SOCAR: Big Problems at the Largest Company in Azerbaijan

written by Samir Aliyev

At an online meeting on August 6 between President Ilham Aliyev and several ministers on the socio-economic situation and the measures against the coronavirus pandemic, Aliyev's remarks about the inefficiency of state-owned companies revived the issue of privatization. Issues such as privatization or the long-term lease of state-owned companies are periodically raised at government meetings. Especially in a time when oil prices on world markets are falling, there is a need to reduce the burden on the state budget, hence attentions are focused on the privatization of state-owned companies. Attracting foreign or local private investment in the utilities, transport, and oil sectors can increase the efficiency of those sectors while reducing the budget burden. The oil sector in Azerbaijan is under the monopoly of the State Oil Company of the Azerbaijan Republic (SOCAR), and SOCAR was one of the companies criticized at this online meeting.

The state participates in the oil and gas industry through SOCAR, which is not only a state-owned company, but also the Azerbaijan's largest company and taxpayer. In 2019, for instance, the company paid 1.409 billion AZN in taxes to the state budget and 173.6 million AZN to the State Social Protection Fund. Usually the company accounts for 6-8% of budget revenues and 15-17% of tax revenues. In 2019, it accounted for 76.4% of taxes and other mandatory payments received from state-owned taxpayers. At the end of 2018, the number of employees in the company was 51,125 people. Last year, the company's assets amounted to 65.4 billion AZN, and total revenues amounted to 83.8 billion AZN. Also, 61% of its revenues were generated from the sale of crude oil, 26.5% from petroleum products, 4.7% from petrochemical products, and 4.9%

from natural gas. The company received most of its revenue (76%) from operations in Switzerland. Only 7.3% of its total revenues originate from Azerbaijan.

SOCAR is a vertically integrated company along the production and sales chain, and it carries out exploration, development, processing, transportation and retail activities, mainly onshore and in the Azerbaijani sector of the Caspian Sea. In addition to domestic retail, it also has retail operations in Georgia, Romania, Switzerland, and Ukraine. The Azerbaijani state constantly provides financial and strategic support to SOCAR. There have been large financial flows between the company and the government for years. The state invests, allocates subsidies, provides loans and tax breaks, also gives financial support to the company to increase its capital. SOCAR, in turn, pays taxes and invests. In some cases, SOCAR received more from the state budget than it paid into it. For example, in 2018, the company's budget payments amounted to 1.425 million AZN, while it received 1.486 million AZN.

Oil and gas production is growing again

Azerbaijan annually produces an average of 38-40 million tons of oil and more than 30 billion cubic meters of gas. Between 2009 and 2017, despite the increase in SOCAR's technological capabilities and the discovery of new fields, there was a decrease in oil production, but in 2017-2019 there was an increase. During this period, the peak level of oil produced by SOCAR was recorded in 2009 (8.5 million tons) and the lowest level (7.4 million tons) in 2017. Over the past 10 years, the Company's oil production has decreased by a total of 9.2%. SOCAR's share in the country's total oil production ranged from 17% to 21%. In 2019, SOCAR's share in total oil production rose to its highest level in 10 years (20.5%). The reason was that SOCAR's oil production was increasing while the total oil production in Azerbaijan was decreasing.

