

The cover features a light blue background with abstract, flowing blue lines at the top and bottom. A world map is rendered in a dotted blue pattern in the center. The text 'annual report' is in a dark blue sans-serif font, and '2007' is in a larger, bold orange sans-serif font.

annual report  
**2007**

State Oil Fund of the  
Republic of Azerbaijan

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## Introduction

Underpinned by its successful National Oil Strategy, Azerbaijan seeks to further expand the development and utilization of its hydrocarbon resources. The commissioning of the Heydar Aliyev Baku-Tbilisi-Ceyhan Main Oil Export Pipeline and Baku-Tbilisi-Erzurum gas pipeline allowed for the exporting of hydrocarbon resources to Western countries on an increasingly broad scale. Through the successful implementation of various projects in the energy sector, Azerbaijan managed to ensure its energy security fully while increasing its share and strategic significance in the global supply of energy. Azerbaijan's enhanced role as a global energy supplier has enabled the country to further strengthen its political authority and position in the international arena.

The tremendous growth of Azerbaijan's oil sector has contributed vastly to the overall economic development of the country, the scope of industrial production and investments, as well as to the enhancement of its budgetary strength and possibilities. Azerbaijan continues to implement new projects and accomplish much in terms of regional development, infrastructure renewal, expansion of the non-oil sector and job creation, all grounded in the country's continually increasing financial capacity.

Joint development of hydrocarbon resources with foreign companies, and the subsequent expansion of oil exports and sales, has led to an increase of the State Oil Fund's revenues in 2007. The Fund's assets amounted to USD2.4 billion at the end of the year, having increased more than USD1 billion over the figure for the previous year. During 2007, in parallel with operation of the Azeri-Chirag-Guneshly field, the Shahdeniz gas condensate field moved into its production phase and yielded the first gas sales revenues for the State Oil Fund. This event was regarded as a major economic accomplishment of the year.

The State Oil Fund played an active contributory role during 2007 in promoting the country's economic growth and in the financing of strategic state programs and projects, as well as addressing important social-economic issues and challenges.

Projects financed by the State Oil Fund in 2007 included, among others, the laying of a water supply line from Oguz-Gabala region to Baku, and the reconstruction of the Samur-Absheron irrigation system, both of which are expected to substantially improve the water supply situation for Baku. Implementation of these two large-scale water projects is in line with the anticipated benefits through implementation of the National Oil Strategy. The inception phase of the Strategy included the construction of the Baku-Tbilisi-Ceyhan main export pipeline, and the following phase foresaw commencement of construction of the infrastructure, in this case water supply line, funded from oil export revenues. In this regard, the Strategy's goal of directing oil revenues towards improvement of the nation's welfare is being fulfilled.

In 2007 the State Oil Fund began financing yet another strategically important infrastructure project; namely building of the Baku-Tbilisi-Kars new railway. This project, which is expected to give a strong impetus to further enhancement of the country's political recognition in the region and secure high profits, aims at promoting Azerbaijan's integration with Western countries and further developing existing political and economic relations between Azerbaijan, Georgia and Turkey. While being assigned a high degree of regional significance, the Baku-Tbilisi-Kars new railway, commonly referred to as the "Silk Railway", will serve as a transport corridor connecting Asia and Europe. The three projects initiated by Azerbaijan - Baku-Tbilisi-Ceyhan, Baku-Tbilisi-Erzurum and Baku-Tbilisi-Kars projects - would, in addition to promoting cross-sectoral relations among the countries of the region, also serve to put the countries on a fast track to economic development and preserve sustainability.

2007 was also marked with major results achieved in improving the social and living conditions of refugees and internally displaced persons, which represent a substantial line item on the State Oil Fund's expenditure budget. Tent camps for IDPs were completely eradicated during the reporting year, and the IDP settlers were relocated into new housing. This is yet another success of the economic policy conducted by the President of the Republic of Azerbaijan.

Year-on-year growth of the State Oil Fund's assets and resources requires developing professional management and administration capacity to maintain the Fund's institutional arrangements and its assets in proper order. In this regard, the Oil Fund undertook a number of measures designed to learn and apply best international practice in asset management along with modern principles of governance. To this end, in 2007 the Fund took major steps towards introducing state-of-the-art technologies as utilised by recognized international investment funds. It also moved towards enhancing the Fund's level of proficiency in international finance, such as through a partnership arrangement with the World Bank for investment portfolio management and by engagement of Thomson Financial Limited, an international leader in the state-of-the-art software applications.

Special emphasis is placed on transparency of the Oil Fund's operations, especially the Extractive Industries Transparency Initiative, in which Azerbaijan retains its leadership in implementation. Furthermore, by means of a set of well-devised, integrated measures and activities, the State Oil Fund yielded yet another success in its comprehensive promotion of Azerbaijan's international recognition in 2007. The State Oil Fund was awarded the 2007 UN Public Service Award for Improvement of Transparency, Accountability and Responsibility in Public Service. The winning of this prestigious award, contested by many countries, by an Azerbaijani public entity, demonstrates another major international accomplishment by Azerbaijan.

Projections and forecasts suggest that the Oil Fund will receive a huge influx of funds from crude oil and gas sales in the near future. With this in mind, the Fund's primary objectives remain the accumulation of State Oil Fund's assets, and ensuring that they are managed effectively and used efficiently to meet the needs of the current generation and to preserve the assets in a reliable and secure manner for the benefit of generations to come.

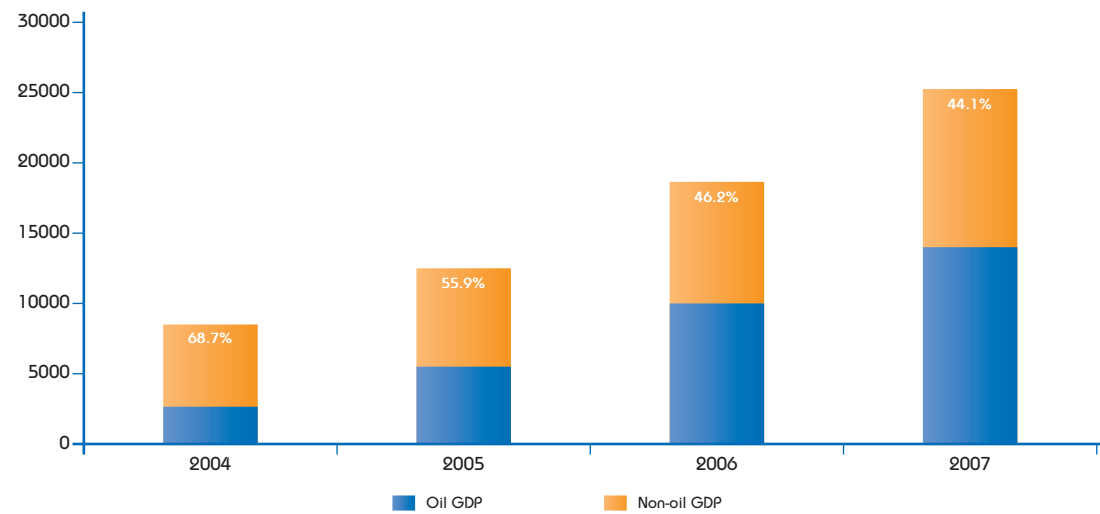
# 2

## Evaluation of macroeconomic development in Azerbaijan

2007 was characterized with a 25% real growth of the Gross Domestic Product in Azerbaijan. GDP per capita increased from AZN2 241.1 in 2006 to AZN2 980.9 in 2007. The oil sector also increased its share in GDP production in 2007. While the oil sector's share of GDP constituted 31.3% in 2004, it rose to 55.9% in 2007, which can be regarded as indicative of the yearly growth of the country's oil production. In 2007, the oil sector showed a real growth of 36.8%, and the non-oil sector 11.3%. *Chart 1* below presents the change path of the oil and non-oil sector GDP in 2004-2007.

**Chart 1**

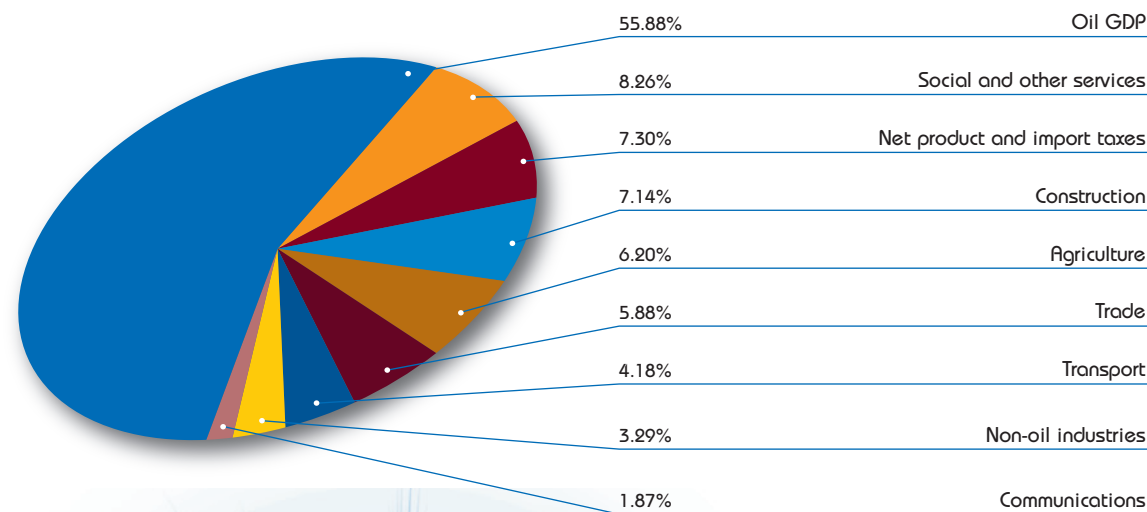
**Change path of oil and non-oil GDP in 2004-2007 in Azerbaijan**  
(at market prices, AZN million)



In 2007, the non-oil sector was dominated by social and other services (8.26%), net product and import taxes (7.3%), construction (7.14%) and agricultural production (6.2%) (*Chart 2* below).

