

ACTION FICHE FOR AZERBAIJAN

1. IDENTIFICATION

	Title	Energy Reform Support Programme (ERSP) - Azerbaijan		
	Total cost	EUR 14 million Euro		
	Aid method / management mode	Sector Policy Support Programme: - Sector budget support (centralised management)		
	DAC-code	23050	Sector	Energy

2. RATIONALE AND COUNTRY CONTEXT

2.1. Rationale

The signing on 7 November 2006 of an EU–Azerbaijan Memorandum of Understanding on Energy (MoUE) by the President of Azerbaijan, Mr Aliyev, the President of the European Commission, Mr Barroso, and the Finnish Presidency of the Council, shows a clear strategic commitment to modernise the energy sector in Azerbaijan through energy cooperation, on the basis of mutual interest. On 30 November 2006, at a Ministerial Conference held in Astana, Kazakhstan, Black Sea and Caspian Sea littoral states, including Azerbaijan, endorsed a road map aimed to enhance regional cooperation by ensuring in particular the convergence of energy markets, increasing energy security, supporting sustainable energy development and attracting investments for energy projects. Energy is one of the three main priorities of the Azerbaijan ENPI National Indicative Programme 2007-2010, as well as of the ENP Action Plan adopted by the EU-Azerbaijan Cooperation Council on 14 November 2006.

The proposed Energy Reform Support Programme (ERSP) will assist Azerbaijan implement MoUE and ENP Action Plan priorities. Building on the *State Programme for the Development of the Fuel and Energy Sector in Azerbaijan (2005-2015)*, the Government of Azerbaijan (GoA) under the ERSP will review the national energy strategy in order to develop an overall, coherent, integrated and transparent energy strategy that covers the supply, transportation, transit and use of all energy resources, the further reforms to be undertaken, identifying the infrastructure rehabilitation requirements and the new infrastructure needs, while specifying more in detail policies and legislative and institutional reforms to promote energy efficiency (EE), energy savings and the greater use of renewable energy sources (RES). It should help to reinforce the energy security of the country through the identification of measures and projects, and also should also have a significant impact on the reduction of poverty in the country by spreading the benefits of its oil-based wealth through renewable energy generation and by rendering energy consumption more cost efficient.

2.2. Economic and social situation

Oil revenues have increased rapidly over the recent years as a result of rising oil prices and growing exports as new pipelines, notably Baku-Tbilisi-Ceyhan, have come on-line to exploit the ACG field, the main Azerbaijani reserve. The parallel exploitation of gas fields in the Caspian, and the entry into operation of the Baku-Tbilisi-Erzurum gas pipeline, also contribute to the country's economic growth. At the same time as domestic demand grows rapidly, the country is currently forecast to again become a net importer of energy by 2020.

This relatively short period of oil wealth necessitates the need for serious programming of its use over the longer term, and puts the emphasis for development priorities on a sustainable non-oil sector. It also has implications for energy security and, consequently, the promotion of EE and RES.

Overall Azerbaijan's economy grew by 34.5% in 2006. The 12-month CPI inflation rate stood at around 17% through the first six months of 2007 compared with just over 5% a year earlier. The Tariff Council early in 2007 announced a 50% increase in gasoline prices and a doubling of water and tripling of electricity tariffs. Other utilities were also affected. According to GoA official figures, poverty in Azerbaijan is declining rapidly, the proportion of poor people fell from about 44.6% in 2002 to 20.8% in 2006. Wages and salaries have more than doubled, with the minimum wage raised fivefold since 2001. GoA social transfers to the poorest 20% of households increased by more than 35% in 2004, while pensions, increased about 44%.

2.3. Cooperation policy of beneficiary country

Following completion of the first PRSP, the *State Programme for Poverty Reduction and Economic Development 2003-2005* (SPPRED), GoA is developing its successor, the *State Programme for Poverty Reduction and Sustainable Development* (SPPRSD) to cover the period from 2006 to 2015. The SPPRSD is expected to be adopted by the President soon, thus becoming fully operational. The SPPRSD is aligned with the Millennium Development Goals (MDGs) and other State programmes, and will be fully integrated with the Medium Term Expenditure Framework (MTEF), the Public Investment Programme (PIP) and State Budget processes. In the future, the GoA will have to pay due attention to the effective implementation of all these programmes and the overall consistency and coordination among them.

