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NATURAL GAS MARKET IN AZERBAIJAN AND REGULATORY FRAMEWORK

By

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1. Description of domestic natural gas market

In 1991, Azerbaijan’s total gas consumption was about 17bcm per annum. During the 1990s Azeri production declined and there was insufficient gas available to supply consumers outside the Absheron area. Hence, the main transmission pipeline network and the unused distribution system fell into disrepair. Currently, Azerbaijan’s total gas consumption is about 10bcm per annum. The State Oil Company of Azerbaijan Republic (SOCAR) was established in 1992. SOCAR and its subsidiaries are responsible, inter alia, for the production of oil and natural gas, and for managing the country’s oil and natural gas imports and exports. Virtually all of Azerbaijan’s natural gas is produced by SOCAR from offshore fields. In addition to SOCAR, Azerbaijan International Operating Company (AIOC) and other international consortia, operating pursuant to Production Sharing Agreements (PSA), produce small amounts of associated natural gas.

Azerigaz State Company (Azerigaz), which is responsible, inter alia, for transportation, processing, and storage of natural gas, was established in 1992. In 1996, Azerigaz was reorganized into a joint-stock company of close type, wholly owned by the state. Azerigaz engages in the aforementioned activities through its divisions. For instance, Azerigaznagliatiat is responsible for transportation of gas by main transmission (high pressure) pipelines, and a number of regional divisions are responsible for local gas distribution. There are two existing, depleted field, natural gas storage facilities in Azerbaijan, at Karadagh and Kalmas. Both facilities require significant investment to operate at their full potential. Azerbaijan’s LNG industry is not well developed. There are no LNG storage facilities except for those of companies producing LNG, which are of small capacity and used for ongoing production. Azerbaijan’s major natural gas production-increases in the future are expected to come from the development of the Shah Deniz offshore natural gas and condensate field, exploited by international consortia pursuant to the Production Sharing Agreement. Industry analysts estimate that Shah Deniz is one of the world’s largest natural gas field discoveries. Azerbaijan currently lacks any infrastructure for the export of natural gas. However, efforts are currently underway to secure export routes and customers for gas deliveries. The main conduit for Azerbaijan’s natural gas exports will be the South Caucasus Pipeline, also known as Baku-Tbilisi-Erzurum, connecting to the Turkish gas pipeline network.

2. Policy and legal framework

The primary legislative act governing the domestic gas sector is the Law on Gas Supply (the Gas Supply Law) of 30 June 1998. The Gas Supply Law regulates production (except for extraction of natural gas as a natural resource), processing, transportation, distribution, sale and use of all energy carriers in the gaseous and liquid state. The Gas Supply Law is premised on the state monopoly over gas production, pipeline transportation and ownership, storage and distribution. The law introduces the licensing system for the domestic natural gas sector. Under this law, a
‘special authorization’ (license) is required to engage in any activity relating to the gas industry (except for extraction of natural gas as a natural resource). In addition to a license, an ‘energy contract’ shall be concluded with Azerigaz to provide gas services, construct gas distribution network, establish, operate and reestablish underground gas storage facilities. The Gas Supply Law also covers safety, standardization, land ownership, engineering and logistic issues which may arise during gas-related activities.

The Law on Subsoil (Subsoil Law) sets forth the principles of exploration, extraction, production, use, protection and safety supervision over Subsoil reserves, including gas, located both within Azerbaijan and its portion of the Caspian sector. The law states that Subsoil use rights may arise only after the ‘special consent’ for the type of activity has been obtained. According to the Subsoil Law: (i) geological and geo-ecological exploration; (ii) extraction of minerals; (iii) use of waste of mining works; (iv) construction and exploitation of underground facilities not related to extraction of minerals; and (v) establishment of specially protected geological facilities (geo-logical sanctuaries, caves and the like) are licensed activities. The Law on Energy (the Energy Law) overlaps with the aforementioned laws and is intended for the regulation of exploration, exploitation, production, processing, storage, transportation, distribution and use of all ‘energy materials and products’, including gas. Essentially, the Energy Law is an ‘umbrella’ law for power regulations. Each person intending to engage in activities related to energy must obtain, prior to commencing such an activity, a special authorisation from the Ministry of Industry and Energy on the basis of an energy contract or application to such ministry. The Energy Law describes in detail the procedure for conclusion of an energy contract, its terms and conditions. The Law on Natural Monopolies governs relations of natural monopoly entities, consumers and state bodies in relevant commodity markets. Provisions of the Law apply, inter alia, to entities engaged in pipeline transportation, storage and distribution of natural gas, since such activities are carried out by natural monopoly entities. The matters of efficient and effective use of energy carriers, including gas, during production, processing, exploitation, transportation and distribution are covered by the Law on Use of Energy Resources (Energy Use Law). Additionally, PSAs concluded between the government of Azerbaijan and international energy companies on production of oil and gas shall also be taken into account. Transportation of natural gas produced in Azerbaijan through the territory of third countries is governed by several international agreements.