**Chart 2**

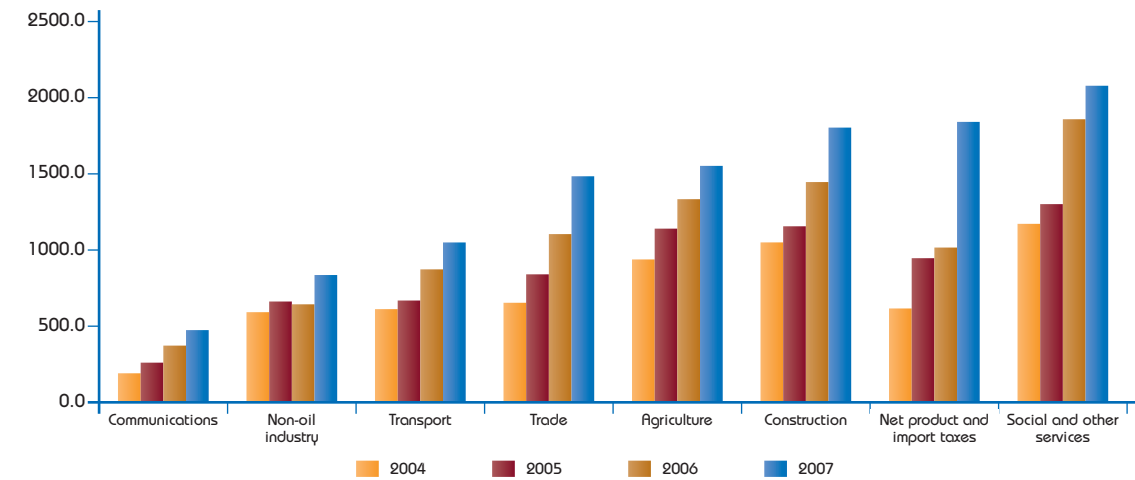
**Structure of GDP in 2007**



In 2007, agriculture, construction and communication sectors demonstrated higher real growth rates as compared to the previous year, thereby becoming the primary contributors to the overall growth of the non-oil sector over the past years. Thus, in 2006 and 2007 agriculture showed real growth rates of 0.9% and 4.0% respectively, construction 8.5% and 16.0% and communications 24.0% and 32.0%.

**Chart 3**

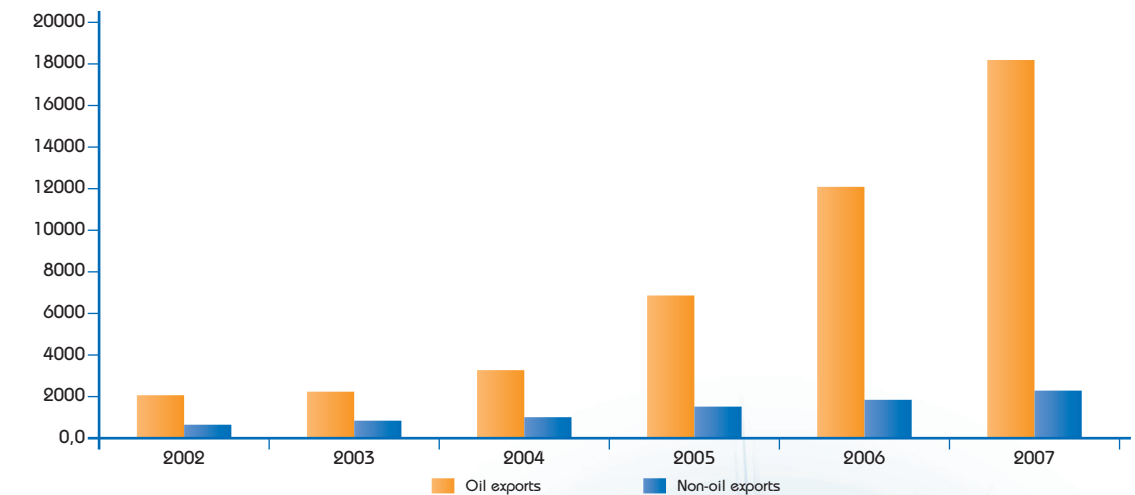
**Change path of non-oil sector industries in 2004-2007**  
(at market prices, AZN million)



Year-on-year increases in oil production and, consequently, crude oil exports, have reduced the proportion of non-oil to oil products in overall exports. While in 2006 non-oil goods and services exports showed an increase of 29.7%, they grew by 22.2% in 2007. In 2007, oil exports amounted to 61.8% of GDP, non-oil exports to 9.1%.

**Chart 4**

**Change path of oil and non-oil exports in 2002-2007**  
(USD million)



Investments in the non-oil sector increased in 2007. Investments in fixed capital in the non-oil sector constituted 27.2% of non-oil GDP in 2006, and 34.5% in 2007. This was primarily due to the rise in public investment expenditure.

State budget expenditures amounted to AZN6.059 billion in 2007, which indicates an increase of AZN2.3 billion or 59.9% against the 2006 level. In 2007, state budget revenues increased, as a percentage of the gross domestic product, by 3.0% against the 2006 level, and state budget expenditures by 3.6%, amounting to 24.1% and 24.6% respectively.

In 2007, individual cash income increased by 40.3%, while average monthly salaries rose by 42.0% (27.8% in 2006). The inflation rate was 16.7% in 2007, which indicates that real income of the population increased.

# 3

## State Oil Fund's Financial Activities in 2007

## Oil Fund's cash flows in 2007

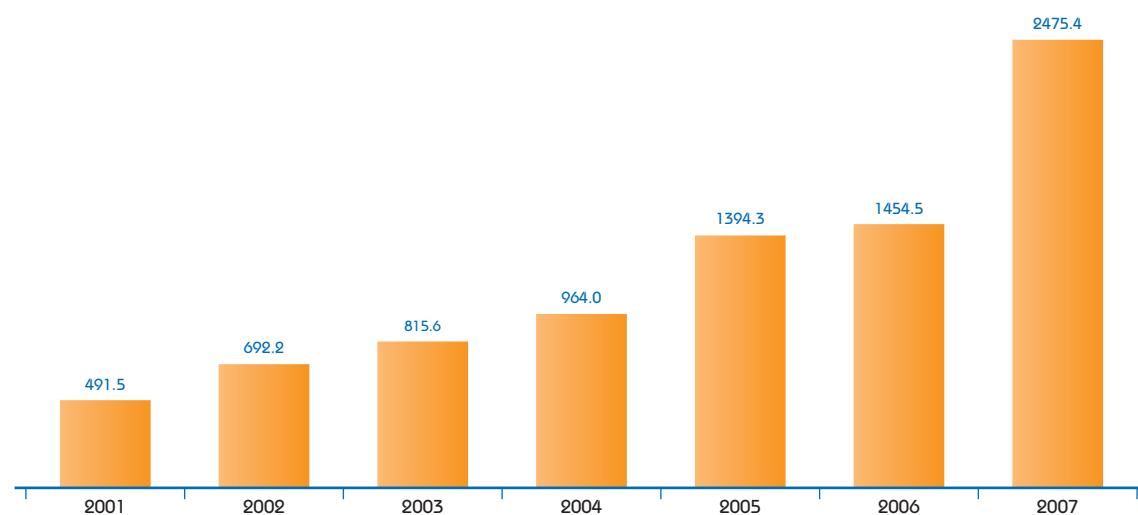
As of January 1, 2007 the State Oil Fund's total accumulations amounted to **AZN1 267 444.8** thousand or **USD1 454.5** million.

As of December 31, 2007 the Fund's total assets amounted to **AZN2 092 406.1\*** thousand or, in USD equivalent, approximately **USD2 475.4** million through an increase of **AZN825.0** million (**USD1 020.9** million) or **65.1%** during the year.

Chart 5 below presents the change path of SOFAZ' assets during 2001-2007.

**Chart 5**

**Change path of the State Oil Fund's assets in 2001-2007**  
(USD million at year-end)



\* Year-end total assets as presented in the Statement of financial position of SOFAZ by Deloitte&Touche Limited Liability Company are below the corresponding amount as presented in the Fund's statement because of deduction of profit taxes at **AZN12.6** million booked in 2007 but actually paid to the state budget in 2008 as well as addition of fixed assets and intangible assets (**AZN6.9** million) and acreage fees payable in 2007 but transferred actually in 2008 (**AZN0.8** million).

The Fund's total revenues from oil and gas contracts and management of the Oil Fund's assets during the reported year amounted to **AZN1 886 164.8** thousand.

In 2007, the Oil Fund's total expenditures amounted to **AZN1 061 203.5** thousand. Table 1 below presents the Oil Fund's cash flow.

**Table 1**

**Oil Fund's 2007 cash flow spreadsheet**

Revenues	Amount	
	AZN thousand	USD mil.
As of 01.01.2007 <b>ASSETS ACCUMULATED</b>	<b>1 267 444.8</b>	<b>1 454.5</b>
<b>TOTAL REVENUES:</b>	<b>1 886 164.8</b>	<b>2 260.8</b>
<i>Including:</i>		
Oil contract revenues	<b>1 799 931.7</b>	<b>2 101.0</b>
Fund's asset management revenues	72 285.3	—
Fund's asset revaluation revenues	13 947.8	—
<b>TOTAL EXPENDITURES:</b>	<b>1 061 203.5</b>	<b>1 239.9</b>
As of 31.12.2007 <b>Balance of the Fund's assets</b>	<b>2 092 406.1</b>	<b>2 475.4</b>

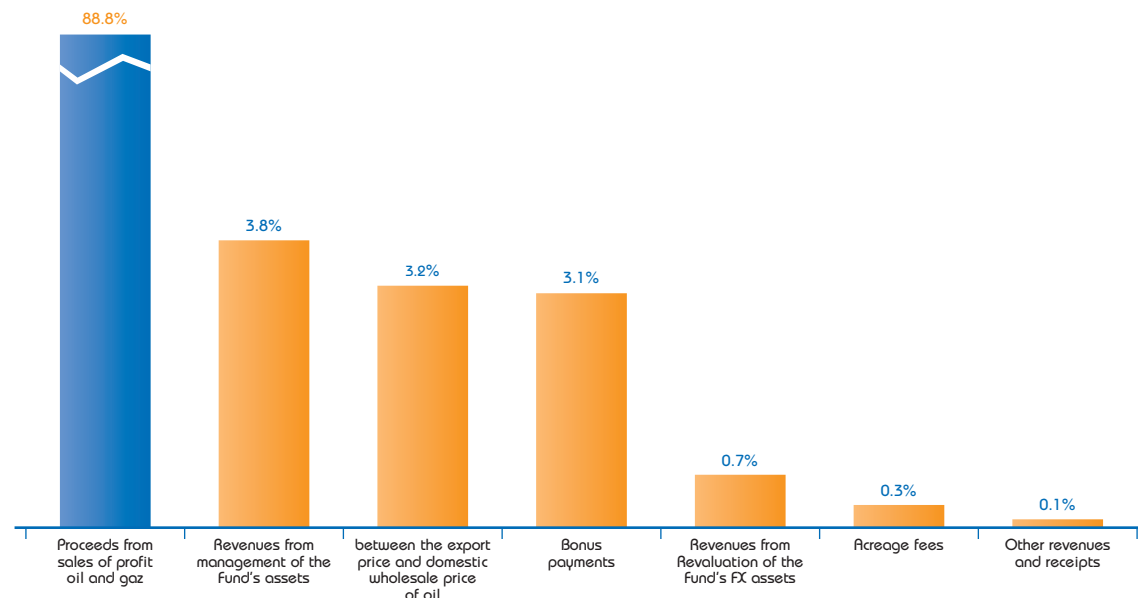
## Revenues

Formation sources of the State Oil Fund's revenues during the reported year included proceeds from sales of the Republic of Azerbaijan's share of hydrocarbons (88.8%), bonus payments (3.1%), acreage fees (0.3%), revenues derived by differences between the contract price of domestically produced and imported crude oil and the domestic wholesale price (3.2%), proceeds from sale of assets delivered by foreign investors to Azerbaijani counterparts (0.1%), revenues from management of the Fund's assets (3.8%) and revenues from revaluation of the Fund's financial assets (0.7%).

