

OPINION

of the NGO Coalition “To Improve Transparency in the Extractive Industry” concerning a report by AGN MAK Azerbaijan Ltd¹ auditing company within the framework of the Extractive Industry Transparency Initiative (EITI) released on January 16, 2006

The Coalition is giving a positive assessment to the joint efforts of the Azerbaijani Government and local and foreign petroleum companies active in the country for their commitment to the principles of the EITI launched in London in 2003 and the consistency and continuity of the initiative in Azerbaijan. It is thanks to these efforts that the results of the third audit have been released.

The Coalition is also grateful to AGN MAK Azerbaijan Ltd which performed the audit. The previous two audits were conducted by Deloitte and Touche. The Coalition believes that it is necessary to practice the attraction of new auditing companies and the Coalition tried to be objective to the maximum extent possible by taking part in the process of selecting this company.

An important component of the report at issue is that for the first time since the process of submitting reports started, it has been joined by all oil companies, including Japanese INPEX which earlier remained uninvolved in the process. Thus, the involvement of all companies in the process of preparing reports has done away with the incompleteness of the previous reports.

The Coalition regards as successful the progress made in the report for the six months of 2005 in comparison with the previous period. Namely, the report now contains associated gas data provided by companies and how they correspond to the figures indicated in the government’s report.

At the same time, the report fully exposed a number of fundamental problems. The Coalition believes it is important to point to these problems and take specific measures together with the Government Commission to eliminate them.

1. As it could have been expected, over the accounting period the main source of government revenues from the activities of petroleum companies was the national share in the profit oil produced as part of Production Sharing Agreements (PSAs). According to the government’s report, this share made up a total of 4.3 m barrels of oil. However, according to reports submitted by companies, the share of the state over the accounting period was 5.7 m barrels (see Table 1). As is evident, the discrepancy is pretty large. The auditing company explained that a portion of this difference– 1.033 m barrels of crude oil, was delivered by companies to the government on June 12, 2005, but SOCAR submitted that information to the government commission in July, i.e. after it was sold. This is how the absence of the oil in the report was explained. Please note that the said portion of oil was handed over to the government 18 days before the end of the accounting period, which is a long enough period for information to find its way to the government’s report. The government’s assurances that this is more of a technical issue which can be explained by objective reasons and the accounting term of “product en route” seem

¹ http://www.oilfund.az/reports/rep_az/sofaz_report_az.pdf

rather unconvincing because the reports of the government and companies indicate the share of the state in the profit oil not in value terms but in kind. The Coalition believes that the discrepancies in the reports has been caused by the fact that SOCAR did not immediately inform the Government Commission of the oil received from the contractor. And this is the result of either official negligence or the absence of appropriate legal documentation and instructions. In both cases it is necessary for the government to take certain measures. In fact, it might be worth reiterating the question which surfaced in the past too: why the revenues shown in the second line of that column aren't indicated in value terms ? As citizens of Azerbaijan we would like to know not only how much profit oil our state has received, but also, more importantly, what the revenues of the state are in monetary terms. Given the volatile oil prices, this issue is particularly important;

2. Another example of discrepancy related to the share of the state in the profit oil – 0.325 m barrels – has to do with the fact that SOCAR is using (According to the explanation of the auditing company) this oil to fill the BTC pipeline. It would be interesting to know on whose books this oil will eventually be reflected and what will happen to it. Therefore, it appears that SOCAR, which is disposing of the oil owned by the state, for some reason did not inform the Government Commission in good time. And this, as mentioned above, is either the illustration of official negligence or the absence of appropriate documentation and instructions.
3. And finally, the fate of 0.017 m barrels of oil is attributed to a complimentary handover of this portion of oil to SOCAR by a foreign company which did not wish to reveal its name. For some reason it is thought that this oil has no bearing to the government. This seemingly easy question is actually only a visible part of a more serious issue – the dual role SOCAR plays in contracts. We will look at the issue later on in this analysis.
4. The discrepancy in transit payments indicated by the government and oil companies is also obvious. For instance, whereas the government says that over the accounting period transit payments were \$8.77m, oil companies point to a figure of \$8.3m. According to the auditor, the discrepancy of \$500,000 was caused by two factors. On the one hand, the payment of \$0.8m for the transit through the Northern Route Export Pipeline was paid not to the government but to SOCAR as a payment for its services. And this, as mentioned above, is explained by the dual role of SOCAR. On the other hand, the fee for transit through the Western Route Export Pipeline in the amount of \$1.28m is connected with the time factor and was indicated by oil companies in the report for 2004.

Against the backdrop of problems in foreign companies' payments to the government, the work of local companies seems even more contradictory and controversial. From this standpoint, revenues on different taxes look very interesting.