2.4. Government Sector Programme

The *State Programme on the Use of Alternative and Renewable Energy Sources*, approved by the President in October 2004¹, incorporates moves towards a more enabling environment for the development of all RES, but concentrated on research activities for the identification of the potential for the production of electricity from renewable sources. In February 2005² the President approved the *State Programme for the Development of the Fuel and Energy Sector in Azerbaijan (2005-2015)*, covering rehabilitation and development of oil, gas and electricity systems. Neither programme focuses on the institutional and market reforms necessary for energy sector development, nor quantifies targets for future achievement. There is no documented agreed policy on EE.

The institutional framework for developing and implementing a sustainable fiscal policy has been established in Azerbaijan. The budget preparation process, incorporates multi-year budgeting through the preparation of a MTEF linked to the SPPRSD and the PIP. Both the MTEF and the PIP, however, are still at an early stage of development. The regulations related to the Budget Systems Law have been adopted, and budget process manuals approved, but it will take some years to bring these strategic exercises to sufficient quality. The budget system has been further enhanced by the introduction of international budget classifications, a single Treasury account and the inclusion of all previously extra-budgetary operations of budget organizations in the annual consolidated budget approved by

¹ Presidential Decree N462, October 21st 2004

² Presidential Decree, 14th February 2005

Parliament, including expenditures (except administrative costs) financed by the State Oil Fund of the Azerbaijan Republic (SOFAZ). In 2006, the GoA drafted laws on State Financial Supervision and Internal Audit signalling its commitment to strengthen public internal financial controls and combat corruption. EU is to support reform of public internal financial control (PIFC) systems within the context of the ENPI. These developments are to be further supported by a new project on Corporate and Public Sector Accountability (CAPSA), financed by the World Bank and the implementation of an action plan for Public Finance Management (PFM) reform to be based on the PEFA PFM PMF³ assessment. A key element will be the implementation of the long-term oil revenue management strategy approved by the President in 2004, a recommendation of IMF's last review. Progress in both of these areas should form an overriding or General Condition for budgetary support and the release of instalments.

2.5. Lessons learnt

Identified as a priority in the European Neighbourhood Policy (ENP) Action Plan, Energy Reform Support Programme will be build on the experience of ten years of budget support under the EC-Food Security Programme. It is clear not only that Azerbaijan qualifies for such support but also that the mechanism is well understood by GoA. The EC-TACIS "Support to the Ministry of Industry and Energy" project⁴ identified the need for further elaboration of the GoA's strategy on EE and RES, concluding that there was significant potential for small hydro power plants (SHPPs) and wind power generation.

2.6. Complementary actions

EC is planning to undertake a number of interventions in parallel in this sector and will coordinate these towards a common sector strategy. Besides the Sectoral Budget Support (SBS), anticipated EC actions include Twinning and INOGATE projects, as well as possible investment projects managed by the European Investment Facility, EBRD and EIB as well as other bilateral or multilateral Financial Developments Institutions of EU Member States.

2.7. Donor coordination

Significant donors active in Energy Efficiency and Renewable Energy fields include Asian Development Bank, currently providing technical assistance to prepare a US\$40mn RE loan, KfW, with a feasibility study on wind power, UNDP supporting a couple of small hydro power plants (SHPP), and EBRD considering SHPP investment. These and other donors also support other elements of the energy sector, particularly rehabilitation of power plants but also policy and regulatory development, including on tariffs. The World Bank (WB) has launched in spring 2007 the PEFA assessment that is planned to be finalized this year. In cooperation with the WB this programme will ensure a follow up of its recommendations.

3. DESCRIPTION

3.1. General objectives

The ERSP will support the implementation of GoA's key priorities in the energy sector, as listed in the Memorandum of Understanding on energy (MoUE), with a view in particular to (i) increasing energy security by diversifying energy sources and (ii) paving the way for

³ Public Finance Management Performance Measurement Framework

⁴ EuropeAid/121410/C/SV/AZ

energy sustainability.