Chart 6 below presents the structure of the Fund's revenues.

**Chart 6**

Structure of the State Oil Fund's revenues in 2007

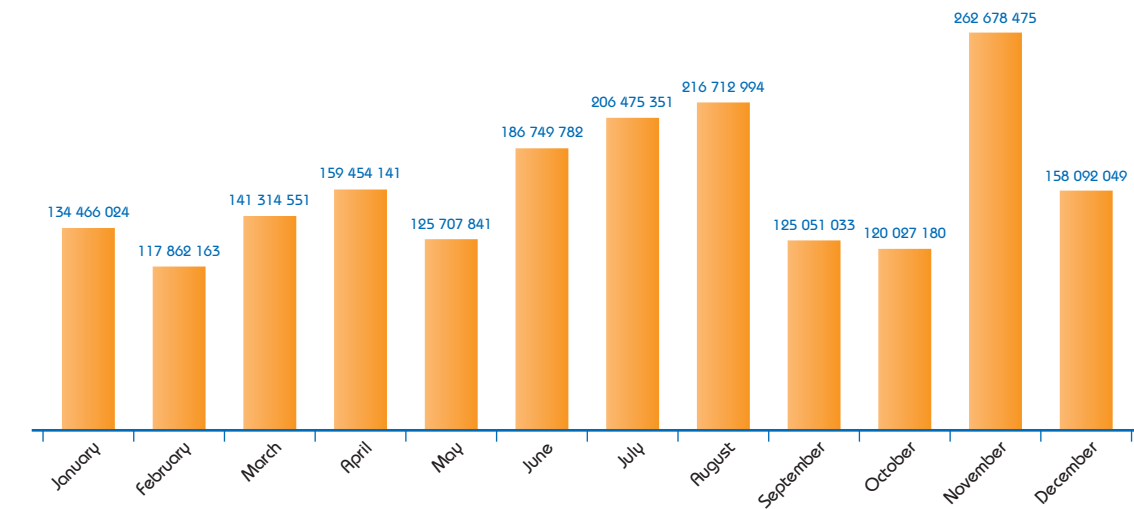


### Proceeds from sales of profit oil and gas

In 2007, the State Oil Fund gained a total of AZN1 675 019.1 thousand, or USD1 954.6 million, generated from sales of the Republic of Azerbaijan's share of hydrocarbons, of which USD1 929.6 million (37 consignments of profit oil) are proceeds from sales of oil produced from the Azeri-Chirag-Guneshly oilfield, USD10.2 million (8 consignments of profit oil) from oil produced in Mishovdag and Kalamaddin oilfield, and USD12.4 million (1 consignment of profit oil) from oil produced in Kursengi and Garabagly oilfield. Furthermore, the State Oil Fund yielded USD2.4 million in revenues from sales of gas produced from Shakhdeniz field (production started last year). Proceeds from sales of profit oil and gas amounted to 88.8% of the total income of SOFAZ.

**Chart 7**

Revenues of SOFAZ from sales of profit oil and gas in 2007



In 2007, world market prices for oil were higher than in the previous years. Thus, in January the average monthly price of Brent oil was USD57.21, in July USD77.82 and in December USD93.89 on the world markets.

The average weighted receipt price per barrel of profit oil consignments sold by the State Oil Company of Azerbaijan Republic and posted to the State Oil Fund in 2007 was approximately USD64.

**Chart 8**

Comparative change paths of world market average monthly prices for Brent oil and average monthly sale prices of profit oil consignments sold by SOCAR in 2007



In 2000-2007, sales of profit oil generated revenues of USD4 521.3 million, with the year of 2007 accounting for USD1 954.6 million or approximately 43.2%.

SOCAR deducts oil transportation costs, banking, customs clearance, and surveyor, marketing and insurance costs when transferring the proceeds from sales of profit oil to the Oil Fund.

#### Bonus payment revenues.

Another source of the State Oil Fund's revenues in 2007 is attributed to bonuses paid by investors in connection with signing or execution of oil and gas contracts. Total bonus payments received by the Oil Fund during the reported year amounted to **AZN58 068.0** thousand or **USD68.0** million. Thus, in 2007, Middle East Petroleum Garachukhur company paid **USD1.0** million for production of Garachukhur oilfield; Lukoil Overseas paid **USD20** million for drilling works at the D-222 (Yalama) field; Rusneft Apsheron Investments Limited paid **USD2** million for developing the block comprising the Zig and Hovsan oilfields. Furthermore, foreign producers paid a total of **USD45** million for commencing production and commercial operation of the Shakhdeniz gas field, where Statoil's share based on the company's participation in the field was **US12.8** million; Lukoil Overseas - **USD5.0** million; Total EP - **USD5.0** million; BP Azerbaijan LTD - **USD12.7** million; Turkiye Petroleum - **USD4.5** million; Naftiran Co - **USD5** million.

Table 2 below presents bonus payments by sources.

Table 2

#### Revenues of State Oil Fund from bonus payments in 2007

Transferor	Oilfield	Date	Amount	
			AZN thousand	USD mil.
Middle East Petroleum Garachukhur	Garachukhur	01.03.07	868.8	1.0
Statoil	Shakhdeniz	21.06.07	10 916.6	12.8
Lukoil	Shakhdeniz	22.06.07	4 280.5	5.0
Total EP	Shakhdeniz	25.06.07	4 280.0	5.0
BP	Shakhdeniz	25.06.07	10 914.0	12.7
Turkiye Petroleum	Shakhdeniz	25.06.07	3 852.0	4.5
Naftiran Co	Shakhdeniz	19.07.07	4 272.5	5.0
Lukoil	D-222 (Yalama)	30.10.07	16 986.0	20.0
Rusneft	Zig and Hovsan	05.11.07	1 697.6	2.0
<b>TOTAL</b>			<b>58 068.0</b>	<b>68.0</b>

Bonus payment revenues constituted 3.1% of the Oil Fund's total income.

#### Acreege fee revenues.

Another source of the Oil Fund's revenues in 2007 was the acreage fees paid by foreign investors for the use of contract areas in connection with the development of hydrocarbon resources. Acreage fees received by the Oil Fund in 2007 totaled **AZN5 594.7** thousand or approximately **USD6.6** million. **USD0.9** million of the acreage fees were paid by BP Azerbaijan, **USD5.7** million by Lukoil. These revenues accounted for 0.3% of the Oil Fund's total income. Table 3 below presents the acreage fee revenues of the Oil Fund during 2007.

Table 3

#### Revenues of State Oil Fund from acreage fee payments in 2007

Transferor	Oilfield	Date	Amount	
			AZN thousand	USD mil.
BP	Inam	04/07	780.2	0.9
Lukoil	Yalama	12/07	4 814.5	5.7
<b>TOTAL</b>			<b>5 594.7</b>	<b>6.6</b>

A major portion of the acreage fees was paid by Lukoil (86.1%), (13.9%) by BP Azerbaijan.

#### Payments from the difference between the contract price and the domestic wholesale price of crude oil produced in and exported from Azerbaijan Republic

Pursuant to the Law "On 2007 State Budget" of the Republic of Azerbaijan as well as the Memorandum of Agreement signed in the reporting year between the Ministry of Finance, Ministry of Economic Development, State Oil Fund and State Oil Company, payments made to the Oil Fund from the differences between the contract price and domestic wholesale price of crude oil produced in and exported from the Republic of Azerbaijan constituted another source of the Fund's revenues. These revenues amounted to **AZN59 961.0** thousand or **USD70.3** million during the reporting year thereby constituting 3.2% of the Fund's total income. **AZN14.4** million of this sum (**USD16.49** million) represents the portion of price differences accrued for 2006, which were transferred to the Fund in early 2007.

#### Other revenues and receipts

Pursuant to the legal and regulatory framework of the State Oil Fund, another source of the Fund's revenues is the proceeds from assets delivered by investors to the State Oil Company of Azerbaijan Republic or relevant government authority under oil and gas contracts.

Under trilateral agreements entered into between the State Oil Company, State Oil Fund and foreign oil companies operating under the Production Sharing Agreements (PSA's), assets used and currently aged under such agreements or surplus considered

assets are to be delivered and handed over to the State Oil Fund. The agreement defines asset delivery mechanisms and appropriate documentation requirements.

Arrangements were made to sell the assets (aged or unused pipes of various lengths and diameters, pipe sections, drilling plants, metal scrap, etc.) received from investors (foreign oil companies) in the reporting year under the oil and gas agreements, and the Fund's revenues from this source totaled **AZN1 288.9** thousand. These revenues constituted 0.1% of the Fund's total income.

#### Revenues of the State Oil Fund from revaluation of financial assets

The Fund's revenues from revaluation of financial assets during the reporting year totaled **AZN13 947.8** thousand. Thus, the Fund's assets are diversified by investing in US Dollars, Euro, British Pounds and other currencies wherefore as foreign currency exchange rates fluctuated the Oil Fund yielded additional balance sheet revenues from revaluation of the Fund's assets (denominated in Azerbaijani Manats). These revenues accounted for 0.7% of the Fund's total income.

#### Income of the State Oil Fund from asset management

Income produced by asset investment and management activities is considered another significant source of the State Oil Fund's total revenues. The Fund's revenues from this source totaled **AZN72 285.3** thousand in 2007. These revenues amounted to 3.8% of the Oil Fund's total revenues.

The current world financial and currency market conditions have a material impact on investment of the State Oil Fund's financial assets and the associated revenues.

With energy and especially crude oil prices remaining high in 2007, and stagnated real-estate markets in the world's leading nations, tensions in the global economy were further brought into focus, which primarily had a negative impact on the rate of global economic growth. As a consequence of the stress that the world's financial markets experienced following rapid growth in the global economy during the first three quarters of 2007, the growth rate dropped back in the fourth quarter, bringing the annual growth rate to 4.9% (5% in 2006). Emerging economies, in particular China, India and Russia, showed tremendous growth rates accounting for about a half of the overall growth globally in 2007. Furthermore, the US balance of payments deficit, peaking at its highest point in recent years, led to a further decrease in the US Dollar exchange rate and a prolonged period of stress that quite tightly gripped the financial and currency markets.

In 2007 the US economy grew at a rate lower compared to the previous year and the average annual growth rate of GDP was 2.2% (this indicator was 2.9% in 2006). In 2007 the consumer price index was 4.1% (2.6% in 2006). While early in the year the country's unemployment rate was 4.6%, it rose to 5.0% later in the year. In 2007 the country's goods

and services exports made USD1 628.4 billion, imports USD2 336.9 billion, with the trade balance deficit amounting to USD708.5 billion through a decrease of 6.6% against the 2006 level. Considering that the US Dollar acts as the world's principal reserve currency, global attention on the US deficit problems grew more intense concerning the US deficit problems and the dramatic depreciation of the US Dollar. All these factors, in their turn, become serious risks for the world economy. In 2007 the trade balance accounted for 5.1% of GDP, as against 5.7% in 2006.

