tackling monopolistic tendencies in certain key sectors is essential for the development of a more attractive investment climate. Over the period of the previous Country Strategy, the EBRD has played an active role in the policy dialogue on investment climate with the Government. Both bilaterally and multilaterally, the EBRD has engaged in detailed discussions with the Government on corruption, the regulatory environment, access to capital and other key components of the investment climate.

***Strengthening the financial sector*** - There was progress late in 2004 in financial sector reforms, including the adoption of the Banking System Law and the National Bank Law, and the implementation of reform measures to foster competition in the banking sector. However, little progress has been made in privatizing the dominant two state-owned banks. The provision of banking services to the Government continues to be dominated by the IBA. The tendering of Government financial services should seek to ensure that, where appropriate, privately-owned commercial banks are given a fair opportunity to compete. Also needed are the strengthening of anti-money laundering legislation, further development of the Government securities market and improvements of corporate governance and accounting and auditing standards.

***Rehabilitating infrastructure*** - Due to the combined impact of limited Government debt capacity and the massive need for rehabilitation of infrastructure, there was little progress made in improving infrastructure. The power sector, in particular, requires substantial investment simply to maintain its current inefficient operations, yet reforms needed to make these investments economically viable have not yet been introduced. Substantial investments in roads are also required, if Azerbaijan is to take advantage of its geographic location at the hub of Asia, Europe and the Middle East.

Over the medium term the main challenge for Azeri economic authorities is prudent and effective management of growing but temporary revenue from energy resources. This is crucial in an economy that has at the same time massive oil revenues and a high incidence of poverty (with 46.7 per cent of population below the poverty line in 2002). An effective management of oil revenue would contribute to economic diversification, macroeconomic sustainability and poverty reduction. The recently adopted long-term oil revenue management strategy, envisages a constant oil wealth, in real terms, and small fluctuations in non-oil fiscal deficits. The relevant essential challenges that remain to achieve a broad-based sustainable growth are the careful design of the composition of public expenditures within a sound and transparent fiscal framework, and the need to strengthen the implementation and monitoring capacity of the government. While the government's structural reform agenda that involves economic diversification and improvement in investment climate is noteworthy, there is great need to strengthen its implementation. In particular, improving governance across sectors and enhancing reforms in the financial and energy sectors are important for effectively channelling resource revenues to the economy.

Although Azerbaijan is participating in the EITI, limited progress has been made toward improving governance in other areas. Corruption remains a significant problem in the country. The Government has yet to show unequivocal commitment and capacity for fully implementing the recent Law on Fighting Corruption and Anti-Corruption Decree. Improving governance and reducing corruption requires completion of the separation of

commercial and regulatory functions of public enterprises and ministries. Further, improving the functioning of the courts is essential since the failure of Azerbaijan's judicial system to provide adequate enforcement of existing laws and regulations, undermines the confidence in the legal system, in particular the upholding of contract rights.

### **2.3 ACCESS TO CAPITAL AND INVESTMENT REQUIREMENTS**

Azerbaijan's external public debt continues to be moderate, at just over 18 per cent of GDP at the end of 2004. The vast majority of aggregate external debt is to official creditors including International Financial Institutions and is largely long-maturity and bearing relatively low interest. Although Azerbaijan enjoys one of the best credit ratings in the region (Fitch: BB), the Government has not yet tapped international capital markets for financing. The domestic capital market remains at an early stage of development, and domestic public debt is minimal.

Foreign direct investment inflows have been predominantly directed towards the oil and gas sector and the FDI in other sectors remains insignificant due to the difficult business environment, perceived high political risks and a relatively small market with limited purchasing power.

Azerbaijan continues to have substantial funding requirements for infrastructure projects. While some of these requirements will be financed through the use of budgetary and State Oil Fund resources, significant reforms and progress in the privatisation of electricity distribution companies could help to open the infrastructure sector to private sector investment. Other areas such as transport infrastructure will, however, continue to rely on state-guaranteed financing until further progress in the commercialisation of various state enterprises has been achieved.

In addition to the problems created by poor infrastructure, economic diversification opportunities are further constrained by a banking sector that is underdeveloped, undercapitalised and in which competition is limited. The depository base of the sector continues to be dominated by the International Bank of Azerbaijan. Private companies, and in particular SMEs, continue to suffer from very limited access to financing. Access to international commercial bank financing to date has been limited and largely short-term.

### **3. STRATEGIC ORIENTATIONS**

#### **3.1 Bank's Priorities for the Strategy Period**

Taking account of past experience and the priorities that the Government has adopted and communicated via the SPPRED, the EBRD's strategic approach in Azerbaijan will be to support economic diversification in support of poverty alleviation. In close support of this strategic orientation and in response to Azerbaijan's status as an Early Transition Country, the EBRD's operational approach in the country will continue to benefit from the resource commitment, operational flexibility and instruments provided through the EBRD's ETC Initiative. Under the ETC initiative, the Bank has increased its impact through introduction of a "tool box" of customized financing instruments; longer funding tenures; more TC and a blend of Bank and donors' grant funding, along with allocation of more internal resources.

Accordingly, the Bank's activities over the coming Strategy period will focus primarily on support targeting the development of the domestic private sector, including through an intensified policy dialogue with the authorities on improving the investment climate. As well, the Bank will focus on supporting the Government to build a more effective and efficient economic infrastructure, particularly in the power and transport sectors.

#### **3.2 SECTORAL CHALLENGES AND BANK OBJECTIVES**

The Bank will focus its efforts on private sector business development and selected public sector interventions that largely enable key infrastructure investment to be undertaken in support of private sector and regional growth.

The ETC Initiative's emphasis on private sector development provides particular flexibility for the Bank's engagement with micro, small and medium-sized enterprises (MSEs and SMEs). These enterprises offer the greatest opportunities for creating sustainable employment and prosperity. Their growth also has a positive impact on a country's transition to democracy: their owners have a stake in improving the ways laws and regulations are made and implemented, and in reducing corruption.

##### **3.2.1 Non-oil private sector development**

The Bank will support the development of the non-oil sector, particularly outside of relatively prosperous Baku, by making direct debt and equity investments and via support to the financial sector. MSEs and SMEs are anticipated to be the primary target for these investments. The following sectors offer the greatest potential for non-oil private sector investments:

*Agribusiness* – The agricultural sector in Azerbaijan remains diffuse and lacking in infrastructure. The de-collectivisation of agricultural land has resulted in a return to subsistence farming, lacking in efficient mechanisms throughout the value chain. The Bank will pursue opportunities in the area of primary processing and packaging, with commercial entities which have developed the necessary logistical infrastructure. As most potential agribusiness clients are nascent commercial operations with little if any experience in operating business to western standards, these projects will be staff intensive and small. Technical assistance will be needed to assist these clients to develop management and

accounting systems, as well as for the development of medium and long term corporate strategies;

*Property and Tourism* – The economic growth currently occurring will increase demand for modern, technologically-advanced commercial office space. The Bank will seek to support investments in this sector as well as in the areas of retail developments and hospitality. The legal environment in which these investments would be made requires significant work. The Bank, along with other members of the donor community, will continue to work towards the development of a cadastre system, a centralized mortgage registry and the other components of a legal environment in which a meaningful collateral interest can be established. Work is also needed to support the development of a judiciary capable of effectively interpreting and enforcing a strengthened legal framework;

*General Industries* – The construction sector in Azerbaijan continues to show strong growth, creating demand for basic construction materials such as concrete, pipes and tubing. As Azerbaijan develops improved transportation corridors both east-west and north-south, these materials will become increasingly viable to export to other fast growing economies in the region. The Bank will seek to invest in both large and small projects in the building materials sector.

*Telecommunications* – The Government of Azerbaijan has begun the process of reforming the telecommunications sector in Azerbaijan. The Bank will continue its policy dialogue with the Government relating to the sector, with a view to enabling investments; and

In all sectors, *Energy Efficiency* is a major challenge in Azerbaijan, which according to recent assessments has high energy intensity. Despite abundant domestic supplies of hydrocarbons, Azerbaijan's energy efficiency is affected by low energy prices and lack of Government commitment to securing efficient energy utilisation. Outside the power sector, the Bank will focus its efforts on industrial projects where an energy efficiency component could be cost-effective, notwithstanding low energy prices. Key to these efforts will be the Bank's Sustainable Energy Programme (SEP) which is designed to speed up investments in sustainable energy projects. The main objectives of the SEP are:

- To mobilise financial support for sustainable energy projects;
- To build capacity;
- To transfer energy management skills;
- To access Carbon Credit off-takers;
- To introduce best practice technologies;
- To improve- capital budgeting, energy cost allocation and relevant accounting; and
- To improve reliability of the energy supply systems.

### **3.2.2 Financial Institutions**

The weak financial sector in Azerbaijan represents a significant risk to Azerbaijan's economic prospects in the medium term. The Bank will be actively engaged in this sector on different levels and will continue to play a leading role in the related policy dialogue. This dialogue will focus on improving the competitiveness, capitalization and regulatory consistency of the sector.

Outside of the two large state-owned banks, the banking sector is small and undercapitalised. These capital constraints seriously limit the ability of privately owned banks to provide medium-sized financing (USD 500,000 to USD 2 million) to growth segments of the credit market, particularly emerging domestic corporations. In order to increase the lending capacity of private banks, the Bank will seek opportunities for equity investment in the sector, particularly within the context of consolidations and mergers.

The Bank will extend further support to partner banks in Azerbaijan using the full range of debt instruments including the Medium-Scale Co-financing Facility (MCFF). Additionally, the Bank will work to support the development of the non-bank financial sector (e.g. leasing and insurance). To enhance the ability of Azerbaijani banks to build stronger loan portfolios, opportunities will be sought to improve, under technical assistance, insolvency procedures and legislation, and the environment for secured transactions. Institution building assistance will be provided to banks in areas such as trade finance and micro- and small lending methodologies.

### **3.2.3 Infrastructure**

The Government's current economic development strategy focuses upon the complementary objectives of non-oil and gas sector development and regional economic development. Critical to the achievement of these objectives is the creation of an efficient economic infrastructure.

The Bank will continue to focus upon improvements to the transportation network in Azerbaijan, in particular on investment opportunities in the road and rail sectors. The Bank will seek to complete the financing of the Baku–Samur Road project with the Ministry of Transportation. A second railway project will also be considered during the Strategy period. The Azerbaijan State Railway is in discussions with the EBRD seeking financing for more efficient locomotives and for the capacity to maintain and repair locomotives. Commercialisation of such operations will be the focus of the Bank's related conditionality.