3.2 Specific objectives

- Reviewing the overall national energy strategy in order to develop a coherent, integrated and transparent energy strategy that covers the supply, transportation, transit and use of all energy resources, the further reforms to be undertaken, identifying the infrastructure rehabilitation requirements and the new infrastructure needs (facilitate financing by multilateral financing institutions and the private sector).

This will specifically include inter alia:

- Developing a specific energy policy component within the above strategy, with the aim of extending the use of EE and RE;
- Carrying out a feasibility study for the establishment of a regulatory body, both for the gas and the electricity sectors;
- Within the overall context of the Energy Strategy, preparing and implementing an Action Plan for promoting EE and RE

This plan will encompass the following aspects

- Legislative and institutional reform, including the setting up, if appropriate, of a National EE and RE Agency;
- Awareness-raising and marketing measures, to disseminate knowledge of the opportunities of EE and RE and of their expansion potential;
- Identifying and implementing relevant economic instruments (incentives and disincentives) in support of this Action Plan.

3.3 Expected results and main activities

The achievements pursued in the framework of the Energy Reform Support Programme (ERSP) are as follows:

- the adoption by Government of Azerbaijan of a comprehensive and fully integrated energy strategy, determining goals and targets over the medium to the longer term. This strategy will include, among other things, the analysis of the challenges to the Azeri security of energy supply; an analysis of the future likely energy production, consumption, mix and transit potential; and it will provide an opportunity to analyse the feasibility and the benefits of establishing an independent energy regulatory body and to identify the prospects for developing EE and RE;
- the approval of a detailed Action Plan for the promotion of EE and RES up to 2015, and the implementation of this Plan during the period covered by the ERSP;
- drafting and submission to Parliament of appropriate new primary legislation on the use of RE and the promotion of EE, together with drafting and GoA approval of all secondary legislation necessary for the wide extension of these;
- the establishment and the practical launch of a new National EE and RE Agency, to support the implementation of the State policy on RE and EE as defined in the Action Plan. In addition, co-operation could be developed within the framework of an EU-Azeri technology platform that could be attached to the Agency;
- the determination of appropriate financial incentives to stimulate the establishment on

the market of RE and EE.

Suitable indicators to measure progress towards achieving these results will be agreed with GoA (through the relevant institutions, notably Ministries of Industry and Energy, Economic Development and Finance).

3.4 Stakeholders

The Ministry of Industry and Energy has the overall responsibility for the energy sector and, therefore, for the implementation of the ERSP. However, the Ministry of Economic Development, responsible for broader economy strategy⁵ and the attraction of investment, and the Ministry of Finance, as the initial beneficiary of the budget resources, both have primary interest in its successful execution. Several other institutions, including the Ministries of Ecology and Natural Resources, Construction, Transport, Taxation, and Justice, the Tariff Council and the Azerbaijan National Academy of Sciences (ANAS), are also concerned with different elements of the ERSP, while the major energy companies: SOCAR, AzerEnergy, and AzerGas will have responsibility for implementing certain of the policy actions. Several donors active in the broader energy sector are also concerned with RES and EE development, including, besides EC, ADB, EBRD, UNDP, the World Bank, EIB, KfW, and USAID. All of these stakeholders will be encouraged to participate in ERSP actions as appropriate.

3.5 Risks and assumptions

The ERSP assumes that GoA's commitment to reform of the energy sector, and to the development of RES and EE in particular, is maintained and reflected as an adequate priority in the political process and in the allocation of financial and other resources, sufficient to ensure effective implementation both of ERSP's specific actions and the roll-out of reforms across the sector. The ERSP envisages the maintenance of macroeconomic and political stability, with continued strong growth to support investment. Ongoing PFM reforms, including further deepening of the MTEF process and continued strong supervision of budget expenditure, suggest no significant risks with respect to eligibility for budget support. Possible risks include obstacles to the penetration of RES electricity to the network as a result of conflicts of interest with AzerEnergy and other incumbent electricity companies; insufficient expansion of electricity transmission and distribution infrastructure to enable potential RES to be connected; delays in RES and EE related legislation becoming effective; insufficient capacity within either MoIE or the new State Agency to implement ERSP actions effectively and on time; insufficient budgetary allocations to meet RES and EE promotion priorities; and the lack of an effective regulatory framework and sufficient financial incentives to stimulate investment in RES use and EE improvement.