The economy of Great Britain has been growing at a stable pace over recent years and GDP growth in 2007 amounted to 3.1% (2.9% in 2006). The country's average annual unemployment rate was 5.2%. Last year the country's consumer price index (inflation rate) was approximately 2.1% (3.0% in 2006).

GDP growth rate in other G7 countries: in Canada 2.0% (1.8% in 2006); in France 1.9% (1.9% in 2006); in Germany 1.8% (3.9% in 2006); and in Japan 2.0% (2.3% in 2006).

As in previous years, 2007 saw dynamic growth in the Asian region, especially China and India. This was a major feature of development of the global economy. While China's average annual GDP growth rate reached 10.4% and India's 9.1% in 2006, in 2007 these were 11.2% and 8.4% respectively.

The GDP growth rate indicators for the above mentioned countries are presented in *Table 4* below.

**Table 4**

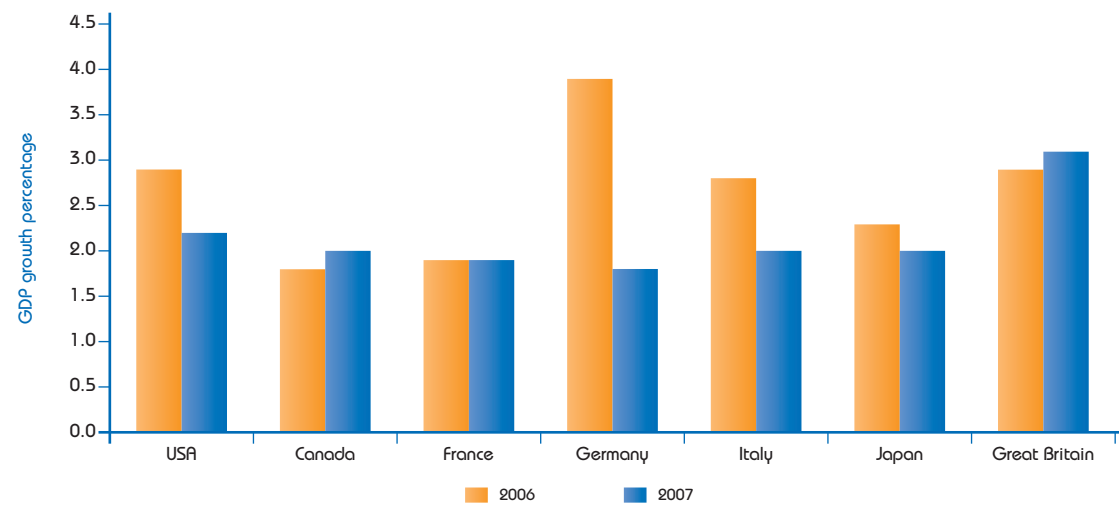
**Comparative analysis of GDP growth rates in G7 countries and developing economies of China and India in 2007 (%)**

	2007				Average annual growth rate
	I	II	III	IV	
USA	1.5	1.9	2.8	2.5	2.2
Canada	2.2	2.9	3.0	2.0	2.0
France	1.9	1.4	2.2	2.1	1.9
Germany	3.7	2.6	2.5	1.8	1.8
Italy	2.4	1.8	1.9	2.0	2.0
Japan	3.0	1.7	1.7	2.0	2.0
Great Britain	3.0	3.2	3.1	2.8	3.1
<b>China</b>	<b>11.1</b>	<b>11.9</b>	<b>11.5</b>	<b>11.2</b>	<b>11.2</b>
<b>India</b>	<b>9.1</b>	<b>9.3</b>	<b>8.9</b>	<b>8.4</b>	<b>8.4</b>

In general, 2007 was characterized with lower economic growth rates in G7 countries than the previous years.

**Chart 9**

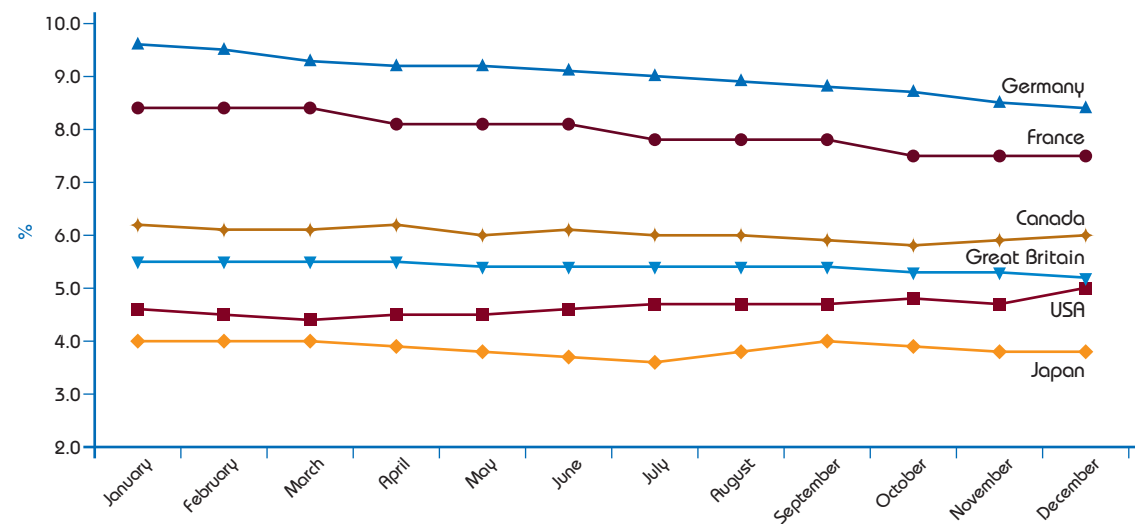
**GDP growth pattern in G7 countries in 2006-2007**



The processes taking place in the world's leading countries last year have also had a positive effect on reducing rates of unemployment. In Canada it fell from 6.1% in 2006 to 6.0% in 2007; in France from 8.8% to 7.8%; in Germany from 9.8% to 8.4%; and in Japan from 4.0% to 3.8%. *Chart 10* below presents unemployment rates for the leading countries.

**Chart 10**

**Unemployment rates in G7 countries (by month)**



In 2007 the prices for crude oil, considered the primary energy carrier, remained high. The oil price was affected by a number of factors. The reduced production of oil in OPEC member countries, with the continually low level of production growth in non-member countries, in the first nine months of the last year gave impetus to a cutback in oil supplies.

Supply reduction was also contributed to by a number of technical and economic factors, such as a weakening of the US Dollar exchange rate and increasing crude oil export charges. Furthermore, with China, a major contributory to the global economic growth, increasing its oil imports during 2007 against the backdrop of cutbacks in oil supply across the globe, there was yet another factor that had an upward pressure on oil prices. In early 2007, one barrel of Brent oil sold for USD57.21 at the world's crude oil markets; this price rose consistently during the year. One barrel of oil sold for over USD70 in June; rising to over USD80 by October and reaching as much as USD93.89 by the end of the year.

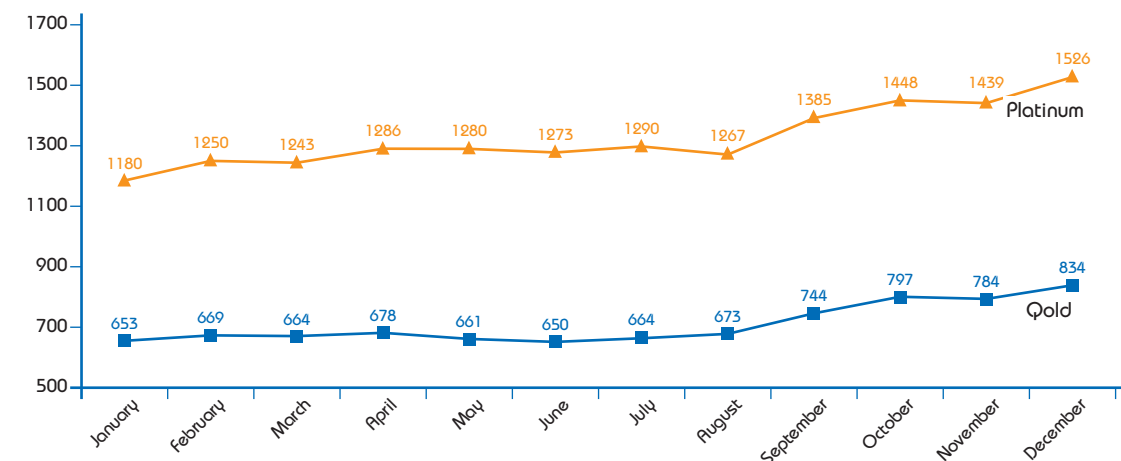
Given the high demand for oil in the emerging Asian economies, especially China and India, as well as the increasing consumption of oil in oil exporting countries due to their fast-tracked economic growth, there is much evidence to support projections for crude oil prices remaining high in the next year or so.

In 2007, as the case was with energy carriers, prices for non-ferrous metals also showed an increase. Prices for gold and platinum rose at higher rates in 2007. During 2007 the price of gold went up by 28%, while the price of platinum rose 29%. Neglecting some minor price drops during the year, the January price per Trojan ounce of gold was USD653 rising to USD834 in December. The price of gold went up due to a number of factors during 2007: such as increased investments in gold as US Dollar exchange rates fell; reduced production of gold in the world's largest producer of gold, the South African Republic; and higher acquisition volumes of gold by India.

The average monthly price per unit of measure of platinum rose from USD1180 in early 2007 to USD1526 by the end of the year. Price for silver displayed relatively stable growth. The price of this precious metal increased by 9.4% during the year, first going down from USD13.5 per unit of measure at the beginning of the year to a mid-year price of USD12.7, and then rising again to USD14.8 by the end of the year.