The Bank will also focus upon much needed improvements in the power sector, seeking to work with the state energy company, Azerenergi. The largest power plant in Azerbaijan, AzGres, is in urgent need of capital investment if it is to maintain its current levels of output. The focus in the power sector will be upon regulatory and tariff policy reforms and on restructuring.

In Baku, the Bank will continue discussions on the development of a solid waste management programme and on the development of a new port. Both which will require a strong commitment to commercialisation, cost recovery and other project related reforms

### **3.2.4 Natural Resources**

Following a comprehensive consultation and due diligence processes, in February of 2004, the EBRD signed the financing agreements for the TBC Pipeline project and for Phase 1 of the ACG Development project. In November of 2004, the Bank also entered into financing agreements with the SOCAR to fund their participation in the Shah Denis Gas and SCP projects. Associated with the latter two projects, the United States Trade and Development Agency provided substantial technical assistance funding in support of a consultancy engagement to work with SOCAR in their efforts to commercialise and restructure. This commercialisation and restructuring exercise, which is a condition of the Bank's financing of the SD and SCP projects, is expected to be the focal point of the Bank's activities over the period covered by this Country Strategy.

With the signing of the four large oil and gas financings in Azerbaijan in 2004, the Bank's focus within this sector will now shift towards on-shore projects. While there are few prospects for new fields, there remains significant potential in the sector for smaller investments in secondary and tertiary recovery projects. An important element of financing these types of projects may be the inclusion of an environmental clean-up component, which would serve to reduce the serious environmental legacy which exists in Azerbaijan.

Additionally, there may be viable projects in the mining sector which the Bank will explore. These potential projects are located in particularly poor regions of Azerbaijan and the potential local economic impacts could be quite significant. Furthermore, the Bank will seek opportunities to take equity in emerging domestic private sector corporations involved in the natural resource sectors and where the Bank's engagement will enhance corporate governance and transparency standards.

### **3.3 POLICY DIALOGUE**

Given the EBRD's ongoing engagement in financing of public sector infrastructure projects as well as its growing private sector portfolio, the Bank is well-placed to undertake an active and effective policy dialogue with the Government. This dialogue will focus broadly on improving the investment climate for the development of small- and medium-sized businesses. Progress in related areas will have particular resonance within the Government, given that the development of the non-oil sector is a key strategic objective of the Government.

## **4. MULTILATERAL AND BILATERAL ASSISTANCE**

### **4.1 MULTILATERAL ASSISTANCE**

#### **Asian Development Bank (ADB)**

Azerbaijan joined the Asian Development Bank in December 1999 and a Liaison office was established in Baku in early 2002. In 2004, a full Representative Office was set up and an active programme was initiated. ADB's activities in Azerbaijan are largely concentrated on the development of the social sector, in view of the urgent need to assist growing numbers of poor people, especially internally displaced persons. This is the major underlying concern in the ADB's interim operational strategy, the goal of which is reducing poverty and raising living standards in Azerbaijan by enhancing human development, supporting good governance and institutional strengthening, and promoting sustainable growth. ADB has a two-pronged assistance strategy in Azerbaijan: helping the Government improve the delivery of essential public goods and services to those in greatest need, and helping strengthen the environment for competitive private investment and job creation. ADB's policy-driven operations will have special emphasis on good governance and strengthening of institutions.

#### **Black Sea Trade and Development Bank (BSTDB)**

Azerbaijan became a member of the BSTDB in 1997. To date its activities in Azerbaijan consisted of the provision of trade finance to the International Bank of Azerbaijan (IBA) and of an equity investment in the newly created Microfinance Bank of Azerbaijan alongside the EBRD. Main objectives of the BSTDB activities in Azerbaijan are to promote co-operation impact among member countries (inter-regional projects); development of non-oil sectors; development of projects that would have significant impact for the country like power projects, manufacturing, agribusiness, food processing.

#### **European Union**

Following on the enlargement of the EU on 1 May 2004, Azerbaijan was offered an opportunity to participate in the European Neighbourhood Policy (ENP). In close co-operation with the Government of Azerbaijan, the European Commission is developing an Action Plan which is likely to include objectives consistent with the EBRD's policy dialogue on investment climate. The ENP offers an important opportunity to further engage Azerbaijan within the international community.

Between 1992 and 2004, the EC has allocated to Azerbaijan a total of €400 million of grant-based assistance under the TACIS, ECHO, Food Security, FEOGA, Exceptional Assistance, Rehabilitation and Exceptional Humanitarian Aid programmes. The general objective under the TACIS programme in Azerbaijan is to assist in the transition to a market economy and pluralist democracy based on human rights with specific initiatives for institutional, legal and administrative reform and private sector development. The indicative budget of TACIS for the upcoming three years is EUR 28 million and is targeting areas such as private sector development, pension reform, ecology, social assistance reforms, and reform of the public administration.

#### **International Finance Corporation**

The International Finance Corporation's strategy in Azerbaijan focuses on strengthening financial sector through promotion of domestic and foreign competition, establishment of joint venture in non-bank financial sector and provision of technical assistance to private local banks; promoting micro-enterprise and SME development; supporting investment in

agricultural and industrial sectors; channeling FDI in non-oil sectors and supporting the investment in the oil and gas related sectors. Funding has been approved for nine projects, including a recently established microfinance bank in co-operation with the EBRD, representing a total value of IFC investment of USD 134.6 million.

### **International Monetary Fund**

A three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), in an amount equivalent to SDR 80.45 million (50 percent of quota), was approved by the Executive Board of the IMF on July 2, 2001. Four disbursements under this arrangement have been made through December 2003. The programme has three main objectives: maintenance of macroeconomic stability, improvement of governance, and growth of the non-oil related sectors of the economy. To date the Government has been on track with the implementation of the programme. As a result of the programme, the Government has finalised a Poverty Reduction Strategy and progressed with reforms in the areas of customs, tax administration, financial sector, the establishment and management of the oil fund, energy sector, governance, fiscal policy and trade policy. In November of 2004, Azerbaijan accepted the obligations of Article VIII, Sections 2, 3 and 4 and is thereby committed to maintain an exchange rate free of restrictions in making payments and transfers for current international transactions. Finally, on 22 December 2004, the IMF's Executive Board completed their fourth and final review under the PRGF.

### **Islamic Development Bank (IsDB)**

Azerbaijan joined the IsDB in 1992. The IsDB's activities have been targeted at improving agriculture development through reconstruction of canal and drainage systems, power generation and construction of a major road. The Bank has financed technical assistance operations in designing infrastructure and agro-industries. The IsDB's investments included the co-financing of the EBRD's Mingechar Power Project by issuing a USD 12.5 million loan for retooling the Mingechar Hydro Power Plant and construction of 110 kV voltage transmission line as well as a new substation

### **UNDP**

The United Nations Development Programme (UNDP) has been represented in Azerbaijan since 1993. As of today, the UNDP has implemented more than 60 programmes and projects worth more than USD 31 million. Initially it focused its operations on post conflict assistance, emergency relief and reconstruction. In association with the World Bank and UNHCR, UNDP helped establish the Azerbaijan Reconstruction and Rehabilitation Agency, responsible for co-ordinating initiatives in war stricken areas, supporting temporary resettlement for the million displaced and refugees and funding income generation activities for the vulnerable population. UNDP also assumed a leading role in the establishment of a National mine action programme contributing to the creation of Azerbaijan National Agency for Mine Action (ANAMA). Today, the main objectives of the UNDP's activities in Azerbaijan are to contribute to the eradication of poverty, the consolidation of respect for individual rights, and the protection of natural resources, to assist the country in becoming a modern democracy through national level reforms with a special focus on democratic governance in line with the principles of the United Nations Charter.

### **World Bank**

Azerbaijan became a member of the World Bank in September 1992 and the International Development Association (IDA) in March 1995. Azerbaijan joined the Multilateral Investment Guarantee Agency (MIGA) and the IFC in 1992 and 1995, respectively. The

major focus of the World Bank's work to date has been to assist Azerbaijan by providing policy advice, financing for both investments and the Government budget, and co-ordination of aid. In particular, the World Bank is working with the authorities to strengthen the Government's institutional capacity to manage its petroleum resources and formulate key policy changes to accelerate reform.

The World Bank is relatively active in Azerbaijan and to date has committed USD 622 million for 25 operations. Seventeen of these projects are ongoing.

## **4.2 MAJOR BILATERAL ASSISTANCE**

### **Japan**

In March/ April 2005, total aggregate commitments of Japan's bilateral official development assistance (ODA) to Azerbaijan stood at USD 404.3 million equivalent (excluding technical cooperation). According to OECD-DAC data on disbursements, Japan was the top bilateral donor in 2000-01, and was the second and third largest in 1997 and 1998-99 respectively.

The largest project to date is the Severnaya gas combined power plant project. Yen loans of USD 193 million equivalent and USD 153 million equivalent were committed for two phases in 1998 and 1999 respectively. Meanwhile, grant assistance has been extended for various purposes including land and irrigation improvement, medical facilities, food production, economic structural adjustment and cultural purposes. A total of USD 3.9 million equivalent was provided for 66 projects through a grass-roots Human Security grant scheme. Humanitarian aid was extended through ICRC and UNHCR, while food aid was donated through WFP.

Technical assistance includes 164 traineeships in Japan and the dispatch of five experts to Azerbaijan during 1993-2004. Based on aid policy consultations in late 2002, the priority areas are (1) economic infrastructure development (in particular the areas of energy, transport and communications), (2) the social sector and (3) human resources development.

### **Germany**

Germany, within the framework of financial co-operation through the Kreditanstalt für Wiederaufbau (KfW) has invested about EUR 72 million in Azerbaijan and is planning to increase this amount to EUR 90 million in the coming two years. In terms of technical co-operation Germany's Gesellschaft fuer Technische Zusammenarbeit (GTZ) provided to date training and consulting services in the value of EUR 9 million and is planning to increase this amount to EUR 14 million in the coming two years.

### **USA**

The USTDA has provided substantial technical assistance in support of the Bank's financing of SOCAR's participation in the Shah Deniz and South Caucasus Pipeline projects. This support will assist SOCAR to develop a comprehensive commercialisation and restructuring plan. The USAID assistance to Azerbaijan is focused in four general areas: SME development (including agriculture), economic reforms, democracy and governance, and humanitarian relief to IDPs.

