Azerbaijan Risk Assessment Report and Risk Management Plan
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I. INTRODUCTION

A. Purpose

1. This Risk Assessment Report and Risk Management Plan has been prepared as an input for the first country partnership strategy (CPS) 2014−2018 between the Asian Development Bank (ADB) and the Government of Azerbaijan. In line with ADB’s Second Governance and Anticorruption Action Plan (GACAP II), this report intends to strengthen ADB’s operations by assisting the government in strengthening its governance systems in the sectors that ADB is active in and to improve the design and implementation of better quality projects and programs. Governance-related risks lead to reduced development effectiveness as the result of inadequate governance systems, weakly performing institutions, or vulnerability to corruption.

2. The purpose of the report is to: (i) identify and assess potential risks that could affect the integrity and effectiveness of ADB’s operations in Azerbaijan, and (ii) put forth recommended mitigation and reform measures that could be undertaken by ADB in cooperation with the government, namely executing and implementing agencies for ADB projects, and other development partners. The findings and recommendations are expected to guide the preparation and implementation of ADB projects in the country.

3. The report comprises a country level risk assessment and risk management plan focusing on the three governance themes contained in GACAP II: public financial management (PFM), procurement, and combating corruption. Additionally, sector specific details related to the three themes are offered when available for transport, energy, and urban water and sanitation. These three sectors are the priority sectors in the CPS for 2014–2018.

4. The assessment closely follows the methodology set out in the Revised Guidelines for Implementing ADB’s Second Governance and Anticorruption Action Plan.2

B. Methodology

5. The report is based primarily on recent secondary sources produced by major development partners and international organizations such as the European Union (EU), European Bank of Reconstruction and Development (EBRD), Organization for Economic Cooperation and Development (OECD), and World Bank. In addition, diagnostic meetings were held with Azerbaijani government officials, agencies in the priority sectors, and key development partners active in the country (Annex 1).

6. Various sector specialists, procurement specialists, financial management specialists, and the Office of the Auditor General (Integrity Division) from ADB also contributed insights and experiences with Azerbaijan through discussions and written communication.

7. The data and information were assessed to determine the key features and risks pertaining to the governance conditions in Azerbaijan, including the legal and regulatory framework, policies, institutional framework, and capacities. The risk matrix in section V summarizes the key risks identified and rates their likelihood of occurring. Based on the risk

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assessment, mitigation measures and indicators are offered in section VI in the risk management plan.

II. COUNTRY OVERVIEW

A. Recent Historical, Political, and Economic Context

8. Azerbaijan was previously one of the republics in the Soviet Union, coming under Soviet control from 1920 until 1991. In 1991 while the Soviet Union was weakening, popular pressure within Azerbaijan led to a declaration of independence. However, Azerbaijan and Armenia were soon at war over territory that included Nagorno-Karabakh in Azerbaijan. Many ethnic Azerbaijanis were forced to flee the area, and the legacy still remains with Azerbaijan having one of the world’s highest per capita ratios of internally displaced people (IDP) and refugees, totaling around 1 million people. A ceasefire was signed in 1994 and the situation remains a stalemate, with Armenian troops still occupying Nagorno-Karabakh and seven nearby districts.

9. Independence brought about an economic collapse in Azerbaijan that was among the worst in the Commonwealth of Independent States (CIS) countries. A combination of trade disruption, loss of financing from Moscow, and the transition to a market economy, among other factors, led to gross domestic product (GDP) shrinking until 1996. The conflict with Armenia exacerbated the economic decline and led to an influx of around one million Azerbaijanis.

10. Economic growth resumed in 1996 with the commencement of the oil revenue windfall that was made possible by the oil investments made starting in 1994. Another factor was the country’s stabilization and structural reform program that began in earnest in 1995.

11. Rapid increases in oil production caused GDP growth to surge during 2005–2007, averaging 28.6% annual growth. Subsequently, GDP growth levels fell to around 10% annually until fluctuations in oil production and oil prices caused annual GDP growth to fall to 5.0% and 0.1% in 2010 and 2011, respectively.

12. The outcome of this rapid economic growth was a sharp decline in poverty. The official poverty rate fell from 68% in 1995 to only 6.0% in 2012. The World Bank concluded that the economic growth was pro-poor because consumption growth was higher for the poorer deciles compared to richer deciles.3

13. The oil revenue windfall led to a considerable rise in government expenditures, which were used to stimulate aggregate demand. The government’s strategy has been to use oil revenue to modernize the economy. Oil wealth has paid for reforms and infrastructure investments that are expected to eventually lead to a more diversified non-oil economy. The government’s approach is essentially one of frontloading the use of oil money to create the necessary foundation for the non-oil sector.

14. By 2013, the government’s budget expenditures increased 22-fold over 2001 and more than doubled as a percentage of GDP. The large increases in budget expenditures, particularly since 2005, have been made possible by substantial transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). However, the result has been that the state budget is becoming highly dependent on transfers from SOFAZ. Between 2008 and 2013, SOFAZ transfers as a percentage of the total state budget revenues rose from 35.3% to 58.2%.

15. In addition to the influx of oil revenue, the rapid socio-economic development can be attributed in part to the government’s attention to social sectors, including social transfers, and increased salaries. The government overhauled the social transfer systems (pensions and the Targeted Social Assistance program) in the mid-2000s and has made significant transfers to social programs ever since. Transfers to households doubled from 2002 to 2008, while the minimum wage and public sector salaries received substantial increases as well. Around three-quarters of social transfers are for pensions, and they cover about 46% of the population. The Targeted Social Assistance program accounts for about 10% of social transfers and covers around 4% of the population. About three-quarters of the IDPs receive social assistance as their main income.

B. Institutional Context for Governance

16. Azerbaijan is guided by a democratic constitution, but the political system has few checks and balances. Under the constitution, Azerbaijan’s executive branch is granted extensive powers compared to the legislative and judicial branches. Since 2002, members of the national assembly are elected by a majority system as opposed to the previous proportional representation system, which has diminished the number of opposition members in Parliament and limits the ability of the opposition to provide a check on proposed legislation. Most legislative initiatives emanate from the presidential administration, and debate on bills in Parliament tends to be very limited. Civil society organizations and NGOs are allowed to operate and have expanded in number, but their limited development hinders their ability to hold the government accountable or to play a more active role in policymaking.

17. Despite the economic growth and improvements in social assistance, Azerbaijan’s institutional capacities have not developed rapidly enough compared to the socio-economic development. Administrative and planning capacities remain limited, and there is a general lack of coordination in planning and implementation among ministries and agencies. Furthermore, macroeconomic policies have lacked both a predictability of expenditures and a medium-term expenditures framework. Inadequate setting of priorities and the lack of sequencing of reforms hinder further development of the non-oil economy.

18. Policy coordination challenges further hamper the institutional setting. Vertical and horizontal coordination problems weaken the preparation and implementation of policies and programs. In some cases, policies are hastily formulated and implemented, leaving little time for coordination.

19. Various fiscal reforms and governance improvements have been launched, but the pace of implementing these measures has lagged. The lack of urgency in devising stronger fiscal tools and governance measures is likely caused by the lack of fiscal pressure on the government due to its significant oil revenue. Large amounts of oil revenue result in the government taking a less conservative fiscal policy, with investment in infrastructure multiplying nearly six-fold over the last ten years. Discovery of new oil and gas fields and the ongoing high prices of oil in world markets will likely continue to restrain fiscal reforms and more conservative expenditure levels.

20. Oil revenue is essentially transparent due to Azerbaijan’s participation in the Extractive Industries Transparency Initiative (EITI), of which Azerbaijan became the first EITI-compliant country in 2009. EITI is a global standard promoting revenue transparency at the local level, whereby companies disclose what they pay in taxes and royalties for the extraction of natural resources, and governments publish what they receive in payments. While the oil revenues themselves are managed transparently, public investments related to the state budget, the State Oil Fund of the Republic of Azerbaijan (SOFAZ), and the state oil company (SOCAR) are reportedly a means to rent seeking.\(^8\) Allegations are made that some public officials indirectly siphon off revenue from the oil industry by embezzling funds from public investments financed by the state budget, SOFAZ, and SOCAR.\(^9\) The restraint of such conduct is limited by the few checks and balances in the system, as noted above.

21. The World Bank’s Independent Evaluation Group identified other reasons for the relatively slow progress in governance reforms.\(^10\) Among the findings of its study was that governance structures and related technical support were transferred to Azerbaijan without a full understanding among the recipient agencies of what the concepts meant and how they should be applied.

C. Recent Studies Related to Governance

22. A limited body of literature exists on governance in Azerbaijan. The number of documents available is further limited by confidentiality and the lack of disclosure of documents and reports to the public both by development partners and the government. A brief summary of the more recent public reports on governance in Azerbaijan prepared by development partners follows below.

23. The World Bank under its previous CPS conducted governance activities that included the Public Expenditure and Financial Accountability (PEFA) assessment, a Public Expenditure Tracking Survey, a Financial Sector Advisory Program update, the Report on the Observance of Standards and Codes (ROSC), the Azerbaijan Transport Sector Projects Fiduciary Review, and the Azerbaijan Human Development Projects Fiduciary Review. The latest PEFA assessment for Azerbaijan was prepared in 2008. Among its findings were the following:

(i) The expenditure management system needs strengthening.
(ii) Weak accounting and auditing capacities persist.
(iii) Prioritization and medium-term investment budgeting are missing.
(iv) Transparency is lacking with the investment budget, which is reported as a lump sum and not broken down by functional or administrative classifications.

24. The World Bank also produced a Country Procurement Assessment Report in 2009, but the document was deemed confidential and not released to the public. In a more recent study conducted by the Independent Evaluation Group (IEG) of the World Bank, it was found that the World Bank’s operations in Azerbaijan had made limited progress in overall governance reforms over the past few years, but improvements were evident in selected areas such as oil revenue

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transparency, streamlining the distribution of social assistance, primary education, and roads.\textsuperscript{11} Limited progress has been made on expenditures, while the strengthening of accountability of institutions has been moderately effective. Also, the evaluation concluded that the World Bank had too much confidence that formal rules, organizational structures, and technology would alter the behavior of government institutions.

25. The European Bank for Reconstruction and Development (EBRD) and the United Nations Commission on International Trade Law (UNCITRAL) conducted a diagnostic on the public procurement legislation in Azerbaijan. The 2012 report assessed Azerbaijan’s 2001 public procurement law (PPL) and related secondary legislation against the standards of the 2011 UNCITRAL Model Law on Public Procurement. The main shortcomings identified included:

(i) The absence of modern procurement methods.
(ii) A lack of sufficient detail in procedural rules.
(iii) Insufficient institutional and legislative safeguards.
(iv) Insufficient publication of case-law related to public procurement.
(v) Absence of an official location for publishing notices and information on public procurement.
(vi) Insufficient regulation on access to and recording of procurement information.\textsuperscript{12}

26. EBRD also produced a public procurement assessment in 2010 that assessed Azerbaijan’s PPL and determined that it attained only 51% compliance with international standards.\textsuperscript{13} Most of the indicators used in the assessment received low scores in Azerbaijan. Within the EBRD region, Azerbaijan’s PPL scored the third lowest out of 29 countries.

27. Another recent report is OECD’s second round of monitoring for the Istanbul Anti-Corruption Action Plan.\textsuperscript{14} The report examines Azerbaijan’s progress with anti-corruption reforms and implementation of recommendations under the Istanbul Anti-Corruption Action Plan, which was endorsed in 2003.\textsuperscript{15} The monitoring report covers anti-corruption policies, criminalization of corruption, and prevention of corruption. On anti-corruption policies, the report expressed concerns about the implementation of policy declarations against corruption. The criminalization of corruption has seen good progress towards international standards, and institutional development has been strengthened within the key anti-corruption bodies. On the prevention of corruption, loopholes need to be closed, and measures are needed to clarify conflicts of interest and to protect whistleblowers. Also, more efforts are needed to address corruption in the private sector.

\textsuperscript{12} EBRD and UNCITRAL. 2012. Legal Diagnostic Report – Compliance of the Public Procurement Legislation in Azerbaijan with International Best Practice as Expressed by the 2011 UNCITRAL Model Law on Public Procurement. London.
\textsuperscript{15} The Action Plan involves Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Ukraine, and Uzbekistan. The process entails peer review of the legal and regulatory frameworks for fighting corruption in the target countries.
III. FINDINGS

A. Public Financial Management

1. Overview

28. Azerbaijan became the first country compliant with EITI. This was an important step in the country’s governance environment as it enhances political accountability for the vast sums of oil revenue flowing into the country and gives a strong signal to investors that efforts are being made to improve transparency. Although oil revenue is managed transparently, other aspects of public financial management (PFM) still exhibit several shortcomings. Some development partners such as the World Bank ring fence their project support because of governance issues.