**Chart 11**

**Prices for gold and platinum in 2007**



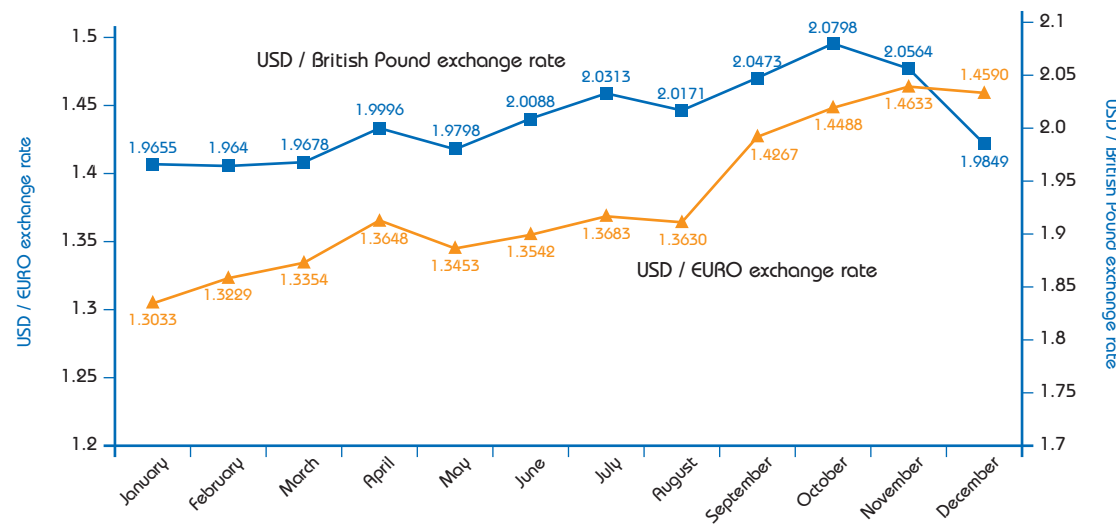
During 2007 the world's currency markets were stressed, which was primarily due to the further devaluation of the USD against other lead currencies. The USD against EURO exchange rate was 1.3033 early in 2007 and, despite slight increases in May, August and

December, the USD exchange rate against EURO continued to drop, falling to 1.4590 by the end of the year.

The USD devalued against the British Pound over the year. The USD exchange rate against the British Pound was 1.9655 early in the year, it weakened to 1.9849 by the end of the year.

**Chart 12**

**USD exchange rates against EURO and British Pound in 2007**

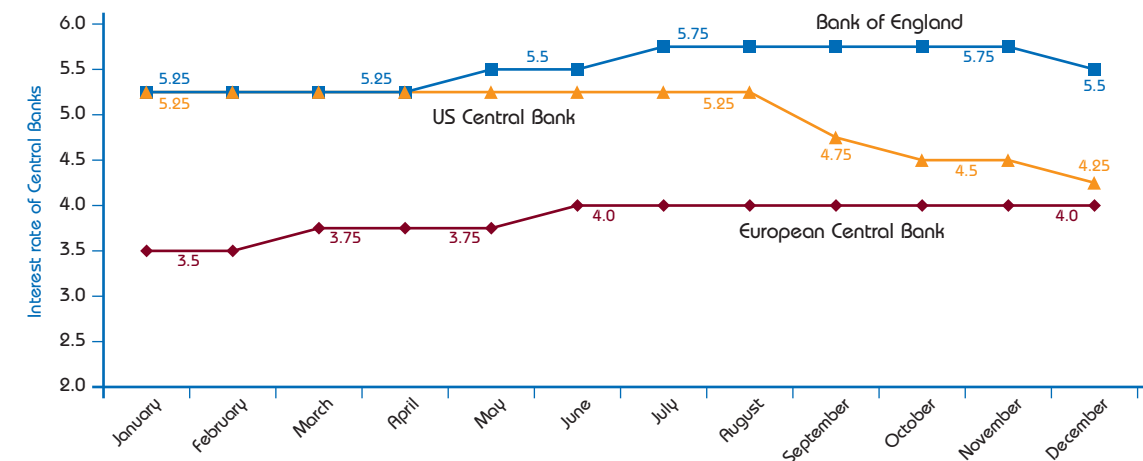


Interest rates of the world's leading central banks changed during 2007. The US Central Bank revised its policy of increasing the interest rate in the past three years and reduced its interest rate three times after August. In order to address the depressed state of the country's credit and real estate markets and provide some stimulation, the US Central Bank reduced its interest rate, that had held at 5.25% until August, to 4.75% in September, then to 4.5% in October and down again to 4.25% in December. On the other hand, the Central Banks of Europe and England continued to pursue a policy of increasing interest rates during the year. The interest rate of the Bank of England was increased from 5.25% to 5.5%, while the interest rate of the European Central Bank was increased from 3.5% to 4.0% during 2007. *Chart 13* below presents the change path of interest rates of the US Central Bank, Bank of England and European Central Bank.

The global economic trends have also had an impact on the world's financial markets. Growth rates achieved by the emerging Asian economies, especially China and India, over recent years allowed for greater capacity to invest and take advantage of investment opportunities in international financial markets. Accordingly, the developing markets of Asia have been making an increasing economic impact on global financial markets. Furthermore, with the windfall of profits from benefits high international oil prices oil exporting countries have been placing an increasingly strong emphasis on enhancing their financial asset holdings through the financial markets. All these factors have further promoted competition in the global financial market arena.

**Chart 13**

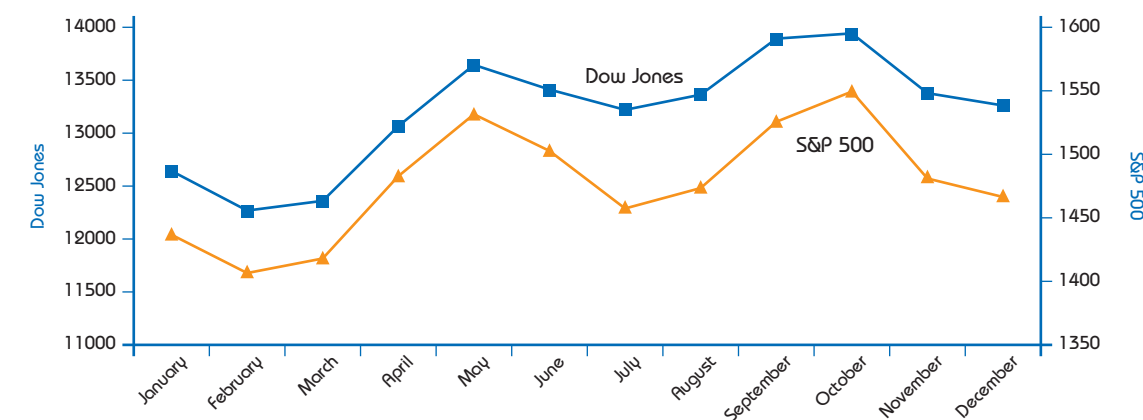
**Comparative change paths of interest rates of US Central Bank, Bank of England and European Central Bank in 2007**



In 2007 the world's financial markets were dominated by instability and volatility, with the US financial markets displaying the signs of such most regularly. The Dow Jones index rose and fell dramatically during the year. The index increased overall by 5.1% during the year. The average weighted Dow Jones index was 13,198 during the year, which exceeded the previous year's corresponding indicator (11,472) by 15%. The S&P 500 index also fluctuated during 2007. This index showed an increase of approximately 1.98% over the 12 months. The average weighted annual S&P 500 index made 1,478, up by 12% on 2006 (1,318).

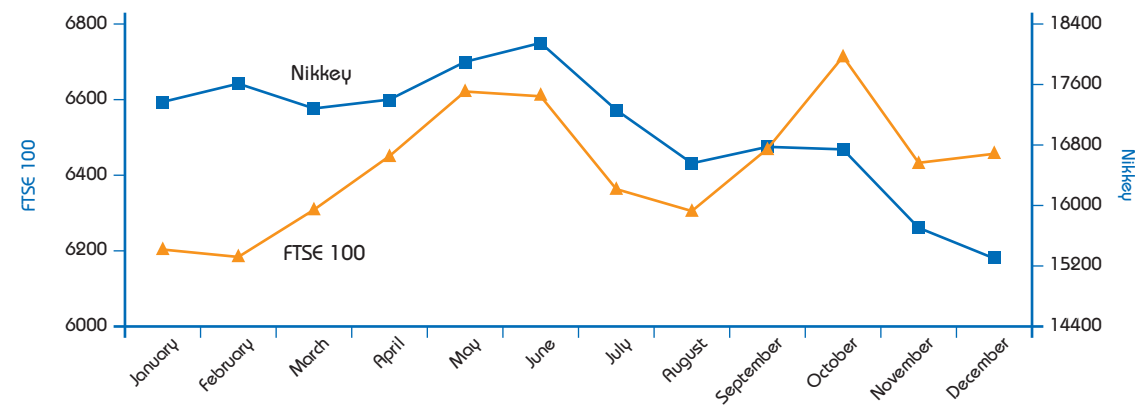
**Chart 14**

**Change path of Dow Jones and S&P 500 indices in 2007**



In 2007 FTSE 100 increased by 4.9% against 2006. The average weighted annual rate of this index was 6,425, which is 8.2% more than the previous year's corresponding indicator (5,941). Stock exchanges of Japan showed a relative reanimation. Last year the Nikkei index increased by 6.9% against the previous year. This index had an average weighted annual value of 17,002, which exceeds the previous year's corresponding rate (16,285) by 4.4%.

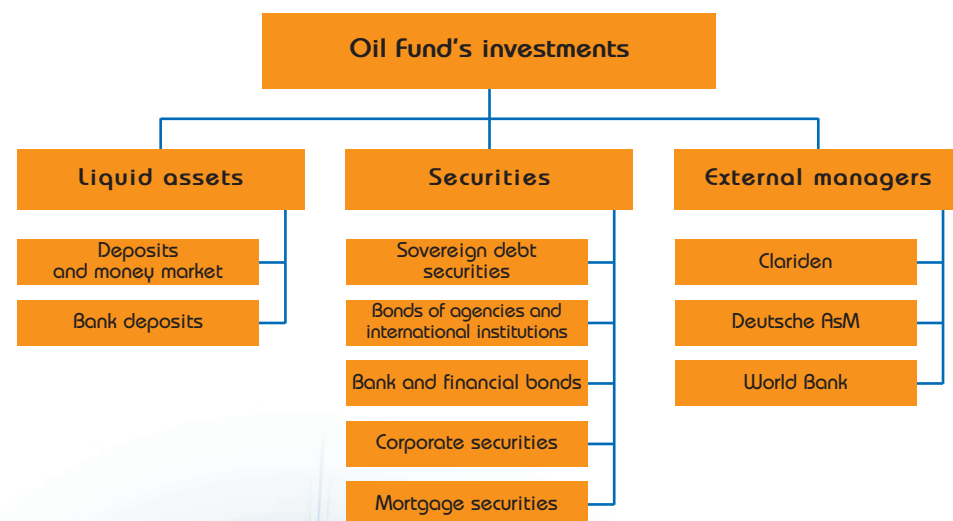
**Chart 15**  
Change path of FTSE 100 and Nikkei indices in 2007



The State Oil Fund's investment portfolio is managed in accordance with the "Asset management guidelines for the State Oil Fund of the Republic of Azerbaijan" approved by Presidential Decree of June 19, 2001. During the reported year the Fund's investment policy related to asset management followed the Investment Program for the State Oil Fund of the Republic of Azerbaijan, including the Investment Policy of the State Oil Fund under this program approved by the Presidential Resolution No.1878 dated December 28, 2006. This program sets the return benchmark on the Oil Fund's assets to be "3 month LIBOR" published by the British Bankers' Association for the respective currency.