**Turkey**

Turkish Eximbank has extended a sovereign guaranteed credit line to the International Bank of Azerbaijan (IBA) of USD 250 million, of which USD 92 million has been disbursed to date. In addition, Eximbank has allocated and disbursed a USD 20 million loan for the rehabilitation of the airport in Baku.

## Annex 1

### EBRD operation in Azerbaijan to 31 December 2004

#### A. Signed EBRD commitments in Azerbaijan, 31 December 2004

Operation Name	Public/ Private Sector	Loan/ Equity	EBRD Financing (EURm)	Signing Date
<b>PUBLIC SECTOR</b>				
<b>Natural Resources</b>				
SOCAR - Shah Deniz Gas Condensate Field Development	state	loan	81	04 Nov 04
SOCAR - South Caucasus Gas Pipeline	state	loan	25	04 Nov 04
	<b>subtotal:</b>		<b>106</b>	
<b>Power and Energy</b>				
Mingechaur Power Project	state	loan	16	24 Jun 97
Yenikend Renewable Energy Project	state	loan	39	21 Dec 94
	<b>subtotal:</b>		<b>55</b>	
<b>Municipal Infrastructure</b>				
Baku Water Rehabilitation Project	state	loan	17	16 Oct 95
	<b>subtotal:</b>		<b>17</b>	
<b>Transport</b>				
Air Navigation Systems Upgrading	state	loan	10	21 Dec 96
Azerbaijan: Silk Road	state	loan	30	22 Jul 04
Azerbaijan: Trans-Caucasian Rail Link Project	state	loan	15	10 Dec 99
Baku Port Development	state	loan	0.1	10 Dec 99
	<b>subtotal:</b>		<b>55</b>	
<b>Subtotal Public Sector</b>			<b>233</b>	
<b>PRIVATE SECTOR</b>				
<b>General Industry</b>				
DIF - Silk Road Motel, Garadak	private	equity	2	29 Nov 99
	<b>subtotal:</b>		<b>2</b>	
<b>Agribusiness</b>				
Castel	private	loan	1	17 Dec 03
Milk-Pro LLC	private	loan	3	19 Nov 04
Milk-Pro LLC Unsecured Loan	private	loan	1	19 Nov 04
	<b>subtotal:</b>		<b>5</b>	
<b>Property &amp; Tourism</b>				
Landmark I (Neptun)	private	loan	2	18 Dec 03
Landmark II (Libra)	private	loan	1	18 Dec 03
	<b>subtotal:</b>		<b>4</b>	
<b>Natural Resources</b>				
ACG Phase I - Amerada Hess	private	loan	1	03 Feb 04
ACG Phase I - Amoco Caspian Sea (Phase 1) Finance Ltd	private	loan	7	03 Feb 04
ACG Phase I - Statoil Apsheron Finance A/S	private	loan	6	03 Feb 04
ACG Phase I - Unocal Phase I Finance Ltd	private	loan	7	03 Feb 04
Baku-Tbilisi-Ceyhan (BTC) Pipeline	private	loan	46	03 Feb 04
Chirag Early Oil	private	loan	11	17 Dec 98
Chirag Early Oil - AMOCO Caspian Sea Finance Ltd	private	loan	24	17 Dec 98
Chirag Early Oil - LUKOIL Overseas	private	loan	14	30 Dec 98
Chirag Early Oil - Turkish Petroleum	private	loan	10	17 Dec 98
Chirag Early Oil - UNOCAL	private	loan	14	17 Dec 98
Frontera Resources	private	loan	10	15 May 00
Nations Azerbaijan (ex Moncrief Azerbaijan Oil Company)	private	loan	38	21 Aug 00
		equity	6	
	<b>subtotal:</b>		<b>194</b>	

Operation Name	Public/ Private Sector	Loan/ Equity	EBRD Financing (EURm)	Signing Date
<b>Financial Institutions</b>				
AIG Silk Road Fund	private	equity	3	25 Sep 97
Azerbaijan Multi Bank FW - Azerdemiryolbank	private	loan	1	14 Jul 99
Azerbaijan Multi Bank FW - Azerdemiryolbank (II)	private	loan	1	27 Sep 04
Azerbaijan Multi Bank FW - Azerigasbank	private	loan	1	27 Sep 04
Azerbaijan Multi Bank FW - Bank of Baku	private	loan	1	13 Feb 04
Azerbaijan Multi Bank FW - International Bank of Azerbaijan	private	loan	3	21 Jul 98
Azerbaijan Multi Bank FW - Unibank (fka MBank)	private	loan	1	29 Nov 02
Azerbaijan Multi-Bank FF - Respublika Bank	private	loan	1	27 Sep 04
Baring Vostok Private Equity Fund	private	equity	2	13 Dec 00
MFBA Azerbaijan Microfinance Bank (Formerly AMB)	private	loan	4	28 Jun 02
		equity	1	
Regional TFP: Azerdemiryolbank	private	loan	0.1	08 Nov 02
Regional TFP: Azerigazbank	private	loan	0.1	19 Dec 03
Regional TFP: Bank of Baku	private	loan	0.3	08 Jun 04
Regional TFP: UniBank (former MBank)	private	loan	1	02 Dec 02
Unibank Equity Investment	private	equity	1	05 Sep 03
	<b>subtotal:</b>		<b>21</b>	
<b>Subtotal Private Sector</b>			<b>226</b>	
<b>TOTAL AZERBAIJAN</b>			<b>459</b>	

## B. Technical Assistance

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name	Sector	Business Group	Linked to Inv.
AZERBAIJAN							
TurnAround Management Programme - Salyan plastic products	31,917	31,917	17/08/98	Closed	Manufacturing	SEEC	N
Preparation of power sector efficiency improvement project	225,008	225,008	20/02/95	Closed	Energy	Energy	Y
EU TAM Programme in Azerbaijan	396,699	396,699	30/08/02	Closed	Manufacturing	SEEC	N
EU BAS Programme in Azerbaijan	772,500	654,986	07/10/02	Disbursing	Manufacturing	SEEC	N
Air navigation systems upgrading project	299,726	299,726	22/06/95	Closed	Transport, Storage	Infrastructure	Y
Azerbaijan Micro Finance Bank: Pre-oper and Oper Phases	1,181,217	1,181,217	18/12/01	Closed	Finance, Business	Deputy Vice President	Y
Baku Port Development, Consultancy Services for PIU support	284,415	284,415	29/04/02	Closed	Transport, Storage	Energy	Y
Twinning programme for SME line of credit and pre-privatisation of International Bank	910,458	910,458	01/11/96	Closed	Finance, Business	Financial Institutions	Y
Institutional Development Programme for SME line of credit of Azerdemiryolbank	491,380	491,380	27/11/96	Closed	Finance, Business	Financial Institutions	Y
Development of Cost Accounting and Management Information Systems	299,012	299,012	14/05/97	Closed	Transport, Storage	Russia & Central Asia	Y
Final design of the Gazi Mammed to Kyurdamir road	353,031	353,031	02/07/97	Closed	Construction	Infrastructure	Y
Multi-bank SME framework financing facility - Institutional Development Programme - Arkobank	317,781	317,781	28/11/97	Closed	Finance, Business	Financial Institutions	Y
Multi-bank SME framework financing facility - Institutional Development Programme - Azerigazbank	435,654	435,654	28/11/97	Closed	Finance, Business	Financial Institutions	Y
Azerbaijan Micro Finance Bank ("AMB"): Micro and Small Enterprise Credit Advisors	406,377	406,377	18/12/01	Closed	Finance, Business	Deputy Vice President	Y

Final design of the Gazi Mammed to Kyurdamir road	364,162	364,162	20/07/98	Closed	Construction	Infrastructure	Y
Institutional development and financial management of Baku Port	990,682	990,682	24/07/98	Closed	Transport, Storage	Infrastructure	Y
Trans-Caucasian Rail Link: Assistance with Project Implementation	234,704	234,704	03/11/98	Closed	Manufacturing	Infrastructure	Y
Azerbaijan Railways: Accounts Strengthening & Business Planning	293,515	293,515	27/09/00	Closed	Transport, Storage	Infrastructure	Y
Central Credit Advisory Services	400,723	400,723	19/12/00	Closed	Finance, Business	Financial Institutions	Y
Trans-Caucasian Rail Link: Assistance with Project Implementation	286,993	286,993	14/11/01	Closed	Manufacturing	Infrastructure	Y
Central Credit Advisory Services	298,327	298,327	08/07/02	Closed	Finance, Business	Financial Institutions	Y
Credit advisory services - Azerdemiryolbank	59,794	59,794	30/09/99	Closed	Finance, Business	Financial Institutions	Y
Preparation of tender documents, procurement assistance and supervision of works - Baku Port	393,977	393,977	08/12/99	Closed	Transport, Storage	Infrastructure	Y
Azerbaijan Micro Finance Bank (AMB)	273,990	273,990	12/12/02	Closed	Finance, Business	Deputy Vice President	Y
Microfinance Bank of Azerbaijan (MFBA) - Regional Expansion	800,000	502,725	07/05/04	Disbursing	Finance, Business	Deputy Vice President	Y
TransCaucasian Rail Link, Project Mngt Consulting	139,960	35,638	08/09/04	Disbursing	Transport, Storage	Financial Institutions	Y
MBASK - Institutional Strengthening Programme	197,800	24,974	07/12/04	Committed	Finance, Business	Financial Institutions	Y
Azerbaijan - Credit Advisory Services	298,750	298,750	30/06/03	Closed	Finance, Business	Financial Institutions	N
Azerbaijan - Institutional Strengthening of Unibank	279,300	0	18/05/04	Committed	Finance, Business	Financial Institutions	Y
Microfinance Bank of Azerbaijan (MFBA) Expansion	800,000	0	18/11/04	Committed	Finance, Business	Deputy Vice President	Y
Azerbaijan - Central Credit Advisory Services Expansion	279,900	83,312	30/09/04	Disbursing	Finance, Business	Financial Institutions	Y
Hajigabul-Kurdamir Road, Lender's Monitoring Consultant	195,810	8,811	15/12/04	Committed	Transport, Storage	Infrastructure	Y
Implementation of Bank of Baku/Ilkbank Institutional Building Programme	200,000	0	20/04/05	Committed	Finance, Business	Financial Institutions	Y
TurnAround Management Programme - Baku Chemistry Pharmaceutical Factory	25,677	25,677	11/09/98	Closed	Manufacturing	SEEC	N
Foreign investment protection law	32,267	32,267	18/06/96	Closed	Community/Social Services	Non-Banking	N
Gazzi Mammed - Kyurdamir Road : Revisions to Designs	77,160	77,160	20/04/04	Closed	Transport, Storage	Infrastructure	Y
Azerbaijan: Trade Finance Advisory Services	64,400	0	07/02/05	Committed	Finance, Business	Financial Institutions	N
TurnAround Management Programme - Mingechar Textile Company	38,072	38,072	17/08/98	Closed	Manufacturing	SEEC	N
Azerbaijan Microfinance Bank - Feasibility Study	84,885	84,885	26/06/00	Closed	Finance, Business	Financial Institutions	Y
Law reform - bankruptcy legislation	11,723	11,723	01/08/96	Closed	Community/Social Services	Non-Banking	N
Turnaround Management Programme (TAM) - SPU "Bakkonditioner"	15,179	15,179	15/02/01	Closed	Manufacturing	SEEC	N
Azerbaijan - M-Pro Investment Support TC	140,000	0	08/02/05	Committed	Manufacturing	Specialised Industries	Y
Trans-Caucasian rail link in Azerbaijan - project identification	49,615	49,615	17/11/97	Closed	Manufacturing	Infrastructure	Y
TurnAround Management Programme - ATEF	27,289	27,289	10/05/99	Closed	Manufacturing	SEEC	N

