

# Can Energy Transition Drive Governance Reforms in Azerbaijan?

written by Ingilab Ahmadov İngilab Əhmədov

The transition from conventional fuel to renewable energy is already a serious necessity. Climate change and decarbonization targets leave no choice for any country, including countries with rich hydrocarbon resources. Under the terms of the Paris Agreement, our main energy partner, the European Union, must [reduce](#) greenhouse gas emissions by at least 40% from 1990 levels by 2030 and achieve net-zero greenhouse gas emissions by 2050. The main target of the UN Sustainable Development Goals is climate change and achieving clean energy.

Oil and gas-rich countries face a double blow. On the one hand, decarbonization targets deprive these economies of their traditional rent income and force them to diversify while, on the other hand, they make the transition to renewable energy more painful than in resource-poor countries. This is due to the fact that it is still very difficult to reform an economy based on relatively cheap energy sources, to put an end to wasteful spending, and to adapt the existing system of governance to new challenges.

Making energy transition and energy efficiency priorities on the political and economic agendas of states is, in a sense, no longer dependent on their own political will, but a commitment under the influence of global processes. Along with technological breakthroughs, political will also plays an important role in accelerating the process, and the need for accelerating the implementation of energy transition in the international arena is no longer in dispute, but revolves around the scale and speed of global demands.

Azerbaijan is also an integral part of these processes. In October 2016, the parliament ratified the Paris Agreement, [committing](#) itself to reducing greenhouse gas emissions by 35% from 1990 levels by 2030. Energy transition is not an ordinary issue for Azerbaijan's economy and politics, but it is crucial enough to decide the country's fate in the near future. In this sense, energy transition is a guarantee of the sustainability and irreversibility of socio-economic reforms.

### **Azerbaijan's position in the international index**

For 10 years now, the World Economic Forum (WEF) has been publishing the Fostering Effective Energy Transition Index. In the latest index released in 2021, Azerbaijan ranks 44th out of 115 countries and [lags behind](#) only Georgia among post-Soviet countries.

The index contains 2 components – system performance and transition readiness. System performance scores are calculated based on energy security, environmental sustainability, and economic growth indicators. Transition readiness assesses the suitability of the environment, specifically energy system structure, human capital, innovation, governance and institutions, regulation, and investment.

It should be noted that Azerbaijan is ranked relatively high compared to other similar countries largely thanks to system performance. The suitability of the environment is relatively weak compared to system performance. The first lesson from the latest index is that, along with energy potential capable of providing a stable energy system and sustainable economic growth, energy transition is also an important target, and in the face of global change, if governance is not flexible and innovative, the sustainability of energy development remains in question.

### **Energy map of Azerbaijan**

In 2019, energy consumption in Azerbaijan can be broken down

as follows: 65% of total energy consumption [came](#) from natural gas, 33% from oil, and only 2% from renewable energy, including hydropower (solar, wind, etc.). fall. For comparison, the share of [renewable energy](#) in neighboring Georgia is around 9%, although most of it is bioenergy and firewood. In Armenia, the figure is [around](#) 6%.

Nevertheless, the renewable energy potential of Azerbaijan is considered very promising. According to the Ministry of Energy, the renewable energy potential is [estimated](#) at 26,940 MW, of which 23,040 MW come from solar and 3,000 MW from wind. So, while current production is unsatisfactory, the potential for renewable energy – the backbone of energy transition – is very high, and this fact distracts both politicians and researchers from the main goal.

### **Renewable energy potential is important, but not sufficient**

Unlike depletable energy sources (oil, gas, coal, etc.), renewable energy is any type of energy found in nature which can be used on a permanent basis. This includes sources such as solar, wind, bio, hydro, etc. Countries with a higher share of renewable energy in their portfolios have achieved this out of necessity. Energy-importing economies, especially poor ones, suffer from energy shortages. Due to the weak economic power of the state, it has been difficult to make energy consistently accessible to consumers. Meanwhile, oil and gas-rich countries are often able to create a cheap and sustainable source of energy for consumers through government subsidies, reminiscent of a room of funhouse mirrors.

In this regard, countries rich in oil and gas (or coal) have been operating so far in energy production with a different frame of reference. It is true that the amount and variety of subsidies in Azerbaijan are much [lower](#) than in other similar countries, but the total amount of subsidies is still significant. For example, if in 2018, USD 2.9 billion in subsidies were allocated for oil, gas and electricity, in 2019

this figure [decreased](#) significantly to USD 1.9 billion.

Ultimately, every subsidy provided by the state comes at the expense of oil and gas rents. For oil and gas-rich countries, energy transition is quite different than for other countries, and in this regard, renewable energy potential is important, but not sufficient for a successful outcome.