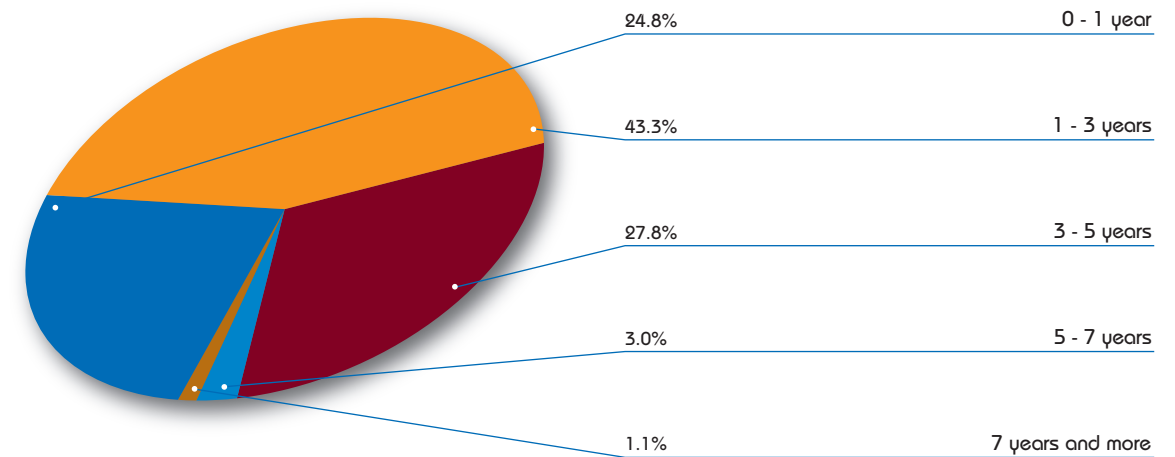
Bank deposits, money market funds, securities, including sovereign debt securities, bonds, and mortgage securities were the primary investment instruments used in 2007 by the Oil Fund. At the same time, a portion of the Fund's assets was managed by external managers - Clariden (Switzerland) of Credit Swiss Group, and Deutsche Asset Management GmbH (Germany) of the Deutsche Bank Group, and the World Bank. Scheme 1 presents the Oil Fund's investment areas.

**Scheme 1**



A major portion of the Oil Fund's assets (43.3%) in 2007 had 1-3 years of maturity. The maturity profile of the Fund's financial assets was as follows: 0 to 1 year maturity - 24.8%, 3 to 5 year maturity - 27.8%, 5 to 7 year maturity - 3.0%, over 7 years - 1.1%. Chart 16 below presents the asset distribution by maturity.

**Chart 16**  
Asset distribution by maturity (as at 31.12.07)



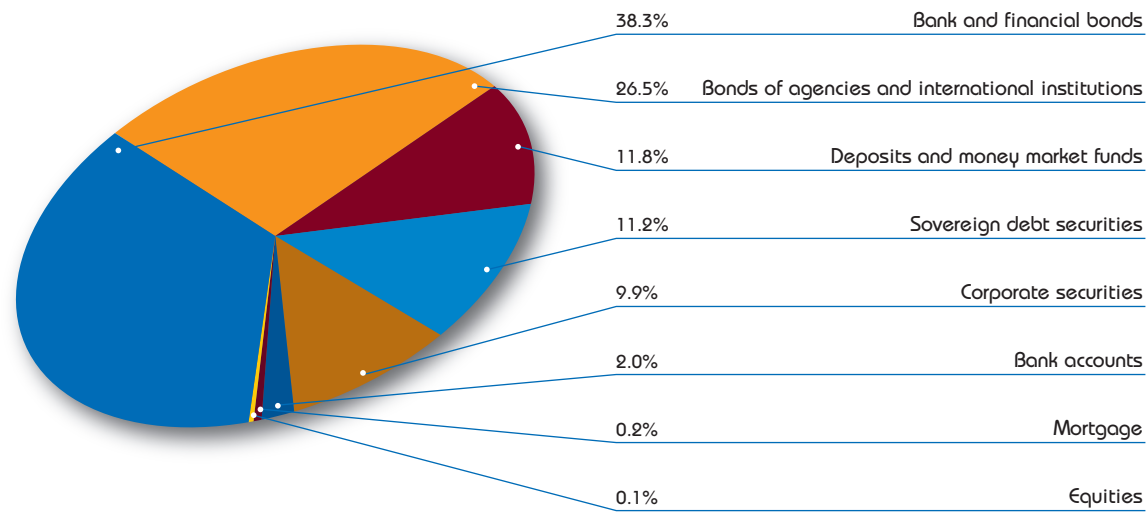
As at December 31, 2007, USD333.5 million or 13.8% of the Oil Fund's resources were invested in liquid assets, USD2 098.8 million or 86.1% in securities, and US2.5 million or 0.1% in equities.

Table 5 below presents the structure of the Oil Fund's investment portfolio by asset class.

**Table 5**  
Oil Fund's financial assets breakdown  
(as at 31.12.07) USD million

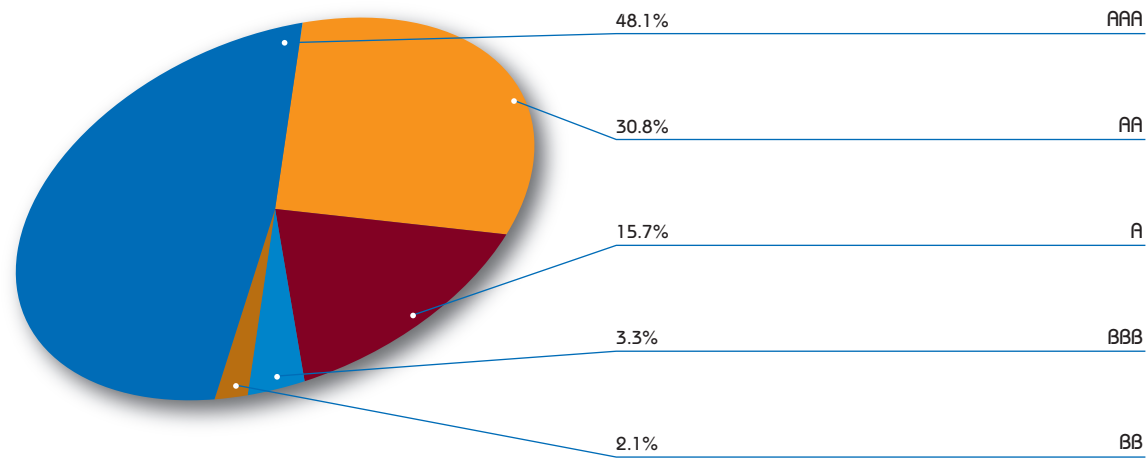
	SOFRAZ	Clariden	Deutsche AsM	World Bank	TOTAL:	%
<b>SECURITIES:</b>	<b>1 869.8</b>	<b>41.1</b>	<b>81.9</b>	<b>106.0</b>	<b>2 098.8</b>	<b>86.1%</b>
Sovereign debt securities	117.7	28.3	56.2	69.6	271.8	11.2%
Bonds of agencies and international institutions	603.5	6.4	—	36.4	646.3	26.5%
Bank and financial bonds	913.9	1.5	19.2	—	934.5	38.3%
Corporate securities	234.7	—	6.5	—	241.2	9.9%
Mortgage	—	4.9	—	—	4.9	0.2%
<b>EQUITIES</b>	<b>—</b>	<b>2.5</b>	<b>—</b>	<b>—</b>	<b>2.5</b>	<b>0.1%</b>
<b>CASH:</b>	<b>327.1</b>	<b>6.2</b>	<b>1.3</b>	<b>1.0</b>	<b>335.5</b>	<b>13.8%</b>
Deposits and money market funds	279.7	6.2	—	1.0	286.9	11.8%
Bank accounts	47.4	—	1.3	—	48.6	2.0%
<b>TOTAL:</b>	<b>2 196.9</b>	<b>49.8</b>	<b>83.1</b>	<b>107.0</b>	<b>2 436.8</b>	<b>100.0%</b>

**Chart 17**  
Structure of SOFAZ assets



During the reported year both the financial institutions as well as the securities invested in by the State Oil Fund, as well as external managers, were rated not below the investment grade by the world's leading credit rating agencies (S&P, Moody's, Fitch). This is clearly indicated by *Chart 18* below.

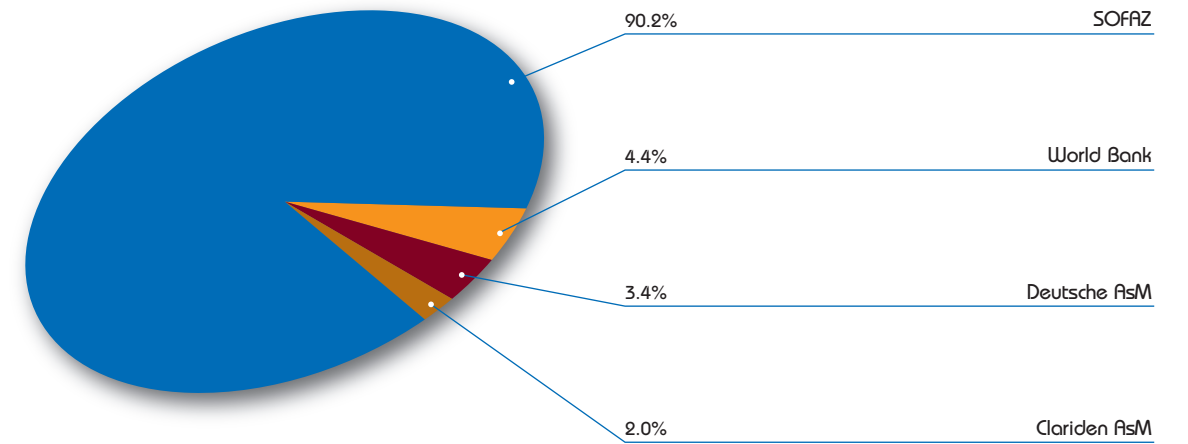
**Chart 18**  
Credit rating of the financial institutions and securities invested in by the State Oil Fund



In 2007 a portion of the Fund's assets was allocated to external managers - Clariden (Switzerland), a member of Credit Swiss Group, and Deutsche Asset Management GmbH (Germany), a member of Deutsche Bank Group, and the World Bank. As of December 31, 2007 total assets under external management were approximately USD240.0 million or 9.8% of the Fund's total assets.