Baku to Astara road improvement project	38,199	38,199	08/05/96	Closed	Construction	Infrastructure	Y
Baku port development	46,272	46,272	07/01/97	Closed	Transport, Storage	Infrastructure	Y
Energy savings and efficiency improvement study	147,914	147,914	17/05/93	Closed	Energy	Energy	Y
Yenikend power sector - feasibility study	171,579	171,579	15/06/94	Closed	Energy	Energy	Y
Turnaround Management Programme - SPU Bakkonditioner	50,993	50,993	30/03/01	Closed	Manufacturing	SEEC	N
Identification of Investment Opportunities in the Agrifood Sector	11,251	0	21/06/01	Committed	Manufacturing	Specialised Industries	N
Yenikend Power - commercial management system	400,000	400,000	01/10/94	Closed	Energy	Energy	Y
Wholesale market	103,454	103,454	01/10/95	Closed	Manufacturing	Specialised Industries	Y
ANS Procurement arrangements - Azerbaijan Airlines - state concern for civil aviation (AZAL)	217,849	217,849	14/06/96	Closed	Community/Social Services	Russia & Central Asia	Y
Yenikend power - procurement arrangements	168,370	168,370	05/09/94	Closed	Energy	Energy	Y
Developing Azerbaijan's National Oil Spill Contingency Plan	221,000	0	26/06/03	Committed	Extractive Industries	Non-Banking	N
Mortgage Registration in Azerbaijan	412,150	2,897	30/11/04	Disbursing	Community/Social Services	Non-Banking	N
Wholesale market	55,512	55,512	25/07/95	Closed	Manufacturing	Specialised Industries	Y
FAO Framework Agreement - identification of investment opportunities in the agrifood sector	16,201	16,201	31/05/01	Closed	Manufacturing	Specialised Industries	N
Yenikend power sector rehabilitation - environmental assistance	54,846	54,846	07/07/94	Closed	Energy	Russia & Central Asia	Y
Advisory services for telecommunications investment planning	14,168	14,168	19/07/95	Closed	Telecommunications	Specialised Industries	Y
Development of secured transactions law	22,984	22,984	01/11/95	Closed	Community/Social Services	Non-Banking	N
Law reform - bankruptcy legislation	95,642	95,642	29/08/96	Closed	Community/Social Services	Non-Banking	N
TurnAround Management Programme - Salyan plastic products	12,348	12,348	05/08/98	Closed	Manufacturing	SEEC	N
TurnAround Management Programme - Mingechar Textile Company	10,839	10,839	05/08/98	Closed	Manufacturing	SEEC	N
TurnAround Management Programme - Baku Chemistry Pharmaceutical Factory	8,260	8,260	15/09/98	Closed	Manufacturing	SEEC	N
Turnaround Management Programme for Azertrans JSC	9,994	9,994	23/04/99	Closed	Manufacturing	SEEC	N
TurnAround Management Programme - ATEF	7,564	7,564	23/04/99	Closed	Manufacturing	SEEC	N
Legal Advisory Services to Azerbaijan in connection with Drafting Securities Market-related Primary Laws	48,895	48,895	31/10/01	Closed	Community/Social Services	Non-Banking	N
ADDY 2: Assistance with Project Preparation	49,940	0	27/01/03	Committed	Transport, Storage	Infrastructure	Y
Azerbaijan: Prioritisation of Investment Needs in Power Generation and Transmission	275,086	267,649	11/12/02	Disbursing	Energy	Energy	Y
SOCAR commercialisation and restructuring	541,754	176,019	08/03/04	Disbursing	Extractive Industries	Energy	Y
	16,972,890	13,349,051					
	16,972,890	13,349,051					
No of Commitments:	71						

## Annex 2

### Pipeline in Azerbaijan at 31 March 2005

The EBRD has a strong pipeline of projects for Azerbaijan. The pipeline reflects closely the EBRD's Operational Priorities outlined within this Country Strategy. There is a strong commitment to contribute to the development of a more viable economic infrastructure; significant numbers of small investments of varying types in the financial sector; an increasing number of smaller potential investments outside of the oil and gas sector; and carefully identified investments in the oil and gas sector.

<b>Stage</b>	<b>Sector</b>	<b>Number of Projects</b>	<b>Anticipated Volume (EUR Million)</b>
Exploratory	Financial Institutions General Industries Agribusiness Power	2-3 2-3 2-3 2-3	10-15 50-60 10-15 20-40
Passed Concept Review	Transport Power Natural Resources General Industries Financial Institutions	2 1 3 1 2	123.0 77.2 100.0 4.7 5.8
Passed Final Review	N/A	0	0
Board Approved	Specialised Industry	1	12.0
<b>TOTAL</b>		<b>18-22</b>	<b>412.7-452.7</b>

## **Annex 3**

### **Political Assessment in the Context of Article 1 of the Agreement Establishing the Bank**

#### **Political Assessment**

Azerbaijan is committed to the principles of Article 1 of the Agreement Establishing the Bank. However, the progress achieved in the implementation of the principles of multi-party democracy, pluralism and market economics has been slow and uneven, and many challenges remain.

There was sizeable progress recorded in transition towards a market economy, but transition to democracy and pluralism did not match the economic achievements. The presidential election of October 2003, although an improvement over previous polls, did not meet international standards for democratic elections. The OSCE urged the authorities to remedy problems which became apparent during the presidential polls. In this respect, the parliamentary elections in November 2005 will be a crucial benchmark for demonstrating progress in democratic transition.

The admission of Azerbaijan to the Council of Europe (CoE) in January 2001 was an incentive for bringing the country's laws in line with European standards and for demonstrating commitment to Europe's democratic principles and values. In their monitoring reports, the CoE noted some progress in respecting these commitments, the most visible of these being the release of political prisoners. At the same time, the CoE called on Azerbaijan to take measures to facilitate the proper functioning of democracy in the country and to implement commitments undertaken upon admission into the organisation.

The CoE also addressed the conflict of Nagorno-Karabakh. In January 2005 the Parliamentary Assembly called on Azerbaijan and Armenia to intensify their efforts for achieving a settlement of the conflict via the mediation of the OSCE's Minsk Group. The Assembly noted that more than ten years after the conflict began considerable parts of the territory of Azerbaijan are still occupied by Armenian forces and that occupation of foreign territory by a member state was a grave violation of obligations to the CoE.

#### **Presidential and parliamentary elections**

According to the Constitution of 1995, as amended in 2002, the Government structure in Azerbaijan is based on a strong executive branch of power, concentrated in the presidency. Parliament is yet to play its role of balancing the executive while the judiciary remains largely ineffective.

Ilham Aliyev succeeded his father Heydar Aliyev after the presidential election of 15 October 2003. According to the OSCE/ODIHR, which has monitored the election, the overall process reflected a lack of commitment required to implement a genuine electoral process. International observers witnessed irregularities during voting, the counting and tabulation of election results. The eight candidates provided the potential for a real choice for voters, although opposition candidates were not afforded equal conditions in which to conduct their campaigns. The state media was biased in its reporting, although free air time and print space was provided for all candidates.

Protests and violence broke out on election night and post-election disturbances continued with rioting in the capital on the next day. This was followed by a government response leading to numerous detentions and arrests.

The post-election violence, resulting in a wave of arrests, raised concerns among the international community. The OSCE/ODIHR and the Council of Europe formulated specific recommendations to remedy the situation, including a public pledge that future elections will meet OSCE commitments and other international standards.

Legislative power is vested in the Milli Mejlis, a unicameral body composed of 125 MPs and elected for five years. The upcoming parliamentary polls are due in November 2005 and are widely perceived as being a crucial test of the government's willingness to organise free and fair elections, in accordance with internationally recognised standards.

The fragmented opposition boycotted local elections in December 2004 but decided to participate in the November 2005 parliamentary polls. In preparation to these elections opposition is in the process of forming electoral blocs and is calling for changing the composition of the electoral commissions to ensure greater transparency of the electoral process.

### **Rule of law and human rights conditions**

The Government's human rights record is uneven and many problems have been reported. The Constitution envisages protection of fundamental human rights. Azerbaijan is party to most UN conventions on human rights, including the International Covenant on Civil and Political Rights and the Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment.

There are reports on the Government restricting freedom of assembly by turning down opposition requests for public demonstrations. There were also reported cases of restrictions of the freedom of association and freedom of expression through pressure on domestic media, human rights activists and NGOs.

According to the Human Rights Watch, the overall human rights situation in Azerbaijan has deteriorated in the last two years. Four major concerns identified by the NGO are the politically-motivated post-electoral trials, cases of state violence, the situation with political prisoners and pressure on the civil society organisations.

