Overview of procurement procedures of SOCAR, legislative framework for joint ventures and production sharing agreements

12 December 2014
PURPOSE OF ANALYSIS

This report is prepared pursuant to instructions and scope agreed between the State Oil Company of Azerbaijan Republic (hereinafter referred to as “Client”, “Company” or “SOCAR”) and the Representative Office of KPMG Azerbaijan Limited in the Republic of Azerbaijan (hereinafter referred to as “KPMG”, “We” or “Us”), in connection with activities and operation of the Client in the Republic of Azerbaijan (“Azerbaijan”) with respect to the following legal matters:

- Overview of current procurement policies adopted by the Company with respect to their compliance with current Azerbaijani legislation;
- Overview of procedures on establishment of joint ventures as provided for by Azerbaijani laws and by the Company’s internal regulations (including procurement guidelines) and existing legal practice;
- Analysis on whether public tender is required for Company’s entering into a production sharing agreement (PSA) and/or joint venture agreement (JVA);
- Overview of international business practices in the field of PSA and JVA execution in certain countries with large oil and gas sector, with particular focus on business practices of state owned oil companies in those countries;
- Overview of procedures of the Company on sale of crude oil and gas, in particular to foreign commodity trading companies and the legislative framework in this area.

EXECUTIVE SUMMARY

- SOCAR’s procurement processes are subject to relevant provisions of the Law of the Republic of Azerbaijan “On Public Procurements” and SOCAR’s internal procedures/guidelines/policies (e.g. Policy “On Procurement”, Procurement Concept, Guidelines “On organization and regulation of SOCAR’s procurement”, Regulations of Procurement Committee, collectively referred to as “Procurement Documentation”). Procurement Documentation does not contradict relevant Azerbaijani legislative acts in all material aspects.
- Procurement Documentation shall apply to all of SOCAR’s enterprises (as defined in SOCAR’s Charter) within its structure, covering all stages of procurement process and determining supervision mechanisms, responsible persons and documentation rules for each stage. At the present time, SOCAR’s Procurement Documentation is not obligatory for its Joint Ventures and has status of recommendation for them, however such Joint Ventures can refer to those documents as methodological guidance when performing procurement. Procurement Documentation envisage main principles and rules for conducting procurement that are predominantly based on relevant principles and requirements of the Azerbaijani Law “On Public Procurements”. 

© 2014 KPMG Azerbaijan Limited. All rights reserved.
• SOCAR’s procurement processes, which are not directly regulated by relevant Azerbaijani legislation, are performed based on Procurement Documentation. Procurement Documentation, generally, sets forth such processes. However, there are certain aspects of procurement process which are not directly regulated either by Azerbaijani legislation or by Procurement Documentation, hence fall within prerogative of relevant SOCAR administrative unit or enterprise, whereby such units or enterprises should act in accordance with their relevant internal regulations.

• SOCAR has Anticorruption Policy in effect, aimed to prevent corruption practices within SOCAR. The Anticorruption Policy applies to all of SOCAR’s enterprises and their employees, and, covers, inter alia procurement processes. SOCAR’s Anticorruption Policy, in all material aspects, complies with Azerbaijani anticorruption legislation.

• Azerbaijani legislation allows for establishment of JVs with foreign participation. Azerbaijani legislation does not contain mandatory requirements for negotiation of issues in connection with establishment of JVs or their structuring, as well as any specific mandatory criteria for selecting venture partners through conducting tenders.

• The general framework for coordination and implementation of procedures on establishment of joint ventures (JVs), as envisaged in internal regulations of SOCAR, does not contradict the applicable Azerbaijani legislation and existing consistent legal practice (i.e. approaches used by investors in different jurisdictions, as well as leading practice examples in the industry).

• Azerbaijani legislation does not stipulate specific provisions with respect to negotiation and/or conclusion of PSA. However, it is the requirement of Azerbaijani legislation that the President of Azerbaijan empowers and authorizes SOCAR to enter into negotiations with counterparties, agree draft of PSA and execute it. Enforcement of PSAs under Azerbaijani legislation takes effect after PSA is executed, approved by the Parliament in the form of law and signed by the President of Azerbaijan, thus becoming a law.

• In the absence of specific legislative act(s) on PSAs governing this area in the Azerbaijani legislation, SOCAR is not restricted to conclude memorandums of understanding/intention and negotiate commercial terms and other similar aspects of PSA in accordance with its Charter, which was approved by the President of Azerbaijan.

• SOCAR’s internal regulations on sale of oil and gas are consistent with applicable Azerbaijani legislation and mainly conform to industry practices in other jurisdictions reviewed for the purposes of this Report.
Contents

1 Overview of SOCAR’s structure
2 Procurement at SOCAR
3 SOCAR’s JVs, subsidiaries and alliances
4 Production Sharing Agreements (PSAs)
5 Non-PSA production of crude oil and gas under Azerbaijani legislation
6 Sale of SOCAR’s crude oil and gas

A Annex 1
   Information and documents used in course of preparation of the Report
B Annex 2
   FACTS and ASSUMPTIONS
C Annex 3
   QUALIFICATIONS, LIMITATIONS AND OBSERVATIONS
D DISCLAIMER
1 **Overview of SOCAR’s structure**

1.1 **Overview of SOCAR’s Charter**

According to Company’s charter, its major aim is ensuring the effective functioning and development of the oil industry as an integrated system and the reliable satisfaction of consumers’ demand for energy resources\(^1\).

The charter defines Company’s main activities as commercial, while noting that the Company exercises ownership over all hydrocarbons produced and petroleum products obtained from their processing.

SOCAR is a legal entity, possessing an independent balance sheet, clearing and other accounts in banks, including foreign banks. The Company prepares a consolidated account (including balance sheet) of its enterprises, other legal entities and non-legal entities belonging to it (representative offices, branches, etc.), together with its independent balance sheet\(^2\).

Company’s prerogative areas include, *inter alia*, performance of efficient investment policy outside of Azerbaijan for integration of Company in international oil and gas projects\(^3\).

1.2 **SOCAR’s management structure**

The Company’s management is performed by its President and 11 vice-presidents\(^4\), all of whom are appointed by the President of Azerbaijan.

The Company’s structure also comprises:

- Company’s Council;
- Audit Committee;
- Risk Management Committee;
- Procurement Committee;
- Human Resources Committee;
- Informational Security Committee;
- Head Office;
- Branches, representative offices and other organisations not having the status of legal entity;
- Joint Ventures and Company’s subsidiaries;
- Other type of enterprises\(^5\)

Company Council’s (“Council”) role, in particular, should be examined separately, as it has broad authorities to resolve on and supervise certain processes within the Company. For instance, the Council

---

1 Article 1.1 of Socar Charter  
2 Article 1.4 of Socar Charter  
3 Article 2.2 of Socar Charter  
4 The number of vice-presidents is correct as of the date of this Report.  
5 Article 1 of Addendum 2 to Socar Charter
discusses expediency of Company’s dealings with other foreign counterparties, while also has say in formation of Company’s development strategy\(^6\).

The Council is collegial body and its meetings are held at least once a month. Its resolutions become effective after approval and execution by Company’s President\(^7\).

1.3 State control over SOCAR’s activities

The Company’s activities and operation as a state-owned organisation are regulated by the Constitution of Azerbaijan, the laws of Azerbaijan, decrees and orders of the President of Azerbaijan, resolutions and orders of the Cabinet of Ministers of Azerbaijan, other regulatory legal acts, international treaties to which Azerbaijan is a party to, agreements approved by laws of Azerbaijan concluded in the sphere of oil exploration and development, and its Charter\(^8\).

Decision on SOCAR’s reorganization or dissolution is taken by the President of Azerbaijan\(^9\). The President of Azerbaijan also appoints President of SOCAR or terminates the authorities of the existing President of the Company.

SOCAR’s activities, in particular its use and disposal of financial resources allocated from Azerbaijani state budget are subject to supervision and scrutiny by the Chamber of Accounts of Azerbaijan. Namely, the Chamber of Accounts exercises control over use of state property and supervises expenditures of funds allocated from the state budget\(^10\).

---

\(^6\) Article 5.9 of Socar Charter
\(^7\) Article 5.10 of Socar Charter
\(^8\) Article 1.3 of Socar Charter
\(^9\) Article 7.1 of Socar Charter
\(^10\) Law of the Republic of Azerbaijan “Accounts Chamber”, Article 2.1
2 Procurement at SOCAR

2.1 Overview of SOCAR’s internal policies/regulations/guidelines

Procurement at SOCAR is regulated by and performed based on Company’s normative acts on organization and conducting procurement. These acts were adopted by the order of President of SOCAR11, which set up range of internal normative acts to ensure transparency within Company’s procurement procedures and processes.

The Order was adopted with the aim of benefiting SOCAR’s procurement processes and implementing best practices of leading oil and gas companies in procurement policies, procedures and processes. By this Order, SOCAR adopted four normative acts in this sphere:

- SOCAR’s Procurement Policy;
- Concept of SOCAR’s Procurement;
- Regulations of Procurement Committee;
- Guidelines “On organization and regulation of SOCAR’s procurement”.

2.1.1 SOCAR’s Procurement Policy

The Policy envisages main principles and rules of conduct, as well as normative acts adopted based on these principles and rules that are to be applied to SOCAR’s procurement processes and shall be applicable to all of SOCAR’s enterprises.12

The main principles of Procurement Policy include:

- **Ethic principles in procurements**

  According to these principles, all procurement procedures must be conducted in the way that will not damage SOCAR’s image and reputation. In addition, the principles restrict SOCAR’s personnel to obtain personal benefits by using their position in the company in connection with procurement conduct.

- **Competition principle**

  According to this principle, tender participants shall be treated equally and provided with equal opportunities.

  The principle also stipulates that long term business relationships with service providers are priority for SOCAR, as the main purpose of SOCAR’s procurements is to ensure continuing development and minimization of company’s expenditures.

- **Legality principle**

  The principle states that all procurements at SOCAR shall comply with relevant requirements of Azerbaijani legislation. In addition, all contracts between SOCAR and foreign companies in relation to procurements are governed by Azerbaijani or English laws. SOCAR has adopted standard contract templates for procurement purposes that can be amended only by obtaining opinion of Legal

---

11 SOCAR President’s Order #105 “On regulation of relations regarding SOCAR’s procurement”

12 SOCAR’s Procurement Policy, Article 2.1
Department of SOCAR’s head office. According to the principle, SOCAR’s purchases which are funded by public funds are subject to requirements of the Law of the Republic of Azerbaijan “On Public Procurement”.

- **Relationship principle with service providers**

Relationship between SOCAR’s personnel involved in procurement processes and tender participant shall be organized in transparent manner and in good faith. By this principle, the Policy also restricts to choose service provider, if conflict of interest exists, as well as acceptance of presents/gifts and other illegal actions, as defined in the Procurement Policy.

- **Confidentiality principle**

SOCAR shall ensure confidentiality of bids made by tender participants. Every negotiation with bidders shall remain confidential throughout the procurement process.

- **Principle of Conflict of Interests**

Service providers that depend on SOCAR from legal, financial and organizational points of view are not allowed to participate in SOCAR’s tenders.

- **Unacceptance of corruption**

The following actions are required to be taken in relation to bidders that were previously involved in corruption with the aim to affect the results of procurement processes:

- Their bids shall be rejected;
- They will not be allowed to participate in future tenders;
- Information on corruption and falsification related acts will be submitted to the relevant authorities.

It is prohibited to accept presents/gifts from bidders in any kind by SOCAR’s staff involved in procurement processes. Information on all presents, regardless of their price/value shall be reported to SOCAR’s management.

### 2.1.2 Procurement Concept

Procurement Concept determines SOCAR’s organizational structure of procurement process, responsibilities of its participants and defines stages of procurement process.\(^\text{13}\)

The Concept determines organizational structure and its functions with regards to procurement processes. The structure is determined as follows:

- President of SOCAR;
- Procurement Committee- body that supervises SOCAR’s internal procurement processes.
- Head Office;
- Structure Units;
- Specialized Procurement Division;

\(^{13}\) SOCAR’s Procurement Concept, General Provisions
- Planning procurements.
  - Procurement Group;
    - Preparation of invitation documents for bidders;
    - Determining criterion of evaluation of bids;
    - Actual evaluation of bids.
  - Coordinating Person;
    - Ensuring compliance of procurements with internal procedures;
    - Preparing protocols for tenders;
    - Training Procurement Group on rules on procurement guidance.
  - Initiating unit.

Stages of procurement processes:
1. Determination of demand for goods (works and/or services);
2. Prequalification of bidders;
3. Approval of bidders’ list and procurement strategy;
4. Preparation and sending invitation documents;
5. Receiving bids;
6. Sending clarification questions;
7. Evaluation of bids;
8. Post-tender negotiations (if required);
9. Approval of tender results;
10. Execution of contract;
11. Performance of contract;
12. Completion of contract.

2.1.3 Procurement Committee

SOCAR’s Procurement Committee is the main body that supervises internal procurement processes in SOCAR. The Committee’s main duties are approval of the list of potential bidders; supervision over implementation of procurement procedures in accordance to SOCAR’s internal normative acts; approval of procurement strategy with regards to purchase of goods (works and services) without tender; granting powers to negotiate with bidders; cancellation and reorganization of tender results, if there are reasonable grounds for suspicions in relation to the price of the goods (works and services) and other considerations.\footnote{Regulation of Procurement Committee of SOCAR, Committee’s Purpose, Rights and Responsibilities}
2.1.4 Procurement Group

Procurement Group is organized with the purpose of effective and operative execution of procurement operations and comprises SOCAR’s leading specialists in defined areas. Depending on value and risks of procurement contracts, Group can consist of the following persons: 15

- Technical expert;
- Expert on environmental issues;
- Legal consultants;
- Financial analysts;
- Other persons.

In essence, Procurement Group can turn down bids which do not meet requirements of terms of reference, request additional information and seek clarifications from bidders. This is done with the aim of ensuring independent decision-making regarding bids and evaluation criteria for consideration of bids. Additionally, Procurement Group is responsible for preparation of invitation documents (terms of reference); evaluation of bids according to evaluation criteria defined in normative acts of SOCAR and other similar matters.

2.1.5 Guidelines “On organization and regulation of SOCAR’s procurement”

The Guidelines regulate main processes of procurement at SOCAR, as well as instructions on organization and regulation of procurement processes within SOCAR. The Guidelines set up main steps and stages of procurement processes, based on relevant Azerbaijani legislative acts.

The Guidelines determine the full process of procurement at SOCAR and respective stages, by setting table, which covers all stages of procurement process and determines supervision mechanisms, responsible persons and documentation rules under each stage.