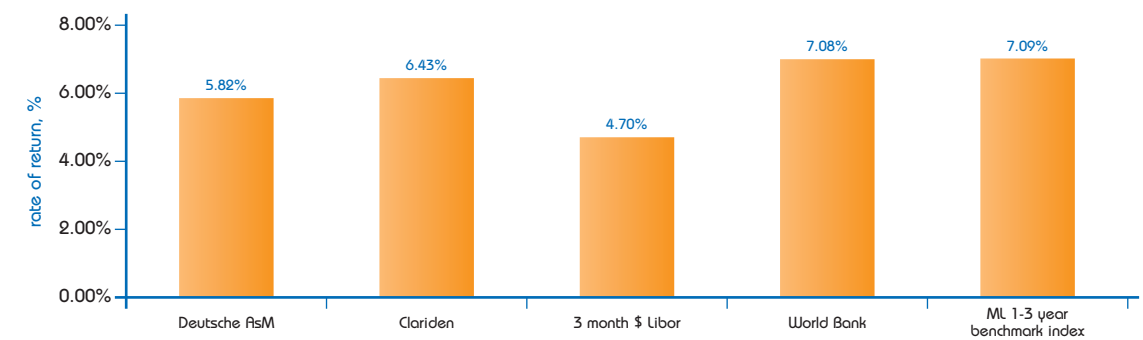
*Chart 19* below presents the weight of assets managed by external managers as total assets of SOFAZ.

**Chart 19**  
Percentage of assets managed by external managers within SOFAZ's total assets



Clariden's actual annual rate of return was 6.43%, Deutsche AsM's - 5.82%, and the World Bank's - 7.08% in 2007. Dynamics of return of the external managers in management of assets can be compared from *Chart 20* below.

**Chart 20**  
Actual rates of return provided by external managers in 2007



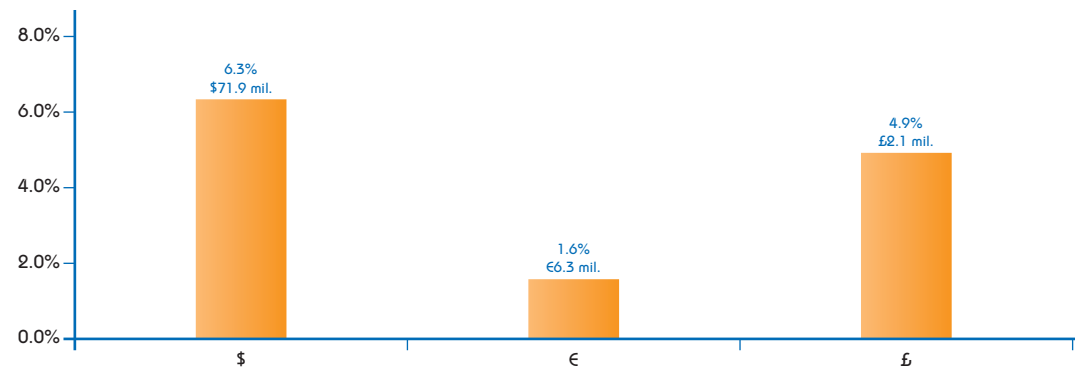
As per the requirements with respect to the currency basket as specified by the Investment Policy (Investment objectives) of the State Oil Fund for 2007 as approved by Resolution No.1878 of the President of the Republic of Azerbaijan dated December 28, 2006, 55% of the total amount of the investment portfolio of the Fund was to be invested in assets denominated in US Dollars, 35% in assets denominated in Euro, 5% in assets denominated in GBP, whereas 5% of the total amount of the investment portfolio of the Fund was to be invested in assets denominated either in currencies of countries with the

long-term country ratings (sovereign debt) not less than the credit ratings A (Standard&Poor's, Fitch) or A2 (Moody's), in US Dollars or in US Dollars, Euro and GBP based on the their percentage in the weight. As of December 31, 2007 61.7% of the Fund's investment portfolio (less the expenditures portfolio) were denominated in US Dollars, 34.0% in Euro and 4.3% in British Pounds.

Different yields were gained on each portfolio. Thus, the annual rate of return on the USD portfolio amounted to 6.3% (USD71.9 million), on the Euro portfolio 1.6% (6.3 million Euro), and on the British Pound portfolio 4.9% (2.1 million Pounds). *Chart 21* below allows for a comparative analysis of rates of return.

**Chart 21**

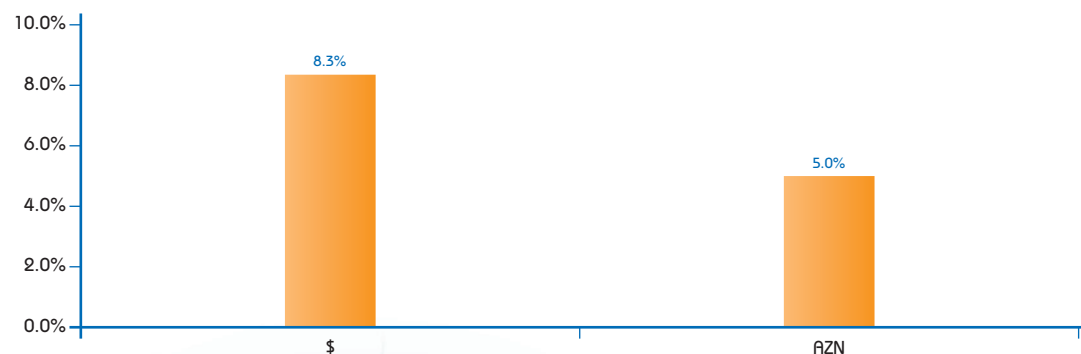
Rate of return on the State Oil Fund's currency portfolio in 2007



The average annualized return of the Oil Fund's assets denominated in base currency (US Dollar) in 2007 was 8.3%. The average annual rate of return on the Fund's assets denominated in the reporting currency (Azerbaijani Manat) made 5.0%.

**Chart 22**

Rates of return/Yield indicators on the State Oil Fund's total assets in 2007 (Azeri Manat and US Dollar)



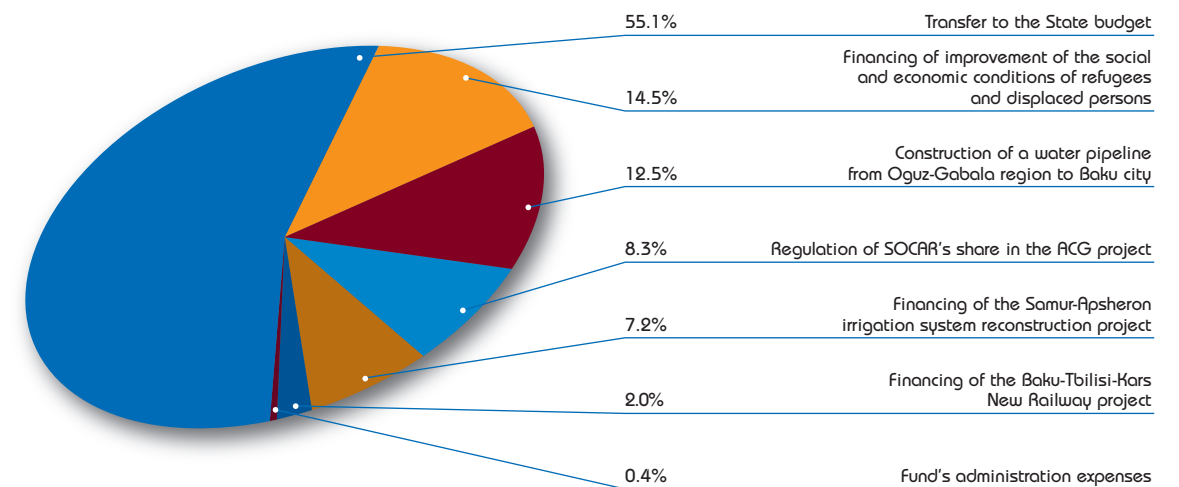
**EXPENDITURES**

Pursuant to the Fund's 2007 budget approved by the Presidential Decree No.505 of December 28, 2007, the State Oil Fund continued to finance the project of improvement of social and economic conditions and settlement of refugees and internally displaced persons; "Construction of a water pipeline from Oguz-Gabala region to Baku city"; "Reconstruction of the Samur Apsheron irrigation system"; and the "Baku-Tbilisi-Kars new railway" in 2007; in this connection, the Fund's resources were used during the reported year to address some issues related to the State Oil Company's share in the joint development of the deep underground reserves of Azeri, Chirag fields and Guneshly field, in accordance with the Presidential Resolution No.2178 of May 16, 2007. At the same time, a major part of the Fund's resources was transferred to the state budget.

*Chart 23* below presents the structure of the Oil Fund's budget expenditures in 2007.

**Chart 23**

Structure of the State Oil Fund's budget expenditures in 2007 (%)



Financing of the improvement of the social and economic conditions of refugees and internally displaced persons

In 2007, financing of the improvement of the social and economic conditions and settlement of refugees and internally displaced persons represented a significant expenditure item on the State Oil Fund's budget.

AZN154 116.6 thousand was allocated along the lines of execution of the State Oil Fund's 2007 budget, as well as support under Presidential Decree No.562, dated 22.08.01 on "Addressing problems of settling Azerbaijanis displaced from their historic lands on the territory of Armenia as a result of the ethnic cleansing by the Armenian nationalists", Presidential Decree No.577 of 07.09.01 "On measures to settle a portion of internally displaced persons from the regions of Agdam and Fizuli, forced out as a result of the occupation of Azerbaijan's lands by the Armenian armed forces and temporarily residing in

tent camps, in the mentioned regions”, and the Presidential Decree No.700 of 13.05.02 “On measures aimed at improving the social and living conditions of internally displaced persons settled in five tent camps in Bilesuvar district”, Directive No.80 of February 4, 2004 “On actions to improve the social, housing and economic conditions and employment of internally displaced persons from Agdam and other regions forced from their native lands as a result of occupation by the Armenian armed forces, and temporarily residing in tented camps in Barda and Agjabedi regions, as well as in cargo railway cars on railways in Barda region” and “The State Program for improvement of housing conditions and employment of refugees and internally displaced persons” approved by Presidential Decree No.298 of July 1, 2004, as well as to finance construction of 100 private houses for internally displaced persons families in Nakhchivan Autonomous Republic as per the Presidential Decree No.132 of October 1, 2004.

The State Oil Fund has allocated a total of AZN378.0 million to finance the above described activities and measures during the period from 2001 to 2007.

Financing of the above mentioned projects by the State Oil Fund was realized based on properly substantiated requests from the implementing agencies. Based on these requests, the resources of the Fund were transferred to the state treasury accounts of the above mentioned agencies and had been paid to contractors by the implementing agencies. The implementing agencies are responsible for overall supervision of project implementation, carrying out bidding processes and other relevant proceedings, and coordination of works through site offices.

The Social Development Fund for Internally Displaced Persons (SDFIDP) is the executing agency for the projects addressing the social and economic and settlement issues of internally displaced persons. In 2007, the SDFIDP implemented projects designed to settle IDP families currently residing in Barda, Agjabedi, Saatly, Sabirabad and Imishly to Fizuli, Bilesuvar, Agdam, Agjabedi and Sabirabad and alleviate their social and economic problems. In this regard, new settlements were built in Ramani and Pirshagi districts.

The Agency for Rehabilitation and Reconstruction of Liberated Areas, acting as the executing agency for projects designed to mitigate the social and economic and settlement issues of refugees and internally displaced persons completed its activities of constructing infrastructure facilities and settling refugees it had started in the previous years, as part of the framework arrangement to re-settle Azerbaijanis displaced from Armenia.