3.6 Crosscutting Issues

Cross-cutting issues cover governance, fiscal prudence, the environment, health and living conditions, as well as sustainable economic development, including employment creation, poverty reduction and equity. There are no negative gender or human rights issues.

4. IMPLEMENTATION ISSUES

⁵ including implementation of the SPPRSD, and chairmanship of the Tariff Council

4.1. Implementation method

As the proposed ERSP is budgetary support, the method of management is centralised i.e. the budgetary support operation will be managed solely by the EC. The budgetary support will be untargeted and channelled directly into the Unified Treasury Account of GoA. Once released, use of the funds will be at the discretion of GoA as all state budgetary resources, managed in compliance with Azerbaijan law.

4.2. Procurement and grant award procedures

For the complementary technical assistance component, the EC will directly manage and award contracts in accordance with the procedures and standard documents laid down and published by the EC for the implementation of external operations, in force at the time of the launch of the procedure in question.

4.3. Budget and calendar

The ERSP has a budget of Euro 14 M, of which Euro 1 M will be used for accompanying technical assistance (TA) and Euro 13 M for sector budget support (SBS). The budget support is proposed to be disbursed over a three year period through an initial instalment of Euro 3 M and two subsequent instalments of Euro 5 million, each payable against policy conditions to be identified and agreed upon by the EC and the GoA in a separate FA. The Euro 1 M of technical assistance will be used for the management of the ERSP, for the external review missions, and for ad-hoc technical advisory support if requested by the Beneficiary. The initial fixed instalment will be contingent upon the signing of the FA by GoA. The other instalments will be released within the two GoA's Fiscal Years following the year of the FA signature, the value of the disbursement from each instalment being dependent on the extent of compliance to conditions related to implementation of the ERSP, assessed on the basis of criteria agreed in the FA. Eligibility conditions to the Sector Support Programme will be valid for all payments during the whole programme. These conditions will be assessed once per year. The final programme implementation date will be 48 months after the signature of the Financing Agreement.

4.4. Performance monitoring and criteria for disbursement

Conditions governing the release of funds will be set out in the FA. Prior to the finalisation of the FA, the conditions and other operational modalities will be discussed and agreed with GoA. Oversight of the ERSP will be entrusted to a Steering Committee (SC). Members of the SC will include representatives of ministries and institutions involved in the implementation of the ERSP, as well as the EC as an observer. The precise membership of the SC will be agreed between the EC and GoA and specified in detail in the FA. A portion of the TA component of the ERSP will be to finance a TA project, with a permanent presence in each of the two key ministries (MoIE and MoF), with responsibilities for coordination of the ERSP's overall objectives with the beneficiary, the monitoring of developments in the sector and progress towards implementation of the reform conditions. The opportunity to have such long term TA was one of the positive lessons learnt from the EC-FSP. The TA in the MoF may also be involved with similar responsibilities in connection with other SBS under the ENPI. The experience of the EC-FSP also supports provision of a budget line allowing the beneficiaries to contract short term TA through a fast-track procedure (framework contract) to provide support at short notice when and where it is needed.

4.5. Evaluation and audit

There will be an independent review of the status of compliance for each of the instalment releases, other than the first, with recommendations made to the EC on the timing and the level of instalment release. The FA will specify that the review for each of these variable instalments must be completed by the end of November each year in order to allow the funds to be received by GoA within the relevant fiscal year. Failure to fulfil the conditions attached to the variable instalments will result in loss of some or all of the instalment.

4.6. Communication and visibility

Communication and visibility will be organised in conjunction with the MoIE. A donors' committee will be created within MoIE with EC representation. As the ERSP develops, the EC will, in conjunction with the MoIE and the newly formed Agency for RES and EE, organise appropriate public relations activities to keep the general public informed of developments in the areas of RES and EE.