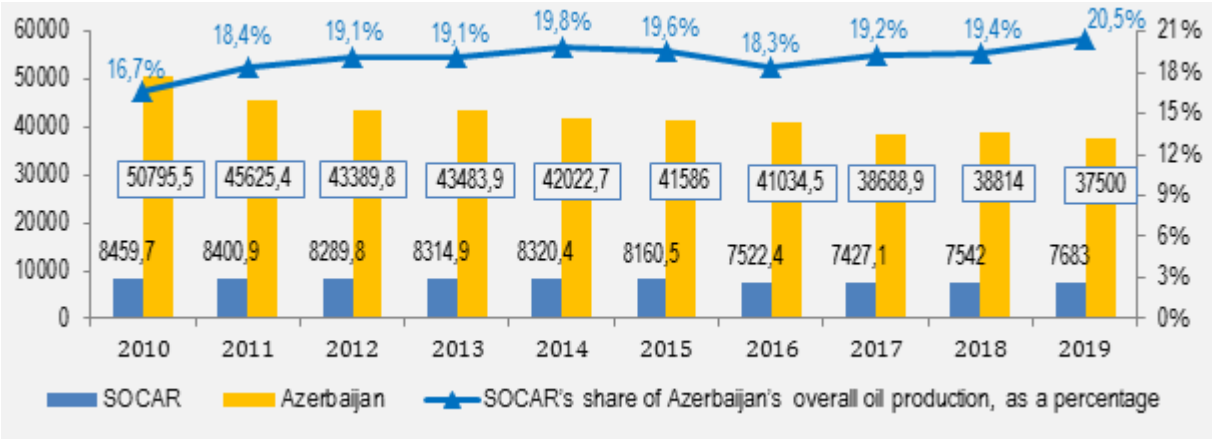


Figure 1. Annual oil production (2009-2019), by thousand tons
Source: SOCAR annual reports

Although gas production was in decline for a long time, it has been increasing in recent years. While the Company's gas production was 7.18 billion cubic meters in 2010, it decreased to 6.82 billion cubic meters in 2019. The decline in gas production over the past 10 years was 5%. However, during that period, gas production in the country increased by 35.1%. The share of SOCAR's natural gas in the country's production fell from 27.2% in 2010 to 19.2% in 2019. This is due to the fact that the growth rate of overall gas production in Azerbaijan exceeded the growth rate of SOCAR's gas production.

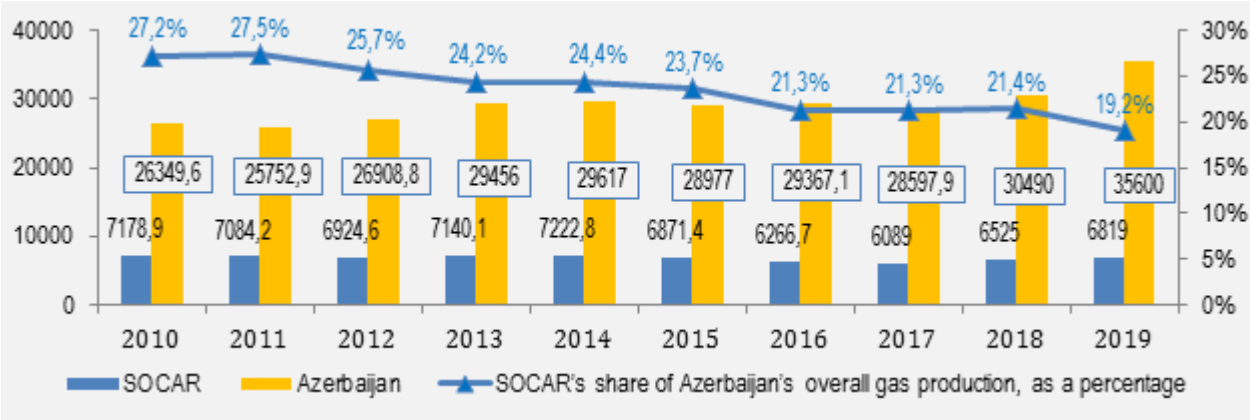


Figure 2. Annual gas production (2010-2019), by million cubic meters
Source: SOCAR annual reports

Although SOCAR plans to produce 7.6 million tons of oil and 7.2 billion cubic meters of gas in 2020, under the terms of

the OPEC+ agreement, in May-June, it reduced daily production by 17,000 barrels to 100,000 barrels. SOCAR decided to gradually increase the total production to 5,000 barrels per day in the second half of 2020 and additional 6,000 barrels per day from 2021, bringing the total crude oil production to 111,000 barrels per day in 2021. According to Fitch Ratings, an international rating agency, SOCAR will reduce oil production by 11% in 2020.