Pursuant to the programme, governmental policy for the domestic natural gas sector for 2005 to 2015 consists of achieving better satisfaction of the gas needs of the population and the economy through development of the natural gas sector, specifically through: the creation of a robust competition environment; the increase of investments attracted to the field; environmental safety; and the application of progressive technological measures to production, processing, transportation, storage and consumption of natural gas.
Pursuant to the Energy Law, the cabinet of ministers of the Republic of Azerbaijan draws up long-term programmes on the organisation and development of the energy sector, which also includes the natural gas sector. At present, a number of ministries and agencies are involved in setting the governmental policy for the natural gas sector, including the president of the Republic of Azerbaijan, the cabinet of ministers, the Ministry of Economic Development (MED), Azerigaz and the Ministry of Industry and Energy.

2.1 Production

Under the Subsoil Law, no person or legal entity may engage in gas exploration and production without the special consent of a relevant body of executive power, such body being undefined. Special consents are awarded by tender, auction or, in exceptional cases, as a result of negotiation. On the other hand, the Energy Law stipulates that exploration and production rights to a specified block are granted on the basis of an energy contract. Therefore, there are certain contradictions between the Subsoil Law and the Energy Law.

Natural gas is produced either by SOCAR, which has the rights to explore onshore and offshore oil and gas reserves, and international oil and gas companies operating on the basis of PSAs. PSAs are considered international agreements approved by the National Parliament. Direct authorisation for exploitation and production of gas is granted by PSAs, which are not subject to regulation by domestic legislation.

The license granted for any Subsoil activity, including exploration and production of natural gas, and the rights contained therein may not be assigned to third parties.

Under the Subsoil Law, the term of the special consent for the extraction of natural resources is limited to 25 years. However, the Energy Law overlaps with the Subsoil Law and provides for conclusion of an energy contract for exploration and production of gas in order to obtain a special authorisation. The term of an energy contract for exploration and production of gas is limited to eight years. The term of special consent and that of an energy contract may be prolonged subject to an agreement to that effect between the licensing agency/agency responsible for conclusion of an energy contract and the Subsoil user.

Pursuant to the Subsoil Law, extraction of natural resources is permitted only within the boundaries of a geological lot attached to the special consent. The legislation does not separately provide for the amount of natural gas to be produced by Subsoil users.

Perhaps, this should be reflected in the special consent granted for the extraction of natural resources (Subsoil Law) and an energy contract. Under the Energy Law, all aspects of exploration and production of natural resources shall be undertaken in
accordance with the ‘work programme’ specifically agreed at the energy contract. The Ministry of Industry and Energy is entitled to monitor compliance with the work programme.

The Subsoil Law provides for efficient, ecologically balanced, technically safe exploitation of Subsoil reserves by Subsoil users. The environmental monitoring is conducted by the Ministry of Ecology and Natural Resources. The State Committee on the Supervision over Safety of Industrial and Mining Works supervises safety of exploration, production and other related activities. The Ministry of Industry and Energy, as a state body with which an energy contract shall be concluded, is entitled to review implementation of all aspects of the work programme, an integral part of an energy contract.

2.2 Transportation and storage

Pipeline transportation and storage of natural gas are deemed natural monopoly activities in Azerbaijan. Azerigaz is responsible for, inter alia, transportation and storage of natural gas. In order to engage in the provision of gas transportation services, construction of underground gas storage facilities and their exploitation, contractors must conclude an energy contract with a relevant body (see 9 below). Currently, Azerigaznagliat, a division of Azerigaz, carries out transportation of gas by main transmission pipelines. Regional transportation and supply of gas is organized by Azerigaz through its regional divisions. There are two existing depleted field natural gas storage facilities in Azerbaijan, at Karadagh and at Kalmas, controlled by Azerigaz.