2. Legislative and Policy Framework

29. Various laws and decrees apply to the PFM environment in Azerbaijan. Some parts of the legal and regulatory framework are being amended under the Ministry of Finance’s (MOF) Public Financial Management Action Plan, 2011–2013. The PFM Action Plan has largely been implemented, and more thorough analysis of the budget is now possible. A key area of progress has been increasing the comprehensiveness of the budget, whereby the budget now includes a table on public investments by sector for 2013–2016, tables on the medium-term revenues and expenditures by sector, and a medium-term breakdown of investment outlays by sector.

30. The Law on Budget Systems (2002 and subsequent amendments) lays out the objectives for the State Treasury Agency for managing cash flows, financing expenditures, and the implementation of state and community budgets. It requires publication of the draft budget for the coming year and publication of the actual budget when it is finalized. Annual and quarterly reports are prepared about the budget. Quarterly budget implementation reports to the Cabinet of Ministers are posted on the MOF website, while the annual reporting takes the form of a draft law submitted by MOF to Parliament entitled “Implementation of the (year) Budget.” The law is published in the local newspapers. The law also mandates the analysis and disclosure of actual income and expenditures compared to the approved budget.

31. The Accounting Law of 2004 sets forth different categories of accounting standards. “Public interest entities” (e.g., credit organizations, insurance companies, investment funds, non-state private social funds, legal entities with securities traded on the stock exchange, and certain types of large commercial organizations) and state-owned enterprises were required to use National Accounting Standards based on International Financial Reporting Standards (IFRS) by January 2008. SMEs can opt to use the Simplified Accounting Rules for Subjects of Small Entrepreneurship or the National Accounting Standards for Commercial Organizations. Other commercial organizations that are not public interest entities or SMEs were to use the National Accounting Standards for Commercial Organizations or IFRS, with implementation by the start of 2008. All commercial organizations are required to submit annual financial statements.

32. Non-commercial organizations such as municipalities, budget organizations, and off-budget state funds were required to prepare financial statements according to National Accounting Standards for Budget Organizations by the start of 2009. The National Accounting Standards for Budget Organizations are based on International Public Sector Accounting
Standards. Non-government organizations must use the National Accounting Standards for Non-government Organizations.

33. Despite the accounting law being in force for several years now, financial statements are still not prepared regularly by public and private entities. Equally concerning is that the liabilities and sanctions for violations of the standards are very low and therefore not a deterrent. In 2009 the government increased the sanctions for accounting offenses seven to ten times their previous levels, but still the maximum fine is only AZN 2,000.

34. Azerbaijan passed the Internal Audit Act in 2007, but the law still has not been implemented. The law is supposed to apply to various economic entities and intends to decentralize the internal audit function. Banks and credit organizations, joint stock companies, insurance organizations, limited liability companies, municipalities and their institutions, monopolies, NGOs, and other organizations are required to perform audits. The types of audits covered under the law include performance audits, financial audits, and compliance audits. The Audit Service Law (adopted 1994 and amended in 2011) regulates the functions of auditors and their rights and obligations. In 2013, the law On Audit Regulation in the Business Sphere and Protection of Entrepreneurs’ Interests was adopted, which establishes the framework for centralized state audits of businesses. Businesses are classified into risk categories for planned audits, with low risk businesses audited every three years, average risk every two years, and high risk every year.

3. Institutional Framework and Capacity

35. The central institution for PFM is MOF, which handles budget formulation, treasury operations, major investments in infrastructure, financial controls, and cooperation with international agencies. Within MOF are several departments and services, including the Public Financial Control Service that controls the spending of budget funds. The Ministry of Economic Development (MOED) and the Ministry of Taxes are also involved in PFM. Rayons (essentially districts) and municipal governments are responsible for local (district level) revenues and expenditures which are also planned during national budget formulation, but no assessment of their capacities is available. For auditing, the Chamber of Accounts, described further below in section 6, conducts audits of income and expenditures and performs supervisory functions.

36. A few generalizations can be made about the institutional capacities for PFM in Azerbaijan. Capacities for financial management and procurement are adequate in most agencies, but clearly they need overall strengthening. Some development partners make limited use of the country’s PFM and procurement systems due to weaknesses. Line ministries and subnational government entities need to strengthen their skills in long-term planning and budget formulation. Annual budgeting, the medium-term expenditure framework (MTEF), and investment planning are still not utilized or prepared adequately by MOF and MOED. Project development and management skills are also lacking in many ministries, leading to delays and higher cost implications. Many investment projects are prepared without proper economic and technical feasibility studies.

37. Structural problems present additional challenges to PFM capacities. Disparities in wages between the public and private sectors render it difficult to recruit and retain qualified civil servants. Required skills for technical functions like auditing are in short supply even in the Chamber of Accounts. Furthermore, ministries do not always have the requisite units for PFM functions. For example, few line ministries have internal control units, and internal audit capacities are severely lacking.

38. Another weakness is that information technology (IT) and e-government are either absent or not utilized to a great extent. At best, there is a mix of some agencies using manual systems and others being partly automated. For instance, the Treasury Information Management System has been under development for many years and is still not rolled out, which affects the timeliness and coverage of cash flows, while the Investment Appraisal System is yet to be designed. Other delays in implementing IT systems include the Government Financial Management Information System (GFMIS) and the Investment Appraisal System. A positive development in the application of IT is the use of MIS for the Targeted Social Assistance Program, which is considered the one of the best in the region.

4. Budgeting

39. The state budget consists of centralized and local revenues and expenditures along with extra-budgetary revenues and expenditures. It contains information according to functional and economic classification and is also broken down for Nakhchivan Autonomous Republic, districts, and towns. The investment program for the budget is broken down by functional and economic classification, along with the financing source. The Chamber of Accounts audits the budget and extra-budgetary funds.

40. In terms of budget process, MOF prepares the initial budget forecast for the upcoming year along with the investment program, accompanied by the medium-term forecast for the following three years. Then all organizations funded by the state budget (including municipalities) submit their draft budgets to MOF. MOF submits a consolidated draft budget to the Cabinet, which then forwards it to the President’s administration. Finally, the budget is sent to the Parliament for final passage as the budget law for the coming year. The draft budget is required by law to be published in the media 10 days after submission to the Parliament. Discussion about the budget in Parliament is limited, and typically the budget bill is passed without change. The whole budgeting process lasts from January to December.

41. According to the budget systems law, municipalities are intended to be independent in the preparation, approval, and execution of their budgets. In accordance with clause 32.6 of the law, the government is not liable for municipality expenditures.

42. The budget formulation process is closely linked to oil revenue, and thus planning for the annual budget is based on expected oil prices. Azerbaijan’s state budget has experienced a large increase in expenditures over the past several years. In 2001, expenditures amounted to 15.2% of GDP, and by 2011 they had risen to nearly 40% of GDP. Actual oil prices over recent years have been higher than what the government based its annual budget on, and therefore the government conducts a mid-year review of the budget which enables it to expand the list of investment projects or increase social spending. The rapid increase in expenditures over the

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past decade has not been accompanied by an effective expenditure management system.\textsuperscript{20} A disconnect persists between planning and budgeting, and strategic budgeting based on the MTEF and Public Investment Plan has not been adopted. Budget planning remains somewhat ad hoc and without an overarching framework, while budgeting tools are not utilized by all agencies. However, transparency in the budget has improved due to increased program-level information contained in the budget and the publication and dissemination of the annual budget law and some budget reports. According to the budget systems law, monthly reports are to be prepared on the execution of the state budget, and quarterly reports are to be submitted to the Parliament and published in the media. In practice though, budget execution statements with limited data are published only on MOF's webpage. Quarterly publications are prepared on the execution of the state budget, but they do not contain all parts of the consolidated budget.

43. A major shortcoming occurs in cash flow management. Cash flows are centralized in the Treasury’s single account, but a nationally integrated and automated treasury information management system is not in place and therefore affects the timeliness and coverage of cash flows.

44. MOF only recently began publishing the State and Consolidated Budget on its website, which includes information on the main fiscal and expenditure policies, along with indicators and forecasts. However, the published state budget has a dearth of information under the general sector or functional classification as defined in the Budget Law. The 2013 budget law contains categories for 12 clearly delineated sectors and two other broad categories, one of which includes line items for municipalities and Nakhchivan Autonomous Republic, and are further broken down by each municipality elsewhere in the law. The details for industry and construction items (capital expenditure) of the budget, however, are not disclosed.

45. The planning of public investment is the responsibility of MOED. The Cabinet of Ministers approves the public investment program every year after approval of the budget law. The public investment program is particularly opaque, but it was published on the MOF website for the first time in 2012 in summary format.\textsuperscript{21} It is reported as a lump sum instead of being broken down by function or administrative category. This might be related to how the public investment planning process is conducted. The selection of projects by MOED tends not to be based on structured programs or quantified objectives for medium and long-term development, and typically no formal cost-benefit or other systematic analysis is used as a screening process. The public investment plan consists of projects funded by the state budget and development partners. Projects or programs funded directly by SOFAZ or other extra-budgetary funds are not included in the public investment plan. Fragmentation further complicates the preparation of the public investment plan. Ministries and other entities can bypass MOF and MOED by sending their investment plans directly to the President’s administration or Cabinet for approval. Further adding to the difficulties in having a comprehensive and accurate public investment plan is the absence or inadequacy of sector master plans.

46. The key problem resulting from this fragmented public investment planning process is that many projects are not prepared in line with political economy realities and not ready for implementation.\textsuperscript{22} Also, projects financed by development partners frequently encounter delays...
because line ministries are trying to proceed before getting approval from MOF or other relevant authorities.

5. **Accounting and Reporting**

47. MOF adopted national accounting standards compliant with International Public Sector Accounting Standards and IFRS. The first stage of accounting reforms included improvements in standards and the development of a legal base for accounting. The second stage of reforms entailed the introduction of updated standards for commercial and non-commercial companies.

48. Several problems persist with accounting. In the public sector, the government still does not have an automated and integrated financial management information system. The systems in use are still from the Soviet times in some entities. Furthermore, some entities continue using manual accounting systems, while others have introduced partly automated systems. Despite the improvement in standards and the 2004 accounting law, not all public sector entities are complying with the required standards, and few balance sheets are released publicly.

6. **Audit and Oversight**

49. Government entities typically lack effective internal audit systems that would identify deficiencies in accounting and reporting. In some cases, ministries and agencies do not have internal control units. Internal audit and internal control are areas that require substantial upgrading across the public sector. Auditors require more training on fraud and corruption risks. As stipulated by law, auditors should have an economic or legal background and at least 4 years of experience in auditing or related assignments. Internal audit is further complicated in agencies with affiliates in districts, such as Azersu, Azerenerji, and the irrigation agency.

50. On external audit, the Chamber of Accounts (COA) serves as the supreme audit institution and is governed by the Law on the Chamber of Accounts. COA audits budget revenue and expenditures and also extra budgetary funds such as SOFAZ. Other functions include the preparation of methodological directives and regulations, the development of audit standards, and examining whether municipalities and other bodies spent the expected funds from the budget. COA does not, however, review internal audits performed by the ministries and agencies.

51. COA is a member of the International Organization of Supreme Audit Institutions (INTOSAI), which is an umbrella organization for the external government audit community. As a member of INTOSAI, COA is also a signatory to INTOSAI’s Lima Declaration of Guidelines on Auditing Precepts. In addition, Azerbaijan’s COA participates in the Council of Heads of Supreme Bodies of Financial Control of CIS countries.

52. Normally, COA conducts around 20-30 audits per year and additional supervisory functions, and the results of its audits are presented to the Parliament. However, the results of audits are not made public. COA reports on its work annually to Azerbaijan’s President.

53. The World Bank’s Independent Evaluation Group reported that COA still performs investigations as opposed to proper audits in line with international standards. Another problem

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found by the Independent Evaluation Group is that audits by COA lack enforcement mechanisms, and thus audits rarely lead to effective sanctions. Also, the fact that COA conducts only 20-30 audits annually indicates that the body’s work is far from comprehensive in terms of many government entities not having their accounts externally audited each year. The World Bank is preparing (as of early 2013) to conduct joint audits and post-procurement reviews together with COA. This initiative will be an important step in the use of country systems.

7. Anti-Money Laundering

54. Anti-money laundering is a new concept for Azerbaijan, but good progress has been made in meeting global standards established to ensure adequate safeguards in commercial banks to facilitate the proceeds of illicit activities from flowing through the financial sector. Laundering money or other property derived from illicit activity has been a criminal activity since the Penal Code was amended in 2006. In 2009, Azerbaijan established its legal and institutional framework for anti-money laundering, aligning it international standards on Anti-Money Laundering and Combating the Fight against Terrorism (AML/CFT).

55. The Law on the Prevention of Legalization of Criminally Obtained Funds or Other Property and Financing of Terrorism (2009) provides for a system of reporting and analyzing suspicious transactions in all financial institutions and designated non-financial businesses and professions. The Financial Monitoring Service (FMS), which sits within the Central Bank, is the county’s financial intelligence unit and investigates suspicious currency transactions. Its director and deputy director are appointed by and report to the President of Azerbaijan. The FMS maintains a progressive website in both Azerbaijani and English which includes links to relevant documentation, organizational details and monthly statistics from 2010 about suspicious transactions reported.