One of the more crucial stages is the first stage—“Planning of purchases”, whereby Structure Units provide forecasts with the list of demands before 30th of November of each calendar year to the Head Office’s Specialized Procurement Division. The said Division, in its turn, approves forecasts before 10th of January of the following year. All information must be described in Forecasts Plan. 16

Comprehensive information on stages is described in more details in below sections of this Report.

Procurement Process at Structure Units

The first step in the process is to determine demand for goods (works and services), which is done by the initiating unit. After the head of the Structure Unit approves the demand for the particular procurement, he needs to be presented the list of bidders and Procurement Strategy for approval. After approval of Procurement Strategy by the head, it shall be subject to verification on its compliance with Competence Limits. In the case, the estimated contract value exceeds the Competence Limits, it should be referred to Procurement Committee.

Competence Limits for SOCAR’s enterprises are defined as follows:

a. Heads of “Azneft” Production Union, “AzeriGas” Production Union, Oil Pipelines Department, IT and Communications Department, Azneftyagh Oil Refinery, Heydar Aliyev Baku Oil

---

15 Regulation of Procurement Group
16 Table 1, Generalized Processes of Procurement Operations
Refinery, Heydar Aliyev Baku Deep Water Jacket Factory, Oil and Gas Construction Trust, Integrated Drilling Trust can approve results, procurement strategy and list of bidders in open tenders with estimated contract value up to AZN 1,000,000.

Selective tendering with estimated contract value up to AZN 50,000.

Heads of the above Structure Units are also authorized to approve 10% increase of contract value during a year.

b. Heads of Investments Division, Marketing and Operations Department, Geophysics and Geology Department, Gas Export Department, Environment Department, Oil and Gas Research and Design Institute approve results, procurement strategy and list of bidders of:

- Open tenders with estimated contract value up to AZN 200,000;
- Selective tendering with estimated contract value up to AZN 50,000.

Heads of the above Structure Units are also authorized to approve 10% increase of contract value during a year.

In case, if estimated value of contract exceeds aforementioned thresholds, Procurement Strategy and bidders list shall be subject to Procurement Committee’s approval. The Committee is authorized to decide whether the procurement shall be conducted by Structure Unit or SOCAR’s Head Office. After approval of Procurement Strategy and bidders’ list, Procurement Group is formed and Invitation Documents (terms of reference) are complied. Invitation Documents shall be published in mass media (in case of open tender) or sent to selected bidders (in case of selective tendering).

After all of the procedures described above are finalized, submitted bids need to be duly accepted and opened in a strict confidential and ethic manner. The bids then are evaluated in accordance with defined criteria and terms of reference. If there arises the need to conduct after-tender negotiations, such negotiations shall be subject to the Procurement Committee’s approval. In case Procurement Committee or Head of Structure Unit does not approve the results of the tender, the tender results shall be revised and may be cancelled. All bidders, whose bids were accepted, shall be informed on the results of tender.

a. Process of Head Office’s Procurement

The process of procurement by Head Office is in many areas similar with Structure Units’ procurement process. However, the main difference is that all of the procurement by the Head Office needs to be processed through Procurement Committee.

b. Selection of Bidders

Initiating Unit and Specialized Procurement Division shall supervise inclusion to the bidders list only those that can provide goods (works and services) which meet SOCAR’s internal standards.

Preparation of bidders list

- The list of bidders are prepared jointly by Initiating Unit and Specialized Procurement Division;
- Potential bidders are not allowed to participate in closed tenders, if not invited by SOCAR’s Head Office or Structure Units;
- There shall be minimum of three bidders in the bidders list for participation in selective tenders. All of the bidders shall have adequate experience and capabilities to perform the contract.

17 Guidelines “On organization and regulation of SOCAR’s procurement”
c. Prequalification of bidders

Initiating Unit and Specialized Procurement Division are bodies responsible for prequalification of bidders in procurement process within SOCAR.

Prequalification process is divided into two elements – General Element and Specific Element.

**General Element**

General Element is evaluation of general capabilities and resources of the bidder. The following information is required for evaluation of bidder:

- Organizational legal form;
- Experience;
- Planning and control over delivery;
- Technical and financial resources;
- Control over product’s quality.

Management over health and safety and environmental control shall be priority for the bidder.

**Specific Element**

Specific Element is evaluation of technical capabilities of bidders regarding scope of work in the contract.

The following information is required for evaluation of bidder:

- Capability to meet technical requirements;
- Experience in specific area;
- History/track record of previous works and experience and its results;
- Consideration of important aspects of bidders’ works or services;
- Use of new technologies;

**Valuation of Prequalification Results**

Valuation criteria must be determined before sending prequalification documents to bidders. Technical, conformity, safety aspects, as well as capabilities shall be priority criteria during evaluation of bidder’s prequalification. However, management, experience and personnel’s skills shall also be taken into account.
d. Types of tenders\textsuperscript{18}

\textit{Open Tender}

All announcements about open tenders are placed in mass media resources (SOCAR’s website, newspapers, magazines and other resources).

\textit{Closed Tender}

Closed tender can be carried out in following cases:

\begin{itemize}
  \item In case, if required goods (works and services) that are very complex in nature can be provided by a limited number of potential bidders;
  \item In case, costs and time spent on the selection of bidder would be disproportional with the actual cost of the goods (works and services) themselves.
\end{itemize}

Bidders that would participate in closed tenders are chosen by Specialized Procurement Division and Initiating Unit or by Procurement Group.

\textit{Electronic Auction}

Tenders can be conducted by means of Electronic Auctions in case, if the main criterion for choosing the service provider is the value of the contract and if bidders offer same level and quality of goods (services).

e. Evaluation of bids\textsuperscript{19}

Evaluation of bids is implemented according to the following principles:

\begin{itemize}
  \item \textit{Confidentiality of procedures} – any information about review of bids, their clarification and evaluation and recommendations for the winner cannot be shared with persons that are not officially involved in the evaluation procedures;
  \item \textit{Preparation of criteria for objective evaluation} - all criteria for evaluation of bids must be determined and agreed with members of Procurement Group before the announcement of the tender is made;
  \item \textit{Change of terms of bids} – Bidders are not allowed to alter their bids after their submission during the tender;
  \item \textit{Rejection of all bids} – In case, there are no bids that meet the tender requirements, or there are no bids at all, or there is evidence or grounds to suggest that bidders will not be able to provide required goods (works and services), all bids can be rejected on the duly grounded basis.
\end{itemize}

Evaluation shall be conducted in order to determine the most competitive bid that meets all requirements of SOCAR and Structure Units. Initiating Unit is responsible for evaluation of technical aspect of the bid. It is recommended not to disclose the identity of bidder if financial evaluation is completed while technical evaluation is still ongoing.

According to the Guidelines, SOCAR is not obliged to choose bids with the lowest price as the tender winner, if another bid contains technical characteristics substantially better than that, notwithstanding higher price.

\textsuperscript{18} Guidelines \textit{“On organization and regulation of SOCAR’s procurement”}, Types of tenders

\textsuperscript{19} Guidelines \textit{“On organization and regulation of SOCAR’s procurement”}, Evaluation of bids
Technical evaluation

During technical evaluation, the following shall be considered:

- Compatibility of bids to technical requirements;
- Execution methods;
- Alternative options offered by bidders;
- Information and/or procedures on bidders’ goods, production or services;
- Information on bidders’ technical experience, equipment and employee’s skills.

Information on results of technical evaluation shall be included to the protocol on results of the tender.

Evaluation of financial offers/bids

Evaluation of financial offers is the responsibility of Coordinating Person. During evaluation of financial offers/bids, the following shall be considered:

- Offered price, tariffs and other alternatives;
- Timing of delivery;
- Any conditions with regards to contract’s terms;
- Quality of bid.

Offered price, tariffs and other aspects shall be indicated in prepared evaluation table. According to Guidelines, usually, bids (which are acceptable from technical standpoint) with lower price should win the tender. However, there are some considerations (currency risks, requirements regarding cash, etc.) that shall affect the outcome of the tender in addition to pricing considerations.

Dismissal of bidders

The following could be the reasons for dismissal of bidders from tenders:

- Not fulfillment of requirements or provision of incomplete documents;
- Acting with the purpose of distortion of evaluation process;
- Change of shareholder, corporate counter-party after the bids were submitted.

f. Announcing the winner

Initiating Unit shall assist Coordinating person in preparation of recommendations regarding tender winner for Procurement Committee’s or Structure Unit’s review. Afterwards, Coordinating Person, along with members of Procurement Group prepare protocol on the results of tender and its winner, which also is subject to approval of Procurement Committee or Structure Unit. After approval of protocol, Coordinating Person shall send official notification to the winner of the tender. Other bidders shall be notified after receipt of winner’s letter of intention on acceptance of the contract terms and conditions.

---

20 Guidelines “On organization and regulation of SOCAR’s procurement”, Announcing the winner
Conclusions

Based on the results of review and thorough analysis of SOCAR’s internal procurement procedures and Procurement Documentation, it could be suggested that SOCAR has established and implemented comprehensive internal guidelines, rules and procedures covering all material aspects of procurement processes that generally comply with relevant Azerbaijani legislative acts and other internal regulations of the Company.

2.2 Overview of procurement in other jurisdictions

Given that in majority of countries where economy is predominantly formed based on oil and gas, production energy companies are privately-owned, for the purposes of this report it is rational to analyse legal framework in respective area in Russian Federation, Brazil and Kuwait, where major oil and gas companies are state-owned or have large state participatory interest.

2.2.1 Russia experience

In Russian Federation, there is legal framework set up for procurement procedures in relation to certain types of corporations where the Russian Federation directly/indirectly participates or where state budget funds are involved. The Federal Law No. 44-FZ of 5 April 2013 “On the Contractual System in the Area of Purchasing Goods, Works and Services for Meeting the State and Municipal Needs” together with quite developed subordinated legislative acts aims to set the framework for efficient use of funds of the budget of the Russian Federation, its regions and municipalities in course of the public procurement process. The Federal Law No. 223-FZ of 18 July 2011 “On Procurement of Goods, Works and Services by Certain Types of Legal Entities” sets similar approach to procurement process of state companies and corporations, natural monopolies, companies operating in certain regulated sectors, certain types of non-commercial enterprises, and also so call “state-owned” companies, i.e. those companies where the Russian Federation directly or indirectly holds more than 50% shares in the share capital. The regulation also extends to procurement process of subsidiaries of the companies where the Russian Federation it the shareholder as described in the previous sentence. As regards the Russian oil and gas sector, when comparing to SOCAR by size and importance to the economy one would refer to examples of organization of procurement by Public Joint Stock Company “Gazprom” and Public Joint Stock Company “NK Rosneft”.

Following provisions of law, an each so-called “state-owned” company must develop a specific procurement policy to build a transparent, clear and effective open tender system to minimize expenses of enterprises for purchasing of materials, equipment, works and services under the strict quality requirements and deadlines for manufacturing. Major state-owned oil and gas companies of Russia, such as Gazprom and Rosneft have developed such procurement policies. These procurement policies stipulate the requirements on purchases, including the procedure for preparing and carrying out the purchase (in particular, purchasing methods - by tender, auction or otherwise), for conclusion and performance of contracts. Procurements should rely on the principles of equality, absence of ungrounded restrictions or unmeasurable requirements on transaction participants. Information about the purchase should be accessible free of charge. Corporate information about current and ongoing procurement is placed on the official site for government procurement disclosure (www.zakupki.gov.ru).
2.2.2 Brazil experience

State procurement procedures in Brazil are regulated by the Brazilian Constitution of 1988 (Article 37) and a number of other legislative acts stipulating general rules for bidding procedures and government contracts. The entities owned by the Government in Brazil obey the principles of lawfulness, impersonality, morality, publicity, and efficiency. Under Article 37 of Brazilian Constitution, all public works, services, purchases, and disposals are contracted by public bidding, ensuring equal conditions to all bidders, with clauses that establish payment obligations, maintaining the effective conditions of the bid\(^{21}\).

The Brazilian state owned oil and gas company – Petrobras is not the subject to the same tendering regulations as other government agencies. It is entitled to establish its own public procurement rules which could be simpler than those established by the state. In this respect Petrobras has developed electronic procurement portal that provides tools for the acquisition of goods and services, serving the Petrobras system companies and their suppliers\(^{22}\). Companies interested in becoming suppliers may register their products or services using mentioned electronic system.

2.2.3 Kuwait experience

In State of Kuwait, the procurement process is regulated by Law No. 37 of 1964 “On Public Tenders” (the “Public Tenders Law”)\(^{23}\). The Public Tenders Law provides that any procurement made by the state owned companies with a value in excess of KWD 5,000 must be conducted through the Central Tenders Committee and in accordance with its procedures in order to ensure competitive pricing. The Central Tender Committee controls the procurement processes in any state-owned company that makes purchases exceeding KWD 5,000 (Legislation and Fatwa Department, 2005)\(^{24}\).

Procurement procedures in three major oil and gas companies - Kuwait Oil Company (KOC), Kuwait National Petroleum Company (KNPC), Kuwait Oil Tanker Company (KOTC) – are regulated by Policies and Regulations of Purchasing of December 2008\(^{25}\). In terms of these regulations the Central Tender Committee considers and decides on purchase, service and entrusting works requests at an estimated value of more than KWD 5 millions.

Kuwait National Petroleum Company in addition to mentioned policies passed the Resolution 7 of 2009 “On material purchase, entrusting services, contracting, consultancy services and sale of surplus material items”\(^{26}\). This document regulates the tender procedures of the oil companies of Kuwait Petroleum Corporation. It provides for detailed regulation of procurement process, technics of purchasing, requirements to vendors, etc.

\(^{21}\) The text of Brazil Constitution - http://www.servat.unibe.ch/icl/br000000__html.


\(^{23}\) http://www.e.gov.kw/CTC_en/Pages/EServices/Openedtenders.aspx#

\(^{24}\) Publication of OECD “Towards New Arrangements for State Ownership in the Middle East and North Africa”.

\(^{25}\) http://www.e.gov.kw/C7E4499E-004F-4B1C-85D8-250FD5D3994/FinalDownload/DownloadId-0464DED804884E54D6F1789F069CBA3/C7E4499E-004F-4B1C-85D8-250FD5D3994/Documents/English/Forms/MOO/MOO\%20Rules\%20EN.pdf

\(^{26}\) http://www.e.gov.kw/C7E4499E-004F-4B1C-85D8-250FD5D3994/FinalDownload/DownloadId-306ECD217363709AD2E3097C8335B80/C7E4499E-004F-4B1C-85D8-250FD5D3994/Documents/English/Forms/
2.3 Overview of Azerbaijani legislation on state procurement

2.3.1 General overview of tender understanding

Tender related provisions, particularly, tender procedure, requirements placed on tender participants, state procurements procedures and related matters are regulated by the Law of the Republic of Azerbaijan “On Public Procurements” (Law “On Public Procurements”).