In a positive development the country's President issued a decree on 20 March 2005, adding to earlier presidential decrees, pardoning people imprisoned for criminal offences and in connection with public disturbances in the immediate aftermath of October 2003 presidential elections. Under the terms of amnesty 115 people have been released from prison, including all the leading representatives of the opposition political parties. The international community welcomed the decision as a step towards the re-establishment of political pluralism, upholding democratic values and encouragement of a dialogue with the opposition parties.

The Constitution and the laws of the country prohibit child and forced labour, although there were reports of incidents of forced labour. The Government has ratified the core ILO Conventions, including the Convention 182 on the elimination of the worst forms of child

labour. The US State Department's Trafficking in Persons Report of June 2004 designated Azerbaijan as a Tier 2 Watch List country, which means that the Government of Azerbaijan does not fully comply with the minimum standards for the elimination of trafficking in persons; however it is making significant efforts to do so.

Corruption remains a serious problem. According to the Transparency International's annual Corruption Perception Index Azerbaijan is traditionally ranked as having high levels of corruption. In 2004 the country ratified two Council of Europe's Conventions on Criminal and Civil Law Corruption respectively. In January 2005 a Law on Corruption entered into force.

In a resource-rich country such as Azerbaijan, revenue reporting is vital in combating corruption. In this respect, Azerbaijan took an important positive step by implementing the recommendations of the UK Government's Extractive Industries Transparency Initiative (EITI). It is hoped that greater transparency and accountability in the resource sector will enhance the country's democratic transition.

In the area of judicial reforms, the authorities are co-operating with the OSCE. A monitoring report of the OSCE/ODIHR in February 2005 identified a number of issues which need to be addressed. While Azerbaijan's laws included the rights required for a fair trial, actual legal proceedings are not always conducted in a manner that guarantees their full implementation. Law enforcement officials sometimes use excessive force in making arrests and the rights of persons in detention are not always adequately protected. Of particular concern are allegations of torture and ill treatment of detainees and that courts accepted evidence that had been derived through coercion.

### **Nagorno-Karabakh conflict**

More than a decade after the armed hostilities started, the conflict over the Nagorno-Karabakh remains unresolved. Upon their accession to the Council of Europe in January 2001 both Armenia and Azerbaijan committed themselves to use peaceful means for settling the conflict. However, no sizeable progress has been achieved since. The Minsk Group of the OSCE, co-chaired by the United States, France and Russia, continues to be the mediator of the conflict.

Lately, the United Nations, the Council of Europe and the EU have shown an increased interest in assisting to resolve the conflict. The EU Special Representative for South Caucasus is frequently visiting the region. In January 2005 the Parliamentary Assembly of the Council of Europe adopted a special resolution on Nagorno-Karabakh. The Assembly called on Armenia and Azerbaijan to actively cooperate with each other via the OSCE's Minsk Group for achieving a settlement. The Assembly stated that more than ten years after the conflict began considerable parts of the territory of Azerbaijan are still occupied by Armenian forces and that occupation of foreign territory by a member state was a grave violation of that state's obligations to the Council of Europe. The Assembly also called on Azerbaijan to establish contacts with the representatives of both communities from Nagorno-Karabakh regarding the future status of the region.

## **External relations**

Externally Azerbaijan is continuing to adhere to a well-established line of maintaining good relations with all its neighbours. This is dictated by a geo-strategic position of the country on the shores of the Caspian Sea with close proximity of Russia in the North and Iran and Turkey in the South. Azerbaijan maintains traditionally good relations with its immediate neighbour Georgia on which, in addition to Russia, it depends for transit of its oil and gas to world markets along the East-West corridor.

In June 2004 the EU offered Azerbaijan, Georgia and Armenia the opportunity to participate in the European Neighbourhood Policy (ENP). The ENP sets ambitious objectives for partnership with neighbouring countries and provides strong incentives for moving towards democracy, the rule of law and respect for human rights, and to political and economic reforms.

Azerbaijan continues its membership in the CIS, although it is not participating in its military security structures. Notwithstanding a consensus between Azerbaijan, Kazakhstan and Russia, the ongoing talks on the legal status of the Caspian Sea have not yet produced a final settlement involving agreement of all five littoral states, also including Iran and Turkmenistan. A second Caspian Summit of the Heads of States, which can achieve progress on the issue, does not yet have a firm date.

## Annex 4

### Legal Transition

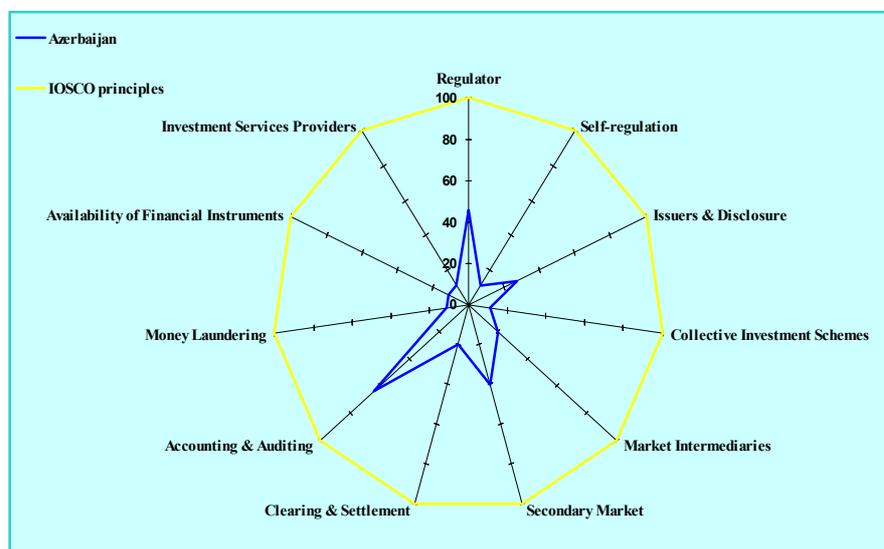
#### ASSESSMENT OF AZERBAIJAN’S COMMERCIAL LAWS

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of laws (also referred to as “effectiveness”). All available results of these assessments can be found at [www.ebrd.com/law](http://www.ebrd.com/law). This annex presents a summary of the results for Azerbaijan, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

#### Capital Markets

The primary law governing Azerbaijan’s securities markets is the “Law on Securities” which entered into force in 1998. The law lays down the basic framework for the issuance of securities and the secondary market organisation. In 2004, EBRD benchmarked the Azeri securities markets framework against the IOSCO Objectives and Principles of Securities Regulations (see chart below). The country scored “*very low compliance*” showing a situation under a critical need for reform.

#### Quality of securities market legislation –Azerbaijan (2004)



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO’s *Objectives and Principles for Securities Regulations*. The fuller the ‘web’, the closer the relevant securities market legislation of the country approximates these principles.

*Source:* EBRD Securities Market Legislation Assessment 2004

The State Committee for Securities under the Auspices of the President of Azerbaijan (the “SCS”) was created in 1998 and is the Azeri securities markets regulator. The regulator is responsible for the licensing and supervision of the issuers. It is entirely financed by the State budget with little operational independence. A stock exchange was established in Baku in 2000 albeit most of the transactions are concluded on the over the counter (OTC) market.<sup>1</sup>

<sup>1</sup> In 2003, transactions on the Baku Stock Exchange accounted for 3.45 Mln USD while on the OTC transactions accounted for 43.2 Mln USD.

The SCS can issue administrative sanctions but this is generally inadequate to discourage illegal behaviours.

Provisions on protection of minority shareholders and mandatory takeover bids exist but their interpretation is not clear. Requirements for licensing of collective investment schemes and sanctions against unlicensed solicitations are generally inadequate, while legislation on prospectus, disclosure and listing requirements needs to be improved. Rules on disclosure duties and segregation of assets are not clear and legislation on intermediaries' supervision and capital adequacy should be enhanced.

Rules on surveillance of the secondary market are poor and no investment protection measures or prudential requirements exist. Shares are not dematerialised, and securities clearance is not centralised. As a consequence, doubts arise on the delivery versus payment system in place. Only a few regulated and defined financial instruments are available and investment service providers are not specifically defined and regulated.

### **Company Law and Corporate Governance**

The corporate governance framework basically comprises the Law on Joint Stock Companies, enacted in August 1995 and amended both in 1996 and 1999, the Law on Enterprises, which entered into force in July 1994 and was amended in 1996, 1999 and 2001, the law "On Limited Liability Companies" which came into force in 1999, and the Civil Code which entered into force in September 2000 and was amended in 2003.

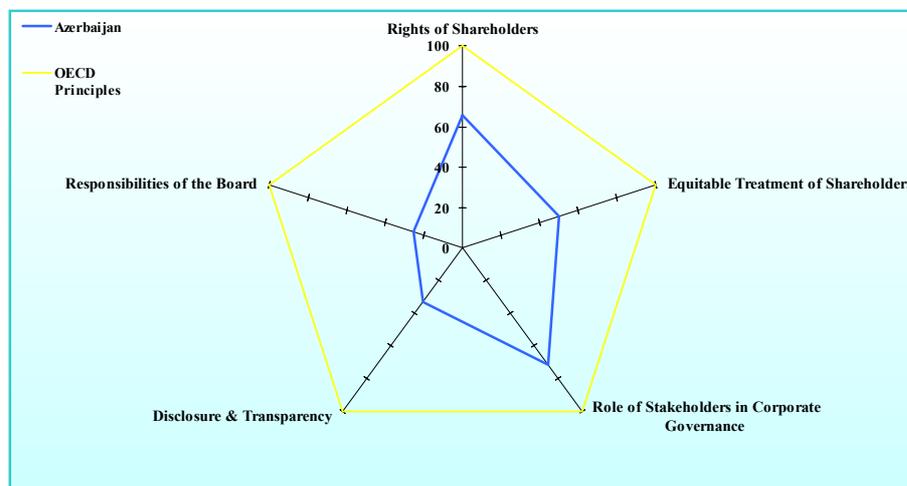
According to the Law on Enterprises, companies can be organised as state companies, individual companies, general partnerships, limited liability companies and joint stock companies. A joint stock company is defined as a company whose share capital is divided into shares. Upon registration at the Ministry of Justice, which acts as the state registration authority for legal entities, the company must register the issue of shares with the State Securities Committee.