The refined products produced by SOCAR over the past 10 years are mostly aimed at the domestic market. In 2009, it exported 56.6% of oil products, while in 2018 the share of exports fell to 18%. Its sales in the domestic market in 2013 reached a record high – 74%.

SOCAR's annual reports show that the prime cost of crude oil and natural gas it produced in 2009-2018 rose by 85.9% and 27.5% respectively. The cost of 1 ton of crude oil in 2009 was 63.4 AZN, but by the end of 2018 it increased to 117.9 AZN. During this period, the cost of 1,000 cubic meters of natural gas increased from 45.2 to 57.6 AZN.

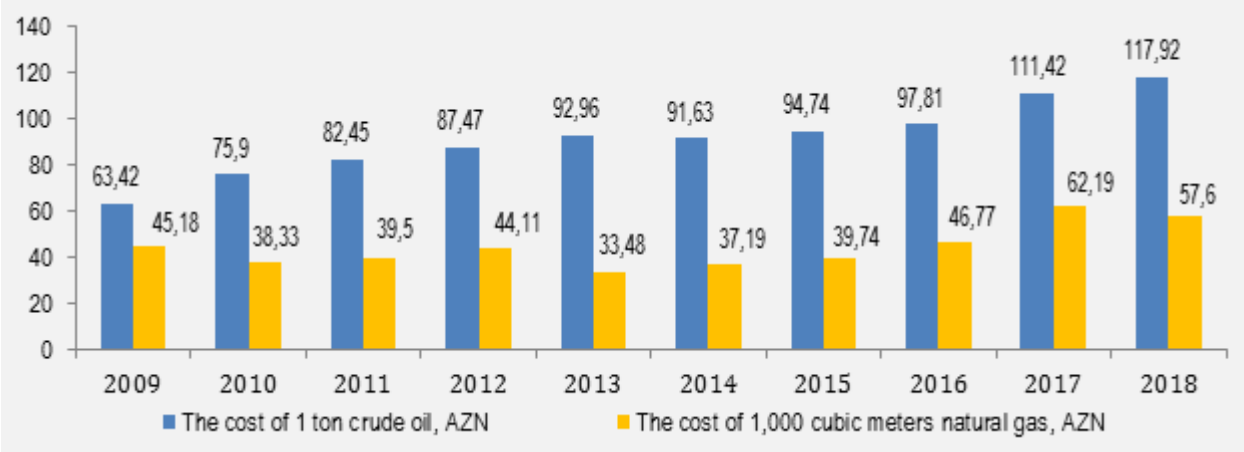


Figure 3. Dynamics of cost of produced crude oil and natural gas, 2010-2019
Source: SOCAR annual reports

Uncertain legal status, non-corporate governance

SOCAR is a state-owned company and 100% of its shares belong

to the Republic of Azerbaijan. The organizational legal form of the company is special and it is registered as a state enterprise. According to SOCAR's Charter, the Company's structure includes the Management Board, the Company's Board and 5 Committees (*Audit*, *Risk Management*, *Procurement*, *Human Resources*, *Information Security Committees*). Its management consists of 13 people, including the Company's president, first vice president and 11 other vice presidents. According to Article 5.3 of the Charter, the President, First Vice-Presidents and all Vice-Presidents are appointed and dismissed by the President of the Republic of Azerbaijan, who is the Head of State and Government. Of the 13 people in the Company's management category, 11 are members of the ruling New Azerbaijan Party. The head of the Company is even represented in the leadership of the party.