In Law “On Public Procurements”, tender is defined as competition held to select the most efficient procurement contract performance proposals submitted by bidders in writing.

The Law “On Public Procurements” applies to procurement of goods/works/services performed in Azerbaijan by state enterprises and organizations (administrations), enterprises and organizations, state share in charter capital of which is 30 and more percent at the account of state funds, loans and grants obtained by state and received under state guarantee.

2.3.2 Persons allowed to organize public procurements

The following state bodies/enterprises/companies have the right for organization of public procurements:

- state enterprises and organizations (administrations);
- enterprises and organizations, with participation interest of the state in the charter capital is 30 and more percent.

The following persons have the right for participation in public procurements:

- any resident legal entity or individual;
- any non-resident legal entity or individual;
- association of legal entities irrespective of state belonging as a single bidder.

The entities with the following criteria are not allowed for participation in tender:

- unavailable to professionalism, experience, technical and financial possibilities, workforce, competency in management, reliability in relevant field to ensure performance of procurement contract;
- has no authority to enter into procurement contract;
- legal entity, which declared its insolvency;
- legal entity, which property is seized/mortgaged;
- legal entity’s commercial activity is suspended by court decision;
- availability of tax and other mandatory payment obligations in Azerbaijan which execution is overdue;

---

• availability of previous conviction within 5 years preceding to commencement of public procurements procedures, for crime connected with their professional activity/professional activity of their employees/incorrect indication of their professional activity/professional activity of their employees/incorrect indication of their qualification indices for conclusion of public procurement contract;

• availability of court decision which prohibits dealing with relevant professional activity\(^{31}\).

2.3.3 Statutory restrictions

Certain restrictions in respect of participation of the bidders in public procurements might be limited on grounds of state of origin. In such case, the relevant procurement agency shall determine reasons for such decision in its report on public procurements procedures\(^{32}\).

2.3.4 Stages of preparation of public procurements

• tender commission is formed;

• package of main terms of tender is prepared;

• tender is announced/invitations to participate in closed tender are sent after approval of the package of basic tender conditions and the announcement about tender by the tender commission\(^{33}\).

2.3.5 Methods of public procurements

The following are methods of public procurements:

• open tender;

• two-stage tender;

• tender with limited participation;

• closed tender;

• request for proposals;

• request for quotations;

• public procurement from one source\(^{34}\).

\textit{Announcement of open tender}

• Announcement on open tender is published twice, first time - not later than 30 (thirty) business days before the date of tendering process, second time - not later than 20 (twenty) business days before the date of opening envelopes.


\(^{32}\) Law of the Republic of Azerbaijan “On Public Procurements”, Article 8.2

\(^{33}\) Law of the Republic of Azerbaijan “On Public Procurements”, Article 22.1

\(^{34}\) Law of the Republic of Azerbaijan “On Public Procurements”, Article 16.1
• the announcements are published in state newspapers of the Republic of Azerbaijan, international mass media\textsuperscript{35}, as well as official internet resources\textsuperscript{36}.

2.3.6 Tender announcement

The following information is reflected in the announcement of the tender:

• date of commencement of tender procedure, time and place of its implementation;

• information on tender organizer;

• information on goods to be purchased, the work to be performed, (scope of work, its contents, specifics of the work to be performed, place of implementation, date of commencement and date of completion, etc.);

• timing required for performance and completion of the works/timetable of works performance;

• payment for participation in tender and bank account for transfer;

• privileges on taxes and duties in respect of procurement contract (if such privileges are envisaged);

• limiting conditions participation of the consignor/contractor in the public procurement procedure by the reason of its state belonging;

• list of documents required to be submitted in order to participate on tender;

• telephone and fax number, time and address for obtaining additional information and documents on tender, name of person responsible for providing these documents and time, address for presentation of the required documents and name of receiving person;

• terms of tender proposal guarantee;

• language(s) of preparation of collection on basic tender conditions;

• deadline and the place for submission of tender proposal;

• criteria and procedures, which are preference in assessment and comparison of qualification indices of the bidders \textsuperscript{37}.

2.3.7 Estimated cost/value of subject of tender

Estimated cost/value of subject of tender is determined based on average market price set by procurement agency prior to announcement of the tender in accordance with the effective legislation of Azerbaijan\textsuperscript{38}.

If necessity arises, experts can be engaged as members of tender commission to prepare collection of principal terms of bidding, conditions and review, assess and compare tender proposals\textsuperscript{39}.

\textsuperscript{35} Publication of announcement on the tender in the international mass media and internet should be in case if total amount of purchased goods is more than 10,000.00 (ten thousand) Azerbaijani manats. Decree of the Board of the Ministry of Finance of the Republic of Azerbaijan # Q-12 dated 20 May 2013, Article 3

\textsuperscript{36} Law of the Republic of Azerbaijan “On Public Procurements”, Article 25.1


\textsuperscript{38} Law of the Republic of Azerbaijan “On Public Procurements”, Article 2, paragraph 17

\textsuperscript{39} Law of the Republic of Azerbaijan “On Public Procurements”, Article 23.3
2.3.8 Documents to be submitted by the bidders

The following is the list of documents, which bidders need to submit for participating in tender:

- application for participation in tender;
- bank receipt confirming payment for participation, or bank liability (guarantee) on payment for participation;
- tender proposal;
- documentation related to bidder (full name of the bidder, legal status, country of incorporation, bank statement about financial position of bidder for the last year);
- the document, reflecting information on qualification indices of consignor.

The bidder must submit the aforementioned documents to the tender organizer not later than one business day before tender process begins. Tender proposal submitted later than specified date will be returned to the bidder in unopened envelope, and bidder will not be admitted to participate in tender.

All documents submitted to tender by the Azerbaijani bidders shall be in Azerbaijani language. Bidders from foreign countries shall attach Azerbaijani translation certified by the notary public to the text prepared by them in the language of their country. If necessary, indicated documents can be translated into one of languages widely used at international trading.

2.3.9 Participation fee

Total amount of participation fee is defined by the procurement agency in an amount not exceeding 0.5 percent of estimated cost of subject matter of tender and 1.5 times of tender costs. All costs related to conducting of tender including costs on announcement, advertisement, lease of rooms for conducting of tender, funding tender of commission, preparation and delivery of tender documents to bidders, as well as all other costs directly associated with conducting of tender, are reimbursed at the expense of participation fee.

2.3.10 Tender proposal

Legal entity/individuals may participate in each tender’s subject matter as one bidder and as bidder shall be entitled to submit only one proposal.

Deadline, time and place of submission of tender proposals shall be set by tender commission the collection of principal terms of bidding.

Tender proposal, signed and stamped, shall be put into two envelops. The bidder signs and stamps the inside of both envelopes and hand over to the procurement enterprises.

---

42 Law of the Republic of Azerbaijan “On Public Procurements”, Article 15
2.3.11 Tender proposal guarantee

Tender proposal guarantee should form 1 to 5 percent of its total cost. Guarantee’s validity shall exceed tender proposal’s validity by 30 (thirty) business days.\textsuperscript{48}

After procurement contract is concluded and guarantee for implementation of the contract is issued, sum of guarantee is returned to the company, which is not declared winner (i.e. does not take first three places) of the tender.\textsuperscript{49}

2.3.12 Tender procedure

The bidder/person authorized by the bidder on the basis of the document certified by the notary public, participates in tender procedure and answers additional questions of members of tender commission.\textsuperscript{50}

Absence of bidder/person authorized by the bidder at the tender procedures is not a reason to exclude such bidder from the tender.\textsuperscript{51}

On the date announced as the beginning of tender process, chairman of the tender commission informs the audience about all received tender proposals and announces names of the registered bidders. Decision adopted by the tender commission is announced on the same day as the bids are considered and is registered in the minutes of the meeting of tender commission. The bidders are informed on the decision of the tender commission on the same day as well.\textsuperscript{52}

2.3.13 Final agreement

The winner of the tender signs procurement contract with the procurement agency within the period indicated in the collection of principal terms of bidding and provides guarantee for implementation of the contract.\textsuperscript{53}

Final agreement specifies responsibilities of tender organizer and winner in case if they fail to fulfill their obligations, guarantees, procedure of settlement of disputes, circumstances sufficient for extension of term of work commencement, conditions of extension, etc.\textsuperscript{54}

Final procurement contract is prepared and signed by appropriate body of executive body.\textsuperscript{55}

2.3.14 Insurance

Procurements to be financed by state funds shall be insured as provided by legislative acts and regulations of the Republic of Azerbaijan.\textsuperscript{56}

If procurement agency considers that insurance is mandatory, it shall reflect it in collection of principal terms of bidding and procurement contract.\textsuperscript{57}

\textsuperscript{48} Law of the Republic of Azerbaijan “On Public Procurements”, Article 33.1
\textsuperscript{49} Law of the Republic of Azerbaijan “On Public Procurements”, Article 33.2.3
\textsuperscript{50} Law of the Republic of Azerbaijan “On Public Procurements”, Article 35.3
\textsuperscript{51} Law of the Republic of Azerbaijan “On Public Procurements”, Article 35.4
\textsuperscript{52} Law of the Republic of Azerbaijan “On Public Procurements”, Articles 35, 36 and 37
\textsuperscript{53} Law of the Republic of Azerbaijan “On Public Procurements”, Articles 40.2
\textsuperscript{54} Law of the Republic of Azerbaijan “On Public Procurements”, Articles 40.10
\textsuperscript{55} Cabinet of Ministers of the Republic of Azerbaijan. Sample of the public procurement contract is approved by the Decree of the Cabinet of Ministers of the Republic of Azerbaijan # 34 dated 28 February 2003
\textsuperscript{56} Law of the Republic of Azerbaijan “On Public Procurements”, Articles 53.1
\textsuperscript{57} Law of the Republic of Azerbaijan “On Public Procurements”, Articles 53.2
State Agency on public procurements of the Republic of Azerbaijan is the designated state body implementing state policy in respect of public procurements\textsuperscript{58}.

2.3.15 Requirements placed on consignors

The consignor shall meet the following criteria in order to participate in public procurement procedures:

- availability of professionalism, experience, technical and financial possibilities, workforce, competency in management, reliability in relevant field to ensure performance of procurement contract;
- authority to enter into procurement contract;
- possibility of free and unlimited use of its assets;
- ability to pay;
- consignor shall not be declared bankrupt;
- consignor’s property shall not be seized/mortgaged;
- consignor’s commercial activity shall not be suspended by court decision;
- absence of tax and other mandatory payment obligations in Azerbaijan which execution is overdue;
- absence of previous conviction within 5 years preceding to commencement of public procurement procedures, for crime connected with their professional activity/professional activity of their employees/incorrect indication of their qualification indices for conclusion of public procurement contract;
- absence of court decision which prohibits to deal with relevant professional activity\textsuperscript{59}.

It might be required from consignor to provide documents/information, confirming that it possesses all of the abovementioned qualifications\textsuperscript{60}.

If consignor provides fictitious information regarding its qualification, it will be excluded from tender\textsuperscript{61}.

Number of bidders shall be no less than 3 (three), otherwise tender shall fail\textsuperscript{62}. In this case procurement agency shall refuse to continue tender and publish relevant information in the mass media within 5 (five) business days, as well as post this information on its official web page\textsuperscript{63}.

2.3.16 Requirements placed on the goods

Any specific features the goods shall be based on objective technical and qualitative indices of the procured goods\textsuperscript{64}.

\textsuperscript{58} Law of the Republic of Azerbaijan “On Public Procurements”, Article 4.1
\textsuperscript{59} Law of the Republic of Azerbaijan “On Public Procurements”, Article 6.2
\textsuperscript{60} Law of the Republic of Azerbaijan “On Public Procurements”, Article 6.3
\textsuperscript{63} Law of the Republic of Azerbaijan “On Public Procurements”, Article 11.1
\textsuperscript{64} Law of the Republic of Azerbaijan “On Public Procurements”, Article 14.1
2.3.17 Estimated price of the goods

The goods shall be procured through open tender, if the estimated price for goods is higher than minimal price set by the Ministry of Finance of Azerbaijan\(^65\) as follows minimum amount of 50,000.00 (fifty thousand) Azerbaijani manats.\(^66\) In addition, minimum amount of the price for the goods (works, services) that are purchased through tender on request for quotations is defined as 5,000.00 (five thousand) Azerbaijani manats.\(^67\)

The following tender proposal is recognized as winning one:

- tender proposal with lowest price;
- tender proposal, considered the best one under criteria indicated in the principal terms of bidding\(^68\).

Tender proposal, which meets the aforementioned criteria is accepted. Procurement agency shall send notice to consignor that submitted such tender proposal within 3 (three) business days within proposal’s validity period\(^69\).

2.4 Overview of SOCAR’s anti-corruption standards in sphere of procurement

The essential document establishing SOCAR’s underlying principles and requirements in the field of anticorruption and compliance with relevant provisions of Azerbaijani anticorruption laws is the Anticorruption Policy of the State Oil Company of the Azerbaijan Republic (“Anticorruption Policy”), which was approved by the Order of SOCAR’s President #108 dated 10 August 2012.

2.4.1 Objectives of the Anticorruption Policy

Anticorruption Policy reflects SOCAR’s “zero-tolerance” to corruption activities and its commitment to high ethical standards of doing business with the aim of “enhancement of the appropriate level of anticorruption culture, maintaining of its business reputation and transparency of business activities” as well as describes measures for minimization of corruption risks in SOCAR’s and its enterprises’ business activities.\(^70\)

Objectives of the Anticorruption Policy are as follows\(^71\):

- collation and interpretation of the key requirements of anticorruption legislation applicable to SOCAR;
- establishment and interpretation of key principles and requirements, underlying rules, standards and norms regulating anticorruption activities and summarize underlying rules, standards and norms of expected behavior;
- identification of obligations and responsibilities of SOCAR’s employees within the procedures preventing corruption activities.

Goals of Anticorruption Policy are following:

---

\(^{65}\) Law of the Republic of Azerbaijan “On Public Procurements”, Article 17.1

\(^{66}\) Decree of the Board of the Ministry of Finance of the Republic of Azerbaijan # Q-12 dated 20 May 2013, Article 1

\(^{67}\) Decree of the Board of the Ministry of Finance of the Republic of Azerbaijan # Q-12 dated 20 May 2013, Article 2

\(^{68}\) Law of the Republic of Azerbaijan “On Public Procurements”, Article 36.7

\(^{69}\) Law of the Republic of Azerbaijan “On Public Procurements”, Article 40.1

\(^{70}\) Anticorruption Policy, Article 1.1.2

\(^{71}\) Anticorruption Policy, Article 1.1.4
To form a uniform understanding of SOCAR’s “Zero-tolerance” to any forms and appearances of Corruption activities with Government authorities, investment community, Counterparties, Subsidiaries and Affiliates, joint ventures, Enterprises, SOCAR’s Employees and other individuals and legal entities;

To minimize corruption risk;

To ensure transparency of SOCAR’s business activities.

