

CONCLUSION

**by the ITEI Coalition of civil society institutions
on the (5th) report by the Government Commission on the results of the first six
months of 2006 in the framework of the Extractive Industry Transparency
Initiative**

April 27, 2007

The ITEI Coalition of civil society institutions considers the release of the results of the audit on the 5th report an important development and an essential step, which the Government of Azerbaijan and the country-active oil & gas companies have jointly taken forward to increase transparency in the extractive industry. The Coalition is pleased to announce that some of its proposals stemming from the 4th report have been taken into consideration, thereby having a positive effect on the qualitative aspects of the final wording of the document. Meanwhile, The ITEI Commission, as a party to the memorandum which was signed along with the Government Commission and oil companies, has arrived at the following conclusions upon an independent analysis of the results of the audit concerning the 5th report:

1. An increase in the amount of capital expenditures applies an axe to the corresponding incomes of Azerbaijan

An insight into the auditor's conclusion lead to the forming of an opinion that the commencement of the comprehensive oil development stage, consequently, the expansion of the production as well as the amount of the profit oil has resulted in a strong influx of petrodollars. In the auditor's conclusion on the results of the first six months of 2006, the Government's share in the profit oil turnout was 8.779 million barrels, slightly more than twice the corresponding performance a year ago (4.3 million barrels). However, the Coalition concludes that the growth pace could have been even higher.

Under the Contract of the Century, for every period of payment (calendar quarter), operating costs are deducted from the market value of the production during the reporting period. Afterwards, half of the remaining amount of crude oil is spent on covering capital expenditures, while the latter half constitutes what is known as profit oil and is shared between the Government of Azerbaijan and partner oil companies. The approval of the ratio of distribution – 30 per cent versus 70 percent or 45 per cent versus 55 per cent or 80 per cent versus 20 per cent – depends on the corresponding financial performance of foreign partners. For the time being, the Government of Azerbaijan gets 30 per cent of the produced crude oil output, with the remaining 70 per cent retained by foreign partners. Therefore, an increase in the amount of capital expenditures keeps Azerbaijan off the introduction of the distribution scheme in the proportion of 45 per cent versus 55 per cent, and ultimately, scales down the amount of incomes of our country from the project.

Out of the total crude oil production of the Azerbaijan International Operating Company over the latest reporting period, the Government of Azerbaijan has been transferred just 8.779 million barrels in profit oil, or 12 per cent, and that – according to another piece of information by the Oil Fund – has translated into the money equivalent of 414.3 million U.S. dollars only.

Still slightly more than half of the production goes off to cover capital and operating expenditures, while the remaining output – 20.5 million barrels – has fallen to the share of the profit oil of foreign partners.

Having concerned over the degree of an increase in the amount of capital expenditures and, correspondingly, an extension of the period of recoupment, the ITEI Coalition of civil society institutions would like to remind that the total cost of the project has risen substantially, from 8 billion U.S. dollars announced at the time when the signing of the Contract of the Century (ACG project) marked a new dawn in history of the country, up to the undisputable 14 billion U.S. dollars nowadays. Experts substantiate such a major ‘increment’ by mismatches in the calculations of the equipment and machinery as well as the expected capital expenditures in certain areas of operation, and a significant delay in the commencement of the phase of production in general. However, in addition to these reasons, an assumption of the overestimation is unlikely proving difficult.

An interesting thing is that since the implementation of the Contract of the Century, the amount of operating expenditures has worked out to less than expected. This fact also gives rise to certain doubts, given that the operating expenditures are mainly generated in Azerbaijan while the origin of capital expenses is linked to overseas activities.

As a matter of fact, the unravelled findings refer to the necessity of taking strict control of capital expenditures. Under the provisions of the Contract of the Century, this control is a matter of responsibility of the State Oil Company of the Azerbaijan Republic (SOCAR). However, SOCAR’s dual status – on the one hand, the company acts on behalf of the customer, the Government of Azerbaijan, while on the other hand, it is among the shareholders who are in charge of the implementation of the project – remains as a cause of the conflict of interests.