2.3 Licensing

Pursuant to the Gas Supply Law, activities in the gas sector are carried out on the basis of special authorisation, which is issued by the relevant body of the executive power, such body being undefined. The relevant provision of the Energy Law (adopted after the Gas Supply Law) sets forth that any person wishing to engage in activities in the energy sector (which include activities in the gas sector) shall obtain, on the basis of an energy contract or application, special authorisation from the Ministry of Industry and Energy. The President’s Decree on licensable activities of 2002 repealed the 1997 Decree and approved a new list of licensable activities, which only provides for licensing of sale of gas products. However, provisions of the Gas Supply Law and Energy Law providing for licensing of activities in the gas sector, which include construction and operation of natural gas transportation pipelines and storage facilities have not been amended yet. Accordingly, although there is a statutory requirement to receive a licence, there is no mechanism in place for issuance of a licence.
2.4 Distribution

Local distribution of natural gas is provided by Azerigaz and its regional divisions. Gas is distributed to consumers by Azerigaz to the regional gas departments who distribute to their local divisions which in turn supply consumers. The entire gas distribution network of Azerbaijan is still operated by Azerigaz. Moreover, the Gas Supply Law does not contain any requirements or procedures for operation of a private gas distribution network. The law merely allows third parties to operate the gas distribution network owned by Azerigaz on the basis of a contract signed between the operator and Azerigaz. Access to the natural gas distribution grid is organised in accordance with the Rules on General Terms of Gas Supply by Gas Distributors. Pursuant to said Rules, consumers wishing to have access to the gas distribution grid are required:

- to apply to a gas distributor for the relevant technical terms;
- to prepare the necessary technical documentation on the basis of technical terms obtained from a gas distributor; and
- to carry out necessary construction in accordance with the technical documentation.

In accordance with the Law on Natural Monopolies gas distribution services are subject to price regulations. Because gas is distributed and sold to final consumers solely by Azerigaz, the costs of distribution services are not separate from the price of supplied gas. The rates or terms of gas supply services are subject to public service obligations established under the Gas Supply Law. Therefore, change of a rate or term of such service depends on the relevant changes in the law.

2.5 Sales and trading

Azerigaz is the sole supplier of natural gas to final consumers. It supplies gas through its regional divisions. The government carries out its oversight with respect to gas supply and trading activities through the following measures:

- mandatory certification and testing of gas facilities, processes and products;
- granting of rights to operate gas facilities under energy contracts;
- monitoring of all facilities, constructions and installations related to any gas activities;
- licensing of gas activities;
- gas prices regulations;
- public service obligations; and
- safety, antitrust and environmental requirements.

All natural gas consumers must purchase a bundled product because Azerigaz both sells natural gas and provides gas transmission services.
2.6 Regulation of liquefied natural gas (LNG)

The LNG industry of Azerbaijan is not well developed. Currently, NG is produced by Oil Processing Plant owned by SOCAR, and thereafter delivered to a gas processing plant owned by Azturkgaz Joint Venture with Turkish supplied capital, where it is put into gas-cylinders. The amount of LNG produced by these two plants does not have a significant stake in the natural gas sector of Azerbaijan. The construction and operation of LNG facilities is regulated by the Gas Supply Law and Energy Law.

Additionally, under the Energy Law, the obtaining of special authorisation from the Ministry of Industry and Energy is required in order to engage in processing of natural gas. Additional authorisations will be required under the Law on Technical Safety, since LNG facilities are considered potentially dangerous facilities. Azerbaijani legislation generally regulates the prices for natural gas sold to all types of consumers including LNG producers. However, LNG producers are entitled to freely establish prices for their products. There are no specific terms of services in the LNG sector.

3. Universal Service

As outlined in the State Programme on the Development of Fuel and Energy Complex of the Republic of Azerbaijan (2005 to 2015) the implementation of universal service is one of fundamental goals of Azerbaijan energy policy.

Most of the obligations currently placed by the State on gas distributor (Azerigas) relate to ensuring the proper distribution and access to expanded natural gas grid in order to meet most urban. Current plans are to ensure that all settlements with a population more than of 1000 people are given access to natural gas grid.

Pursuant to the Energy Law, the Distribution Company has the following obligations under the energy distribution contracts:

- to distribute energy products to all consumers within the energy distribution contract’s territory;
- to install and exploit all installations necessary for activity under a contract;
- to install and exploit the energy transportation systems for the purposes of transportation and delivery of energy materials and products

4. The Regulators and Institutions

The gas subsectors are controlled by the Government, which acts as owner, operator, regulator, and policy maker. The following governmental and administrative authorities determine regulatory policies for gas activities:

- parliament (Milli Mejlis) as legislator of the Gas Supply Law, the Subsoil Law, the Energy Law and the Law On Use of Energy Resources, which form the framework legislation establishing the legal basis for the production, transmission, distribution, and supply of natural gas;
• the President of the Republic of Azerbaijan;
• the cabinet of ministers; and
• different public authorities, most importantly – the Ministry of Industry and Energy, Azerigaz and the MED.