56. In 2012, the Council of Europe’s Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) ended the formal reporting regime in Azerbaijan due to the progress made in fulfilling recommendations. Azerbaijan is now fully in line with the UN conventions, the Financial Action Task Force (FATF) 40+9 recommendations, and the relevant EU directives.

8. SOFAZ

57. Azerbaijan’s biggest accomplishment in PFM is the establishment and management of SOFAZ, because the country’s oil production and revenues are systematically reported and audited to international standards.

58. The oil fund was established in 1999 with IMF and World Bank support. The purpose of SOFAZ is to efficiently manage the country’s accumulated oil revenues and utilize them for the development of the country, particularly for the implementation of priority socio-economic

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27 Operations of AZN 20,000 or more must be reported to FMS.
projects. SOFAZ intends to use the oil revenues to generate “perpetual income for current and future generations” and “to ensure intergenerational equality with regard to the country's oil wealth.”

59. SOFAZ contained $34.13 billion as of January 2013, the latest figure posted on SOFAZ's website.

60. SOFAZ’s assets are managed in accordance with the Presidential decree on "Rules on Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan" (2001 and amended periodically), the President’s annual decree on "Investment Policy of the State Oil Fund of the Republic of Azerbaijan,” and the “Long-term Strategy on the Management of Oil and Gas Revenues, 2005-2025.” Transfers from SOFAZ to the state budget are recorded as part of the consolidated budget approved by Parliament.

61. SOFAZ is a legal entity with a separate management structure. It does not act as a special account in the central bank, nor can it be used for lending to any state or non-state organizations or as a guarantee for others' liabilities.

62. The seven-member Supervisory Board considers SOFAZ’s annual budget, annual report, and all financial statements. All members are appointed by the President of Azerbaijan, and the current board members represent various government bodies, including the Parliament and central bank. An Executive Director, also appointed by the President, manages the fund’s activities and is required to submit an annual report on SOFAZ to the President for approval.

63. The oil fund has received international recognition for its management. In 2007, SOFAZ received the United Nations Public Service Award for “improving transparency, accountability and responsiveness in the public service category.” SOFAZ also received the EITI Award for 2009 upon being declared the first candidate country compliant with EITI. This award recognized the gains made in institutionalizing the transparency by both the government and companies involved in resource extraction.

64. The implementation criteria for EITI consist of the following:

(i) Regular publication of all material oil, gas and mining payments by companies to governments (“payments”) and all material revenues received by governments from oil, gas and mining companies (“revenues”) to a wide audience in a publicly accessible, comprehensive and comprehensible manner.

(ii) Where such audits do not already exist, payments and revenues are the subject of a credible, independent audit, applying international auditing standards.

(iii) Payments and revenues are reconciled by a credible, independent administrator, applying international auditing standards and with publication of the administrator’s opinion regarding that reconciliation including discrepancies, should any be identified.

(iv) This approach is extended to all companies including state-owned enterprises.

(v) Civil society is actively engaged as a participant in the design, monitoring and evaluation of this process and contributes towards public debate.


A public, financially sustainable work plan for all the above is developed by the host government with assistance from the international financial institutions where required, including measurable targets, a timetable for implementation, and an assessment of potential capacity constraints.\(^{32}\)

65. The management and transparency of SOFAZ have some issues despite the overall good practices. The drawdown of funds from SOFAZ appears rather discretionary. There are no clear fiscal guidelines or rules to limit how much is transferred annually to the state budget, which calls into question how the funds are being used for present versus future consumption. Although the government has developed a medium-term policy for managing SOFAZ revenue, the policy gives only limited direction. Funds from SOFAZ have been used increasingly to fill the fiscal deficit, which would have been AZN 9.7 billion (18\% of GDP) in 2012 without transfers from SOFAZ to the state budget. Furthermore, the annual law on the state budget does not report how SOFAZ transfers will be spent. The annual budget law merely has a single line item on revenues from SOFAZ. Reporting in conformance with the EITI requirements has not been stringent lately, with the last EITI annual report and audit report being 2011 (as of March 2013).

\textbf{B. Sector Specific PFM Issues}

1. PFM in Transport

66. The transport sector comprises a substantial portion of the public investment plan. In 2011, 45 projects accounted for 25\% of the public investment plan. ADB's 2013 Transport Sector Assessment identified public financial management as an area of weakness.\(^{33}\)

67. The transport sector is managed by the Ministry of Transport, which oversees specialized agencies. The road network (excluding Nakhchivan Autonomous Region) is the responsibility of the AzerRoadService Open Joint-Stock Company (ARS). Azerbaijan Railway (ADY) oversees the development and operations of the railways.

68. The legal and regulatory framework for the transportation network is incomplete. For example, the new road law has not been approved as of 2013. Other legislation or regulations that have been pending include the establishment of a Road Advisory Board, licensing and route management, and road tolling. The existing legislation consists of the Law on Transport (1999), Law on Automobile Roads (1999, amended in 2001, and also known as the “road law”), Law on Road Traffic (1999), and Law on Automobile Transport (2008). Vehicle testing based on European standards began in 2009, with the Traffic Police Department responsible for implementation. Truck licensing commenced in 2010 and falls under the responsibility of the Ministry of Transport.

69. Although the Road Advisory Board has not been established yet, an inter-agency traffic safety commission chaired by the Deputy Prime Minister is operational. It includes members from the Ministry of Transport and Traffic Police Department, among others.

70. Despite some progress on policy and institutional reforms, the institutional framework for the transport sector is still not ideal in terms of having a separation of regulatory, infrastructure development, and operating functions. This situation creates conflict of interest as well as leads


to inefficiencies. ADY currently assumes all functions pertaining to the railways, including transport operations and railway development. Much of ADY’s revenue derives from the transport of hydrocarbon products. However, ADY has not re-invested sufficient amounts of revenue into upgrading the rail infrastructure and rolling stock, resulting in a severe deterioration of the tracks and rolling stock. The outcome of this state of infrastructure is reduced speed, longer transport times, and higher operations and maintenance costs. Inattention to investment and fiscal management threatens to cease operations of the railways in the near future.

71. Railway tariffs are below market rates, thus resulting in cross-subsidies by the government to operate the railways.

72. For roads, responsibilities are not clearly delineated among MOF, Ministry of Transport, and ARS. Furthermore, within ARS the functions of road administration and management are still not separate from the supply of maintenance services. New road investment and road maintenance are not efficient, while the investment costs tend to be high and the quality of maintenance is often not satisfactory. The government’s total investment plan for the road network is $500 million a year during 2006–2015.

73. The Road Fund, abolished in 2001 and restored in 2007, continues to function as a division of the Ministry of Transport. The fund relies entirely on allocations from the state budget because tolls or other user charges are not yet in place. The Ministry of Transport is considering the introduction of tolls for selected road sections.

74. Measures are planned to improve the railway subsector’s performance and management. The government’s ten-year railway program for 2006–2015 envisages $8.46 billion in investment, but it also covers the development of regulations and operational procedures; capacity building for planning, monitoring and evaluation, and reporting; and private sector participation in construction and maintenance.

75. The reorganization plan for ADY will separate its four lines of business: freight transport, passenger transport, infrastructure, and non-transport activities. The plan also calls for the railway track and infrastructure to remain under state ownership and be maintained by state funds, and the railway operator will pay access charges. Other reform initiatives under the program include developing and implementing market-based tariffs, defining and implementing a policy for track access charges, and enabling the provision and renting of wagons by private companies.

76. Institutional capacity in the transport sector has improved as a result of reforms and capacity measures, but the agencies’ skills and standards have much more room for improvement before efficiency and effectiveness are achieved. Financial management in the transport sector was identified in ADB’s transportation sector assessment as a particular area of weakness.

77. The effective use of the Ministry of Transport’s substantial amount of public finance during 2006–2015 for roads depends greatly on the relevant agencies’ improved financial management and adoption of best practices on project design, standards, and reforms. Many of

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the staff in these agencies have limited experience with project management, although some agencies are better than others such as ARS’s project implementation unit (PIU).

78. Some agencies still have not transitioned to the new accounting standards. ADY is moving towards the adoption of international financial reporting standards, but it is not clear when they will apply the new standards.

79. The installation and utilization of appropriate PFM IT systems are also lagging. In the Ministry of Transport and ARS, the absence of a comprehensive Management Information System (MIS) for roads constrains planning, investment, and maintenance needs. ARS has a partial database in operation containing data on roads in Azerbaijan, but its development and training rollout are still in progress.

2. PFM in Energy

80. The government’s energy sector policy framework intends to achieve several objectives, some of which pertain to improved PFM. Among the objectives are (i) promoting efficient use of energy resources and increasing sector operation efficiency, (ii) establishing a sound regulatory environment to promote competition, (iii) improving the sector structure to attract more investment, (iv) promoting renewable energy and sustainable development to ensure environmental safety, and (v) strengthening financial discipline in the sector and ensuring full payment for energy consumption. The government’s State Program on Socio-Economic Development of Regions (2009-2013) includes an investment program for the energy sector.

81. The power sub-sector is vertically integrated whereby the state-owned Azerenerji Joint Stock Company (Azerenerji) handles most of the country’s operations and management of major thermal and hydropower generation plants, the transmission and distribution network, commercial activities such as connections, metering, billing and bill collection, and customer service. Other entities perform such functions in Baku and Nakhchivan Autonomous Republic. Azerbaijan’s legislation does not require transmission and distribution to be separated. However, some mini-power plants have been privatized and two independent regional distribution companies have been established.

82. Key issues related to PFM in the power-subsector include eliminating hidden subsidies, implementing a tariff transition plan, and increasing transparency in tariff setting and financial operations. These issues are addressed in ongoing reforms related to the power sub-sector under the State Program for the Development of the Fuel and Energy Sector (2005–2015). Other priority PFM-related capacity development needs in the power sub-sector were identified in ADB’s energy sector assessment. These include: (i) long-term corporate planning, (ii) project appraisal, (iii) project management and supervision, and (iv) financial management. Financial operations and transparency are being strengthened gradually through the requirement for state-owned utilities to adopt IFRS, but Azerenerji is still in the transition to IFRS. Azerenerji is also expected to roll out enterprise resource planning (ERP) software and strengthen its internal audit, budgeting, and planning functions.

83. Currently, the government heavily subsidizes the gas used in power generation, estimated to be at least $650 million per year. The cross-subsidy is expected to be eliminated gradually, which will promote better use of government finances and improve fiscal

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transparency in Azerenerji. Large subsidies have been a necessity for the power utilities due to their precarious financial situation that occurs from a combination of technical losses, unpaid power usage, and poor billing arrangements.

84. Since 2007, meters are gradually being installed in all residential customers. The eventual result will be higher rates of revenue collection, fewer losses from the system, and reduced administrative expenses. Collection rates from residential customers have been low, averaging merely 38% in 2006 to around 50% from 2006 to 2008. The metering is already showing significant results with a collection rate of nearly 85% in 2011.

85. The medium-term tariff policy calls for a transition to full cost recovery for utility service providers, including Azerenerji. Azerenerji submits proposals for tariff increases, but the decision-making authority is the Tariff Council.

3. PFM in Urban Services

86. This section focuses mainly on water and sanitation because of the greater availability of information and ADB’s own experience in the sector. Solid waste management is a relatively “new” sub-sector in Azerbaijan, and hence institutions and the legal framework are not well established and the governance issues are not evident yet.

87. The Presidential order “On Improvement of the Management in Water Supply Sector” (2004) converted the previous water utility into Azersu Joint Stock Company. Azersu is responsible for most of the drinking water supply in Azerbaijan. The State Amelioration and Water Management Committee (SAWMC) of Nakhchivan Autonomous Republic handles both water supply and irrigation in all five rayons of the autonomous republic.

88. Azersu is legally independent but in fact not able to operate independently, even in terms of financial sustainability. In principle, Azersu is supposed to be self-financing. Residential and industrial water tariffs are proposed by Azersu, then endorsed by MOF, and finally approved by the Tariff Council. In practice, tariffs are tightly regulated by the central government, although a number of tariff increases have occurred over recent years to bring them closer to the actual costs of delivering services.

89. Azersu provides water supply and wastewater services through its affiliates comprised of water and wastewater utilities (sukanal departments)\(^{38}\) and pipeline management departments. Azersu also has subsidiary legal entities (i.e., joint stock companies) in Ganja, Sheki, Agdash and Goychay rayons that were established under donor-financed projects.

90. The government introduced legislation in 1996 to support the establishment of Water Users Associations (WUAs) and the introduction of water charges. Six WUAs are functioning and in charge of operations and maintenance of irrigation and drainage systems, collection of water charges, and water allocation.

91. Solid waste management in Azerbaijan outside Baku is managed through regional state-owned executive bodies (appointed by the Presidential administration) and municipal elected bodies, which are poorly funded from lease revenues and are functioning only intermittently. There is a significant lack of technical data for both operational and strategic assessment.