To scrutinize the reasons for substantial increase in the amount of capital expenditures, it appears to be expedient to set up a trilateral commission to be composed of representatives from the Government, Azerbaijan International Operating Company, and the Coalition. So the Coalition hopes that the Government Commission and AIOC will carefully consider this proposal.

2. Reporting system at SOCAR and the amount of payments by the company to the Government of Azerbaijan are of contradictory nature

An analysis of the auditor’s conclusion on the 5th report has shown that the information on contributions from local companies to the Government of Azerbaijan still has points of controversy. It has been indicated in the report that over the first six months of 2006, the total amount of contributions from local companies – remittances by SOCAR and Joint Ventures, in which the company has an interest and who are signatories to the Memorandum of Understanding and operate in the country, to the Government of Azerbaijan in the framework of production activities – have constituted 403.6 million manats, down by 119 million manats from the corresponding figure last

year (595.4 million manats). Meanwhile, since the outset of 2006, the amount of payments from local companies to the Government of Azerbaijan has more than tripled. To the same point, throughout 2005 the companies were not subject to profit tax in the framework of the ACG agreement, while the year of 2006 has started with the imposition of this levy on project shareholders, including SOCAR. Notwithstanding with this fact, the report-included amount of the paid profit tax is called in question. Over the first half of 2006, local companies have reportedly paid 11.6 million manats in profit tax, up just 3.1 million manats as compared to the corresponding figure of the last year (8.5 million manats). A point of concern is that SOCAR as a company with a 10-percent interest in the ACG project should have paid about 23.6 million manats in profit tax, given that foreign partners who retain the remaining 90 per cent of shares in the same project have met their corresponding levy obligations to the amount of 213 million manats. Remaining open is the question as to how the difference of 15 million manats can be explained.

As to other taxes, to be paid, certain points can be called in question as well; therefore, the Coalition hopes that SOCAR will clarify all the notes taken.

3. A feeling of regret for late-as-expected submission of EITI reports

The commitments hopes that a solution to the problems with the later-than-expected release of the report, which is a clear manifestation of systematic and continuous fulfilment of the commitments on the Extractive Industry Transparency Initiative, will be found out shortly afterwards, so that the next report will be submitted in the timeframe prescribed in the Memorandum of Understanding. Though BP-TNK of the Russian Federation, who yet have not joined the EITI, regularly post the information on all kinds of revenues (tax payments, net profit and other performance indicators).

4. Access to the analytical information on company activities remains a problem

Release of company reports on an individual basis creates difficulties in identifying the company who are faulty of the divergence of figures in the auditor's conclusion. From another viewpoint, the fact that the letters of enquiries which the ITEI Coalition of civil society institutions has addressed to BP and SOCAR remain unanswered redoubles the corresponding concerns. The failure to respond to the letters which the Coalition has addressed to the above-mentioned companies is submitted for consideration to the public in the context of the violation of the provisions of the Azerbaijan Republic law on "Data accessing."

The ITEI Coalition of civil society institutions recommends the following suggestions be taken into consideration with respect to the 5th report by the Government in the framework of the Initiative:

1. Proceeding from the requirements of the Memorandum of Understanding, a new format of discussions must get the go-ahead in order to refine the existing reporting system;

2. The Government Commission and ITEI Coalition of civil society institutions should enlarge the room for initiatives in order to ensure the submission of company reports on an individual basis;
3. With the purpose of the preparation of the auditor's conclusion, a competitive tender environment must be ensured so that other respectful audit companies will get involved in it;
4. The staff must receive training on the ways of dealing with the accidental problems in the reporting system of companies;
5. SOCAR's dual status must be terminated. Given that the company is a shareholder in oil contracts, another competent agency must be transferred the right of acting on behalf of the Government in the same projects. In this case, the corresponding changes must be made in the already signed oil agreements.