Legislative and methodological background

According to Anticorruption Policy, it is developed strictly in accordance with requirements of the legislation of the Republic of Azerbaijan, the Charter of SOCAR and other internal documents taking into account international and foreign anticorruption legislations as well as recommendations of international organizations and leading international anticorruption practices72.

According to Anticorruption Policy, its legislative groundwork is based on the following normative-legislative acts:

1. **International legislation:**73
   - United Nations Convention against Corruption (adopted in New York on October 31, 2003 by Resolution 58/4 at 51st plenary assembly of 58th sitting of United Nations General Assembly);
   - Criminal Law Convention on Corruption (adopted in Strasbourg city on January 27, 1999 ETS No 173);

2. **Anticorruption legislation of the Republic of Azerbaijan:**74
   - Criminal Code of the Republic of Azerbaijan;
   - Administrative Affairs Code of the Republic of Azerbaijan;

3. **Foreign Anticorruption Legislation:**75

According to Anticorruption Policy, its methodological background is based on the following normative-legislative acts:

**Legislation of the Republic of Azerbaijan:**76


---

72 Anticorruption Policy, Article 1.2.1
73 Anticorruption Policy, Article 1.2.2.1
74 Anticorruption Policy, Article 1.2.2.2
75 Anticorruption Policy, Article 1.2.2.3
76 Anticorruption Policy, Article 1.2.3.1

2. International recommendations: 78

- Guidance of Ministry of Justice of UK on implementation of the system of adequate procedures in order to comply with the norms of the UK Bribery Act 2010, issued on March 30, 2011;
- Transparency International, the 2010 UK Bribery Act Adequate Procedures Guidance on good practice procedures for corporate anti-bribery programs;
- Transparency International and Social Accountability, International Business Principles for Countering Bribery;
- Transparency International Anti-corruption Plain Language Guide;
- International Commercial Chamber Rules on Combating corruption;
- International Commercial Chamber Guidelines on Agents, Intermediaries and Other Third Parties.

Scope of application

The Anticorruption Policy is mandatory for all senior employees of SOCAR, as well as other employees regardless of their position, during execution of their employment responsibilities and/or representation of the SOCAR’s interests in any country around the world. 79

According to Anticorruption Policy, the underlying principles and requirements of the Policy also apply to subsidiaries, affiliates, and joint ventures, all counterparties of SOCAR, including suppliers, agents, intermediaries, consultants, representatives and other individuals and legal entities, when such responsibilities are fastened by agreements with them, in their internal documents or follow directly from the Applicable Anticorruption Legislation.

2.4.2 Key Principles of the Anticorruption System 80

“Zero tolerance” principle

According to Anticorruption Policy, SOCAR adheres to the principle of “zero tolerance” to corruption activities or non-acceptance of any forms of corruption activities within its business activities, while executing projects and interacting with government authorities, government officials, public formations and their representatives, politicians, investors, counterparties, partners and other individuals and legal entities. 81

Absence of hierarchic obstacles principle

According to Anticorruption Policy, principles and requirements of tit are mandatory for all employees of SOCAR, regardless of their position, duration of their labor relations with SOCAR, etc. 82

77 Anticorruption Policy, Article 1.2.3.2
78 Anticorruption Policy, Article 1.2.3.3
79 Anticorruption Policy, Article 1.3.1
80 Anticorruption Policy, Article 2
81 Anticorruption Policy, Article 2.1
82 Anticorruption Policy, Article 2.2
Inevitability of punishment principle

According to Anticorruption Policy, employees violating anticorruption principles and requirements of SOCAR irrespective of the scale and form of the violation, would be held liable according to the legislation of the Republic of Azerbaijan and internal regulations of SOCAR, including the Anticorruption Policy and when applicable – international legislative and regulatory acts and legislation of foreign states.83

2.4.3 Corruption Practices Tackling System84

Corruption risk management

According to the Anticorruption Policy, respective structural unit of SOCAR identifies and on a regular basis evaluates corruption risks typical to all countries where SOCAR maintains business activities.85 Respective structural units of SOCAR that evaluate various types of corruption risks are determined by Order #108 of SOCAR’s President.86 According to the Order, Head Office of SOCAR and risk management divisions of its structural units are identified as respective structural units evaluating corruption risks typical to all countries where SOCAR maintains business activities. In addition, the Order #108 appoints Risk Management Committee and SOCAR’s Head Office’s Legal Department as structural units that are responsible for evaluation of corruption risks arising within procurement processes. For these purposes, SOCAR develops and maintains up to date the list of corruption risk indicators typical for its business processes that can be subject to corruption.87

2.4.4 Decisions on the Most Risky Business Areas88

Gifts, hospitality and business entertainment expenses

According to Anticorruption Policy, it is prohibited for employees of SOCAR to ask, request or compel third parties to grant gifts and/or provide hospitality and business entertainments to them or to their close relatives.89 SOCAR prohibits granting or accepting gifts, hospitality or business entertainments if they can influence the outcome of the deal and/or the decision made by the decision maker in favor of the individual or the legal entity who granted the gift, and are not accomplished in good faith.90 Gifts as souvenirs of low value with a logo of the grantor (i.e. branded goods) distributed at exhibitions, open presentations, forums and other marketing events where SOCAR officially participates, or in honor of official and professional holidays, are recognized as promotional goods.91 Gifts, including promotional goods, provided to third parties on behalf of SOCAR and/or at its expense are reflected in a special register with appropriate level of details in accordance with requirements of SOCAR’s internal

83 Anticorruption Policy, Article 2.3
84 Anticorruption Policy, Article 3
85 Anticorruption Policy, Article 3.2.1
86 SOCAR President’s Order #108, Article 2.2.1
87 Anticorruption Policy, Article 3.2.1
88 Anticorruption Policy, Article 4
89 Anticorruption Policy, Article 4.1.2
90 Anticorruption Policy, Article 4.1.3
91 Anticorruption Policy, Article 4.1.7
documents.\textsuperscript{92} Gifts excluding promotional goods, foodstuff and gifts of low value received by SOCAR’s employees during official, protocol or other events/meetings, in business trips while executing their work responsibilities are considered to be the property of SOCAR.\textsuperscript{93}

Hence, SOCAR’s employee who has received a gift as stipulated in the abovementioned cases should inform his direct supervisor, complete the internal memorandum to the head of the respective structural unit and transfer the gift to the head of the respective structural unit.\textsuperscript{94}

**Facilitation payments**

SOCAR does not perform any kind of facilitation payments (e.g. administrative, bureaucratic, etc.) to government authorities, government officials, etc.\textsuperscript{95}

**Charity, social and sponsorship activities**

Information about charity, social and sponsorship activities is subject to mandatory disclosure on SOCAR or its enterprises’ internet web-site(s), in its sustainability report or by other means.\textsuperscript{96} SOCAR being a state entity understands its role in charity, social and sponsorship assistance.\textsuperscript{97} Charity, social and sponsorship activities should comply with the following criteria:\textsuperscript{98}

- Correspond to norms of the applicable legislation, principles and requirements of internal documents of SOCAR, including the Anticorruption Policy;
- Be directly or indirectly connected to business interests or the purposes outlined in the Charter of SOCAR;
- Positively influence SOCAR’s reputation and be effective in achievement of social and public goals in practice.

**Financing of political parties and movements**

SOCAR does not finance political parties, political movements and politicians.\textsuperscript{99}

**Public Relations arrangements**

According to Anticorruption Policy, SOCAR does not allow publications in press and/or broadcasting in mass media of information with the aim of promoting personal image of any third parties intended to influence their further decision in SOCAR’s interests.\textsuperscript{100} Events carried out by SOCAR should comply with the following requirements:\textsuperscript{101}

- Be in line with the applicable legislation, principles and requirements of SOCAR’s internal documents, including the Anticorruption Policy;

\textsuperscript{92} Anticorruption Policy, Article 4.1.8
\textsuperscript{93} Anticorruption Policy, Article 4.1.9
\textsuperscript{94} Anticorruption Policy, Article 4.1.9
\textsuperscript{95} Anticorruption Policy, Article 4.2
\textsuperscript{96} Anticorruption Policy, Article 4.3.5
\textsuperscript{97} Anticorruption Policy, Article 4.3.1
\textsuperscript{98} Anticorruption Policy, Article 4.3.2
\textsuperscript{99} Anticorruption Policy, Article 4.4.1
\textsuperscript{100} Anticorruption Policy, Article 4.5.1
\textsuperscript{101} Anticorruption Policy, Article 4.5.2
• Be directly connected with SOCAR’s business;
• Be reasonable and proportionate to their importance, including format of the event;
• Should not represent the remuneration, including hidden remuneration, and/or should not influence the decision making process in favor of SOCAR and/or its employees;
• Should not create reputational risk to SOCAR, its employees and/or other individuals or legal entities in case of disclosure of the information about conducted and/or financed events.

Relations with Counterparties and Third Parties

According to Anticorruption Policy, SOCAR does not pay any expenses of government officials, politicians and their close relatives or in their interests, including providing them with any material and/or immaterial benefits at SOCAR’s expense (for instance, payments for transport, accommodation, meals, entertainment and etc.), except for expenses related to participation of such individuals in the official events organized and/or sponsored by SOCAR. 

In order to minimize the risk of doing business with counterparties who may be involved in corruption activities/practices, SOCAR:

• analyzes the information about reliability, business reputation and tolerance to corruption of its counterparties (i.e. Due Diligence) and perform conflict of interest check;
• informs them about principles and requirements of the Anticorruption Policy;
• includes into agreements anticorruption provisions regarding their obligation to follow norms of the applicable anticorruption legislation and underlying principles and requirements of the Anticorruption Policy while keeping the right for SOCAR to unilaterally terminate an agreement without reference to court and claim reimbursement of losses within the limits of the applicable legislation in case the counterparty is involved in any corruption activities.

According to Anticorruption Policy, SOCAR cannot engage agents, consultants, representatives and other intermediaries to perform any payments and/or actions contradicting norms of the applicable anticorruption legislation and requirements of SOCAR’s internal documents, including the Anticorruption Policy, and/or creating risks for business reputation of SOCAR and/or its employees.

102 Anticorruption Policy, Article 6
103 Anticorruption Policy, Article 6.1
104 Anticorruption Policy, Article 6.2
105 Anticorruption Policy, Article 6.2.2
3 SOCAR’s JVs, subsidiaries and alliances

3.1 SOCAR’s JVs

3.1.1 Overview of Azerbaijani legislation

While a legal definition of incorporated joint venture is absent under the legislation of Republic of Azerbaijan, by its nature and existing practice of activities of JVs, a joint venture could be defined as a legal entity, formed by venture partners, pursuing a common business interest. Joint ventures might be either local or international, in the latter case at least one of the partners is foreign. For the purposes of this Report, we do not consider local joint ventures in further details, discussing solely international JVs.

Foreign participation in JV and its protection

Under the Law of Republic of Azerbaijan “On Protection of Foreign Investment”, foreign investments might be represented by any kind of property and proprietary rights, including right for results of intellectual activity and other non-proprietary rights being contributed by foreign investors to the objects of entrepreneurial activity and other kinds of activity with the objective of obtaining profits.

Foreign investors might make investments in the territory of Azerbaijan by the way of participation in enterprises, organizations established jointly with legal entities and citizens of Azerbaijan.

Pursuant to the Law “On Protection of Foreign Investment”, foreign investors (including foreign partners in joint ventures established in Azerbaijan) enjoy “national treatment”\(^{106}\). In other words, foreign partners in joint ventures enjoy the same or non-less preferential treatment compared to local partners.

In addition to the Law, the Government has signed treaties on promotion and mutual protection of foreign investment with a number of countries. These treaties typically include guarantees of non-discrimination for new investments, national treatment principle for established investments, most-favored nation treatment for investors, protection of investments from expropriation and nationalization, as well as other measures of similar effect, excluding for expropriation for public purposes in a non-discriminatory manner and upon payment of prompt and adequate compensation equivalent to the market value of the expropriated investment, free transfer of investments into and out of the agreeing countries and other guarantees for promotion and protection of investments\(^{107}\).

According to article 13 of the Law “On Use of Energy Resources”\(^{108}\) (“Energy Resources Law”), financing sources for the measures on the efficient and rational use of energy resources shall come, among other sources, considered the fund of rational power utilization, domestic and foreign investments, state budget and other sources. Article 4 of the Energy Resources Law provides that development programs with regard to power resources are financed from the state budget of the Azerbaijan Republic, fund of efficient use of power resources, legal entities and physical persons, including foreign investors.

In addition to the above, investors contributing progressive technology, materials, or financial resources as investment to improve the efficiency of energy use in Azerbaijan, shall adhere to requirements of the

\(^{106}\) Law “On Protection of Foreign Investment”, article 5

\(^{107}\) See, e.g. Treaty on Mutual Promotion and Protection of Investment between Government of Republic of Azerbaijan and Government of Republic of Turkey, effective from May 2, 2013

\(^{108}\) Energy Resources Law, effective from 20 November 1996
Energy Resources Law, the legislation regulating investment protection and the activity in this sphere, as well as other applicable normative legal acts\textsuperscript{109}.

\textit{Choice of legal vehicle}

Azerbaijan legislation does not contain restrictions on the choice of legal vehicle (organizational-legal form) for incorporated joint ventures. According to the Law of Republic of Azerbaijan “On Protection of Foreign Investment”, enterprises with foreign investments are established in the form of joint-stock companies (either open or closed), limited liability companies and also in any other forms not contradicting the legislation of the Republic of Azerbaijan. Thus, the legislation allows freedom of the choice of legal vehicle for the establishment of an incorporated joint venture, depending on the specific circumstances and economic considerations of the parties considering entering into such an arrangement.

\textit{Applicability of public procurement regulations}

While the issue has not been tested in courts, the analysis of the Public Procurement Law indicates that the establishment of incorporated JVs does not fall under the concept of state procurement as defined in legislation\textsuperscript{110}. Hence, the process of negotiation and establishment of JVs is not subject to state procurement process.