Successful practices emphasize the political independence of the leaders of state-owned companies. The Benchmarking Framework, developed by experts from the Natural Resources Governance Institute, states that in order to achieve a high level of corporate governance, the decision-making process should rely on independent and professional managers, not politicians. This means that the government and the state-owned company must find the right balance between independent and business-oriented decision-making, and oversight by public authorities. Successful management in public companies should consist of specialists and politically independent individuals selected on the basis of transparent and well-defined procedures. State-owned companies should appoint members on the basis of technical analysis, not patronage. To further reduce the impact of politics, it is suggested to set term limits for the members. However, SOCAR's Charter does not provide for any criteria, including age and work experience, for the knowledge and skills of senior executives. At the same time, the term limits for senior officials are yet to be determined.

SOCAR's reports periodically emphasize that the Company

implements a centralized management system based on the principles of corporate governance. However, our research shows that SOCAR's management does not meet corporate governance standards. If we go further, we can even see that the Company does not fully comply with the requirements of the Civil Code it refers to. Although the Code contains important elements of corporate governance, this is not the case in SOCAR's management structure.

According to the Civil Code, the supreme governing body in business entities is the general assembly of their participants (shareholders). The general assembly establishes the Board of Directors (or supervisory board) and (or) the audit commission (inspector) of the Company for a period of not more than 3 years. The Company's board of directors (supervisory board) exercises general management and control over the Company's activities within its powers. In addition, a collegial (board, management) or sole (director, general director) executive body of the Company may be established. The executive body carries out the day-to-day management of the Company's activities, reports to the board of directors (supervisory board) and the general assembly of shareholders. The executive body is elected by the supervisory board or the general assembly, if this power is not delegated to the supervisory board in the Charter.

At present, SOCAR does not have a *general assembly* or a *supervisory board*. In fact, their functions are performed by the President of Azerbaijan. The Company Board (CB), as a collegial governing body, acts as a board of directors. The CB includes the company's president, vice-presidents and other officials appointed by the Company's president. Its meetings are chaired by the president of the company. SOCAR does not have mutual control mechanisms, control is only one-sided – it is intended for the structures at the disposal of the president of the company.

Auditing activities in SOCAR are carried out by the Audit

Committee established under the President of the Company. The Audit Committee defines and implements the internal audit policy and strategy. It has 3 members: the vice-presidents of SOCAR and the head of the legal department. The Committee is chaired by the Vice President who is the member of the Company Board. However, according to Article 107 of the Civil Code, the Audit Committee is established and subordinated to the Board of Directors (supervisory board).

As can be seen, in corporate standards, internal audit units are subordinate to the Board of Directors (supervisory board) of the oversight body, not to the executive body. The purpose of this subordination is to monitor the implementation process and ensure transparency. In the case of SOCAR, the head of the executive body both creates and controls the internal control unit. There is no internal control over the activities of the executive body.

For a long time, two documents providing for the application of corporate governance standards in relation to banking and economic societies in Azerbaijan were in force – *Corporate Governance Standards in Banks* and *Azerbaijan Corporate Governance Standards*. But the Cabinet of Ministers approved the *Rules and Standards of Corporate Governance in State-Owned Joint Stock Companies* in 2019. The decision states that these Rules and Standards have been developed taking into account the specifics of the national economy and the *Guidelines on Corporate Governance of State-Owned Enterprises* approved by the Organization for Economic Cooperation and Development (OECD). However, it seems that the current organizational and legal form of SOCAR do not comply with this document because the above-mentioned Rules and Standards are intended for state-owned joint stock companies. The organizational and legal form of SOCAR as a commercial entity, however, is not clear, which contradicts the requirements of the current Civil Code. According to Article 64 of the Code, a commercial organization means economic *partnerships* and *companies*. Such entities are considered commercial organizations with

authorized (joint) capital divided among the shares of their founders (participants). According to the Code, when establishing economic *partnerships* and *companies*, the words "limited liability company" and "joint stock company" must be indicated in the company's name.