1. Over the accounting period, local companies (the list includes SOCAR and three joint ventures: JV Anshad Petrol, JV Shirvan Oil and JV Azgerneft) have paid a profit tax in the amount of 42.7 billion manats, which is a far cry from 2004. We recall that in 2004 local companies paid profit taxes to the government to the tune of 333.7 billion manats². We have to acknowledge that the available data reflects tax

² <http://www.oilfund.az/doc/aze2004.pdf>

payments for six months of 2005, but still they are too low, which causes a great deal of suspicion with regard to the existing accounting system at SOCAR.

2. A similar picture is observed with royalty. Whereas in 2004 a total of 1 trillion 961,2 billion manats³ was paid to the government, in six months of 2005 the figure stands at just 195.9 billion manats.
3. Other taxes (VAT, excises, land tax, property tax, etc.) paid to the government by local companies, in the amount of 357 billion manats, seem more credible when compared with the data for 2004 (820 billion manats⁴).

It would also be interesting to compare the revenues reflected in the report with total tax payments by SOCAR. We recall that SOCAR's payments within the EITI framework reflect only production indicators and those of refining and other company subdivisions are not included. Therefore, SOCAR's total tax payments are naturally higher than the economic indicators in the extractive industry. On the other hand, if we take into account that EITI reports are not only the reports of SOCAR but all local companies, the picture becomes even more complicated.

Despite all this, the examples below clearly show that the company's activities are not transparent and that it is still too far away from a commercial status.

For example, while the report says that the royalty tax paid by local companies to the government in six months of 2005 totaled 195.9 billion manats, SOCAR paid the government 205.4 billion manats⁵ in royalty over the same period. This means that the difference between the EITI and SOCAR reports is negligible, i.e. the former constitutes 96% of SOCAR's total royalty tax. However, if we compare this procedure with the 2004 report, the picture will be completely different. In 2004, this proportion made up only 0.4%. The same holds true for the profit tax. Thus, whereas in six months of 2005 this proportion was 55%, in 2004 it equaled 0.2%. The picture changes dramatically for other taxes. While this proportion in the present report stands at 42%, last year it was 64%.

All these comparisons cause legitimate suspicion with regard to the accuracy of SOCAR's financial turnover. And since this company is one of the key participants in the EITI, it must be independently investigated.

Therefore, having scrutinized the third auditing report within the EITI framework, the Coalition has come to the conclusion that:

1. The participation of all oil companies in the process of preparing the report can be regarded as progress in comparison with previous reports;
2. The discrepancies between a number of indicators in the government's and companies' reports for the first half of 2005 and the comparisons between the latest report and previous ones confirm the existence of some pressing problems;
3. The main discrepancies are to a certain extent connected with the dual role of SOCAR. The commercial role of the company and its role as a representative of the government in contracts contradict each other. In addition to leading to the conflict of interest, this preconditions certain loopholes in the statistical registration of oil revenues;
4. It is possible to eliminate the discrepancies and contradictions by means of individual disclosure of reports by companies. This is what the Coalition suggested at the start of the initiative. From this standpoint, it might be appropriate to divide reports by local companies into those of SOCAR and joint ventures;

³ <http://www.oilfund.az/doc/aze2004.pdf>

⁴ <http://www.oilfund.az/doc/aze2004.pdf>

□ General information about taxes and other revenues. Ministry of Taxation.

5. It is seen appropriate for local companies to disclose all types of tax.

In accordance with the principles of the EITI and the conditions of the trilateral memorandum signed on November 24, 2004, in an effort to ensure dynamic development of the initiative in Azerbaijan and, most importantly, to turn oil revenues into a blessing for all members of society, the Coalition suggests:

1. In all subsequent reports, the revenues of the government on the “profit oil” and “gas” items, which are indicated in kind, must also be specified in value terms. Otherwise, as is seen from the table below, the country’s total revenues over a specific period of time remain unclear;
2. The government must step up the process of restructuring SOCAR and take effective steps towards strengthening its commercial status and boosting the transparency of its financial performance;
3. Taking into consideration the negative aspects of SOCAR’s dual status in PSAs, the government must assign the function of operating the state’s share in contracts to another body (for example, the Ministry of Industry and Energy);
4. Parties to the memorandum must aspire to eliminate the existing drawbacks before the next report.

Table of state revenues from the Azerbaijan oil industry in the first half of 2005

	Revenues in value terms		Revenues in kind	
	Billion USD	Billion manats	Oil, million barrels	Gas (natural, associated) thousand cubic meters
1	2	3	4	5
1. Host government revenues from foreign companies				
State share in profit oil				
Gas (natural and associated)			4.3 (5.7)**	628168.0
Per-acre payments	1.28			
Transit fee	8.77 (8.3)**			
2. Other government revenues from local companies				
Royalty		195.9		
Profit tax		42.8 (42.7)**		
3. Other taxes (except income tax for physical entities, social taxes and taxes deducted from payment sources)		356.7 (356.5)**		
Total:	10.05	595.4	4.3	628168.0

* this table represents a simplified version of the official report (the report can be viewed at: www.oilfund.az/reports/rep_az/jan-jun_2005_az.pdf)

** the figures in brackets represent reports by companies. Absence of brackets means the figures provided by the government and companies correspond.