The President of the Republic of Azerbaijan is entitled to determine the scope of power of executive authorities to implement the existing gas legislation. The president also has the power to establish, reorganise or disband ministries and other governmental entities engaged in implementation of gas legislation. The cabinet of ministers is entitled to adopt technical and other supplementary regulations in the field of gas activities, long-term state energy development programmes, minimise the scope of technical requirements in respect of certain businesses, approve the pipeline routes, allocate money for reconstruction of gas infrastructure, etc. The Ministry of Industry and Energy carries out control over the use of energy resources, observes fulfilment of environmental requirements, develops technical regulations on effective use of energy resources, grants licences and applies certain restrictions or gas activities, ensures implementation of international standards in case of the absence of domestic regulations, takes measures necessary to prevent industrial emergencies, enters into energy contracts and supervises their implementation, etc. Azerigaz carries out the control over independent gas experts, enters into energy contracts and supervises their implementation, applies exceptions in technical requirements established by the Gas Supply Law, carries out inspection of buildings and installations used in gas activities, raises the matter of suspension of activities in cases of violation of existing requirements, applies sanctions, etc.

5. National Development Plans, Privatization and Investment Issues

The Government has given high priority to the rehabilitation and development of natural gas as a primary domestic energy source, so that a higher proportion of Azerbaijan’s primary energy requirements can be met by natural gas, and dependence on petroleum products and firewood can be reduced.

The adoption of a State Programme on the Development of Fuel and Energy Complex of the Republic of Azerbaijan (2005 to 2015) has become a major recent development in the domestic energy sector, which also includes the gas sector. Pursuant to the programme, works are being undertaken towards the development of the domestic gas sector consisting mainly of: improving the material and technical basis of the sector; reinforcement of financial discipline; development and technical maintenance of Azerigaz within an investment programme; and increasing quality and sales volume of gas, etc.

Recovery, reconstruction, and longer-term development will require new investment which requires substantial private sector participation. Currently, the government is planning to transfer the Baku Gas Department, the largest gas distributor of Azerigaz, to a long-term operation with further privatisation. For the last years, the government implemented some projects on reforming and reconstructing Azerbaijan’s gas infrastructure. One of the achievements has been the modernization of some gas pipelines and facilities in Baku.
The Government’s operational strategy for the energy sector is aimed at promoting economic growth by removing impediments to the modernization and reconstruction program—in particular, policy, financial, regulatory, and institutional constraints.

- establish separate policy and regulatory functions;
- undertake sector restructuring; and
- improve operations, maintenance, and safety standards.

It will, however, take time to formulate new policy frameworks, modify legislation and regulations, achieve financial sustainability, and reorganize the sectors. Long-term sustainability requires promoting development of energy resources on a least cost basis in an environmentally sound and socially acceptable way. Azerbaijan’s natural gas could be utilized economically, and estimates suggest that all the country’s energy needs could be met from domestic resources. An expanded natural gas grid could meet most urban and rural energy needs and would assist in reducing environmental degradation.

- In summary the key issues in the natural gas sector are the following:
- Strengthening the capacity of the key institutions to support sector rehabilitation and reconstruction.
- Separating policy making, regulatory, and operations functions.
- Establishing an efficient policy and regulatory framework to facilitate future private sector investment in oil and gas exploration and development.
- Increasing government revenues by improving overall system efficiency, eliminating production and transmission losses, phasing out price subsidies, and improving payment collection by gas and power utilities.
- Developing policy on interregional energy trade among neighboring countries to facilitate import and export of natural gas through a transmission network.
- Creating institutional capacity for negotiating and monitoring investments in oil and gas exploration and development.
- Establishing appropriate codes and standards for the oil and gas industry, and preparing enforcement and monitoring procedures.

6. International cooperation

Azerbaijan is a party to a number of multilateral and bilateral treaties regulating principles of cooperation in the sphere of production, processing and transportation of natural gas. Exploration and production of gas reserves by international energy companies are governed by PSAs concluded between international energy companies and Azerbaijan. The specific nature of Azeri PSAs is that they are ratified by the Parliament as international agreements and prevail over domestic legislation. Because imports of natural gas are carried out by the government, the rules of importation of natural gas are governed by bilateral agreements. The specific commercial regulations, however, are stipulated in the import contracts concluded between relevant seller and buyer (ie SOCAR). The legislation of Azerbaijan does not provide for rules regulating cross-border sales or deliveries of natural gas. In fact cross-border sales or deliveries of natural gas are governed by intergovernmental agreements followed by contracts concluded between companies.