SOCAR's organizational and legal status is indicated in the Company's name as a "state company." The state registration of the Company was carried out in 1992 on the basis of the legislation in force at that time. The current Civil Code was adopted in 2000. Unfortunately, although the Company's Charter was renewed in 2003, this factor was not taken into account. It is not clear to which category the Company belongs – an economic partnership or a company. At the very least, the law requires that the name of the firm be categorized.

Transparency without oversight and limited accountability

As a result of amendments to SOCAR's Charter in 2014, the publishing of financial reports became a mandatory obligation. Clause 6.1-1 of the Charter indicates that the Company should publish consolidated financial reports together with the auditor's report on its website and in periodicals no later than June 30 of the following year after the end of the reporting period. On January 1, 2008, SOCAR switched to international financial reporting standards. Since 2009, the Company annually publishes financial reports prepared by an external audit company on its official website. Along with financial statements, it regularly publishes the *Annual Report* and the *Sustainable Development Report* on its official website. Unlike these two last reports, financial statements are not *machine-readable*, which makes them difficult to use.

Parliament has limited authority to inspect and monitor SOCAR's activities. SOCAR only answers to the President of the Republic of Azerbaijan. Therefore, the Company does not report on its activities to other bodies, including the Parliament. The Parliament can inspect SOCAR within the limited powers of

the Chamber of Accounts. Article 2.1 of the *Law on the Chamber of Accounts* gives the Chamber the authority to control the use of funds from the state budget to legal entities and municipalities. However, so far there is no information on the inspection of the activities of SOCAR, which receives sufficient funds from the state each year.

In international practice, it is not acceptable for a company to work with the same audit company for an extended period because it creates mistrust among investors about transparency. Financial reports since 2009 are available on SOCAR's website. During this period, SOCAR collaborated with only one audit company – *Ernst and Young Holding*. For instance, the State Oil Fund (SOFAZ) has worked with 3 audit companies between 2002 and 2019. These were *Ernst and Young Holding* (2002-2006, 2010-2012), *Deloitte and Touche* (2007-2009) and *PwC* (2013-2019).

In general, long-term experience with a single audit company is widespread in state-owned companies in the former USSR. For example, Kazakhstan's *KazMunayGas* worked only with *Ernst and Young Holding* (2005-2019). The Russian giant *Gazprom* worked with *PwC* in 1998-2014 and *FBK* in 2015-2019. Ukrainian *Naftogaz* has worked with three companies; in its early years, as external auditors, it used the services of local audit company *BDO LLC* (2001-2003, 2010-2011), then world-class companies such as *Ernst and Young Holding* (2004-2009) and *Deloitte & Touche USC* (2012-2019). *KazMunayGas* published an audit report for the first quarter of 2020, while *Gazprom* and *Naftogaz* published financial reports that have not been independently audited. However, SOCAR's accountability is limited to the publication of annual financial reports.

A vision without a strategy

SOCAR's goal is to become a vertically integrated international oil and gas company in line with best practices in terms of operational efficiency, as well as social and

environmental responsibility. In return for such an ambitious goal, the company does not have a separate development strategy that sets out its goals for the short and medium term. The company's activities are very diverse and it has a number of duties. While in the 1990s, SOCAR's main goal was to ensure the sale of Azerbaijani oil in foreign markets and to master modern technologies, in the 21st century, especially in 2010s, its goal was to achieve the sale of Azerbaijani gas in European markets, and to further increase the Company's processing and sales capabilities.

SOCAR has usually participated in and contributed to the strategies adopted by the government. For example, *the State Program for the Development of the Fuel and Energy Complex of the Republic of Azerbaijan (2005-2015)* sets as the main tasks for SOCAR to intensify the development of existing fields, accelerate the introduction of modern geophysical mining and oilfield equipment.