\(^{38}\) Sukanal departments are independent self-financing organizations in charge of all operations, maintenance, implementation of investments, billing, collection, and customer services in their areas of service.
92. Azersu’s and sukanals’ capacities have been strengthened through the implementation of ongoing water supply projects jointly financed by international donor agencies, but they still has a large gap compared to advanced countries’ utilities in terms of their ability to plan, design, and manage water and sanitation services. Other weaknesses include management information systems, financial management and accounting practices, and human resource development.

93. The institutional capacities of the sukanals are still developing. Most of them emphasize the technical/engineering aspects as opposed to maintenance, operational efficiency, and financial management. Their staffing also reflects this orientation, with sufficient engineers but too few personnel in planning and financial management.

94. All of the water utilities in Azerbaijan lack proper management systems that provide the necessary information for effective planning and efficient operations. Their management structures tend to be overly centralized, which hinders the utilities’ ability to maintain and operate the local water and wastewater systems. Furthermore, improvements are needed in the planning and sequencing of investments in the water infrastructure network.

95. Water tariffs have risen gradually over recent years, but they are still insufficient to cover the actual costs of operations, maintenance, and investment. Farmers also pay for water, but the government subsidizes 85% of the water fees. High cross-subsidies by some categories of consumers enable the low tariffs for farmers and other users. The water utilities lack transparent and targeted subsidies for the poor.

96. In addition to the less-than-cost recovery tariff levels, financial management and sustainability are hindered by low collection rates. Collection rates for water and wastewater charges have been hampered by the limited installation of meters, resistance of users to pay for water, and the concomitant reluctance of water utilities to discontinue service to non-paying customers.

97. Sukanals are making a slow transition to the required accounting standards in line with international standards. No sukanal has produced auditable accounts based on International Accounting Standards 8 (IAS 8).

98. Financial audits of sukanals are guided by a 1996 resolution of the Cabinet of Ministers which establishes the basic principles of conducting an audit for state-owned enterprises. Based on information available, it appears that none of the sukanals has had an external audit. Azersu has contracted international audit firms to prepare auditor’s reports and financial statements since 1995. In the case of the Absheron Regional Water Company, deficiencies of the accounts and financial management system have prevented auditors from expressing an opinion on the financial statements even though they were prepared according to IAS.


99. The risks presented above can be presented collectively as follows. Proposed efforts to mitigate those risks are also identified.

100. Weak planning, budgeting, monitoring systems and practices in the public sector, which limit efficient resource use to achieve development targets. Several initiatives are underway to strengthen public sector planning skills. SECO is providing support to the MOED, MOF, and CBA on macroeconomic modeling. MOF, together with EU and the World Bank, is
implementing a reform program to strengthen the capacity in MOED and line ministries to prepare the annual state consolidated budget, MTEF, and PIP. MOF is also strengthening linkages between its investment and budget departments to improve allocations for maintenance costs. ADB will help counterpart agencies prepare medium-term sector “road maps” and investment plans. ADB will also strengthen the capacity of counterparts in planning, forecasting, and cost benefit analysis through project preparatory technical assistance and multitranche financing facilities (MFFs).

101. **Insufficient allocations for operations and maintenance of infrastructure and low cost recovery, which undermine the sustainability of infrastructure.** Sustainability of investments was identified as an issue in each of the three sectors in which ADB is working, with free access roads and subsidies for rail transport, energy, and water. While MOF is implementing internal measures between its investment and budget departments to strengthen the linkage of investments and subsequent allocations for maintenance costs, all three sectors require diversification of their funding base. ADB will help counterpart agencies to address more systematically their capital investment issues, operation and maintenance funding, and other sector specific issues. Reports and Recommendation of the President (RRPs) will reflect these improvements. ADB will hold regular discussion with MOF and concerned ministries/agencies about the need for cost recovery and operations and maintenance mechanisms. Meters will be installed and systems of modern billing and collection will be introduced in urban water and sanitation programming. ADB will support ARS and the Road Fund to assess the feasibility of introducing toll roads on particular segments.

102. **Inadequate oversight, and weak internal controls and auditing, which hinder effective expenditure management and may result in financial losses.** The lack of consistent application of internationally accepted audit practices results in uncertainty over the veracity of statements provided. The EU-supported PFM Action Plan is expected to develop a pilot internal audit section under the State Financial Control Service and to create internal audit sections in public institutions. MOF is preparing to develop a strategy to implement international standards in internal audits, and a response system is being established for audit findings. National auditing standards for financial and performance auditing are being developed. To ensure that resources provided by ADB are appropriately managed, ADB will conduct a diagnostic study of accounting and auditing practices in Azerbaijan through regional technical assistance, and also provide technical assistance to executing and implementing agencies to improve the quality of project financial statements and the quality of audit opinions issued by government auditors. Requirements for external audits will be included in loan covenants.

C. **Public Procurement**

1. **Overview**

103. The amount of public procurement has expanded rapidly over the last few years. The value of all contracts procured increased from AZN1.97 billion in 2006 to AZN2.66 billion in 2011. The number of contracts has also increased substantially from around 6,000 in 2006 to about 12,500 in 2011. Azerbaijan has had an almost six-fold increase in infrastructure investment mainly in roads, railways, energy, and water and sanitation over the last 10 years.
2. Legislative and Regulatory Framework

104. Azerbaijan’s public procurement law (PPL) passed in December 2001. Several decrees and Cabinet decisions serve as secondary laws and round out the legislation on public procurement. For instance, a 2002 Presidential decree states that all public procurements of AZN250 million (equivalent now to 50,000 new Azeri manat) or more shall be carried out through tender and a 2002 Cabinet resolution that the minimal amount for open tender be AZN250 million (equivalent now to 50,000 new Azeri manat). PPL was intentionally based on the 1994 UNCITRAL Model Law on Procurement of Goods, Construction and Services, but it did not incorporate all of the 1994 standards and has subsequently not been updated to include recent international best practices.

105. The PPL covers all contracts for goods, works and services awarded by government organizations and state-owned enterprises at the central, regional, and local levels in which the government’s financing constitutes 30% or more of the total contract. The law also contains provisions for procurement methods for standard goods and small-value contracts.

106. The PPL provides for the following procurement procedures:
   (i) open tender
   (ii) two-stage tender
   (iii) restricted tender and closed tender
   (iv) request for proposals
   (v) request for quotations
   (vi) direct contracting

107. However, a key weakness in the PPL is that there are no clear rules on how the choice of the aforementioned public procurement procedures is to be made, nor does the PPL prescribe the specific procedures for each procurement method. Contracts in excess of AZN50,000 (new manat) are subject to open tender, but as will be discussed in section 4 below, this requirement is often bypassed in favor of single source procurement, which is allowed under the PPL in limited circumstances. The guidelines are generally expected to be as follows: for goods/services ranging between AZN2,000–50,000 the shopping (quotations) method is to be used, and for goods/services under AZN2,000 the procuring agency can use direct contracting.

108. Other procurement methods can be justified when the contract exceeds the threshold for open tender, according to the PPL. Such situations include the need for compatibility with previously procured goods, when only one supplier exists, or when goods or services are urgently needed. All of these types of cases allow for single-source procurement, but again, such flexibilities are often misused by procuring entities.

109. As a whole, the PPL is too general and lacks sufficient procedural details for state procuring entities. Its scope is rather limited in that it only covers solicitation, evaluation, and the award phase; the law contains nothing on public procurement planning rules or contract

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39 As of April 2013, the PPL is under the process of being amended.
management after award. Additionally, the PPL does not state the number of days in which the entire procurement process should be completed, but some steps or procedures have defined timelines stated in the law.

110. EBRD conducted two relatively recent assessments of Azerbaijan’s PPL that measured it compared to international and regional standards. Details of the findings are provided in a subsequent section of this report, but the overall conclusions were the following:

(i) Azerbaijan’s legal framework for public procurement received a low compliance rating for the EBRD region. It scored 53 out of a total possible score of 100, which was the third worst among EBRD member countries.  
(ii) Azerbaijan received a score of 74% compliance with the UNCITRAL Model Law benchmark, which means that the national framework is satisfactory but not in full compliance with current standards. Key weaknesses were found in the legal and institutional framework, procurement notification and submissions, review procedures, and procurement records.

3. Institutional Framework, Systems, and Capacity

111. The main policy body on procurement is the State Procurement Agency (SPA), established in 1997. The PPL states SPA’s functions as the following: (i) develop public procurement policies, legislation, and regulations, (ii) supervise the legality of state procurement processes, (iii) consider disputes in public procurement procedures, (iv) provide technical support and methodological support to procuring agencies, including training and methodology materials, (v) define the rules for producing reports on public procurement and ensuring their dissemination to the public, (vi) prepare an annual report on public procurement, and (vii) establish a website on public procurement that contains information on tenders and requests for proposals.

112. SPA does not conduct procurement itself. Its supervisory powers over state procuring agencies are limited, essentially entailing only recommendations. For instance, SPA is not entitled to intervene in the procurement process other than imposing a 7 day delay if irregularities are suspected or public complaints are received. The PPL only allows SPA to “raise the matter of cancellation of tender results to [the] procurement agency” if a breach of law is suspected. SPA can refer possible cases of violations to state prosecutors for investigation. Only the courts can make binding decisions.

113. SPA reports to the Cabinet. The director and deputy director are appointed by the President of Azerbaijan. SPA is organized into six departments: (i) organization and supervision of goods contracts, (ii) organization and supervision of works and services contracts, (iii) organization of seminars and training methodology, (iv) preparation of legal documents, (v) finance, and (vi) administration.

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114. The actual procurement processes are conducted by the state agencies themselves, such as ministries, rayons, and municipalities. In a recent development, procurement plans are submitted to SPA by the contracting authorities in line with the requirement of the National Action Plan to Combat Corruption for 2012–2015. SPA’s website contains a file that is at least a partial list of annual procurement by state entities. Previously, procurement planning and the budget process (including expenditures) were not well integrated, but it remains to be seen if the new requirement to have a consolidated procurement plan will enhance the integration of procurement and budgeting.

115. A major shortcoming and one that hinders the effectiveness and transparency of the procurement processes is the absence of e-procurement systems throughout the government.

116. Procurement capacities throughout the government are generally not up to international standards due to the limited experience of state agencies. A great deal of progress has been made with capacity development, albeit only gradually. Capacities are further limited as one goes down to the rayon and municipality levels.

4. Procurement Risks and Mitigation Measures

117. Numerous shortcomings are inherent in Azerbaijan’s PPL and the associated procurement processes. These weaknesses have been identified at length in the reports by EBRD, OECD, and World Bank. This section attempts to consolidate and summarize the procurement weaknesses that present significant risks to development partners operating in Azerbaijan. Recommended actions for ADB are also presented.

118. Weak procurement capacity results in delays, inefficiencies and sub-optimal contract award. A framework for transparent, objective procurement has not yet been fully developed or implemented, and thus procurement skills and capacity remain low across the government. UNCITRAL has a program to provide assistance to strengthen procurement skills in Azerbaijan and MOF has prepared a certification system for procurement specialists, but further work is needed to bring the skills of those working in procurement in government agencies in line with international standards.

119. To mitigate the identified risks, ADB will maintain current threshold levels and will continue to strengthen the skills and capacity of personnel working on ADB-funded projects. ADB will include Azerbaijan in a regional technical assistance on “Developing Procurement Capacity for Improved Procurement Outcomes.” ADB will also provide regular training for executing agencies (EAs), SPA, and staff of other agencies. Due diligence training will be conducted to strengthen verification skills of EAs. Other training will be provided periodically as need. Qualified procurement consultants will be recruited to help verify the authenticity of proposals presented and assist EAs in carrying out procurement. This will be included in ADB procurement plans. To verify the work being done by EAs, ADB will randomly check the original bids to validate the bid evaluation reports prepared by the implementing agencies. Spot checks of information presented in proposals will be conducted by ADB to ensure authenticity of information presented. ADB will appoint a dedicated staff member at its Resident Mission to provide assistance to EAs on procurement and recruitment and to help oversee the integrity of procurement processes.

120. **Inadequate national procurement framework limits competition.** Risks associated with the use of country procurement systems in Azerbaijan include the following:

(i) **Inadequate templates.** Specific templates for the full range of procurement methods have not been developed. A universal template is available on SPA’s website and may be adapted by procurement agencies to their needs. SPA’s website contains sections that are supposed to have standard bidding documents for goods, works, and services, but only the link for the procurement of goods actually has a file for downloading. The procurement of goods sample document is only in the Azerbaijani language, while the sample procurement contract is only in Russian. In the absence of e-procurement, bids are submitted as hard copies. An e-procurement project is slowly being rolled out with technical assistance and training from the European Union (EU).