Joint stock companies may be established as "open joint stock companies", where shareholders may dispose of their shares without the consent of other shareholders and shares are issued by public subscription or "closed joint stock companies" where shares are issued to the founders or to a specific group of persons. A supervisory council is obligatory in all cases where the company has more than 50 shareholders. Information on the companies' shareholding can be difficult to obtain. According to the State Committee for Securities, currently 232 joint stock companies have more than 100 shareholders.

In 2003, the EBRD Corporate Governance Sector Assessment compared corporate legislation in the Bank's 27 countries of operations with the OECD Principles of corporate governance. Azerbaijan was rated as being in "*very low compliance*" with those principles (see chart below). Among the various shortcomings, the law is silent on the requirement to maintain a share register and it is not clear whether the registration constitutes proof of ownership. Further, the law does not require shareholders to be notified and vote on amendments to the rights attached to a class of shares. While the law provides for a duty to disclose significant shareholdings, there are no sanctions in case of breach. Cross-shareholdings are not regulated and anti-takeover devices are not subject to shareholders scrutiny. The law also shows serious shortcomings with reference to the basic duties of directors and the standards for exercising their functions. Transparency and disclosure

requirements are problematic thereby making the law inadequate in protecting the company against self-dealing and conflict of interest issues.

### Quality of corporate governance legislation –Azerbaijan (2003)



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

*Source:* EBRD Corporate Governance Sector Assessment, 2003 assessment

With the aim of improving the Azeri corporate governance framework, a project is currently run by the International Finance Corporation, financed by the State Secretariat for Economic Affairs of Switzerland. The project specific goal is to improve corporate governance practices in joint stock companies, including commercial banks. The project started in 2004 and will last till 2007.

### Concessions

Azerbaijan does not have a general framework Concessions Act. Instead, the country takes a sector-by-sector approach in regulating concessions. The rights and obligations of concessionaires, as well as the nature of government regulation, vary sector by sector.

According to the Law on the Subsoil of 13 February 1998, licenses for exploration or mining of natural resources can be granted by an executive agency, on the basis of tender offers, auctions, or direct negotiations in special circumstances. The law aims to ensure everyone has an equal chance to obtain a mining license. The maximum term for a license is 25 years, extended to 30 if exploration is also involved. The fee and tax structure laid out in the law is overly complex, with fees established for granting the license, in addition to fees for participation in the tender, a special “mountain tax”, general taxes as well as contributions to a national fund for further exploration for extractable resources. Disputes arising under the law can be resolved by the executive agency, as well as in the courts. However, it may be difficult for investors to recoup losses caused by governmental mismanagement or wrongdoing, even following a victory in the courts, because damages are to be covered from the personal assets of individual transgressors.

The law On Power Stations of 28 December 1999 allows private entities, both domestic and foreign to build, renovate and operate power stations on the basis of special permission from the government. Permission to build a new plant is to be granted if the prospective operator can show a need for energy and also demonstrate that the projected output will be cheaper than that of existing sources. Permission must also be obtained for any changes in the regime of operation of a power station; however, stations operating on renewable resources

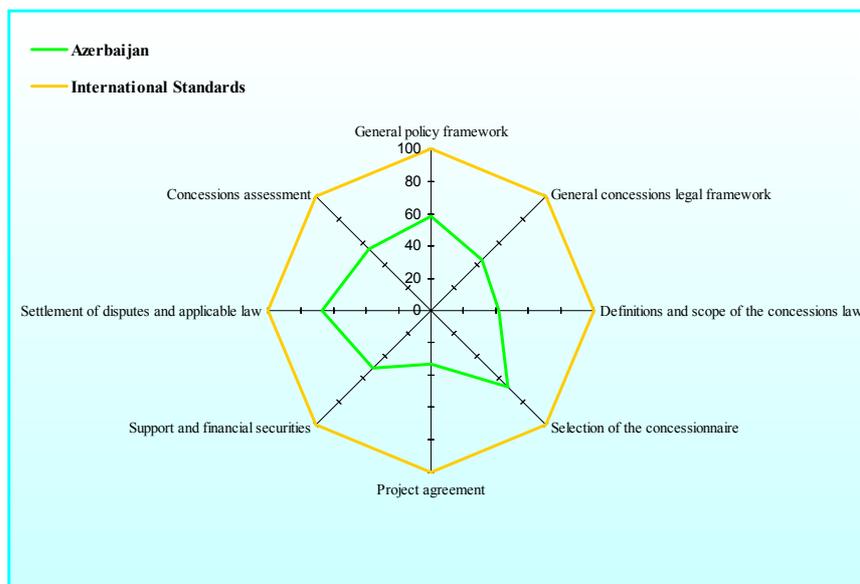
are exempt and subject to a more favourable and subsidised regime. Similar assistance is available for operators of plants deemed particularly important for national needs. The issue of eventual ownership of the plants remains unclear in the law.

The general tender procedure is regulated by the law On Tenders of 11 February 1997, as amended on 2 June 1999. Tenders are conducted by special tender committees. Tenders are usually open, but can be conducted as closed on the basis of invitations if the number of potential bidders is limited and known, if state security is involved, or, more vaguely, if funds for the tender are so earmarked. All else being equal, contracts are to be awarded to Azeri firms over foreigners. Participants who feel that the committee behaved illegally in its selection can appeal its decision in the courts.

Azerbaijan is currently developing a law on the oil and gas sector. This sector is currently governed by the general laws mentioned above as well as individual production sharing agreements which have the force of legislative acts upon ratification. The lack of a consistent legal framework for concessions weakens the effect of the otherwise quite well written and environmentally progressive individual laws.

The recent EBRD Concession Laws Assessment, undertaken to evaluate applicable regimes throughout the EBRD’s 27 countries of operations, (the law on the books only, rather than how they work in practice), revealed that the laws of Azerbaijan “*generally conform with internationally accepted principles of concessions laws*”. As can be seen from the chart below, while rules covering settlement of disputes in concession-related arrangements and selection of a concessionaire, for instance, are regulated fairly extensively, most other areas, in particular, the project agreement need dramatic improvement in order to meet the requirements of a modern legal framework facilitating private sector participation.

### Quality of concession legislation –Azerbaijan (2004)



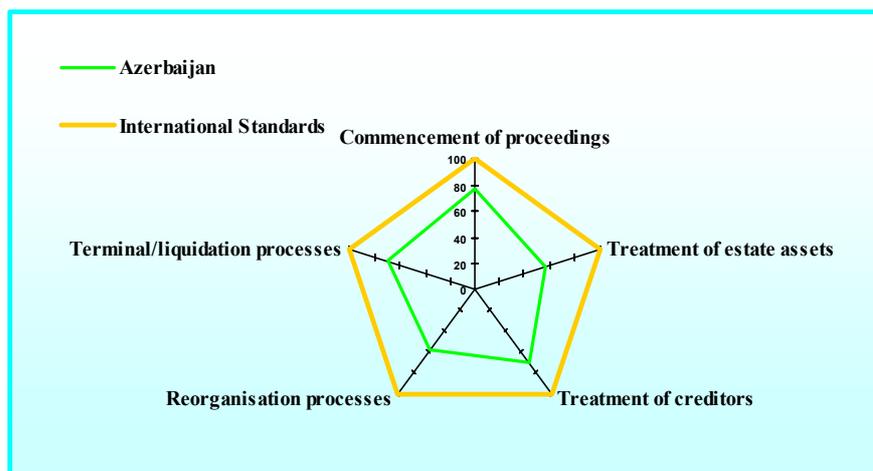
Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the ‘web’, the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2004

### Insolvency

Bankruptcy and insolvency are governed by the Law on Insolvency and Bankruptcy (as amended) (the “Insolvency Law”). This law scored “*low compliance*” when compared with international standards in the EBRD’s 2003 Insolvency Sector Assessment. The graph

below displays the data collected in this project and shows level of compliance of the Insolvency Law with international standards in five core areas:



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank’s Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on “Legislative Guidelines for Insolvency Law”, and others. The fuller the ‘web’, the more closely insolvency laws of the country approximate these standards.

*Source:* EBRD Insolvency Sector Assessment Project, 2003/4

As the above graph reveals, this law is deficient in many key areas of insolvency. Specifically, the Insolvency Law does not provide for a ‘balance sheet’ test for insolvency and does not provide expedited time limits within which an insolvency case must be heard by the court. In addition, the law’s provisions on the avoidance of suspicious pre-bankruptcy transactions are extremely vague and do not provide the necessary detail to create a predictable avoidance regime. As regards the unlawful disposal of property *after* the commencement of insolvency proceedings, the law is silent whereas it should provide for the speedy recovery of such property.

As is common in insolvency legislation in ETC countries, the Insolvency Law is particularly deficient in addressing the issue of reorganisation. At present, the reorganisation provisions amount to a composition to pay debts in full over a period of time. A meaningful reorganisation scheme, however, should allow for the compromising of obligations to facilitate recovery. Under the current scheme, virtually no ongoing financing during restructuring will be available and the percentage of creditor support required to approve a restructuring plan is too high. Both of these issues must be addressed. Finally, given Azerbaijan’s increasing business relationships with foreign countries, it would be worthwhile for the law to address the issue of cross-border insolvency proceedings (although, admittedly, this is not as pressing an issue as the other deficiencies discussed herein).

Although the insolvency law does contain some positive elements, such as the provision of a stay of proceedings once an insolvency case is opened and clear requirements for the qualification, appointment and removal of an insolvency administrator, there is some doubt as to whether these positive attributes can be positively implemented. The EBRD 2004 Legal Indicator Survey on Insolvency examined the ‘effectiveness’ (or how the law works in practise) of insolvency regimes in both creditor-initiated insolvencies (looking at 8 different factors) and debtor-initiated insolvencies (looking at 10 different factors). In particular, the effectiveness of the regime as it relates to the commencement of insolvency proceedings and the granting of an initial insolvency court order (sometimes called the “effective final order”) was measured. The results of the survey clearly show that the practical application of the insolvency law is likely to be unduly expensive and overly complex. In addition, the results

of the survey show that the predictability and competence of judges hearing bankruptcy cases is fairly unreliable and that, in the case of creditors, the requirements to commence an insolvency proceeding against a recalcitrant debtor are needlessly formalistic.

All of these factors, together with the law's deficiencies, militate against the insolvency regime functioning properly as a 'stick' to induce debtors to act in good faith and as a 'carrot' to induce insolvency debtors, with businesses that are fundamentally viable, to try to promote the rescue of such businesses.