In the absence of an action plan or a strategy outlining the company's short and medium-term goals, however, it is difficult to determine what role SOCAR will play in the global energy sector in the future and whether it intends to enter other sectors. SOCAR's management periodically reports in the press that such a strategy has been developed, but the public has yet to see these documents. For example, the company's president said that SOCAR, a leading force in the energy strategy implemented in Azerbaijan, had developed a Comprehensive Plan for long-term strategic development from 2011 to 2025. A few years later, he once again announced the development of a new Strategy. He said that SOCAR started working with McKinsey to develop a new strategy until 2035 and plans to submit it to the government in the near future. However, other than such announcements in media, it is impossible to find any information about these strategies.

For comparison, in 2018, Russia's *Gazprom* adopted a strategy in the field of electricity for 2018-2027. Kazakhstan's

KazMunayGas has a development strategy until 2025. At a time when the share of renewable energy in world markets is growing rapidly, *British Petroleum*, which specializes in oil and gas production, has announced the main goals of its strategy until 2030. The essence of this strategy is to gradually replace traditional energy with green energy. Thus, BP plans to increase investment in low-carbon technologies and reduce oil and gas production.

Recent trends

SOCAR's activities have always been at the center of public attention. Civil society, including the media, has difficulty obtaining the necessary information from SOCAR. The company does not appear interested in being open to the public, despite posting financial and performance reports. There are no reports on the financial and software activities of the Company's joint ventures and subsidiaries.

The following trends have been observed in SOCAR's activities in recent years:

1. SOCAR is growing rapidly, entering the non-oil sector and becoming a major risk for the country's economy

2. Debt obligations that exceed the country's foreign debt continue to grow, and their repayment threatens the stability of the country's foreign exchange market

3. Against the backdrop of rapid changes in the global energy segment and the increasing share of renewable energy, there is no single medium and long-term strategy document that defines the company's vision and goals for the future and envisages its development

4. The company, which always emphasizes in its reports that it applies corporate governance systems, has management that does not meet corporate governance standards.

5. There is hardly any parliamentary mechanism to control the

company's activities.

6. There are no clear regulations governing financial flows between the company and the state

SOCAR's foreign debts are growing every year. By the end of 2019, long-term debt amounted to $11.4 billion. However, this figure was $9.5 billion in 2017 and $9.7 billion in 2018. The company's borrowing will continue in 2020. In January-May, the Company attracted new long-term and short-term loans from local and international banks totaling 1.71 billion AZN to repay a debt of 1.82 billion AZN. It should be noted that as of July 1, 2020, the debt of the Azerbaijani state on direct and contingent liabilities amounted to 9,813.3 million USD.

Taking all this into account, it is important to increase the efficiency of SOCAR's management and ensure transparency and accountability. First of all, the organizational form of the company should be clarified and reorganized into a joint-stock company. Corporate governance standards based on the OECD *Guidelines on Corporate Governance of State-Owned Enterprises* should be applied in the management of the company. In addition, changes should be made to the relevant legislation to define clear and transparent frameworks for transparency and accountability commitments. *The Law on Access to Information* should be amended to include SOCAR in the category of information owners, and the Company's financial and operational information should be included in the list of information that must be disclosed. At the same time, SOCAR must be held accountable to Parliament. One of the important steps to be taken is to develop a unified Development Strategy for the company's medium (5 years) and long-term (15-20 years) period. The vertical integration goals of SOCAR, which is expanding without restriction, should be limited, and the issue of the independence of *Azeriqaz* PU from the company should be considered.

Finally, I would like to briefly mention the privatization of

SOCAR. Talk of the privatization of the State Oil Company began in the late 1990s. So far, however, the idea has not developed beyond a public discussion. The government is generally reluctant to discuss the privatization of the oil sector. Given SOCAR's economic role and social importance, it is unlikely that the government will be interested in selling the company in the near future. But since the company's debt exceeds the country's debt and the demand for traditional energy resources such as oil and gas will decline significantly over the next few decades, SOCAR's future is somewhat hazy. The government must seriously consider this issue.