(ii) **Inadequate level of detail in bid documents.** The PPL does not require that technical specifications use technical standards when such standards are available and it has been observed that key elements of the requirements are not described adequately or are omitted entirely.\(^{46}\) Procuring entities can determine the technical specifications along with the evaluation process and criteria. The PPL permits the use of different types of evaluation criteria, but the criteria do not necessarily have to be objective and quantifiable. Nor does the PPL require that the weight of the criteria be stated in the solicitation documents. This may result in inaccurate or inappropriate procurement. The PPL prescribes certain eligibility requirements, such as a clean criminal record, professionalism, and financial solvency, but does not present required qualification criteria, such as economic, financial, and/or technical capacities.\(^{47}\) This may result in contracts being awarded to entities which are unqualified or under-qualified and may not be able to execute the contract, if awarded. Further distinction between eligibility and qualifications is needed to ensure appropriate quality of service provision.\(^{48}\)

(iii) **Frequent use of single source procurement.** In 2009 (most recent data available), 30% of public procurement was single sourced. Among the reasons for such a high rate of single source procurement are (i) release of budget funds towards the end of the fiscal year, and therefore the need for agencies to spend funds quickly, and (ii) agencies often lack procurement plans and have to carry out emergency procurement.\(^{49}\) The PPL does not mandate advanced notification about single source procurement or other direct procurement methods.\(^{50}\)

(iv) **High cost of entry.** Document fees are much higher compared to the benchmarks in the UNCITRAL Model Law which are meant to cover the cost of providing documents to suppliers or contractors. The PPL allows contracting entities to charge between 0.5% and 1.5% of the contract value for bid documents, resulting in much higher costs than presented in the UNCITRAL Model Law, which advocate fees which cover the cost of

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\(^{50}\) EBRD and UNCITRAL. 2012. Legal Diagnostic Report – Compliance of the Public Procurement Legislation in Azerbaijan with International Best Practice as Expressed by the 2011 UNCITRAL Model Law on Public Procurement. London.
providing documents to suppliers or contractors. The comparatively high cost serves as an additional disincentive to bidders and limits competition.51

(v) **Restrictive national language requirement.** Unless otherwise stated, all tender documents submitted by bidders must be in the Azerbaijani language,52 a requirement which disadvantages foreign participants, especially those without a local partner.

(vi) **Limited public access and disclosure.** By law, international tenders valued at over AZN10,000 must be announced in state newspapers, international media, and official websites, and details of awarded contracts must be published within 5 banking days in the media where the tender announcement was published and on SPA’s website. Many agencies use the UN Development Business to fulfill the international media requirement, especially for donor-financed projects. Some agencies, such as Azersu, publish local public tenders in their websites, and most post notices in state newspapers such as the **Azerbaijan** and **Xalq Qazeti**. Donor reports in 2010-2012 noted the limited and *ad hoc* dissemination of procurement opportunities and the absence of a centralized location for public procurement information. The lack of information about opportunities and awards makes it difficult for civil society and others to monitor procurement decisions. Public access to information on procurement is confined to the reports posted on SPA’s website, which also contains information on changes in procedural rules and legislation, updates on the implementation of e-procurement, cooperation activities with development partners, summaries of complaints received, and figures on procurements conducted for the year. However, it appears that only a limited number of contract award notices are published on SPA’s website, given that only 100 contracts are shown as being registered (as of March 2013). The lack of information about opportunities and awards makes it difficult for civil society and others to monitor procurement decisions. Furthermore, the legal underpinning for transparency and accountability is missing, as there is no requirement to publish reviews of procurement decisions or court decisions, nor does SPA have to inform stakeholders of its decisions when reviewing cases.53

121. Although UNCITRAL is providing assistance to strengthen the country’s procurement practices, and an electronic procurement system is gradually being rolled out, at present Azerbaijan’s country system for procurement is inadequate to ensure the transparency and competitiveness required by ADB.

122. **Opaque and preferential procurement environment limits competition.** Integrity safeguards and efficiency instruments have not been adequately built in to the PPL,54 resulting in abuses and preferential treatment. No code of conduct has been prepared by SPA to bind the behavior of procuring entities, and the PPL only states that persons involved with the procurement cannot be connected with the bidders. Additionally, the provisions on conflict of interest contained in the PPL are too broad and not clear about the various types of conflict of interest.55 In the absence of specific guidance in the PPL, procuring entities have a great deal of

discretion in determining which procurement method to use, what technical specifications to present, and how to evaluate bids received. The PPL allows different types of evaluation criteria to be used, but does not require that the criteria be objective or quantifiable. The procuring agency also has the discretion to negotiate with a bidder before completing the two stage procurement process, which can result in financial inefficiencies.\(^{56}\) While the PPL allows for domestic preference and single source or direct procurement, in accordance with the UNCITRAL Model Law, there is no requirement that these be disclosed at the time of a tender.\(^{57}\) Weighting of evaluation criteria is also not required in the bid documents. These loopholes can be used to direct contracts to preferred vendors, undermining the intention of competitive processes.

123. The prevalence of conflicts of interest further complicates the procurement environment. Over the past few years, the media have reported that a number of government officials and politicians have direct and indirect ownership and control of large companies in key sectors,\(^{58}\) including transportation and energy, creating a *de facto* monopoly. Non-transparent corporate structures\(^{59}\) and the use of third-party identities serve to obfuscate the relationship between officials and their corporate holdings. While the law\(^{60}\) prohibits government officials from owning businesses, there are no such restrictions on family members, and participation of these companies in public tenders creates conflicts of interest in the procurement process and has been cited as a major impediment to private sector development, in particular to new entrants in a sector.\(^{61}\) Current provisions related to conflicts of interest lack specificity and are in need of greater detail to inform and guide the procuring entities.\(^{62}\) Furthermore, SPA can be seen as having inherent conflicts of interest due to it serving as the only body responsible for the regulation of procurement while also reviewing the procurement procedures and conduct of procuring entities.\(^{63}\)

124. To assess patterns in procurement practices and bidding, ADB will undertake a construction industry assessment, focusing on the road and water supply sectors, to identify trends in bidding. ADB will continue to discourage single-source procurement in its projects, and will increase efforts to encourage broader participation in international competitive bidding. Due diligence training will be conducted to strengthen verification skills within EAs and among ADB staff to ensure the validity of competing proposals. EAs will undertake a heightened degree of

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56 It has been reported that costs of goods and services are frequently inflated above benchmark costs. Hannes Meissner. 2011. “Informal Politics in Azerbaijan: Corruption and Rent Seeking Patterns.” *Caucasus Analytical Digest*, number 24.
59 Ownership is often difficult to determine, as companies are not listed publicly and information is not easily accessible.
60 Conflicts of interest are covered under several statutes. The Law on Civil Service contains a framework to prevent conflicts of interest. The Law on Combating Corruption also helps to govern conflicts of interest by not allowing next of kin to hold positions under the authority of officials except for elected offices. The draft law on Prevention on Conflict of Interest in the Activity of Public Officials has been pending since 2010.
verification of information presented in proposals, with spot checking to be provided by ADB staff. ADB will also spot review bid evaluation reports prepared by implementing agencies against submitted proposals to ensure that the bid evaluation reports adequately reflect the bids submitted.

125. ADB will also introduce a conflict of interest check into procurement processes, to encourage members of the procurement committees to identify whether they have any conflicts of interest with regard to the bidding parties, and will request corporate certificates of ownership with identification of financial beneficiaries for contractors and suppliers. ADB will request the companies’ certificate of ownership for contractors and suppliers and will include appropriate provisions of ADB’s Anticorruption Policy in the loan and project agreements and the bidding documents.

5. Sector Specific Issues

126. No assessment was undertaken on the procurement bodies in transport, energy, and water and sanitation. Also, no reports on these sectors’ procurement bodies have been made publicly available to the best of the authors’ knowledge.

D. Anti-Corruption

1. Overview

127. Corruption is a major concern among the government and development partners. Reported high levels of corruption adversely affect the efficiency and effectiveness of programs and investments in Azerbaijan and thwart the development of the private sector. Corruption is prevalent in many aspects of life in Azerbaijan, from payments for state-provided medical services, to entrance to universities, to bribes for traffic police or customs officials. However, the 2006 Council of Europe’s Group of States Against Corruption (GRECO) evaluation noted that it is not clear which sectors are most affected by corruption or the causes of it.

128. The President of Azerbaijan has placed combating corruption high on his administration’s agenda since 2011. Corruption is seen as a threat to the social and political development of the country and could harm the economic growth achievements made to date. A “no tolerance” policy towards corruption was announced in January 2011, and media reports indicate that indeed corruption is now being taken more seriously. Many officials and police, including some high ranking ones, have been fired from their positions after investigations into corruption.

129. Azerbaijan’s efforts on anti-corruption since the mid-2000s indicate that fundamental improvements have occurred, and these efforts are acknowledged by regional anti-corruption

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bodies.\(^{65}\) The approach to combating corruption by the authorities is not solely reliant upon repressive measures. It also involves preventive measures such as educating public officials and raising salaries, steps which GRECO endorsed in its 2006 evaluation.\(^{66}\) Nonetheless, various global indices on corruption and governance indicate that corruption is widespread in Azerbaijan.\(^{67}\)

2. Participation in Global and Regional Anti-corruption Initiatives

130. Azerbaijani is involved in several global and regional anti-corruption initiatives. As a member of the OECD-led Istanbul Anti-Corruption Action Plan (2003), Azerbaijan is subject to systematic and peer review of its legal and institutional framework for anti-corruption. Azerbaijan has been reviewed twice under the Istanbul Anti-Corruption Action Plan in 2006 and 2010. Azerbaijan signed in 2003 and ratified the following year the European Criminal Law Convention on Corruption and European Civil Law Convention on Corruption. It also signed the UN Convention Against Corruption in 2004 and ratified it in 2005, along with the UN Convention Against Transnational Organized Crime. Azerbaijan is party to the Convention on Laundering, Search, and Seizure of the Proceeds from Crime.

131. Azerbaijan participates as a member of the Council of Europe’s GRECO. Evaluation and compliance reports were prepared about Azerbaijan for the three evaluation rounds completed by GRECO, but rounds 1 and 2 were combined for Azerbaijan due to its joining after the closure of round 1. Round 4, launched in 2012, has not concluded.

3. Legislative and Policy Framework


133. The NSITCC contained the following measures: (i) improve the legislative framework, (ii) promote the integrity of the civil service, (iii) strengthen anti-corruption law enforcement and the judiciary, (iv) measures covering the economic and social spheres, (v) public awareness raising, and (vi) international cooperation. Ministries and local authorities were required to prepare anti-corruption action plans under the NSITCC.\(^{68}\) The Commission on Combating Corruption (CCC) and the Cabinet were the main bodies monitoring the implementation of NSITCC, and they reported to the President (for CCC) and the Parliament (for Cabinet). The NSITCC used World Bank governance indicators to assess its implementation.

134. In 2011 the President of Azerbaijan launched a new anti-corruption drive, which was followed by a draft action plan in early 2012 that was disseminated for public discussion. In

\(^{65}\) See, for example, the Group of States Against Corruption, which noted the diligent efforts being made, while also recognizing the extent of measures that are still needed to effectively combat corruption. Group of States Against Corruption. 2006. Joint First and Second Evaluation Rounds: Evaluation Report on Azerbaijan. Strasbourg.


\(^{67}\) The government of Azerbaijan has conducted several surveys on corruption, but the results of these surveys have not been published. OECD. 2010. OECD Anti-Corruption Network for Eastern Europe and Central Asia. Istanbul Anti-Corruption Action Plan. Second Round of Monitoring – Azerbaijan Monitoring Report. Paris.

September 2012 a decree approved two new national action plans: the National Action Plan for Promoting Open Government, 2012−2015 and the National Action Plan for Combating Corruption, 2012−2015. As part of the Open Government Partnership, Azerbaijan’s Open Government Action Plan aims to increase the amount of information available to the public about the work of government, strengthen the role of civil society in decision making, and expand the number of e-government services offered to the public. The new Combating Corruption Action Plan will continue many of the previous measures to combat corruption and improve governance, and also introduce new and amended legislation pertaining to corruption.

135. The main legislative and institutional foundation is in place for dealing with corruption. Since 2004, Azerbaijan has made good progress in adopting new legislation and updating existing laws, but there are still several weak points and gaps. Not all of the legislation on criminalizing corruption is in line with international standards. The biggest challenge facing the country, however, is effective implementation of the laws and policies.

136. The main piece of legislation is the Law on Combating Corruption (2004). The law states that corruption-related offenses involving public officials can lead to disciplinary, civil, administrative, or criminal liability under other laws. The law permits confiscation of the proceeds from corruption and requires that public officials declare their assets and income. A Presidential Decree in 2004 was issued to implement the Law on Combating Corruption. This decree set up the new Department on Combating Corruption under the Prosecutor General’s office and laid the groundwork for establishing the Commission on Combating Corruption (CCC) and bringing other existing legislation into conformity with the combating corruption law.

137. A main weakness with the Law on Combating Corruption is that it relies on other laws for enforcement and sanctions, but these other laws are not explicitly stated in the Law on Combating Corruption.

138. Other laws were promulgated or updated in 2005, including Submission of Financial Information by Public Officials, Right to Obtain Information, Judicial Legal Council, and Administrative Proceedings. Amendments to the Law on Courts and Judges (1997) led to new procedures for recruiting judges and lifting immunities for judges.