As noted, since the share of subsidies in Azerbaijan is not critical compared to other similar countries, reforming the subsidy policy in its energy transition and developing a preference for more renewable energy seems to be a simple technical issue at first glance. But the problem is that, unlike most other countries, the beneficiaries of the subsidy in Azerbaijan are not vulnerable social groups, but primarily state-owned [enterprises](#) that are accustomed to receiving assistance from the state budget.

In energy transition, this issue is the main condition affecting the privatization of relevant state-owned enterprises, the involvement of the private sector in the process, and thus the restoration of a competitive environment. The market structure cannot be changed by simply involving private business in renewable energy production while maintaining the status quo in ownership, and therefore the transition to an efficient and sustainable energy paradigm is achieved through the reform of state-owned enterprises.

### **Energy transition and new risks: A competitive economy**

In the 2019 Global Competitiveness Index, Azerbaijan [ranked](#) 58th out of 140 countries receiving its weakest score for innovation. This is important for energy transition. Unlike traditional depletable energy, renewable energy does not provide rent. The main condition for success here is not the solar energy or wind that the climate provides to one country or another (although that does matter), but economic activity based on competition and a favorable economic environment. The reality is that the technology in this area is rapidly

evolving and is concentrated in the most innovative countries. Therefore, ensuring attractiveness for foreign investment is the number one issue in the energy transition. The power of oil rents will no longer work in this business. The opportunities are almost the same for everyone, and ultimately a more competitive economy will ensure a more successful energy transition.

## **Governance**

Currently, the biggest risk to energy transition efficiency comes from the current form of governance in this area. The legislative framework has not met the goals set so far. The recently enacted [law](#) *On the use of renewable energy sources in electricity generation* is a very important step, albeit a belated one. But this is only the first legislative act. To ensure the process's sustainability and institutional framework, the legislative framework and the resulting governance mechanism must be both thorough and flexible. The Ministry of Energy should have greater powers in this area as a central player.

Following the same logic, another major risk is the current state of state-owned enterprises. Due to the traditional corporate status of state-owned enterprises specializing in the energy field, it is unrealistic to expect them to be drivers in the energy transition. And if we take into account that in the current situation, the firewall between most large enterprises and public funding is very fragile, there is a risk that the large amounts of public funds needed for the energy transition could become a source of corruption.

The establishment of Azerbaijan Investment Holding last year and the placement of state-owned enterprises under its management are positive developments, but there is a risk that the process will slow down and the relevant large state-owned enterprises in their current status will become an obstacle to a successful energy transition. In this respect, the reform of

state-owned enterprises will play an important role in a successful energy transition.

## **Pricing policy**

The current pricing policy in the energy sector creates almost no incentive for producers or consumers to improve the quality of energy supply. As a rule, the government sees price regulation in this area simply as regular rate increases. After each increase, producers of gas, electricity, etc. say that the new rate will allow them to operate profitably. Meanwhile, the situation remains unchanged.

The root of the problem is that the government's policy of regulating natural monopolies is fundamentally wrong. None of the principles recommended by classical regulatory theory (accountability, focus, foresight, consistency, adaptability, efficiency) are taken into account. If the current pricing policy is applied to the renewable energy sector, success is doubtful. Therefore, radical change in the state's energy management must go hand in hand with a reform of its pricing policy.

## **Consumer behavior**

Another important risk on the way to a successful energy transition is consumer behavior. Unfortunately, in addition to the obvious negative effects of the oil and gas economy, there are also indirect effects. An indirect effect of cheap energy syndrome is that the average consumer becomes accustomed to wasteful spending, and it is not easy for them to break this habit. The tensions with consumers against the backdrop of the recent increase in utility rates are a clear example of this. But the reality is that any energy, regardless of its source, must be profitable for the producer and affordable for the consumer. Vulnerable social classes must receive targeted benefits from the state. Strange as it may sound, today the average citizen of Azerbaijan thinks that electricity, oil products, and natural gas should be much cheaper. The argument

is simple: we are an oil and gas country. The problem is that usually the only subject of such discourses is the high rate. However, against the backdrop of high rates, the consumer's first step should have been to attempt to reduce costs. Of course, with such behaviors the transition to renewable energy will be painful.

On the threshold of the energy transition, it is very important to take into account these risks. Our economy, based on oil and gas energy, has solved many problems. Suffice it to say that, recalling a time before the new oil era, we see how Azerbaijan's economic power has increased dramatically compared to 1994. But let's agree that oil, in the true sense of the word, could not have been a driver of the country's economic development. Nevertheless, oil and gas potential has created unique financial, technological, and cooperative opportunities for Azerbaijan. Thanks to these opportunities, we can make the energy transition more successful.