### **Secured Transactions**

Taking security over property in Azerbaijan is severely hindered by the confusion over different legal provisions that apply without clear co-ordination among them, as well as the lack of functioning institutions. Recent amendments have compounded the problem and users are suffering from lack of clarity and certainty. Without comprehensive and thorough reforms, it is difficult to see how the secured credit market can further develop.

Security rights over movable and immovable assets in Azerbaijan are primarily governed by the 1999 Civil Code, which entered into force on 1 September 2001. The Civil Code has not repealed the Pledge Law of 19 August 1998, which in principle is still applicable to the extent that it does not contradict the Civil Code provisions. Yet these provisions cannot be reconciled as their respective approach is very different. The Civil Code draws a fundamental distinction between pledges and mortgages:

- Pledges can be of various nature: the charged assets being given in possession to the creditor (this is called "pawn") or not (this is valid in the case of a pledge of "goods in circulation"), they can cover intangible assets (e.g. account receivables). The main point is that pledges are mostly not registered.
- Mortgages must be registered in the relevant official registry. For movable assets, this refers to existing asset-based registries, such as motor vehicles registry, ship registry, etc.

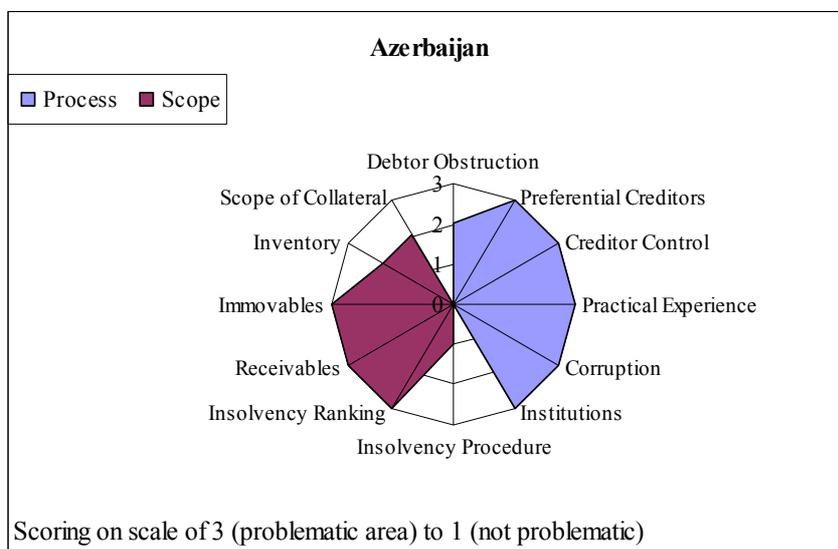
In contrast, the 1998 Pledge Law envisages a much more general mode of registration for all sorts of "mortgages" (including an enterprise mortgage), a pledge being only a security in which possession of the asset was transferred to the creditor. It is thus difficult to see how the Pledge Law can remain applicable when its fundamental concepts clash with those of the Civil Code.

Beyond the question of which types of security must be registered, the Civil Code does not comprise a number of positive features, which figured in the Pledge Law: for example, the possibility to take a mortgage over the whole or part of a business/enterprise; the possibility to charge assets that would be generally described or future in the charging agreement; the possibility for the charger to sell some of the charged assets in the ordinary course of business with the acquirer acquiring them free from the charge (essential if a charge is taken over the whole enterprise); and the possibility for the charge holder in case of default of the charger to take possession of the charged assets.

In a survey conducted by the EBRD in 2003 on enforcement of a charge over a piece of equipment, Azerbaijan's legal regime was among the least efficient, allowing the secured creditor to recover little of its secured debt, after a lengthy and complex procedure. As the graph below shows, almost all aspects of the enforcement process present difficulties, and

the results would be identically mediocre should the scope of enforcement differ (e.g. in case of the debtor’s insolvency or where the collateral would be real estate).

### Obstacles to charge enforcement process –Azerbaijan (2003)



*Note:* The fuller the half moons, the more serious the problems are in each of the respective categories. “Process” factors measure the impact of specific incidences on the enforcement proceedings. “Scope” factors relate to the ability of the system to deal with specific situations or items.

*Source:* EBRD Legal Indicator Survey 2003

As far as real estate is concerned, some steps were taken to try to improve the registration system by providing for the unification and rationalisation of all existing registries: the situation in Azerbaijan (like in effect in many of the CIS countries) is that registration of immovable property is scattered between various institutions.

In 2003, a Presidential decree appointed the Ministry of Economic Development for operating a State Immovable Property Registry. Some work was undertaken but in February 2005, a new decree moved once again this function, this time to the Cabinet of Ministers’ level. Meanwhile, the 2003 reform has prohibited notaries from notarising any documents for the transfer or ancillary rights (such as mortgages) over property which has not been previously registered in the (presently non-existent) State Immovable Registry. This reform, relying on a non-existent institution, had created a legal deadlock, preventing transactions (such as mortgages but also transfer of title) to take place as the law intends it.

It is clear from the above that the government urgently needs to take steps to address these problems: one recommendation is to consider the creation of a central registry for charges over movable (tangible and intangible property) which would be debtor-based, as opposed to asset-based. Such registry would allow all charges created by that debtor (individual or legal entity) to be filed, thereby ensuring publicity of such charge and establishing creditors’ ranking order. This is what EBRD has been promoting for many years (including when it worked in Azerbaijan) and helped setting up such systems in a number of countries, including Hungary, Slovakia, Latvia, etc. Such system was provided in the 1998 Pledge Law provided but was never put in place. It seems that the Asian Development Bank is currently considering providing technical assistance in this respect in the context of supporting the development of micro and SME finance.

Regarding real estate, EBRD is currently providing technical assistance to the Ministry of Economic Development for the creation of a system for registering mortgages, which would be comprehensive, efficient and transparent. A mortgage registry would enable mortgages to

be registered over any type of property (including buildings in construction) in a single, unified place, and the information to be fully accessible by anyone. Being a transaction-only publicity system, the mortgages registry would only provide lenders full publicity of their security rights without directly addressing the underlying issue of title (or other rights) over the property. The mortgage registry, however, would guarantee the publicity and priority of the registered mortgage.

Further work will also be needed to review the foreclosure, protection and realisation of the charged assets in the view to maximise the return lenders are likely to receive after completion of the process, in particular to allow direct sale (i.e. not public auction) to take place and allow out-of-court enforcement to be conducted for all types of charges.

## **Telecommunications**

The telecommunications sector in Azerbaijan is currently governed by the Telecommunications Law of 1997 (the “1997 Telecom Law”) and is regulated by the Ministry of Communications and Information Technology (MCIT). MCIT was established in February 2004, replacing the Ministry of Telecommunications as telecom sector policy-maker and regulator. MCIT also maintains the state shareholding in both dominant incumbent Aztelecom and alternative operators. The 1997 law has since been bypassed by the significant sector developments since enactment. While a number of competitors to Aztelecom have emerged, the government's failure to introduce the necessary liberalisation framework has stifled competition.

Aztelecom remains wholly state-owned, with no apparent movement on privatisation of state holdings. The authorities, mostly through MCIT, currently keep a tight control over the sector through requiring telecom operators be joint venture with the government. This requirement, together with MCIT’s conflicting role as regulator and policy-maker significantly distorts the market and arguably leaves commercial operations hostage to political agendas. The government has previously indicated an intention, on a number of occasions, to reduce its participation in operations through privatisation. Unfortunately, little activity of substance appears to be taking place in this regard. Aztelecom dominates the fixed-line market, with competitive operators making little impact, particularly so given that the state controls stakes in most if not all competitors.

Fixed network penetration levels in Azerbaijan are low (c. 12%) with much network infrastructure remaining from the old Soviet system, in urgent need of replacement. telephone equipment that is technologically outdated, a lack of telephone lines for residential use, and inadequate connections to many rural locations. Digitisation of the nation’s telephone lines has yet to reach meaningful levels. The government has adopted programmes to deal with network upgrade and expansion, including MCIT’s “Plan for Development of Telecommunications by the year 2010”. Unfortunately, progress to date has been slow.

Limited availability of fixed-line network, coupled with poor quality of those connections available has a significant increase in the number and use of mobile phones. Mobile penetration rates stood at 17% in mid 2004, an almost three-fold increase since 2001. Competition, however, is limited with only two operators in the market, Azercell and Bakcell, with Azercell dominating the market.

The government has so far largely failed to facilitate the development of a modern competitive telecoms sector. The persistent conflicts present in MCIT’s role as policymaker, regulator and

sector shareholder, allied to the government's wavering commitment to privatisation, continues to stymie sector growth and significantly retard the development of Azerbaijan's telecoms sector. The absence of a proper international standard primary legislative framework and appropriate secondary legislation makes it unlikely that meaningful competition will emerge. Despite the entrance of a number of alternative operators on the market, competition has been limited due to state control over infrastructure and tendency to levy high interconnection fees. In practice, the fundamental absence of an independent regulator hinders the opening-up of the telecommunications sector. Accordingly, the government should act immediately to address the state's conflicting role by enhancing MCIT's role as sector policymaker, establishing an independent sector specific regulatory authority and committing to a precise and definitive timetable for a transparent process from privatisation of key state shareholdings in the telecoms sector. In tandem with these actions, the government should begin to immediately revise the legislative framework sufficiently to reflect international best practice and implement the necessary secondary legislation to support individual frameworks for interconnection, licensing, tariff setting and universal service.

## **Annex 5**

### **Environmental Condition**

#### **Background**

Azerbaijan's National Environmental Action Plan (NEAP) developed from 1996 to 1998 identified the following key environmental issues: industrial pollution resulting mainly from oil exploration and production as well as energy generation; losses in biodiversity including collapse of the sturgeon stock; deteriorating water quality, especially drinking water in both urban and rural areas; loss of agricultural lands from erosion, salinization, pollution with heavy metal and chemicals, and damages to the Caspian coastal zone by flooding from a rise in sea level and pollution. Azerbaijan inherited large-scale and complex environmental issues from the previous regime and has begun to tackle them. The Performance Review Report (2003) by the United Nations Economic Commission for Europe (UNECE) assesses the country as follows: (i) the NEAP brought larger environmental policy consensus among stakeholders although approximately only 20 % of the activities listed in the NEAP were implemented in the five-year period of the NEAP due to insufficient financing and planning; and (ii) Azerbaijan improved environmental protection systems by updating the environmental legal framework and establishing the Ministry of Ecology and Natural Resources in 2001 although further work is still needed including additional development of law on environmental impact assessment. The EU Tacis Indicative Program for Azerbaijan 2004-2006 also confirms the country's need for further improvement in environmental management to implement environmental legislation through capacity building for the Ministry of Ecology and Natural Resources and other relevant institutions.