139. In 2009 the legal and institutional framework for anti-money laundering was established. Azerbaijan’s national legal framework was aligned with the international standards on Anti-Money Laundering and Combating the Fight against Terrorism. Azerbaijan is now fully in line with the UN conventions, the Financial Action Task Force (FATF) 40+9 recommendations, and the relevant EU directives. The Law on the Prevention of Legalization of Criminally Obtained Funds or Other Property and Financing of Terrorism (2009) provides for a system of reporting and analyzing suspicious transactions in all financial institutions and designated non-financial businesses and professions.

140. The Penal Code of 2000 was also revised between 2004 and 2011 to include or revise provisions on the criminalization of trading in influence, active and passive bribery, exceeding official powers, money laundering, and confiscation. Amendments in 2006 made the Penal Code more in line with the Criminal Law Convention on Corruption. Amendments included a

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redefinition of active and passive bribery, a redefinition of the concept of public official, stronger sanctions for active and passive bribery, and the criminalization of the trading of influence. Although some weaknesses remain (discussed below), GRECO acknowledged that much effort has been made to address several of its concerns from earlier evaluation and compliance reports.\(^\text{71}\)

141. A major gap in the anti-corruption legal framework was finally addressed in 2011. Previously, the various laws and regulations pertaining to corruption among public officials contained different terms related to government officials and civil servants. Different parts of the legal framework used varying terms such as “civil servants,” “state public officials,” and “officials.” It was not always clear which rights and obligations applied to the different types of public sector employees, and more concerning was that some categories of public sector employees might not have been covered under any of the laws.\(^\text{72}\) In 2011, amendments were made to the Penal Code regarding the definition of officials so that it was broadened to cover any civil servants and public employees engaged in corruption. GRECO acknowledged in 2012 that this issue had been addressed satisfactorily.\(^\text{73}\)

142. Regarding conflict of interest in the public sector, the Law on Civil Service contains a framework to prevent conflicts of interest. The Law on Combating Corruption also helps to govern conflicts of interest by not allowing next of kin to hold positions under the authority of officials except for elected offices. The draft law on Prevention on Conflict of Interest in the Activity of Public Officials was still pending as of 2010 but it covered gifts, ownership of companies, political activities, the use of state resources, and officials moving to the private sector.

4. Institutional Framework and Capacity

143. Several of the anti-corruption institutions are relatively recent developments, and therefore their capacities are still being strengthened. Specialized institutions are in place alongside or embedded within divisions or departments in the ministries and the central bank. In addition to the ongoing capacity development, ministries and specialized institutions are still working to improve their communication and cooperation on anti-corruption measures and investigations. Fragmentation and jurisdictional boundaries had been affecting the investigation and prosecution of corruption, but progress has been made in the past few years in terms of conducting joint training among agencies and, in 2009, operationalizing the Integrated Database of Corruption Offenses, which contains information on detection, investigation, prosecution, and adjudication of corruption offenses.\(^\text{74}\) All investigative bodies have access to it through the Department of Combating Corruption at the Office of the Prosecutor General.

144. The key specialized anti-corruption bodies are the following:

145. **Commission on Combating Corruption.** The Commission on Combating Corruption (CCC) is the focal coordinating institution for implementing the government’s anti-corruption policies. The CCC is comprised of 15 members: five appointed by the President, five by Parliament, and five by the Constitutional Court.

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146. **Anti-Corruption Department.** The Anti-Corruption Department (ACD) became operational in 2005 under the Office of the Prosecutor General. ACD is entrusted with the task of investigating and prosecuting corruption and corruption-related offenses. Another function is to promote public awareness of corruption and conduct prevention activities. They are entitled to receive all information on corruption cases from law enforcement agencies, but up until 2011 ACD had no power to undertake special investigative measures. Under the Detective Search Activity Act, ACD can now use special investigative measures and therefore no longer relies as much on voluntary information about bribery and other forms of corruption. The department reports annually to the President and CCC. ACD has sufficient autonomy and resources to investigate and prosecute.

147. **Financial Monitoring Service.** The Financial Monitoring Service (FMS) was established within the central bank in 2009. Under its charter, FMS was designed to be an independent financial intelligence unit that investigates suspicious currency transactions related to money laundering and the financing of terrorism. Its director and deputy director are appointed by and report to the President. Operations of AZN 20,000 or more must be reported to FMS.

148. **Other investigative bodies.** Other government bodies or units within ministries involved in anti-corruption include the following:

(i) Prosecution services consist of the Prosecutor General’s Office, the Prosecution Office of Nakhchivan Autonomous Region, and district and city prosecution offices. These bodies handle cases of bribery, people with immunities, and abuse of authority by the President, Parliament, judges, and customs officials.

(ii) MOF, which oversees the administration of state finances and financial control over all bodies funded by the state, including SOEs, has a role in inspecting the financial activities of state-funded organizations. Any suspicions of corruption must be reported to the prosecutors. The Chamber of Accounts is similarly obliged.

(iii) The National Bank and State Securities Agency collects information on suspicious transactions from banks and stock brokers.

(iv) The national police have a Department on Combating Organized Crime to investigate corruption cases.

(v) The Ministry of Taxes has an Investigations Department for investigating corruption offenses if they are related to tax evasion.

(vi) The Ministry of Internal Affairs and Ministry of National Security have functions on detecting corruption.

(vii) Internal investigation bodies are situated in the Ministry of Justice, State Customs Committee, and State Border Guard Services.

149. **Every ministry has an internal control body that conducts investigations into possible violations.** The ministry can decide on disciplinary measures. If an offense has been committed, the ministry must submit evidence to prosecutors for further investigation. The Law on Civil Service provides for various disciplinary measures, such as reduction in salary for one year, transfer to a position of the same grade but with lower salary, demotion, and dismissal.

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150. In 2012 the government established the State Agency for Public Services and Social Innovations as part of its public administration reform. While not dealing directly with anti-corruption, the new agency should reduce opportunities for corruption by providing public services to citizens through a one-stop, e-government service. As part of the reforms, a new service, ASAN (Easy) Service, was established under the new state agency. ASAN Service has a pilot center in Baku covering several regions of the capital. Service branches will be expanded in 2013 to other parts of the country. The service centers are expected to improve public satisfaction with the civil service and avoid cases of corruption. In 2012 there were 10 types of the services listed, mainly for registration matters.

151. **Judiciary.** There were no specialized judges for corruption cases as of 2010, but it was reported that year by GRECO that 15 judges would be assigned to handle corruption cases. However, it was not known if the judges were to receive specialized training for this function. Judges are supposed to be independent and impartial. To help ensure this, judges receive many immunities from prosecution, but this makes it difficult to investigate and prosecute judges for alleged corruption. It is difficult to remove judges during their terms of office. They can only be removed by a decision of Parliament, but the President can initiate proceedings against them.

152. **Civil Service.** Azerbaijan’s civil service is becoming more merit-based with steps taken over the past several years, and training on ethics and anti-corruption is occurring more frequently. Adequate training on ethics and anti-corruption for all civil servants is an important preventive measure in combating corruption. The Law on Civil Service (2000) states that competitive recruitment is one of the central principles of the civil service. Recruitment is done through competitive examinations or interviews in order to enhance transparency and ensure merit-based recruitment. Previously, civil service recruitment was done by each ministry or agency, but the process was centralized in 2006. The Commission on Civil Service Issues, established under the President, implements state policy on matters related to the civil service, mainly about recruitment to the civil service.

153. Although ministries no longer conduct recruitment themselves, they retain some discretion in allocating bonuses that could open up opportunities for favoritism or corruption. Additional wages, such as premiums, are determined by the head of each agency.

154. The Public Administration Academy, established in 1999, offers in-service training for civil servants. Training on ethics is included, but it is not clear how often training on corruption is delivered or if it is mandatory. In 2007 the Parliament passed a law on the code of conduct for civil servants. Similar codes are in place for state tax officials, customs officials, and police.

5. **Selected Issues with the Anti-corruption Laws and Regulations**

155. While Azerbaijan has made significant progress over the past 10 years in its anti-corruption legal and regulatory framework, several gaps and weaknesses are still present. This

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section attempts to summarize some of the key issues that pose risks for development partners operating in the country.

156. **Customs.** In an effort to reduce corruption and improve transparency, a new customs code was adopted in early 2012. The State Customs Committee (SCC) promulgated secondary legislation meant to support the implementation of the new customs code, and it adopted a new code of ethics for customs officials. In addition, the Cabinet received draft rules under the new customs code for determining preferential and non-preferential origin of goods.

157. **Taxes.** Extensive complaints about the Ministry of Taxes’ officials demanding excessive fees led to the establishment of the websites Tariff.az and rusum.az. The websites intend to improve transparency and reduce corruption by publishing official rates. The tax code was amended in 2012, and the Ministry of Taxes started an e-registration of legal entities in order to reduce the cost and number of procedures for starting a business. A new Two-Way Messaging Service was also launched in 2012 with the aim of improving the dissemination of information about legal requirements and tax liabilities to taxpayers. Furthermore, the Ministry of Taxes began using a computer-assisted audit system. All of these initiatives are meant to improve efficiency and reduce opportunities for corruption.

158. **Bribery, trading of influence, and gifts.** Bribery and trading of influence provisions of the Penal Code were amended in 2011 so that now the “offer” and “promise” of an advantage and the acceptance of an offer or promise are explicitly criminalized. Previously the “offer” and “promise” of a bribe and the “acceptance of an offer or a promise” were missing in the Penal Code. The 2011 amendments to the Penal Code cover active and passive bribery and accepting an offer or promise. Other improvements to the Penal Code in 2011 related to amendments on trading in influence (i.e., improper influence of an official’s decision). The new provisions explicitly cover the offer or promise of an advantage and the acceptance of them, and the involvement of third party beneficiaries in the offer or promise of a bribe. These changes apply to domestic or foreign public officials. However, the legal system still allows for automatic exemption from punishment for any perpetrators of bribery who report it to the authorities before it is detected.

159. A weakness still persists regarding gift giving to public officials. Gifts for civil servants are governed by the Law on Combating Corruption, but there was strong debate in Parliament about the difference between gift giving and bribery. Gifts worth around €50 received by civil servants are considered to be the property of the agency they work for, but the problem is that gifts of that high a value could be seen as facilitation payments.

160. **Confiscation.** The penal code was amended in 2006 to allow for confiscation of property in all cases of bribery. Penalties can be prison or fines. The amended penal code also now allows for confiscating the “value equivalent” of the property being confiscated if such

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property cannot be confiscated. (Also known as “value confiscation,” which means that assets of an equivalent value to the proceeds of corruption can be confiscated.) However, the amended Penal Code says nothing about confiscating property in the hands of third parties, which is a major loophole that could benefit people who receive bribes or who benefit from the payment of a bribe.\textsuperscript{88} Furthermore, GRECO reported that it believes confiscation of the proceeds of corruption rarely occurs despite what is allowed in the Penal Code.\textsuperscript{89}

161. **Financial declaration of civil servants.** Under the Law on Civil Service, civil servants are required to submit an annual financial report on their personal income and estates to the head of their agency. Included in the necessary information are the sources, types, and amount of additional income. The procedures for the annual declaration are governed by the Law on Approval of Procedures for Submission of Financial Information by Public Officials (2005). The President and members of Parliament must submit their declarations to the CCC. The problem with the financial declarations system is that it is not clear how the information is supposed to be validated.\textsuperscript{90} GRECO had raised this concern in 2006, but no progress had been made in verifying the information or disclosing it to the public as of the 2010 GRECO report.\textsuperscript{91} The OECD reports that the legal obligation for public officials to declare income and assets is not enforced.\textsuperscript{92}

162. **Treatment of legal persons.** The authorities in Azerbaijan have limited familiarity about crimes committed by legal persons\textsuperscript{93} and therefore weaknesses remain in the legal framework for corruption committed by legal persons. GRECO expressed concern that its recommendations for introducing specific provisions for bribery by the private sector in the Penal Code was not taken up, as the government authorities concluded that the existing language in the Penal Code was sufficient.\textsuperscript{94} The government did, however, strengthen the language to cover the full range of people working in any capacity for a legal person who commit bribery offenses. The legal system covers civil liability for damages from corruption and administrative liability for violations of petty administrative regulations, but the legal system does not provide for liability of corruption, money laundering, and trading in influence. In the case of administrative liabilities, there are no liabilities of legal persons for corruption, money laundering, and trading in influence unless an administrative regulation is violated.\textsuperscript{95} The Law on Combating Corruption says that legal persons can be fined or liquidated for corruption, but there is no criminal liability. GRECO noted the need to establish liability of legal persons for acts of bribery, money laundering, and trading in influence and for sanctions to be stronger in order to have more of a deterrent effect.\textsuperscript{96}

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163. Criminal and administrative liability applies for negligent accounting by legal persons. The Law on Accounting, the Penal Code, and the Code of Administrative Violations apply in such instances. Accountants and auditors are not obligated to report suspicious accounting to the authorities, but auditors do have a Professional Code of Ethics that can allow them to disclose information on a serious crime in accordance with the Penal Code.\textsuperscript{97}

164. Finally, the system of registration of legal persons has limited ability to prevent legal persons being used for criminal activities. The registry does not check for criminal background of founders of a legal person.\textsuperscript{98}

165. **Immunities.** Various immunities are provided to the President, members of Parliament, Prime Minister, and judges. Only special circumstances and procedures allow for their removal from office or arrest.\textsuperscript{99} While some immunities are necessary for independence and to prevent political interference, GRECO recommended that the number of categories of people enjoying immunity from prosecution be reduced.\textsuperscript{100}

166. **Reporting of corruption and whistleblowers.** No legislation has been passed with explicit provisions obliging civil servants to report suspicions of corruption, except for the police. However, the Penal Code does oblige all citizens, including civil servants and public officials, to report serious crimes. Also, no legal measures are in place to protect whistleblowers reporting corruption, except for the security measures for witnesses provided for in the Law on State Protection of Persons Participating in Criminal Proceedings.\textsuperscript{101}

167. **Limited involvement of civil society.** Civil society, including non-government organizations (NGOs), has limited participation in anti-corruption activities.\textsuperscript{102} Despite the completed NSITCC calling for inputs from NGOs, no formal channels were established for NGO participation in monitoring the policy implementation.\textsuperscript{103} Civil society participates in the Working Group on Legislation with 2 of the 28 members coming from NGOs, but it has no representation in CCC. In an effort to provide more recourse to action against victims of corruption, the government established Advocacy and Legal Advice Centers which enable citizens to assert their rights in cases of corruption.