\textit{Antitrust restrictions}

Establishment of an incorporated joint venture may be subject to obtaining clearance from the State Service for Antimonopoly Policy and Consumer Rights’ Protection under the Ministry of Economy and Industry of the Republic of Azerbaijan (“SSAP”). According to the Law “On Antimonopoly Activity”, the following transactions, concluded between economic subjects (including legal entities) shall require prior approval and consent of the Service:

- merger and association of economic subjects (if it results in the establishment of economic subjects, the share of which exceeds 35\% in respective commodities market);
- association and merger of economic subjects, whose total value of assets exceeds 75 000 times the minimum salary;
- liquidation (except for cases of liquidation of enterprises as a result of a court decision) and division of the enterprises, the total value of assets of which exceeds 50 000 times of the minimal amount of salary, and also national and municipal enterprises (if it results in the establishment of economic subjects, the share of which exceeds 35\% at respective commercial market)\textsuperscript{111}.

The entity which intends to establish such economic subjects meeting the above criteria should submit to SSAP the application and supporting documentation with regard to the particular transaction. Pursuant to the Law\textsuperscript{112}, SSAP should inform the applicant in writing about its decision not later than 15 days after the receipt of required documents attached to the application. If State Antimonopoly Service refuses to grant its approval, the applicant has a right to appeal in an administrative order to the Ministry of Economy and Industry of Republic of Azerbaijan, or file a claim in the relevant administrative-economic court of Azerbaijan for the annulment of such decision.

\textsuperscript{109} Energy Resources Law, article 31
\textsuperscript{110} Law of the Republic of Azerbaijan “On Public Procurements”, article 2
\textsuperscript{111} The Law “On Antimonopoly Activities”, article 13.1
\textsuperscript{112} The Law “On Antimonopoly Activities”, article 13.2
Establishment of a joint venture between competing entities may trigger application of unfair competition rules. According to the Law of Republic of Azerbaijan “On Unfair Competition” (“Unfair Competition Law”), unfair competition occurs when the activities of business entities contradict customary business practices and the requirements of reasonableness, honesty and fairness, and have inflicted or may inflict losses on other competing business entities, or have damaged or may damage their business reputation. Unfair Competition Law expressly prohibits acts of unfair competition, including, inter alia, unfair entrepreneurship, discrediting or interference with economic activity of the competitor, the dissemination of false, inaccurate, or distorted information. The responsibility for enforcement of competition regulations is within the prerogative of SSAP.

According to the Presidential Decree No. 310 “On Measures to Improve the Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan”, the production and processing of oil and oil products can only be conducted by state enterprises or joint-stock companies in which the controlling stake belongs to the state. However, article 2.5 of SOCAR Charter stipulates that entities within structure of the Company may engage in activities envisaged in the Charter without obtaining relevant special permits (licenses). It should also be noted that Azerbaijani legislation does not envisage the possibility of transferring of a license from partner to the corporate joint venture. Licensing

Negotiation procedure for JV establishment

Legislation does not prescribe a set procedure for negotiation by venture partners of issues regarding the establishment of incorporated JV or contain any dispositive norms in this regard.

3.1.2 Overview of SOCAR’s internal regulations on establishment of JVs

According to article 2.3 of the Charter, the Company may establish legal entities (joint ventures) with a view of attracting the necessary investment, technology, equipment etc. and improvement of services rendered in this field. The Charter or its internal normative regulations do not restrict the Company in choice of legal vehicle for establishment of incorporated JVs. Given that Azerbaijani legislation similarly does not contain restrictions in this matter, it could be assumed that joint ventures operating in the field of oil and gas, may be formed in any organisational-legal form, as envisaged by the Civil Code of Republic of Azerbaijan, as well as by the relevant legislation of foreign jurisdiction where JV is established. As a matter of practice, the majority of joint ventures formed in partnership with SOCAR are incorporated as limited liability companies.

According to articles 5.9-5.10 of Company’s Charter, Company’s Council has the competence to adopt the decision on establishment of a joint venture.

---

113 Unfair Competition Law, articles 6-9
114 Regulations on Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan adopted by Presidential Decree No. 782 “On Measures to Improve the Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan” of December 2, 2002, art. 1.6
115 Charter of SOCAR
Under SOCAR’s internal regulations the review of issues in connection with establishment of incorporated JVs should be carried out by the Company’s Investment Department.

3.2 SOCAR’s foreign subsidiaries, representative and branch offices

SOCAR's wholly and majority owned subsidiaries are engaged in various activities, including engineering, research, production activities, transportation, construction activities supporting the main operations, as well as other commercial activities.

3.2.1 Overview SOCAR's internal regulations and legislative framework on establishment of foreign subsidiaries, branches and representative offices

According to SOCAR Charter 116, the Company is entitled to adopt decisions on establishment of representative offices, branches, and legal entities in foreign countries.

Representative/branch offices of SOCAR’s foreign subsidiaries in Azerbaijan are regulated by the relevant norms of Civil Code in parts concerning branch and representative offices 117.

3.3 SOCAR’s local subsidiaries

3.3.1 Overview of legislation on local subsidiaries, representative and branch offices

According to the Civil Code 118 of the Republic of Azerbaijan, a legal entity established in Azerbaijan may form subsidiaries in any of the legal forms as stipulated in the Civil Code. A subsidiary is a separate and distinct legal entity; the parent enterprise may contribute property to its subsidiary however, generally, is not liable for the obligations of the subsidiary. A parent company, however, may be held liable for obligations of its subsidiary in bankruptcy if such bankruptcy was caused through the fault of the parent company in connection with execution of its instruction. Additionally, a parent company and its subsidiary are jointly and severally liable for obligations incurred by the latter as a direct result of implementation of instructions of the former even if the former is not subjected to bankruptcy proceedings.

According to the Civil Code, representative and branch offices are subdivisions of a legal entity. Notwithstanding the fact that branch/representative offices do not constitute legal entities 119 under Azerbaijani legislation, they are subject to taxation, including profits tax provided they engage in commercial activity and generally share majority of characteristics of legal entities. Both carry out all or some of the functions of its parent legal entity and can be engaged in revenue generating activities. In practical terms, the branch and representative offices share common features, however, in legal terms branch offices are regarded predominantly as commercial (revenue generating) organizations, whereas representative offices are intended to promote the interests of its parent company.

Both the representative and branches operate on the basis of regulations approved by their parent legal entity. A representative office, unlike a separate legal entity, a branch or subsidiary, cannot perform any business in the name of the parent company.

---

116 Charter of SOCAR, Art. 2.4
117 Refer to section 3.3.1 of this Report
118 The Civil Code of the Republic of Azerbaijan, Art. 67
119 The Civil Code of the Republic of Azerbaijan, Art. 53
The legislation does not impose limitations on “upstream guarantees” (promise of the debt repayment of a parent company by a subsidiary company).

3.3.2 Overview of SOCAR’s internal structure and internal regulations on local subsidiaries, as well as other relevant legislative framework

According to the Charter of SOCAR, the structure of the Company is approved by the President of the Republic of Azerbaijan. The entities within the structure of SOCAR are established, reorganized and liquidated by the Company’s President according to the structure in compliance with established procedure.

The Charter establishes SOCAR as a holding company structure, operating through its departments organized as separate subsidiary legal entities (enterprises) managed by separate heads.

Pursuant to the Charter, heads and deputy heads of entities within the structure of Company are appointed and dismissed by the Company’s President.

3.4. SOCAR’s alliances

Under the legislation of Republic of Azerbaijan, joint venture partners may establish joint ventures on contractual basis, without the establishment of a relevant legal entity. According to the civil legislation, conditions of such arrangements (e.g. agreements on alliances, joint operations, consortiums, cooperation etc.) may be regulated by the contract concluded between the joint venture partners, or, alternatively, fall under the scope of different types of contractual obligations under Civil Code.

The Company’s Charter envisages the possibility for implementation of joint projects without establishment of a legal entity (alliance) with a view of investment, advanced technology and equipment into the field (of Company’s activities).

The Company Board has the competence to discuss the expedience of joint work with foreign companies.

The Charter does not contain restrictions as to the legal form for establishing alliances with foreign companies.

3.5 International experience

Across the globe, international companies form joint ventures with domestic companies with the main idea to enter new markets quite usually. Foreign companies generally contribute new technologies and business practices to the joint venture, while the domestic companies contribute their relationships and requisite governmental documents within the country, along with their established involvement in the
domestic industry. The exact shape of the parties’ investment in JV largely depends, however, on its business purpose, commercial sector, other economic and business factors/considerations.

Negotiation and establishment of JV in international practice normally consists of the below major steps taken at early and at the developed stage of a particular JV structuring:

*Early stage:*

- assessing the suitability of the potential JV partners. The choice of partners may depend on different factors such as financial, technical, and strategic. Often the choice of partners may be driven by the investor’s state strategy.

- background check of partners. Procedures generally referred to as know your client procedures are applied to the choice and check of partners. It’s a standard form that ensures a company knows detailed information about investment partners’ risk tolerance, corporate and financial position, criminal story.

- execution of a termsheet containing major provisions of the potential deal, objectives, financial and other recourse contributions of each partner, management and control responsibilities, sharing/re-allocation of liabilities, exit strategy. All mentioned provisions are further developed in details in the shareholders (joint venture) agreement.

JV’s tax and legal structuring stage aimed at selecting most efficient model for operation of the JV may precede or be conducted simultaneously with the execution of termsheet.

*Developed stage:*

- Drafting, negotiations and execution of transactional documents, which generally include: shareholders agreements (JV agreements), and depending on the transactional structure, certain side agreements (existing or newly issued shares share purchase agreements, option agreements, financial agreements, etc.) Shareholders agreements could be governed by national law if it provides for effective mechanisms of shareholders’ rights protection or, lacking such, often the choice of law is made in favor of laws with internationally strong reputation like laws of England and Wales. The parties to the shareholders agreement shall typically include provisions on dispute resolution forum into the Shareholders agreement, too.

- establishment of holding companies for carrying out of operational functions;

- obtaining regulatory approvals (passing through antimonopoly clearance and any other respective administrative procedures).

*Conclusions*

While approaches on establishment of incorporated and unincorporated JVs adopted by different jurisdictions could vary significantly depending on the purpose, shareholding structure and other parameters of specific JVs, the general framework for coordination and implementation of procedures on establishment of JVs, as envisaged in internal regulations of SOCAR, does not contradict the applicable Azerbaijani legislation, the general approaches in other jurisdictions analysed for the purposes of this Report, as well as leading industry practice.
4 Production Sharing Agreements (PSAs)

4.1 Concept of PSA in Azerbaijani legislation

Based on general definitions of Production Sharing Agreements in various legal systems, PSA means an agreement, which is generally concluded between government (state company/party representing the state) and foreign company/group of companies, engaged in upstream activity. Based on PSA, the government (state company/party representing the state) awards the execution of exploration and production activities to an oil and gas company. Such oil and gas company should have expertise to execute exploration and production activities.

4.2 PSA in Azerbaijani legislation

In Azerbaijani legislation, the concept of PSA is not defined or used. It is incorporated into Azerbaijani legislation by way of separate law on approval of PSA concluded by SOCAR, acting on behalf of the Azerbaijani state, with foreign counter-parties. Many of PSAs provide the conditions for conclusion of PSA by SOCAR - the other party(ies) of PSA should possess relevant expertise in order to perform exploration and production activities in Azerbaijan. Thus, ACG PSA states that “the Contractor has the technical knowledge and experience, the administrative and managerial expertise, and the financial resources to efficiently develop and produce the Petroleum resources of the Contract Area, and desires to contract with SOCAR for that purpose …”

Azerbaijan so far has concluded numerous PSAs, that include but are not limited to the following:

- Absheron
- Araz, Alov, Sharg
- Azeri, Chirag, Gunashli
- Bahar, Gum Daniz
- Shahdaniz
- Shafag Asiman
- Balakhani and other blocks
- Kurovdag
- Kursangi Garabaghli
- Mishovdag Kalamaddin
- Neftchala and other blocks
- Padar
- Pirsaahhat
- Surakhani

127 Petroleum means both crude and natural gas, the ACG PSA, Appendix I, Definitions
128 Preamble of the ACG PSA
Zigh Hovsan

For the purposes of this document, the analysis of PSA in existing Azerbaijani legislation will be performed using the example of Agreement “On the joint development and production sharing for the Azeri and Chirag fields and the deep water portion of the Gunashli Field in the Azerbaijan Sector of the Caspian Sea among the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OJJESELSKAP a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLLELERI A.O., UNOCAL KHAZAR, LTD” (“ACG PSA”) and Agreement “On the exploration, development and production sharing for the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea between the State Oil Company of the Republic of Azerbaijan and Socar Commercial affiliate, BP Exploration (Azerbaijan) Limited, ELF Petroleum Azerbaijan B.V., Lukoil International Ltd, Oil Industries Engineering and Construction, Statoil Azerbaijan A.S., and Turkish Petroleum Overseas Company Limited” (“Shahdeniz PSA”).

Azerbaijani legislation does not regulate the issues covered by the ACG PSA and Shahdeniz PSA fully and based on the up-to-date requirements, as well as there is no Azerbaijani laws on carbo-hydrogen resources. Therefore, those PSAs were adopted in their full and complete form and incorporated into the Azerbaijani legislation as separate laws, thus creating distinct legal regime for certain areas of law in Azerbaijan.

The ACG PSA stipulates that “the Contract term shall commence on the Effective Date and shall continue for a period of thirty (30) years after the Effective Date…”130 “the Effective Date shall be the date upon which SOCAR delivers to Contractor written evidence of the enactment by the legislature of the Azerbaijan Republic in full compliance with the Constitution and all requisite legal formalities and procedures and publication in the customary manner of legislation giving this Contract … the full force of law in Azerbaijan” 131.

Thus, ACG PSA became law once it was duly enacted in accordance relevant procedures within the legislation of Azerbaijan.

The same provision is stipulated under Shahdeniz PSA: “The Effective Date shall be the date upon which SOCAR delivers to Contractor written evidence of the enactment by the legislature of the Republic of Azerbaijan in full compliance with the Constitution and all requisite legal formalities and procedures and publication in the customary manner of legislation giving this Agreement … the full force of law in the Azerbaijan Republic”132.

---

129 Preamble of the Law of the Republic of Azerbaijan “On acceptance, approval and granting permit for implementation of the agreement on the joint development and production sharing for the Azeri, Chirag fields and deep water portion of Gunashli field in the Azerbaijani Sector of the Caspian Sea concluded between the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OJJESELSKAP a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLLELERI A.O.”