#### **Bank's environmental approaches**

During the next two years that the Country Strategy covers, the Bank will continue to take account potential environmental impacts associated with the Bank's extensive involvement in the natural resources sector in Azerbaijan and the Caspian region in general. In addition the Bank will endeavour to focus upon institutional capacity building in discussion with the competent authorities. In the natural resources sector, EBRD has been involved in several large projects in Azerbaijan including the Azeri, Chirag Gunashli (ACG) offshore oil production project and the associated Baku Tbilisi Ceyhan (BTC) oil export pipeline, the Shah Deniz offshore gas production and South Caucasus Pipeline for the export of this gas. These projects have a strict environmental compliance and monitoring regime summarised on the project websites. In addition, an Independent Environmental Consultant has been retained to monitor compliance with project commitments. This monitoring occurs quarterly, and results of this are also made available to the general public on the following web address <http://www.caspiandevlopmentandexport.com/ASP/Home.asp>.

In terms of capacity building, EBRD is currently implementing its Technical Cooperation initiative aimed at developing Azerbaijan's National Oil Spill Contingency Plan in line with relevant international conventions (MARPOL 73/78, OPRC 90). EBRD and the Ministry of the Ecology and Natural Resources of Azerbaijan, the Beneficiary of the project, are currently in the process of organising a Roundtable with the participation of governmental departments, state-owned oil and shipping industry and international operators present in Azerbaijan to discuss and develop the structure, composition and functions of the future National Oil Spill Planning Committee. It is expected that a draft national Oil Spill

Contingency Plan will be presented to stakeholders in a formal workshop to be held in August 2005 in Baku.

In order to support regional efforts for environmental preservation of the Caspian Sea, from 2001 to 2003, the Bank worked with the United Nations Economic Commission for Europe (UNECE), the United Nations Environment Programme (UNEP), the Caspian Environment Programme (CEP) and the five littoral states of the Caspian (Azerbaijan, the Islamic Republic of Iran, Kazakhstan, Russia, Turkmenistan) to develop guidelines and procedures for projects with transboundary impacts. A second phase of the project is currently being discussed by UNEP, which would involve training of local environmental authorities and involvement of NGOs. In November 2004, Representatives of CEP and bilateral and multilateral organizations including EBRD and the World Bank, business and NGOs gathered for the Caspian Environment Program Investment and Donor's Forum and discussed investment and technical assistance priorities in Baku. The Bank will continue its support for the regional effort in co-operation with other international and bilateral organizations. Among other institutions, the World Bank places the environmental sector as one of the priorities in Azerbaijan by implementing the irrigation management improvement project, Baku water supply project, urgent environmental investment project and cultural heritage project. EU Tacis has been supporting CEP together with GEF and UNDP to promote ecologically sustainable management of the Caspian environment.

In consideration of the above issues and the role of other IFI and the partners are playing, EBRD will pursue three main approaches with respect to environmental issues. Firstly robust environmental monitoring and enforcement of environmental requirements on existing projects. Secondly new projects in Azerbaijan will continue to be subject to the Bank's Environmental Procedures and Public Information Policy and incorporate, where appropriate, EAPs into the legal documentation in order to address issues raised during due diligence, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects. Thirdly, the Bank will work with other international organisations and government agencies as appropriate to strengthen Azerbaijan's capacities with respect to environmental management.

### **Social dimension**

Whilst the natural resources sector has brought benefits to Azerbaijan, as shown by the robust economic performance, the distribution of the project-related benefits has not been equal throughout the population. In rural areas access to basic infrastructure (water, power, transportation, health care and education) has deteriorated and in many cases become inadequate. There are groups of the population who have become particularly vulnerable; these include the elderly, former employees of state companies, people with disabilities and farmers in areas where there are water shortages. In areas where there are considerable numbers of Internally Displaced Persons (IDPs) and refugees (another vulnerable group), there have at least been concentrated attempts by NGOs to improve infrastructure and restore basic services for communities, whereas this has not been the case in other places. Azerbaijan is also a country where it is difficult for NGOs to register and to operate. The operational priorities can provide opportunities for EBRD to address issues of alleviating poverty and enabling a broader section of the population to benefit from the economic growth.

With respect to the operational objective of non-oil private sector development, EBRD will work with its sponsors and partners to implement core labour standards so as to prevent any adverse impacts and maximise the potential socio-economic benefits to be enjoyed. With respect to infrastructure projects, the Bank will seek to ensure that not only is access for the poor and vulnerable improved, but also that affordability issues are addressed. The Bank will also work with our sponsors, partners, NGOs and the government as appropriate to enhance the distribution of project benefits to project affected persons and communities. This will be implemented by not only increasing employment opportunities with the project company and local suppliers and partners, but also through ancillary and associated community development projects.

## Annex 6

### Selected Economic Indicators

	1999	2000	2001	2002	2003	2004 <i>Estimate</i>	2005 <i>Projection</i>
<b>Output and expenditure</b> <i>(Percentage change in real terms)</i>							
GDP	7.9	10.3	9.6	9.7	10.8	10.0	21.0
Industrial gross output <sup>1</sup>	3.5	6.8	5.2	3.6	6.1	5.7	na
Agricultural gross output	7.0	12.1	11.1	6.4	na	na	na
<b>Employment</b> <i>(Percentage change)</i>							
Labour force (end-year)	0.1	0.0	0.4	0.4	0.6	na	na
Employment (end-year)	0.1	-0.1	0.3	0.3	0.5	na	na
			<i>(In per cent of labour force)</i>				
Unemployment (end-year)	1.1	1.1	1.3	1.3	1.4	na	na
<b>Prices and wages</b> <i>(Percentage change)</i>							
Consumer prices (annual average)	-8.5	1.8	1.5	2.8	2.2	6.8	5.0
Consumer prices (end-year)	-0.5	2.2	1.5	3.3	3.6	10.5	5.8
Producer prices (annual average)	-6.1	27.4	na	na	na	na	na
Producer prices (end-year)	17.9	14.5	-4.4	-5.2	11.2	na	na
Gross average monthly earnings in economy (annual average)	9.5	20.2	17.3	21.2	22.8	24.9	na
<b>Government sector</b> <i>(In per cent of GDP)</i>							
General government balance <sup>2</sup>	-4.7	-0.6	-0.4	-0.5	-1.2	0.8	2.2
General government expenditure	23.6	20.8	18.7	27.7	28.9	26.3	na
General government debt	24.2	25.7	25.5	23.5	24.5	21.3	na
<b>Monetary sector</b> <i>(Percentage change)</i>							
Broad money (M2, end-year)	8.7	27.1	31.8	43.7	4.5	33.6	na
Domestic credit (end-year)	-10.4	13.5	-38.1	84.2	27.1	34.1	na
			<i>(In per cent of GDP)</i>				
Broad money (M2, end-year)	10.9	11.0	12.9	16.3	14.7	16.3	na
<b>Interest and exchange rates</b> <i>(In per cent per annum, end-year)</i>							
Refinance rate (6 months)	10.0	10.0	10.0	7.0	7.0	7.0	na
Interbank interest rate (3 months) <sup>3</sup>	20.5	22.5	19.8	19.7	20.3	na	na
Deposit rate	11.4	12.9	8.5	8.7	9.5	na	na
Lending rate	17.9	19.7	19.7	17.4	15.5	na	na
			<i>(Manats per US dollar)</i>				
Exchange rate (end-year)	4,378.0	4,565.0	4,775.0	4,893.0	4,923.0	4,903.0	na
Exchange rate (annual average)	4,120.2	4,474.2	4,656.6	4,860.8	4,910.7	4,913.5	na
<b>External sector</b> <i>(In millions of US dollars)</i>							
Current account	-600	-187	-49	-770	-2,020	-2,331	-721
Trade balance	-408	260	581	482	-98	271	1,405
Merchandise exports	1,025	1,799	2,046	2,305	2,625	3,718	5,079
Merchandise imports	1,433	1,539	1,465	1,823	2,723	3,447	3,674
Foreign direct investment, net	510	149	299	1,048	2,353	2,531	1,282
Gross reserves, excluding gold (end-year) <sup>4</sup>	673	680	725	721	803	923	na
External debt stock	870	1,282	1,270	1,398	1,507	1,746	na
			<i>(In months of imports of goods and services)</i>				
Gross reserves, excluding gold (end-year)	4.2	4.0	4.1	2.8	2.0	1.8	na
			<i>(In per cent of exports of goods and services)</i>				
Debt service	6.7	8.8	5.7	7.0	8.0	6.0	na

<b>Memorandum items</b>	<i>(Denominations as indicated)</i>						
Population (end-year, million)	8.0	8.0	8.1	8.2	8.3	8.3	na
GDP (in billions of manats)	18,875	23,591	26,578	30,312	35,054	42,246	53,929
GDP per capita (in US dollar) <sup>5</sup>	571	659	705	760	864	1,041	na
Share of industry in GDP (in per cent)	22.2	36.0	37.6	34.9	31.9	na	na
Share of agriculture in GDP (in per cent)	18.2	15.9	14.8	13.8	12.9	na	na
Current account/GDP (in per cent)	-13.1	-3.5	-0.9	-12.3	-28.3	-27.1	-6.6
External debt - reserves (in USD million)	197	602	545	677	704	823	na
External debt/GDP (in per cent)	19.0	24.3	22.3	22.4	21.1	20.3	na
External debt/exports of goods and services (in per cent)	67.9	62.3	54.4	52.4	49.3	41.5	na

<sup>1</sup> Industrial output excludes crude oil production.

<sup>2</sup> General government consolidates all levels of government, except for municipalities and state-owned enterprises, and includes the State Oil Fund and other extra-budgetary funds.

<sup>3</sup> 90-day interbank offer rate in manats, nominal.

<sup>4</sup> By end-December 2004 there were additional foreign exchange assets of approximately USD 970 million in the State Oil Fund.

<sup>5</sup> An improved method of calculating value-added in the oil sector has led to a sharp upward revision in nominal GDP and related variables for 2000 relative to previous estimates.