6. **Common Forms of Corruption**

168. Various global indices on corruption and governance suggest that corruption is widespread in Azerbaijan, but quantitative data and evidence on the dynamics of corruption are lacking. Despite several corruption surveys having been conducted by the government, the


results of these surveys have not been published.\textsuperscript{104} This section summarizes some of the main forms of corruption that are alleged to occur in Azerbaijan. The intent is to highlight some of the major risks that could be encountered by development partners operating in the country.

169. **Private companies owned by officials.** Some government officials and politicians are alleged to have direct ownership and control of large holding companies and other firms.\textsuperscript{105} The firms might also be held in the name of family members or other proxies. In other cases, business owners work towards the interests of corrupt officials as part of the patronage-based system.\textsuperscript{106} Corrupt officials will try to get government contracts for their own businesses, defying the regulations and laws pertaining to conflicts of interest. Ownership is often difficult to determine, because companies are not listed publicly and information is not easily accessible. In addition to the conflict of interest in winning government-funded contracts, the problem of companies connected to government officials is a major impediment to private sector development, in particularly to new entrants in a sector.\textsuperscript{107}

170. **Monopolies.** Numerous monopolies exist in the many sectors of the economy. Many of them are informal monopolies that rely on government connections to restrict new players in a sector. The trading sector is prevalent with informal monopolies that control the import or export of a particular good or brand, often with the assistance of customs officials who use customs procedures or other means to restrict access to other players and ensure little or no competition.\textsuperscript{108} The result is artificially high prices and single suppliers for a particular good.

171. **Facilitation payments.** Bribes are frequently given by companies for tax inspections and obtaining licenses.\textsuperscript{109} As a result, firms might not have the technical or financial requirements to bid on government contracts but they are nevertheless allowed to participate. Projects financed by development partners face the risk of companies winning the contract even though they are not qualified.

172. **Single sourcing.** As noted earlier, open tender procurement is often bypassed even when the minimum value of a contract is reached, as stated in the law. Many government contracts, often large ones, use single source procurement based on reasons such as compatibility, sole supplier, or other factors. Weaknesses in the procurement law enable this discretion among the procuring agencies.

173. **Inflated costs.** Costs for delivering goods or services are frequently inflated well above normal benchmark per unit costs. For example, one report cited construction costs per kilometer of road to be $23 million, well above the international standard, which likely demonstrates corruption.\textsuperscript{110} The extreme per unit cost was explained away as compensation payments to

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relocated residents. In other cases the materials used in infrastructure projects are overpriced because of the patronage connections or ownership of the supplier by a government official.\textsuperscript{111}

174. **Rent seeking in the oil sector.** The oil industry is not immune from corruption, but it is considered to be less corrupt than other sectors such as infrastructure, healthcare, education, and the police.\textsuperscript{112} Most likely the comparatively lower level of corruption in the oil industry can be attributed in part to Azerbaijan’s compliance with EITI. Nevertheless, some public positions are misused to siphon off revenue from the oil industry. Typically this is done indirectly through embezzling funds from public investments financed by the state budget, SOFAZ, and SOCAR because of the transparency of the oil revenues (under EITI).\textsuperscript{113} Political elites award tenders to companies associated with them. The companies then embezzle some of the funds by means of producing low quality work that saves money under the contract.

E. **Anticorruption Risks and Mitigation**

175. There are risks associated with working in environments reputed to have a high incidence of corruption. In Azerbaijan, the risks are equal across all sectors and cut across a number of themes, including public financial management and procurement, and are evidenced by inefficient use of resources. Initiatives presented in other sections of this report will help contribute to improved transparency and accountability in ADB’s operations in Azerbaijan. Anticorruption considerations will be a cross-cutting focus across ADB’s programs in Azerbaijan.

176. ADB will continue to strengthen the skills of EAs implementing agencies and ADB staff to identify fraudulent proposals and collusive situations. ADB will also conduct training for EA staff and other government counterparts, as well as the business community and civil society, to improve awareness of ADB’s Anticorruption Policy, to strengthen their ability to identify fraud and corruption, and to inform them of how to confidently report concerns to ADB so that they may be investigated. During project implementation, ADB will be alert to potential mismanagement of resources or substitution of personnel or materials to ensure compliance with technical and human resource expectations. ADB will conduct thorough situational analyses, detailed appraisals, regular project performance monitoring and evaluation, and include appropriate provisions of ADB’s Anticorruption Policy in the loan and project agreements and the bidding documents.

IV. **ONGOING REFORMS**

A. **Ongoing and Imminent Government Reforms**

1. **Public Financial Management**

177. The Chamber of Accounts is implementing its Strategic Development Plan, 2012–2014. The work includes applying international standards to national accounting, financial audit, performance audit, and human resources.\textsuperscript{114}


2. Anti-corruption

178. As noted earlier, the government is continuing the efforts made under the NSITCC with a new action plan for 2012–2015. The new National Anti-Corruption Action Plan will introduce new legislation on personal protection of witnesses and collaborators in corruption cases. It will also adjust rules restricting the immunity of judges suspected of corruption. A major emphasis is placed on expanding the e-government services. Phase I of the e-government portal was launched in April 2012 and operates under the “one window” principle. Currently, around 16 executive bodies including the Ministry of Interior and Ministry of Taxes are offering services under the portal. As of 2012, around 60 e-services were available.

179. Near future plans include offering around 300 e-services in the second half of 2013. Users of the services will utilize an e-signature card costing AZN 20-30 for individuals, AZN 135 for civil servants, and AZN 168 for commercial entities. The idea is that the e-signature cards would enable access to the full range of e-government services and reduce the bureaucratic obstacles. Additionally, the services should reduce or eliminate possible corruption.

180. The Open Government National Action Plan for 2012–2015 will prepare a draft Civil Service Code that is expected to include rules for staff performance appraisals and improved ethics rules.115

181. Other ongoing efforts include awareness raising campaigns, hotlines to report corruption, the dissemination of brochures and leaflets, radio and TV shows, and anti-corruption training. However, OECD does not consider these programs to be a comprehensive campaign, and the visibility has been low.116

182. Azerbaijan continues to cooperate with INTERPOL to combat organized crime.

B. Donor Support for Reforms

183. Numerous development partner initiatives are underway or planned. Given the vast number and wide scope of initiatives, the activities are presented below in a summary table according to donor and area of support. This list is not necessarily comprehensive, and it is drawn from the donor coordination matrices initiated by the Delegation of the European Union in Baku, drawing in particular from the democracy and human rights matrix and the socio-economic matrix. The coordination matrices are shared documents and updated by the development partners themselves.

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<th>Donor</th>
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<td>Austria</td>
<td>Combating crime (planned)</td>
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<td>Police training (planned)</td>
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<td>Witness protection</td>
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<td>Council of Europe</td>
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<td>EU</td>
<td>Citizen participation and increasing accountability of elected bodies</td>
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<td>Developing civil society capacity</td>
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<td>Modernization of the justice system</td>
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<td>Promoting freedom, professionalism and pluralism of the media</td>
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<td>Improving legal environment and organizational capacity of civil society organizations</td>
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<td>Integrated border management</td>
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<td>GIZ</td>
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<td>Judicial and legal reform</td>
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<td>Norway</td>
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<td>Access to justice</td>
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<td>Anti-money laundering</td>
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<td>Combatting financing of terrorism</td>
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<td>Rule of law</td>
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<td>Advocacy and Legal Advice Centers</td>
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<td>Anti-trafficking, civic engagement in political processes</td>
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<td>Women’s participation, rule of law</td>
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<td>Media advancement, anti-corruption and legal advice centers</td>
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<td>UNDP</td>
<td>Civil service reform</td>
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<td>Capacity development support to various state institutions</td>
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<td>Integrated border management</td>
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C. Assessment of Likelihood of Effectiveness

184. In order to attain its goals of a diversified, knowledge-based economy by 2020, one which is not so heavily dependent on oil revenue, the government will have to tackle the governance and corruption constraints that are hindering economic progress outside of the oil sector. The government appears to recognize this with the resurgent interest since 2011 in weeding out corruption. Yet rapid improvements in governance and anti-corruption are unlikely given the long, entrenched nature of the problems that date back decades, and hence a continued gradual approach is more realistic. Progress should be measured with the baseline from the early 1990s in mind.

185. As for the development partners in Azerbaijan, they have few entry points available to them for interventions in good governance, at least in terms of initiatives than go into the necessary depth of reform that is needed. Despite the seemingly large number of development partner initiatives noted in the table above, experience has shown that many of them fail to go into the necessary depth of reform or fail to get government ownership. Development partners must recognize that they have limited leverage in the areas of PFM, public procurement, and anti-corruption because of Azerbaijan’s extensive oil wealth and the extremely low level of donor funding as a percentage of GDP. Hence, the development partners can only accomplish governance reforms in areas for which there is substantial government willingness and support. Rather than taking a hardline stance towards governance and anti-corruption, development partners will need to identify those areas in which the government has indicated it wants to reform, and recognize that the success of the reform initiatives will likely be predicated on a gradual approach as opposed to a rapid, comprehensive overhaul in which all areas of reform are undertaken concurrently. The World Bank’s Independent Evaluation Group concluded that the gradual approach to reform was validated in the road sub-sector. Such an approach seems applicable to the broader governance reforms.

186. Development partners can also be more effective in addressing governance issues by having close coordination with each other. Presenting a united front to the government on key issues to address and avoid overlap, or worse, contradictions, in their support for reform will enhance whatever leverage may be available to the development partners.

187. Finally, the effectiveness of development partner-supported governance reforms will depend in part on development partners bearing in mind a key lesson learned, which is that most of the government agencies specializing in these matters were established very recently, and many of the governance concepts are still new to them and not fully understood.

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118 Independent Evaluation Group. 2011. Azerbaijan: World Bank Country-Level Engagement on Governance an Anticorruption. IEG Working Paper 2011/9. Washington DC. External debt comprised only 6.0–7.8% of GDP between 2010 and 2012. However, it is not possible to determine how much of this is lending from development partners, because the government does not provide a detailed breakdown of external debt.
## V. SUMMARY OF RISK MATRIX

<table>
<thead>
<tr>
<th>Risk Identified</th>
<th>Likely</th>
<th>Relatively Serious</th>
<th>Not Mitigated Over CPS Period</th>
<th>High Risk (all three columns ticked)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PUBLIC FINANCIAL MANAGEMENT</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Institutional Arrangements and Capacity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inadequate capacity for planning, sequencing, forecasting, and cost benefit analysis.</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Line ministries and sector agencies have limited financial management skills, which constrains planning, investment, and maintenance needs.</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Line ministries and sector agencies have limited experience with project management and few have management information systems deployed.</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Tariff levels are below cost recovery in energy and water and sanitation sectors, thereby harming financial sustainability of agencies and their investments.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Collection rates for water and wastewater charges have been hampered by the limited installation of meters, resistance of users to pay for water, and the concomitant reluctance of water utilities to discontinue service to non-paying customers.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>In transport sector, no separation of regulatory, infrastructure development, and operating functions, creating conflict of interest and inefficiencies.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New road investment costs tend to be high and the quality of maintenance is often not satisfactory.</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In energy, the absence of an independent regulatory authority is a factor in the power sub-sector's weak performance.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Azersu is legally independent but not able to operate independently, even in terms of financial sustainability.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Water utilities’ management structures tend to be overly centralized, which hinders the utilities’ ability to maintain and operate the local water and wastewater systems.