130 Article 4.1, paragraph (a) of ACG PSA

131 Article 25.1, paragraph (a) of ACG PSA

132 Article 25.1, paragraph (a) of the Shahdeniz PSA
The Law of the Republic of Azerbaijan “On acceptance, approval and granting permit for implementation of the agreement on the joint development and production sharing for the Azeri, Chirag fields and deep water portion of Gunashli field in the Azerbaijani Sector of the Caspian Sea concluded between the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OLJESELSkap a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLLERI A.O.” (hereinafter referred to as the “Law On ACG PSA”) stipulates that based on provisions of the ACG PSA, it becomes law once it is adopted by the legislative body of Azerbaijan, i.e. Milli Mejlis.133

The analogous provision is stipulated under the Law of the Republic of Azerbaijan “On acceptance, approval and granting permit for implementation of Agreement on the exploration, development and production sharing for the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea between the State Oil Company of the Republic of Azerbaijan and Socar Commercial affiliate, BP Exploration (Azerbaijan) Limited, ELF Petroleum Azerbaijan B.V., Lukoil International Ltd., Oil Industries Engineering and Construction, Statoil Azerbaijan A.S., and Turkish Petroleum Overseas Company Limited”, (hereinafter referred to as the “Law On Shahdeniz PSA”), which states that based on provisions of Shahdeniz PSA, it becomes law once it is adopted by the legislative authority of Azerbaijan.134

The Law On ACG PSA states the following:

“The agreement on the joint development and production sharing for the Azeri, Chirag fields and deep water portion of Gunashli field in the Azerbaijani Sector of the Caspian Sea concluded between the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OLJESELSkap a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLLERI A.O., UNOCAL KHAZAR, LTD. is accepted and approved, the permit for its implementation is granted.135

Engineering and Construction, Statoil Azerbaijan A.S., and Turkish Petroleum Overseas Company Limited” is accepted and approved, the permit for its implementation is granted.136

The ACG PSA formed part of Azerbaijani legislation once the Law On ACG PSA become effective in accordance with relevant procedures for this purposes as stipulated in Azerbaijani legislation.137

The Law On ACG PSA prevails over provisions of the existing Azerbaijani law, or law that could be adopted in the future, decree, or administrative orders, that are not in compliance with or contradicts to the ACG PSA.138

By analogy, the Law On Shahdeniz PSA states that Shahdeniz PSA prevails over provisions of the existing law, or law that could be adopted, decree, or administrative orders, that are not in compliance with or contradict to Shahdeniz PSA.139

4.3 SOCAR’s participation in PSAs

In accordance with the Charter of SOCAR, SOCAR exercises ownership over all produced carbo-hydrogen, as well as all oil, petrochemical and gas products of Azerbaijan.140

Based on Presidential Decree “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”, SOCAR was granted authorities for conduct of negotiations on exploration and development of Azeri and Chirag fields, preparation and conclusion of the contract.141 The ACG PSA also makes reference to negotiations that were held by SOCAR:

“SOCAR has held discussions with a group comprised of Amoco, Unocal, BP, McDermott, Ramco and Statoil (such group being known hereinafter as the "Azeri Field Group") with a view to the possible development of the Azeri Field” “SOCAR has held discussions with a group comprised of BP and


137 Article 3 of the Law of the Republic of Azerbaijan “On acceptance, approval and granting permit for implementation of the agreement on the joint development and production sharing for the Azeri, Chirag fields and deep water portion of Gunashli field in the Azerbaijani Sector of the Caspian Sea concluded between the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OLIJESELSKAP a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLERI A.O.”

138 Article 3 of the Law of the Republic of Azerbaijan “On acceptance, approval and granting permit for implementation of the agreement on the joint development and production sharing for the Azeri, Chirag fields and deep water portion of Gunashli field in the Azerbaijani Sector of the Caspian Sea concluded between the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OLIJESELSKAP a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLERI A.O.”


140 Article 1.2 of the Charter of SOCAR and Preamble of the ACG PSA

141 Article 2 of the Presidential Regulations “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”
Statoil (such group being known hereinafter as the "Chirag Field Group") with a view to the possible development of the Chirag Field ….”

By analogy, based on Presidential Decree “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea” SOCAR was granted authorities for conduct of negotiations on exploration and development of Azeri and Chirag fields, preparation and conclusion of the contract.

4.4 Pre-PSA stage

The Presidential Regulations “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields” approved offers on negotiations held by SOCAR with foreign oil companies (Amoco, British Petroleum, Statoil, Penzoil, Ramco, Unocal, Mcdermott, Turkish Oil Company).

Thus, based on provisions of the Presidential Regulations “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”, one may suggest that as a part of initial stage, firstly SOCAR receives offers from foreign oil companies, such as mentioned in the above paragraph, considers them, and performs their evaluation/analysis internally.

In accordance with the provisions of Charter of SOCAR, SOCAR performs negotiations in order to reach initial understandings, which are not legally binding, with the leading companies for the purposes of attraction of advanced technologies and investments for exploration, development of carbo-hydrogen accumulations.

Having analyzed the above provisions of the Presidential Regulations “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields” and provisions of Charter of SOCAR, indicated above, one may conclude that SOCAR is authorized to reach initial understandings with oil companies for the purposes of exploration, development of carbo-hydrogen accumulations and that such initial understandings are discussed and reached with those oil companies whose offers/requests were considered as acceptable by SOCAR.

Memorandum of Intentions (“MOI”) might be considered as one of such initial understandings, as based on provisions of Civil Code of Azerbaijan, “agreement on intentions does not establish civil law consequences, unless the parties have not explicitly expressed such intention”.

Thus, then SOCAR executes Memorandum of Intentions (“MOI”) with the party (foreign oil company), whose offer is considered reasonable and acceptable by SOCAR.

After MOI is signed, SOCAR starts negotiations with that party on relevant terms and conditions of prospective PSA. As it has already been mentioned above, SOCAR is authorized to perform negotiations in order to reach initial understandings, which are not legally binding based on provisions of Charter of SOCAR.

---

142 Preamble of the ACG PSA
143 Article 2 of the Presidential Regulations “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”
144 Article 1 of the Presidential Regulations “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”
145 Article 2.3, paragraph 15 of the Charter of SOCAR
146 Article 402.6 of the Civil Code of the Republic of Azerbaijan
147 Article 2.3, paragraph 15 of the Charter of SOCAR
4.5 Conclusion of PSA

After the initial understandings between SOCAR and counter-parties are reached, procedures for preparation and approval of PSA commences.148

The draft of PSA is submitted to the relevant authorities of executive power for the purposes of concurrence.

For example, based on Presidential Decree “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea” SOCAR has to provide the PSA for review of the President after its execution149

By analogy, Presidential Decree “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”, SOCAR has to provide the PSA for review of the President after its execution.150

After the relevant opinions and approvals are obtained, the draft of PSA would need to be agreed and signed between SOCAR and relevant commercial counter-parties.

In the example of Shahdeniz PSA, Presidential Decree “On finalization of negotiations with foreign oil companies on exploration, development and production sharing of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea” approved the draft of Shahdeniz PSA and authorized SOCAR to execute it on behalf of the state.151

Similarly, the Presidential Decree “On finalization of negotiations with consortium of foreign oil companies on joint development of oil pools in the Azerbaijani sector of Caspian Sea”, approved the draft of ACG PSA and authorized SOCAR to execute it on behalf of the state.152

Once the draft of PSA is agreed and signed, it shall be submitted to the Parliament of the Republic of Azerbaijan for its adoption. After the Parliament adopts decision on approval of particular PSA, the bill is submitted to the President of Azerbaijan for approval and adoption, as well as granting permission for implementation of particular PSA, after which the particular PSA becomes effective as law of Azerbaijan.

Thus, based on Presidential Regulations “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”, the ACG PSA shall be provided to the President for review once it is signed.153

Analogically, Presidential Regulations “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”, stipulates that “Shahdeniz PSA” shall be provided to the President for review once it is signed.154

---

148 Article 2.3, paragraph 15 of the Charter of SOCAR
149 Article 2 of the Presidential Regulations “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”
150 Article 2 of the “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”
151 Articles 1 and 2 of the Presidential Decree “On finalization of negotiations with foreign oil companies on exploration, development and production sharing of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”
152 Article 1 and 2 of the Presidential Decree “On finalization of negotiations with consortium of foreign oil companies on joint development of oil pools in the Azerbaijani sector of Caspian Sea”
153 Article 3 of the Presidential Regulations “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”
154 Article 2 of the Presidential Regulations “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”
4.6 Joining and exiting PSAs

ACG PSA stipulates provisions on joining of new contractors through assignment of all or part of rights and obligations of the existing contractor to the third party.\(^{155}\) Such third party shall:

- “have the technical and financial ability commensurate with the responsibilities and obligations which would be imposed on it hereunder;
- as to the interest assigned, accepts and assumes all of the terms and conditions of this Contract; and
- is an entity with which SOCAR can legally do business.”\(^{156}\)

Such assignment is performed once the prior approval of SOCAR has been obtained. Thus, if within ninety (90) days following notification to SOCAR of a proposed assignment accompanied by the relevant information and the draft deed of assignment… SOCAR has not given its decision, such assignment … shall be deemed to be approved by SOCAR.”\(^{157}\) Essentially, the said assignment under particular PSA implies the sale of stakes from existing contractor to third party.

Likewise, under Shahdeniz PSA, new contractor may join through assignment of all or part of its rights and obligations arising under Shahdeniz PSA to any third party. However, such third party shall meet all those criteria that are indicated in ACG PSA.\(^{158}\)

ACG PSA outlines procedure for relinquishment (i.e. exiting) by the contractor. Particularly, based on provisions of ACG PSA, “Contractor may terminate this Contract at any time by giving SOCAR ninety (90) days prior written notice. Upon such termination, Contractor shall have no further obligations of any kind whatsoever to SOCAR except for the performance of its obligations under the Minimum Obligatory Work Programme \(^{159}\) and the then current Annual Work Programme \(^{160}\) …”\(^{161}\)

The 90-day prior written notice, shall specify the date upon which the relinquishment takes effect and the manner in which contractor will perform any remaining obligations\(^{162}\)

If SOCAR or contractor requests, a meeting of the Steering Committee \(^{163}\) shall be convened to address any questions which may arise in connection with the relinquishment.\(^{164}\)

The ACG PSA states that “the Contractor shall have no unilateral right to relinquish a part of the contract area. In the event the Steering Committee decides not to develop any portions of the contract area, the Parties (i.e. SOCAR and contractor) will discuss the possibility of partial relinquishment on mutually agreed terms.”\(^{165}\)

---

\(^{155}\) Article 22.2, paragraph (b) of ACG PSA

\(^{156}\) Article 22.2, paragraph (b), (i) of ACG PSA

\(^{157}\) Article 22.2, paragraph (b), (iii) of ACG PSA

\(^{158}\) Article 22.2, paragraph (b), (i) of Shahdeniz PSA

\(^{159}\) Minimum Obligatory Work Programme means the programme of minimum work obligations of contractor, Appendix I of ACG, Definitions

\(^{160}\) "Annual Work Programme" means the document describing, item by item, the petroleum operations to be carried out during a calendar year in or related to the contract area

\(^{161}\) Article 30.3, paragraph (a) of ACG PSA

\(^{162}\) Article 30.3, paragraph (b) of ACG PSA

\(^{163}\) Steering Committee is a body established by SOCAR and contractor(s). Functions of Steering Committee includes, but are not limited to overseeing petroleum operations, examination, revision and approval of the contractor’s Annual Work Programmes and budgets and etc.

\(^{164}\) Article 30.3, paragraph (b) of ACG PSA

\(^{165}\) Article 30.5 of ACG PSA
The similar provisions are stipulated under Shahdeniz PSA:

“Contractor shall terminate this Agreement with effect on or at any time after the expiry of the Exploration Period or if Contractor enters the Additional Exploration Period then with effect on or at any time after the expiry of the Additional Exploration Period, by giving SOCAR ninety (90) days prior written notice. Upon such termination, Contractor shall have no further obligations of any kind whatsoever to SOCAR except for the performance of its obligations under the then current Annual Work Programme.”

“Contractor shall have no unilateral right to relinquish a part of the contract area. In the event Contractor decides not to develop any portions of the contract area, the parties (i.e. SOCAR and contractor) will discuss the possibility of partial relinquishment on mutually agreed terms.”

Conclusions

Azerbaijani legislation does not regulate specifically the process/steps of negotiation and/or conclusion of PSA. However, based on analysis of the relevant PSAs randomly chosen for the purposes of this report and normative-legal acts above, it could be concluded that negotiation of PSAs is performed based on authorisations vested to SOCAR by virtue of relevant Presidential Decree and their enforcement under Azerbaijani legislation takes effect after the executed PSA is approved by Azerbaijani Parliament and becomes law after President of Azerbaijan signs the relevant law on PSA. Without such procedure PSA would not legally integrate into Azerbaijani legislative system and thus have no legally binding status. It could be also concluded that there is a consistent legal practice in Azerbaijan on PSA establishment since 1994 which remains substantially unchanged.

Based on the above, it could be concluded that PSA establishment practice does not contradict Azerbaijani legislation and PSAs concluded through passing of appropriate stages and procedure have legally binding status in Azerbaijani legislative system.

4.7 Practices on PSAs in oil dependent economics

4.7.1 Introduction

A Production Sharing Agreement (“PSA”) is a contract under which the State, as the owner of mineral resources, engages one or more oil companies (“OC”), often foreign, as contractors to provide technical and financial services for exploration and development operations. The State is traditionally represented by the Government or a National Oil Company (“NOC”). The OCs acquire an entitlement to a stipulated share of the oil produced as a reward for the risk taken and services rendered. The State, however, remains the owner of the petroleum produced subject only to the contractors’ entitlement to their share of production. The Government or its NOC usually has the option to participate in different aspects of the exploration and development process. In addition, PSAs frequently provide for the establishment of a joint committee where all parties are represented and which monitors the operations.

The PSA originated through the 1960s and 70s in Indonesia. The country had a similar cultural and conceptual system in their agriculture sector, where agriculture leases traditionally had been based on simple production sharing. The country wanted to free itself from the Dutch colonization, which had

---

166 Exploration Period shall be three (3) years from the Effective date of this Agreement, Article 4.1 of Shahdeniz PSA
167 Additional Exploration Period is a period which Contractor may request from SOCAR by notifying in writing 90 (ninety) days before the end of Exploration Period on its desire for carrying out additional exploration work
168 Article 29.3, paragraph (a) of Shahdeniz PSA
169 Article 29.5 of the Shahdeniz PSA
lasted for about 300-400 years. The nationalistic sympathies can often be traced in the contract where it expresses itself in many ways.

The PSA was a great success, Indonesia achieved solid economic results on the basis of its application. This is probably the main reason why the PSA has spread to numerous countries around the world. The PSA represents the key element in a regulatory system used in the exploration and production business worldwide, except in some European countries (where a concession based system prevails), in the US and in some Latin American countries which have during their privatization period in the 1990s reintroduced mineral concessions on the Chilean model (Chile, Argentina, Columbia, Peru in particular).

A high degree of standardization across PSAs is evident and a large number of model form agreements exist across jurisdictions in Africa, Central Asia and South-East Asia. Where this is the case, the model form has been used as a starting point or precedent, with modifications resulting from negotiations between the international oil companies and state concerned noted.

4.7.3 Practice of state-owned companies operating in oil and gas sector in some jurisdictions

Originally, a production-sharing agreement regime was established in Russia in parallel with the licensing regime with the intention to encourage foreign investments in geographically isolated areas where there were technically complex hydrocarbon projects. Specific PSA legislation was adopted in 1995 in Russia. The Federal law of 30 December 1995 No. 225-FZ “On production sharing agreements” sets the framework for execution of PSAs including main provisions to be included into the PSA, PSA execution procedure and ways of state control over the PSA performance. Separate federal laws provide for lists of subsoil areas to be developed on PSA basis.

Currently, PSA model is not commonly used in Russia. Today in Russia there are only three large production sharing agreements: Sakhalin I, Sakhalin II and Kharyaga.

Sakhalin 1, located offshore, is an international consortium that started with Exxon Neftegas (30%), Japan’s Sodeco (30%), Sakhalinmorneftegaz-Shelf (23%), and Rosneft-Sakhalin (17%). The PSA for the project was approved in 1995. Sakhalin 2, valued at $15 billion, has two fields off the coast of Sakhalin, Astokhskoye and Lunskoye. Sakhalin 2 originally involved Sakhalin Energy Investment, a joint venture of Marathon (30%), Mitsui (20%), McDermott (20%), Shell (20%), and Mitsubishi (10%). The PSA was approved in 1995 and the consortium started producing oil in 1999.

4.7.4 Brazil Experience in PSA area

The PSA regime in Brazil was introduced after a major oil discovery in 2007 of the Tupi field, which contained prospective oil located offshore about 7000 meters below the water surface, crossing a salt barrier (pre-salt). The Brazilian Government decided to introduce a Production Sharing Agreement and to incorporate a special State owned company to capture a larger share of the prospective revenues from the oil reserves.

From 1995, when Brazil relaxed the requirements for State monopoly by amending the regulations and allowing for greater involvement of companies, until the discovery of the pre-salt area, the regulatory regime in Brazil had been a concession regime where the Brazilian Government was allowed to contract with State owned and private companies. The PSA regime that was introduced after the discovery in 2007 applies to the pre-salt area, as well as other areas the Brazilian Government defines as strategic. The concession regime applies to the remaining areas.

The PSA entitles the oil company (contractor) to explore and produce oil within a determined area. The contractor bears the risk and expenses under the exploration and production. The host country may
participate by supporting certain expenses, especially those associated with the development of commercial discoveries. In case of a commercial discovery in the pre-salt area in Brazil, the contractor is entitled to recover the costs incurred as a percentage of the production, so called “cost oil”. The remaining production oil is categorized as “profit oil”, and is shared between the oil company and the federal government after the deduction of royalties. A contractor in the Brazilian PSA regime also has to pay a signature bonus. The signature bonus is the amount to be paid by the winning bidders to the State of Brazil as consideration for granting and executing the relevant PSA. The royalties are a constitutionally granted financial compensation for the exploitation of hydrocarbons, payable and distributed to certain Municipalities, States and the Union.

The new PSA regime was introduced in Brazil with the implementation of three new laws; (1) Law 12,276/2010 (“Onerous Assignment”), (2) Law 12,304/2010 (“Pré-sal Petróleo S.A.”) and (3) Law 12,351/2010 (“Production Sharing System”, the “PSA Law”), not only adopting the PSA system, but also allowing for the possibility of awarding a direct contract from the Government to Petróleo Brasileiro S.A. (“Petrobras”) of any given block in the pre-salt area, if deemed to be “in the public interest” . Petrobras is partly owned by the Brazilian State, but the company also has its shares traded in the international market.

According to Article 4 of the PSA Law, Petrobras shall be appointed as the sole operator responsible for the execution, directly or indirectly, of all project related exploration, appraisal, development, production and abandonment activities. As the project’s operator, Petrobras will hold a minimum participating interest of 30 % in each new block within the pre-salt and strategic areas, the remaining 70 % interest may be contracted with other companies under competitive bid rounds. As a consequence, these companies will have to form a consortium with Petrobras and the Pré-sal Petróleo S.A. or the “Pre-Salt Petroleum Co” (the “PPSA”). Petrobras may also compete in the competitive bid rounds, by itself or under a joint bidding arrangement, to increase its 30 % participating interest by up to 100 %.

The bidding rounds are arranged by the National Petroleum, Natural Gas and Biofuels Agency (the “ANP”), which subject to the National Energy Policy Council’s (“CNPE”) authorization, will promote public bid rounds for each PSA . All oil companies that meet the necessary technical, legal and financial qualification criteria set out in the tender documents may participate. The bidding process’ award criteria shall be highest offer of profit oil for the Government. If there is a tie between the offers, the companies will be given a new deadline to present renewed and improved offers.

The PPSA was created to represent the Government in the consortium that is awarded the right to explore and develop a block within the pre-salt area, and to be the Government's voice on the respective operating committees.

The PPSA will not perform upstream oil and gas activities itself and will not engage in investments, but has very important roles, including:

- management, audit and supervision of oil and gas activities performed under the PSA regime;
- management and control of costs arising from the PSA;
- participation in the operating committees, electing half of its members, including its chair, having voting rights and veto power over operations; and
- negotiation of unitizations.

Under the PSA regime, the Brazilian State thus receives a substantial part of the oil without bearing risk, and without investing money in prospecting or exploring natural resources.

The PSA regime is however criticized because it may affect foreign investors’ willingness to invest in Brazil. The mandatory creation of a consortium to undertake petroleum activities in the pre-salt area, which involves the participation of two State controlled companies with considerable influence on the project’s direction, may raise particular concerns.
5 Non-PSA production of crude oil and gas under Azerbaijani legislation

5.1 Overview of Azerbaijani legislation

The general legal framework for production of oil and gas in Azerbaijan is regulated by the Law “On Subsoil” (“Subsoil Law”), which governs the exploration, use, protection, safety and supervision of the use of subsoil reserves including, but not limited to, oil located both within Azerbaijan and in the Azerbaijani sector of the continental shelf of the Caspian Sea. Under the Subsoil Law, no person or legal entity may engage in oil or gas exploration and production without the relevant license\textsuperscript{170}.

According to Subsoil Law, the government issues an exploration license for a period of up to five years and a production license for up to 25 years. Alternatively, a combined license for both the exploration and production may be granted for a period of up to 30 years\textsuperscript{171}. This period may be extended, subject to the subsoil user’s compliance with the terms of the license. An extension may be granted for a term agreed between the subsoil user and the licensing authority. Additionally, an existing license holder has a preferential right to obtain an extension.

According to the Presidential Decree No. 310 “On Measures to Improve the Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan”, the production and processing of oil and oil products can only be conducted by state enterprises or joint-stock companies in which the controlling stake belongs to the state\textsuperscript{172}.

However, article 2.5 of SOCAR Charter stipulates that entities within structure of the Company may engage in activities envisaged in the Charter without obtaining relevant special permits (licenses).

It should also be noted that Azerbaijani legislation does not envisage the possibility of transferring of a license from partner to the corporate joint venture\textsuperscript{173}.

Additionally, Azerbaijani legislation requires obtaining a special permit from SOCAR for environmental use in connection with oil and gas activities\textsuperscript{174}.

Additionally, the exploration, exploitation, production, processing, storage, transportation, distribution and use of all ‘energy materials and products’, including gas, is regulated by the Energy Law, which defines the legal, economic and social fundamentals of state policy on the use of energy resources, as well as the main directions for policy implementation. According to Energy Resources Law, each person/entity intending to engage in activities related to energy must obtain, prior to commencing such an activity, special authorization from the Ministry of Energy on the basis of an energy contract\textsuperscript{175}.

The Law “On Gas Supply” (“Gas Supply Law”) regulates the process of the production, processing, transportation, storage, distribution, sale and use of all types of gas (including natural gas). According

\textsuperscript{170} Law “On Subsoil”; art. 8
\textsuperscript{171} The Law on Subsoil of Republic of Azerbaijan, Art. 12
\textsuperscript{172} Presidential Decree No. 310 “On Measures to Improve the Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan”, art. 3
\textsuperscript{173} Regulations on Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan adopted by Presidential Decree No. 782 “On Measures to Improve the Issuance of Special Permits (Licenses) for Certain Types of Entrepreneurial Activities in the Republic of Azerbaijan” of December 2, 2002, art. 1.6
\textsuperscript{175} Law “On Use of Energy Resources”, art. 10

© 2014 KPMG Azerbaijan Limited. All rights reserved.
to the Gas Supply Law, gas production is subject to obtaining a license from the Ministry of Energy.

Legislation of Republic of Azerbaijan does not contain a requirement for any minimum (or controlling) participating interest of the Government in any non-PSA project with regard to development of oil or gas fields in the territory of Azerbaijan. Neither does it grant the state a preferential right to acquire such participating interest, in case of its sale to a third party.

In accordance with Presidential Decree, the Ministry of Energy participates in the preparation and implementation of state policy in the areas of the production, transportation and processing of oil and gas. The Ministry in co-operation with SOCAR has the mandate to prepare, negotiate, execute and oversee the implementation of the PSA or other agreements on behalf of the state with respect to the development of hydrocarbon reserves in Azerbaijan.

According to the Law of Republic of Azerbaijan “On the Special Economic Regime for Export Oil and Gas Activity”, Government of Azerbaijan applies special, customs and currency regime and other benefits to local contractors (i.e., Azerbaijani entity, with or without foreign investment) and their local or foreign sub-contractors carrying out oil and gas activities (including the exploration, sale and purchase of oil and natural gas) oriented towards exports (e.g., the supply of goods, work and services in connection with oil and gas operations). The Law applies to these activities if they are not covered by PSA, agreement on main export pipeline or other similar agreements.
6 Sale of SOCAR’s crude oil and gas

Access to distribution grid

In accordance with legislation, the domestic and international transportation of goods by means of water, air, and motor transport is subject to licensing by the Ministry of Transportation. Transportation of hazardous substances is authorized by the Ministry of Emergency Situations. Legislation does not contain any requirements applicable specifically to licensing of oil transportation.

According to article 16.2 of Energy Law, agreements on main power transportation systems are concluded based on competition between transportation means and/or power materials and products. If there are serious obstacles to investments, after reimbursement of costs on only one kind of power material and product and conclusion of agreements, exclusive agreements might be concluded on main power transportation systems. If agreement is of exclusive nature, contractor should at any time fulfill requirement of the third party on transportation. Otherwise contractor loses exclusive right on operation of the systems and may not claim the conclusion of additional agreement on main power transportation systems. According to Azerbaijani legislation, in cases where system (transportation and distribution) operators refuse to provide access to their systems, they must provide full substantiation for the reasons of such refusal.

The Gas Supplies Law allows third parties to operate the gas distribution network owned by AzeriGas on the basis of a contract signed between the operator and AzeriGas. Access to the natural gas distribution grid is governed the Regulations “On General Terms of Gas Supply by Gas Distributors. Pursuant to the Rules¹⁸¹, consumers wishing to have access to the gas distribution grid are required:

- to apply to the gas distributor for obtaining relevant technical terms;
- to prepare the required technical documentation on the basis of technical terms obtained from the gas distributor;
- to implement necessary construction works in accordance with the technical documentation.

The Gas Supplies Law does not contain any regulation, requirements or procedures for operation of a private gas distribution network.

In accordance with the Law “On Natural Monopolies”, transportation of crude oil and oil products through the main pipelines, as well as, transportation of natural gas through the pipelines, its storage and distribution, are considered as the spheres of activity of subjects of natural monopoly¹⁸². Oil and gas transportation and distribution services are subject to price regulations by the state¹⁸³.

As regards to cross-border transportation of gas, agreements regulating operation of Baku-Tbilisi-Ceyhan pipeline¹⁸⁴ and South Caucasus Pipeline¹⁸⁵ allow third party access to the pipelines on commercial terms.

---

¹⁸¹ Regulations on General Terms of Gas Supply by Gas Distributors, adopted by the Decree of the Cabinet of Ministers of Republic of Azerbaijan of May 31, 1999
¹⁸² The Law on Natural Monopolies, art. 5
¹⁸³ The Law on Natural Monopolies, art. 2.2.1
¹⁸⁴ BTC Host Government Agreement, Art. 4.1.(vii)
¹⁸⁵ SCP Host Government Agreement, Art. 4.1.(vii)
Sale of oil and gas

Pursuant to the Decree of the President\textsuperscript{186}, which contains the exhaustive list of licensable activities, sale of oil and gas products is subject to prior obtaining of relevant licenses from the Ministry of Energy.

Submission of following license-specific documents is necessary for obtaining the license for sale of oil products\textsuperscript{187}:

- availability of containers and equipment required for the sale and documents from State Committee of Republic of Azerbaijan on Standardization, Metrology and Patents confirming their compliance with state standards.

Submission of following license-specific documents is necessary for obtaining the license for sale of gas products\textsuperscript{188}:

- availability of containers and equipment required for the sale and documents from the territorial department of the Ministry of Emergency Situations of Republic of Azerbaijan confirming their compliance with technical requirements;
- availability of containers and equipment required for the sale and documents from State Committee of Republic of Azerbaijan on Standardization, Metrology and Patents confirming their compliance with state standards.

Both licenses are granted for a five-year term.

Azerbaijan legislation does not envisage separate rules regulating cross-border sales or deliveries of oil and gas.

According to the general principles of the civil legislation of Republic of Azerbaijan\textsuperscript{189}, the specific commercial terms and regulations may be envisaged by the import contracts concluded between relevant seller and buyer (i.e. SOCAR). Cross-border sales or deliveries of natural gas are governed by intergovernmental agreements, followed by contracts concluded between companies.

SOCAR’s internal regulations

The sale of crude oil and gas is conducted by SOCAR’s Marketing and Operations Department registered as a separate legal entity in Azerbaijan. According to its Charter\textsuperscript{190}, Marketing and Operations Department carries out directly sale operations with regard to crude oil, oil products and gas by SOCAR, its joint ventures and other commercial entities in local and foreign markets. The Department’s functions include effective implementation of export operations, search and selection of potential partners with view of establishing direct ties between SOCAR and foreign companies, firms and organizations, as well as conclusion of transactions (including contracts with local and foreign purchasers of crude oil, gas and oil products) on behalf of SOCAR.\textsuperscript{191}

\textsuperscript{186} Decree of the President of Republic of Azerbaijan No. 510 of December 29, 2006
\textsuperscript{187} Decree of the Cabinet of Ministers of Republic of Azerbaijan No. 174 of November 7, 2002, art. 5
\textsuperscript{188} Decree of the Cabinet of Ministers of Republic of Azerbaijan No. 174 of November 7, 2002, art. 6
\textsuperscript{189} The Civil Code of Republic of Azerbaijan, art. 328
\textsuperscript{190} Charter of SOCAR Marketing and Operations Department, art. 2.2
\textsuperscript{191} Charter of SOCAR Marketing and Operations Department, art. 2.4
The Head, Deputy Head and Chief Accountant of the Marketing and Operations Department are appointed by the President of SOCAR. The Head of Department concludes sale contracts on the basis of a power of attorney issued by SOCAR.