<p>| (ii) Budget Formulation and Execution | The annual budget law has broad headings. The limited breakdown does not clearly convey what the money is to be spent for, thereby making public scrutiny of the expenditures difficult. | ✓ | |
| Planning and budgeting functions are not well integrated, thereby affecting forecasting, planning, and budget execution. | ✓ | |
| Line ministries and subnational government entities need to strengthen their skills in long-term planning and budget formulation. | ✓ | ✓ |
| Strategic budgeting based on the medium-term expenditure framework and PIP has not been implemented adequately. | ✓ | |
| PIP is published in summary format as a lump sum instead of being broken down by function or administrative category. | ✓ | |
| Projects or programs funded directly by SOFAZ or other extra-budgetary funds are not included in the public investment plan. | ✓ | |
| The selection of projects by MOED in PIP is sometimes not based on structured programs or quantified objectives for medium and long-term development, and typically no formal cost-benefit or other systematic analysis is used as a screening process. | ✓ | ✓ | ✓ | ✓ |
| Ministries and other entities can bypass MOF and MOED by sending their investment plans directly to the President’s administration or Cabinet for approval, leading to incomplete national investment plans and creating delays in approvals for donor-funded projects. | ✓ | ✓ | |</p>
<table>
<thead>
<tr>
<th></th>
<th>✓</th>
<th>✓</th>
<th>✓</th>
<th>✓</th>
<th>✓</th>
</tr>
</thead>
<tbody>
<tr>
<td>The absence or weakness of sector master plans creates deficiencies in PIP.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Treasury Information Management System still under development, which affects the timeliness and coverage of cash flows, while the Investment Appraisal System is yet to be designed.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>No consolidated budget execution statements have been published despite the requirements in law.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>(iii) Project preparation</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Project development and management skills are lacking in some ministries. Results in project delays, higher costs, and investment projects prepared without economic and technical feasibility studies.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Significant cost escalations to investment projects due to poor quality initial budget estimates, inflated costs, and mid-course changes to project design.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>(iv) Accounting and Reporting</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Not all public sector entities are complying with the required accounting standards.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Few financial statements are prepared regularly by public and private entities and released publicly.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Liabilities and sanctions for violations of the accounting standards are very low.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Some government entities continue to use manual accounting systems, while others have introduced partly automated systems.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>(v) Audit and Oversight</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Internal Audit Act passed but not being implemented.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Insufficient internal controls on revenue and expenditure management, often due to some line ministries not having internal control units. A lack of effective internal audit units can lead to diversion of funds to unauthorized uses.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Some line ministries’ internal audit capacities are severely lacking.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Chamber of Accounts’ audit results are not made public. COA still performs investigations as opposed to proper audits in line with international standards.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Most, if not all, sukanals have not had external audits.</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### PROCUREMENT

(i) Legislative and regulatory framework

| PPL scope is limited in that it only covers solicitation, evaluation, and the award phase; the law contains nothing on public procurement planning rules or contract management after award. | ✓ | | | |

(ii) Institutional framework and capacities

| SPA’s supervisory powers over state procuring agencies are limited, essentially entailing only recommendations. SPA is not entitled to intervene in the procurement process other than imposing a 7 day delay if irregularities are suspected or public complaints are received. | ✓ | | | |

<p>| Procurement capacities throughout the government are generally not up to international standards due to the limited experience of state agencies. Capacities are further limited as one goes down to the rayon and municipality levels. | ✓ | | | |</p>
<table>
<thead>
<tr>
<th>(iii) Procurement operations</th>
<th>The submission of proposals and tenders is entirely paper-based. The absence of e-procurement systems throughout the government hinders the effectiveness and transparency of the procurement processes.</th>
<th>✓</th>
<th>✓</th>
<th>✓</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The technical requirements and eligibility criteria are often not clearly delineated or distinguished in the procurement notices. Unqualified bidders are therefore allowed to be considered based on eligibility criteria only.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>The PPL does not require that technical specifications use technical standards when such standards are available.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>There is no requirement that the bidders’ expertise and capacities must be proportionate to the scope, value, and complexity of whatever goods or services are being procured.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>(iv) Integrity of public procurement</td>
<td>No code of conduct has been prepared by SPA to bind the behavior of procuring entities.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Provisions related to conflict of interest in the PPL are too broad and lack clarity.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Domestic preference limits the interest of international competition.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>High cost for tender documents serves as a disincentive to potential bidders.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Procurement criteria do not have to be objective and quantifiable. PPL does not require that the weight of the criteria be stated in the solicitation documents.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>PPL permits negotiation between the contracting entity and a participant before the completion of a two stage procurement process.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>High use of single source procurement limits the use of competitive procurement methods.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Seemingly limited and ad hoc dissemination of procurement opportunities and the absence of a centralized location to find</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>
There is no requirement to publish reviews of procurement decisions or court decisions, which hurts transparency and accountability.

Lack of information available to the public curtails public scrutiny of procurement activities.

Some government officials and politicians are alleged to have direct ownership and control of large holding companies and other firms, or the ownership is held by family members or proxies. Ownership is often difficult to determine, because companies are not listed publicly and information is not easily accessible.

Unofficial monopolies, often with connections to public officials, exist in many sectors of the economy, resulting in artificially high prices and single suppliers for a particular good.

<table>
<thead>
<tr>
<th>CORRUPTION</th>
<th>(i) Legislative and policy framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Law on Combating Corruption relies on other laws for enforcement and sanctions, but these other laws are not explicitly stated in the Law on Combating Corruption.</td>
<td>✓</td>
</tr>
<tr>
<td>A high threshold of allowable gifts can enable corruption through facilitation payments.</td>
<td>✓</td>
</tr>
<tr>
<td>No provision in the Penal Code to confiscate property in the hands of third parties.</td>
<td>✓</td>
</tr>
</tbody>
</table>
| Legal persons are not criminally liable for corruption, money laundering, and trading in influence unless an administrative regulation is violated. Thus, there is no deterrent. | ✓  

Too many categories of officials who receive immunities from prosecution except under limited circumstances. Judges are immune from prosecution, and this makes it difficult to investigate and prosecute judges for alleged corruption.
No legal measures in place to protect whistleblowers reporting corruption, except for the security measures for witnesses.  

(ii) Systems and processes for preventing corruption

<table>
<thead>
<tr>
<th>Description</th>
<th>✓</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is no legislation obliging civil servants to report suspicions of corruption.</td>
<td>✓</td>
</tr>
<tr>
<td>Accountants and auditors are not obligated to report suspicious accounting to the authorities.</td>
<td>✓</td>
</tr>
<tr>
<td>Financial declarations system for public officials is not clear about how the information is supposed to be validated, thereby reducing its effectiveness and utility in detecting corruption.</td>
<td>✓</td>
</tr>
<tr>
<td>The system of registration of legal persons has limited ability to prevent legal persons being used for criminal activities. The registry does not check for criminal background of founders of a legal person.</td>
<td>✓</td>
</tr>
<tr>
<td>The authorities have limited familiarity about crimes committed by legal persons.</td>
<td>✓</td>
</tr>
<tr>
<td>Ministries anti-corruption action plans are of poor quality.</td>
<td>✓</td>
</tr>
<tr>
<td>Bribes are frequently given by companies for tax inspections and obtaining licenses. As a result, firms might not have the technical or financial requirements to bid on government contracts but they are nevertheless allowed to participate.</td>
<td>✓</td>
</tr>
<tr>
<td>Costs for delivering goods or services are frequently inflated well above normal benchmark per unit costs. Also, material input costs often over-priced, thereby escalating project costs.</td>
<td>✓</td>
</tr>
</tbody>
</table>

VI. RISK MANAGEMENT PLAN

188. The risk management plan consolidates the major risks identified in section V and highlights the ongoing mitigation measures that the government is currently implementing. It also proposes mitigation measures to be performed by ADB. The ADB mitigation actions will be directed at the sector-level interventions because of ADB’s focus on infrastructure projects in Azerbaijan.

<table>
<thead>
<tr>
<th>High Risks</th>
<th>Ongoing Mitigation Measures by Government</th>
<th>Proposed ADB Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Financial Management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Weak planning, budgeting, monitoring systems and practices in the public sector, which limit efficient resource use to achieve development targets</td>
<td>SECO providing support to MOED, MOF, and CBA on macroeconomic modeling. MOF implementing reform program jointly with the EU and World Bank to strengthen capacity in MOED and line ministries for preparing the annual state consolidated budget, MTEF, and PIP. MOF is implementing internal measures between its investment and budget departments to strengthen the linkage of investments and subsequent allocations for maintenance costs.</td>
<td>1. Technical assistance (TA) will develop a medium-term investment plan format to be linked with the budget and sector deliverables. 2. Government capacities will be strengthened to develop, implement and monitor a results based investment plan, and to prioritize investments through cost benefit analyses.</td>
</tr>
<tr>
<td>2. Insufficient allocations for operations and maintenance of infrastructure and low cost recovery, which undermine the sustainability of infrastructure.</td>
<td>MOF is implementing internal measures between its investment and budget departments to strengthen the linkage of investments and subsequent allocations for maintenance costs.</td>
<td>1. Provision of TA on public management to help government bodies develop expenditure priorities and management criteria and systems. 2. Provide support to government bodies to address more systematically their capital investment issues and operation and maintenance funding. 3. Conduct regular dialogue with MOF and concerned ministries, and agencies on cost recovery and operations and maintenance mechanisms to sustain investments and to foster private participation in infrastructure provision. 4. Explore additional sources of revenue from current assets, e.g., installation of meters, modern billing and collection methods, and introduction of toll roads.</td>
</tr>
<tr>
<td>3. Inadequate oversight, and weak internal</td>
<td>EU-supported PFM Action Plan is expected to develop a pilot internal</td>
<td>1. Inclusion of Azerbaijan in a regional TA (RETA) that will conduct a</td>
</tr>
</tbody>
</table>
controls and auditing, which hinder effective expenditure management and may result in financial losses.

- Audit section under the State Financial Control Service and create internal audit sections in public institutions.
- Preparation work is ongoing at MOF to develop a strategy for implementing international standards in internal audit.
- A response system is being established for audit findings.
- National Auditing Standards for financial and performance auditing are being developed.

### Procurement

1. Weak procurement capacity results in delays, inefficiencies and sub-optimal award of contracts.

   - UNCITRAL program is providing assistance for strengthening the country's procurement practices.
   - MOF has prepared a certification system for specialists (including procurement).

2. Inadequate national procurement framework limits competition.

   - UNCITRAL program is providing assistance for strengthening the country's procurement practices.

### External Audit Requirements

1. Provision of technical assistance (under RETA 8262) to assist with: (i) a procurement reform scoping and action planning exercise, and (ii) if requested by the government, drafting updated procurement legislation, implementing rules and related documents, and strengthening the capacity of procurement agencies and oversight bodies in accordance with the revised legislation.

2. Conduct regular training on procurement and due diligence for executing agencies, SPA, and other agencies.

3. Recruit procurement consultants to assist executing agencies in carrying out procurement.

4. Randomly check original bids submitted by bidders to validate the bid evaluation reports prepared by the implementing agencies, and spot check proposals to ensure the veracity of information.

5. Appoint a Resident Mission staff to provide assistance to the executing agencies on procurement and recruitment.

1. Specify in procurement plans that prior review of the government agencies' procurement method and bids must be conducted.
Electronic procurement system is gradually being rolled out. (Currently at e-announcement state only.)

IFI-funded projects are required to have procurement plans and disclose them publicly.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Provision of technical assistance (under RETA 8262) to assist with: (i) a procurement reform scoping and action planning exercise, and (ii) if requested by the government, drafting updated procurement legislation, implementing rules and related documents, and strengthening the capacity of procurement agencies and oversight bodies in accordance with the revised legislation.</td>
<td></td>
</tr>
</tbody>
</table>

3. Opaque and preferential procurement environment limits competition.

1. Discourage single-source selection and increase efforts to encourage broader participation in ICB.

2. Conduct due diligence training to strengthen verification skills of EAs, randomly check original bids submitted by bidders to validate the bid evaluation reports prepared by the implementing agencies, and spot check proposals to ensure the veracity of information.

3. Introduce a conflict of interest check into procurement processes.

### Anti-Corruption

1. Corruption compromises the efficient use of resources and the achievement of intended development results.

   Law on the Prevention of Conflicts of Interest is being drafted.

   Create a training facility to deliver regular training on AML case intelligence and investigation to the law enforcement and investigation bodies.

2. Conduct training for EAs and other government counterparts, the business community, and civil society to increase awareness of ADB’s Anticorruption Policy, to identify fraud and corruption, and how to confidently report concerns to ADB.

3. Conduct thorough situational analyses, detailed appraisals, and regular project performance monitoring and evaluation.

4. Include appropriate provisions of ADB’s Anticorruption Policy in loan and project agreements and bidding documents.

ADB = Asian Development Bank, AML = anti-money laundering, EA = executing agency, EU = European Union, ICB = international competitive bidding, MOED = Ministry of Economic Development, MOF = Ministry of Finance, RETA = regional technical assistance, SECO = State Secretariat for Economic Affairs (Switzerland), SPA = State Procurement Agency, TA = technical assistance