Based on the above, it could be concluded that guidelines are consistent with applicable Azerbaijani legislation.

192 Charter of SOCAR Marketing and Operations Department, art. 4.3
193 Charter of SOCAR Marketing and Operations Department, art. 4.4
## A  Annex 1

### Information and documents used in course of preparation of the Report

<table>
<thead>
<tr>
<th>No.</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Civil Code of the Republic of Azerbaijan, effective from 1 September, 2000</td>
</tr>
<tr>
<td>2</td>
<td>Agreement “On the joint development and production sharing for the Azeri and Chirag fields and the deep water portion of the Gunashli Field in the Azerbaijani Sector of the Caspian Sea among the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OLJESELKAP a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLLERI A.O., UNOCAL KHAZAR, LTD”, effective from 6 December 1994;</td>
</tr>
<tr>
<td>3</td>
<td>Law of the Republic of Azerbaijan “On acceptance, approval and granting permit for implementation of the agreement on the joint development and production sharing for the Azeri, Chirag fields and deep water portion of Gunashli field in the Azerbaijani Sector of the Caspian Sea concluded between the SOCAR and AMOCO CASPIAN SEA PETROLEUM LIMITED, BP EXPLORATION (CASPIAN SEA) LIMITED, DELTA NIMIR KHAZAR LIMITED, DEN NORSKE STATS OLJESELKAP a.s, LUKOIL JOINT STOCK COMPANY, MCDERMOTT AZERBAIJAN, Inc., PENNZOIL CASPIAN CORPORATION, RAMCO HAZAR ENERGY LIMITED, TURKIYE PETROLLERI A.O.” effective from 6 December, 1994;</td>
</tr>
<tr>
<td>4</td>
<td>Decree of the President of Azerbaijan “On Speeding Up the development of the Republic of Azerbaijan’s Offshore Oil Fields”, effective from 8 February 1994;</td>
</tr>
<tr>
<td>5</td>
<td>Charter of SOCAR;</td>
</tr>
<tr>
<td>6</td>
<td>Charter of SOCAR’s Marketing and Operations Department;</td>
</tr>
<tr>
<td>9</td>
<td>Presidential Regulations “On exploration and development of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”, effective from 7 October 1995</td>
</tr>
<tr>
<td>10</td>
<td>Presidential Decree “On finalization of negotiations with foreign oil companies on exploration, development and production sharing of the Shahdeniz prospective area in the Azerbaijani sector of Caspian Sea”, signed on 2 June 1996</td>
</tr>
</tbody>
</table>
11 Presidential Decree “On finalization of negotiations with consortium of foreign oil companies on joint development of oil pools in the Azerbaijani sector of Caspian Sea”, signed on 14 September 1994

12 Order #105 of the President of SOCAR “On regulation of relations regarding SOCAR’s procurement” dated 31 July of 2009

13 SOCAR’s Procurement Policy, approved by SOCAR’s President’s Order #105 “On regulation of relations regarding SOCAR’s procurement”.

14 SOCAR’s Procurement Concept, approved by SOCAR’s President’s Order #105 “On regulation of relations regarding SOCAR’s procurement”.

15 Regulations of Procurement Committee of SOCAR, approved by SOCAR’s President’s Order #105 “On regulation of relations regarding SOCAR’s procurement”.

16 Regulations of Procurement Group of SOCAR, approved by SOCAR’s President’s Order #105 “On regulation of relations regarding SOCAR’s procurement”.

17 Guidelines “On organization and regulation of SOCAR’s procurement”, approved by SOCAR’s President’s Order #105 “On regulation of relations regarding SOCAR’s procurement”.

18 Generalized Processes of Procurement Operations in SOCAR


20 Decree of the Board of the Ministry of Finance of the Republic of Azerbaijan # Q-12 dated 20 May 2013

21 Decree of the Cabinet of Ministers of the Republic of Azerbaijan # 34 dated 28 February 2003

22 Anticorruption Policy of SOCAR, approved by the Order #108 dated 10 August 2012


31 Law of Republic of Azerbaijan “On the Special Economic Regime for Export Oil and Gas Activity” No. 766-IIIQ, effective from 17 April 2009;


35 Decree of the President of Republic of Azerbaijan “On approval of Regulations of the Ministry of the Republic of Azerbaijan of Energy, structure of the Ministry and limit in number of the staff” No. 404, effective from 16 May 2006;

36 Regulation of the Ministry of Energy, adopted by the Decree of President of the Republic of Azerbaijan No. 149 dated 11 April 2014;


39 Baku-Tbilisi-Ceyhan Main Export Pipeline Host Government Agreement, signed on 18 November 1999;

40 Treaty on Mutual Promotion and Protection of Investment between Government of Republic of Azerbaijan and Government of Republic of Turkey, effective from May 2, 2013

41 Decree of the President of Republic of Azerbaijan “On additional measures for Issuance of Special Permits (Licenses) for Certain Types of Activities” No. 510, effective from 1 January 2007;

42 Decree of the Cabinet of Ministers of Republic of Azerbaijan “On additional measures for Issuance of Special Permits (Licenses) depended from Types of Entrepreneurial Activity” No. 174, effective from 7 November 2002.
FACTS & ASSUMPTIONS

In case any of the below facts and assumptions is erroneous, incorrect, imprecise or becomes invalid, please notify us immediately, as our conclusions in the present Report may be affected.

- Socar is a wholly state-owned legal entity, established in accordance with the legislation of the Republic of Azerbaijan;
- Socar is validly existing as a state company and in good standing under Azerbaijani laws and is qualified as a legal entity and in good standing in Azerbaijan;
- For the purposes of the preparation of the Report, we have assumed:
- the genuineness of all signatures, the authenticity of all documents submitted to us by the Client as originals, the conformity with authentic originals of all documents submitted to us as copies, the identity of all individuals acting or purporting to act as corporate officers, and
- the identity and capacity of all individuals acting or purporting to act as public officials. No amendments were made to the documents provided to us up to the date of this Report;
- the accuracy and completeness of all information available in public electronic resources of various governmental bodies/agencies, and the Company itself, as well as electronic legislative database maintained by the Ministry of Justice of Azerbaijan and Milli Mejlis (Parliament) of Azerbaijan;
- the Client has obtained necessary consents, permits, approvals based on corporate regulations, from state authorities/agencies and/or third parties in submitting the request for preparation of the present Report by KPMG;
- the Client is not subject and does not possess any material evidence/information to suggest that it will be subjected to bankruptcy, liquidation or dissolution proceedings at the date of this present Report.
The Report is subject to the following qualifications, limitations and observations:

1 CORPORATE

1.1. Establishment and Registration of the Company. We do not opine on due establishment of the Company or proper registration as this requires due diligence to be carried out to confirm that the application on registration of the company was conducted in accordance with all applicable laws. For the purposes of this Report we assume that the Company has properly been established under Azerbaijani Laws. We note that non compliance with Azerbaijani Laws in these respects may influence the power and capacity of the Company to enter into and perform the transactions. We did not make any independent enquiries into the official registrars of Azerbaijan and have not conducted due diligence exercise or review of financial status of the Company.

1.2. Bankruptcy. For the purposes of this Report we assume that the Company is in good financial standing and in not subject to liquidation or any kind of insolvency procedures. We have not conducted review of financial or accounting documentation of the Company, or any other obligation and/or documents revealing indebtedness of the Company. We also note that there are no independent public sources to verify that the company does not satisfy the bankruptcy criteria stipulated in Azerbaijani legislation.

2 CONTRACTUAL

Limitations of Review.

Our review is limited to the documents provided to us by the Company and available on the website of the Company as listed in Appendix 1 to this Report.

We do not provide any opinion with respect to any particular contractual practices of the Company, and we have not reviewed any documents with respect to any tenders, actions, other procurement procedures relating to any particular contract, commitment or arrangement entered into by the Company by the date of this Report.

3 COURT INTERPRETATION

Diversity of Court Interpretations. The construction and enforcement of laws by Azerbaijani courts are frequently prejudiced. Azerbaijani civil legislation is drafted using many principles, terms and procedures. As such, the understanding and interpretation applied to these principles and the terms and procedures used by judges are not easy to definitively anticipate with any degree of certainty. We, therefore, express no opinion as to the interpretation which a court of the Republic of Azerbaijan would give to particular laws or regulations of the Republic of Azerbaijan.

4 TAXES

Except as otherwise specifically stated herein, we have not considered the tax consequences of entering into, exercising the rights or performing the obligations under, or enforcing any of the documents used for the purposes of this Report.
5 CURRENCY CONTROL, SETTLEMENTS

5.1. Currency Control. We have not conducted review and analysis of Azerbaijani currency legislation and do not opine on the conformity of the documents used for the purposes of this Report with the Azerbaijani currency legislation.

6 SCOPE OF REVIEW

6.1. No Due Diligence. We have not conducted a due diligence exercise or gone beyond the information set for in the documents used for the purposes of this Report.

6.2. Materiality. We have described only material matters related to the documents used for the purposes of this Report.

7 LEGISLATION

7.1. State of Azerbaijani Laws. The legal system of the Republic of Azerbaijan is not yet fully developed, certain elements of basic legislation remain to be enacted. Azerbaijani Legislation is made up of Azerbaijani laws, Cabinet of Ministers’ Decrees, Parliament’s Decisions, Presidential decrees and regulations and other normative-legal acts of other state authorities of the Republic of Azerbaijan. These bodies of legislation can overlap and conflict with one another, sometimes with uncertain results. Furthermore, the application of Azerbaijani Legislation by Azerbaijani governmental authorities is often subject to a high degree of discretion, which can result in inconsistent stances being taken by different authorities or even with the same authority by different officials. We express no opinion in the event of (a) a change by authorized officials of Azerbaijan in the interpretation of Azerbaijani Legislation; (b) the adoption of a retroactive law or regulation by officials of Azerbaijan; or (c) an application of Azerbaijani Legislation by officials in a manner inconsistent with a previous application thereof.

7.2. Conclusions in this Report on matters arising under Azerbaijani Legislation are based on the assumptions that (a) governmental authorities have the competence and jurisdiction which they, either implied or directly, assert; (b) published or publicly available normative acts will be correctly interpreted and applied and enforced substantially in the manner in which they are written; and (c) ambiguities and inconsistencies will be resolved with due consideration given to matters of equity and fairness.

7.3. Legislation is Constitutional. Due Adoption of Legislation. We give no opinion that legislation or instruments on which we rely is constitutional and was properly adopted in accordance with the relevant procedures and regulations.

7.4. Reviewed Legislation. Save as directly provided in the this Report with regard to particular aspects of international business practice of execution of Joint Ventures and Production Sharing Agreements, we express no opinion as to any laws other than the Azerbaijani laws, Cabinet of Ministers’ Decrees, Parliament’s Decisions, Presidential decrees and regulations and other normative-legal acts of other state authorities of the Republic of Azerbaijan presently in effect and in force in Azerbaijan.

7.5. Only Officially Published Legislation. Any conclusion expressed herein as to matters of Azerbaijani Legislation is confined solely to laws, regulations, edicts, decrees and administrative decisions that have been officially published or are publicly available, and does not take into account any modification thereof by any other regulations, decrees or administrative decisions that have not been officially published or are publicly available. We do not take into account in this Report any acts which are classified, secret or otherwise restricted in circulation.
7.6. Interpretation. Every qualification, limitation, exception or assumption (whether express or implied) contained herein shall be construed without limiting any other qualification, limitation, exception or assumption. For convenience, the qualifications and limitations have been provided under the headings, which refer to the matters, to which the qualifications and limitations most directly relate. Those qualifications and limitations nevertheless apply for the purposes of any other matters to which they may be applicable.

7.7. No Duty to Update. This Report is effective as of the date above written, and we have not undertaken to update this Report in the event of changes to any laws, procedures or regulations subsequent to the date of this Report.

7.8. This Report is governed by and shall be construed in accordance with Azerbaijani Legislation. The reference to foreign legislation where given is provided for information purposes only and we have not conducted any in-depth analysis of foreign laws and regulations.
Annex 4

DISCLAIMER

This Report is not binding on tax or other relevant authorities or the courts and should not be considered as a representation, warranty, or guarantee that the tax and other relevant authorities or the courts will concur with contents of our Report. This Report cannot be relied upon in decision making of the management of the Company.

We expressly disclaim all liability to any person other than the intended recipient of this Report (which is Company only) in respect of anything, the consequences of anything, done or omitted to be done wholly and/or partly in reliance upon the whole or any part of the contents of this legal opinion letter. This Report and its contents should not be relied upon by any other person. Any other person who chooses to rely on this report does so at their own risk. No other reader should act or refrain from acting on the basis of any matter contained in this without seeking the appropriate legal or other professional advice on the particular facts and circumstances.

To the fullest extent permitted by the Azerbaijani legislation, KPMG accepts no responsibility or liability to them in connection with Report and its contents.

Contents of Report are limited to the conclusions specifically set forth herein and are based on the completeness and accuracy of the foregoing assumptions and/or representations. If any of the foregoing assumptions and/or representations is not entirely complete or accurate, this could have a material effect on our conclusions. If this is the case, it is imperative that we should be informed immediately, and we will amend this letter accordingly.

Report is based on Azerbaijani legislation effective at its date and might be subject to changes, sometimes with retroactive effect. Any such change could affect the validity of our conclusions.

Report has been prepared for the sole benefit of the intended recipient and pursuant to the terms of KPMG’s Engagement Contract. It should not be relied upon by any other person. To the fullest extent permitted by the legislation, KPMG accepts no responsibility or liability to them in connection with Report.

The Company warrants that in case of disclosure of this Report at the website of the Company or its provision to any third party(-ies), the Company will disclose it fully indicating all Qualifications, Limitations and Observations.

KPMG Azerbaijan

© 2014 KPMG Azerbaijan Limited. All rights reserved.
The information contained herein is of general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2014 KPMG Azerbaijan Limited, a company incorporated under the Laws of the Guernsey, acting through its Representative Office in the Republic of Azerbaijan, a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name, logo and “cutting through complexity” are registered trademarks or trademarks of KPMG International.