In 2007 tent camps where internally displaced persons resided were closed, which can be treated as a major accomplishment of the year 2007.



View of the Qayidish settlement in Fuzuli district

Table 6

Activities under the projects of improvement of the social and economic conditions of refugees and internally displaced persons in 2001-2007

	Unit of measure	Total
Number of settlements	unit	54
Houses	unit	15 110
Residential floor space	thousand m <sup>2</sup>	842.5
Schools	unit/place	46/9386
Music schools	unit	4
Kindergartens	unit/place	34/1276
Hospitals	unit/place	4/110
Medical facilities	unit	37
Clubs - community centers	unit/place	30/4140
Communication facility	unit	30
Baths	unit/place	31/352
Administrative buildings	unit	37
Veterinary offices	unit	6
Fire department	unit/place	7/17
Roads	km	456.55
Water supply lines	km	526.28
Artesian wells	unit	157
Overhead power supply lines	km	815.3
Gas supply lines	km	56.6
Sewerage network	km	26.1
Drainage network	km	139.2
Irrigation systems	ha	10 125.0
Water reservoirs	unit	111
Pump stations	unit	26
Pressure water tower, 50 m <sup>3</sup>	unit	47
Complete transformer substations	set	438
High voltage transformers	unit	22
Upgrade of 330/110/10 Agjabedi substation	unit	1
Replacement of the 125MVA transformer with a 250MVA transformer at 330/220/110/10 KV Imishly substation	unit	1
110/35/10 KV substation (Yeni Bilesuvar, Tazakand)	unit	2
Upgrade of the 110/35/10 KV Hindiristan substation	unit	1
35/10 KV transformer substations	unit	7
Mine clearing works	ha	2 650.0

#### Transfers to the state budget of Azerbaijan Republic in 2007

In 2007, AZN585 000.0 thousand were transferred to the state budget in line with the execution of the State Oil Fund's 2007 budget approved by Presidential Decree No.505 of December 28, 2006. These expenses constituted 55.1% of the Fund's total budgetary expenditures. The amounts were transferred to the Finance Ministry's account at the Central Treasury. The Oil Fund's transfers to the state budget during 2003-2007 totaled AZN1 550 000.0 thousand. AZN100 000.0 thousand was transferred in 2003, AZN130 000.0 thousand in 2004, AZN150 000.0 thousand in 2005, AZN585 000.0 thousand in 2006 and AZN585 000.0 thousand in 2007.

Financing of the project of constructing a water pipeline from Oguz-Gabala region to Baku city

During the reported year the State Oil Fund allocated **AZN132 906.5** thousand to finance the project of "Construction of a water pipeline from Oguz-Gabala region to Baku city". These expenses amounted to 12.5% of the Fund's total budgeted expenditures.

Resolution No.42s of February 24, 2006 by the Cabinet of Ministers of the Republic of Azerbaijan assigned the responsibilities of the project implementation and executing agency to Azersu Joint Stock Company. The project's feasibility study and project/design documents were developed by CES Consulting Engineers, Germany.

Azersu Joint Stock Company invited bids to procure glass fiber pipes and awarded an AZN229 379.6 thousand value contract to "Azkompozit", a domestic pipe manufacturing company, to purchase 265 km of glass fiber pipes and piping materials. As per the applicable laws, Azersu Joint Stock Company also invited bids from potential suppliers for the design and construction of the water pipeline and awarded this contract to a Turkish company "Hazinadaroglu".

The project is designed to use an underground water source in Oguz-Gabala region to supply water to Baku by gravity feed at the flow rate of 5 cubic meters per second and thus provide the residents with high quality water. To this end, a water intake will be built that will draw water from approximately 100 wells (150 m deep, 350 mm diameter). Pressure of water to be trafficked to Baku will reach up to 19 cubic meters per second and will be sufficient to provide 24 hour supply of water to the city. Pressure control facilities will be built along the pipeline alignment in Shamakhi and Absheron districts.

50.96 km of the water pipeline out of the total of 250 km planned under the project were laid in 2007; preparations were completed for well drilling and construction works and the manufacturer commenced supplying the glass fiber polyester pipes.

State Oil Fund has allocated AZN215.6 million to finance this project during 2006-2007.



Construction works of Oguz-Qebele water pipeline

Financing of the Samur Absheron irrigation system reconstruction project

In 2007, the State Oil Fund allocated **AZN76 900.0** thousand to finance the Samur Absheron irrigation system reconstruction project. This expense item constituted 7.2% of the Oil Fund's total budgeted expenditures for 2007.

Resolution No.42s of February 24, 2006 by the Cabinet of Ministers of the Republic of Azerbaijan assigned the responsibilities of the project implementation and executing agency to "Azerbaijan Irrigation Systems and Water Industry" Joint Stock Company. The "Long-Term Strategy and Feasibility Study for the Samur-Absheron Canal System" were developed by "Nippon Koei", Japan and a local company "Sulako" in 2004.

The contractor and subcontractors for implementation of the project were selected by the executing agency through a competitive procurement procedure in accordance with the Law of the Republic of Azerbaijan "On public procurements". Thus, through the bidding process for the "Joint Construction of the Takhtakorpu Water Reservoir and Water Power Plant" component a Consortium of winning bidders was set up, which comprises "Azerkorpu" (lead contractor), "Azerenerjitektinqurashdirma", "Azersutikinti" Joint Stock Companies and "Temelsu" (Turkey). The contract cost of this component, inclusive of VAT, was put at AZN365.951 million. The estimated duration of the project is 4 years.

Through an open bidding procedure for preparing the bidding documents for the cost estimate/budget and construction of the "Takhtakorpu - Jeyranbatan Canal Construction" component the contract was awarded to "Tekhnomost" - "Irrigator" association. The VAT-inclusive contract cost of these activities, which are to be completed in 2007, was put at AZN1.7 million.

A portion of the project funds will be deployed for draining the water reservoir area, constructing a new settlement where refugees settled in this area will be relocated to, and relocating the existing roads, main oil and gas pipelines located in the floodable/submersible area, as part of preparations for the "Takhtakorpu Water Reservoir Construction" component. Another part of the project funds will be used for developing



Dam building works in Takhtakorpu Water Reservoir

the production design/project of the "Takhtakorpu Water Reservoir Construction" component and building the dam as well as for implementing the design and survey works, preparatory and construction works for the "Takhtakorpu-Jeyranbatan Canal Construction" component.

In 2007, relocation of the existing oil and gas pipelines running through the water reservoir area and construction of motor access roads were completed; a new settlement was built for internally displaced persons who resided temporarily in this area and the IDP's were relocated.

State Oil Fund allocated a total of AZN113.9 million to finance this project during 2006-2007.

#### Financing of the Baku-Tbilisi-Kars new railway

Pursuant to the Presidential Resolution No.1974 of February 21, 2007, the State Oil Fund allocated AZN20 712.5 thousand to finance the Baku-Tbilisi-Kars new railway construction project. These expenses amounted to 2.0% of the Fund's total budgeted expenditures.

The project is designed to build a 105 km long Kars-Akhalkalaki railway line, 76 km of which pass through Turkey and 29 km through Georgia, and to rehabilitate and reconstruct the 160 km long Akhalkalaki-Marabda railway in Georgia. The project contemplates construction of a wheel pair/wheelset replacement facility in an area between the Marabda station in Georgia and the state border with Turkey.

This connection is expected to provide for cargo transit of 3 million tons in the 3rd year of operation, 6-8 million tons in the 5th year of operation and 10 million tons and more in the 8th year of operation. The connection is to be used for transporting primarily ferrous and non-ferrous metals, coal, cotton, crops, sulphur, petroleum and petroleum products, equipment, food products and other loads. "Yuksel Domanic", a Turkish company, conducted the marketing activities and the feasibility study for the project. "Azerinshaatservis" LLC was appointed as the contractor for building the Akhalkalaki-Kartsakhi section of the railway.

Implementation of the international project of building the Baku-Tbilisi-Kars railway line and construction of a railway tunnel in the Bosphorus strait, in addition to connecting the Trans-European and Trans-Asian railway networks, and ensuring the capabilities necessary for delivering cargo and passenger traffic to Europe and Asia by going directly through Azerbaijan, Georgia and Turkey, would also serve the purpose of enhancing the transit potential of the region's countries, accelerating the process of integrating into Europe, further promoting cooperation under the European Neighborhood Policy, strengthening Azerbaijan's independence and sovereignty and expanding our country's foreign economic contacts and relations.

#### Regulation of SOCAR's participation in the ACG project

The Oil Fund transferred AZN87 559.0 thousand or USD102 312.4 thousand to the State Oil Company as another expenditure item on the Fund's 2007 budget. Thus, USD102 312.4 thousand represented the State Oil Company's share of revenues from sales of profit oil under the production sharing agreements during 1999-2002 that was transferred to the State Oil Fund. These funds were returned to the State Oil Company during the report-

ed year as required by the Presidential Resolution No.2178 of May 16, 2007 "On addressing certain issues relating to the share of the State Oil Company of Azerbaijan Republic in the project of joint development of Azeri-Chirag fields and Guneshly field".

These expenses accounted for 8.3% of the Oil Fund's total budgeted expenditure in 2007.

#### State Oil Fund's administration expenses

Pursuant to the State Oil Fund's Regulations, the Oil Fund's budget for operating costs is subject to presentation by the Fund's Executive Director to the President of the Republic of Azerbaijan for approval. The Oil Fund's 2007 operating expenditures were approved by Presidential Decree No.1878 of December 28, 2006.

In 2007, the Oil Fund's administration and operating costs amounted to **AZN4 008.9** thousand, which constituted 0.4% of the Fund's total budgeted expenditures.

#### State Oil Fund's 2007 budget execution

The State Oil Fund's 2007 annual budget was approved by Presidential Decree No.505 of December 28, 2006. Amendments and additions to the State Oil Fund's 2007 budget were approved by Presidential Decrees No.601 of June 28, 2007 and No.686 of December 26, 2007.

Thus, in order to finance the "Baku-Tbilisi-Kars new Railway" project from the State Oil Fund's resources as per the Presidential Decree No.1974 of February 21, 2007, and for the purposes of addressing some issues relating to the State Oil Company's share in the project of joint development of the deep underground part of Azeri-Chirag fields and Guneshly field as per the Presidential Decree No.2178 of May 16, 2007, additional expenditure items were incorporated in the State Oil Fund's 2007 budget in the amount of AZN50 000.0 thousand to provide financing of the "Baku-Tbilisi-Kars new Railway" project, and AZN88 500.0 thousand to address some issues relating to the State Oil Company's share in the project of joint development of the deep underground part of Azeri-Chirag fields and Guneshly field, whereby the Fund's total budgeted expenditures rose from AZN977 066.9 thousand to AZN1 115 566.9 thousand.

As per the amendments introduced by Presidential Decree No.686 of December 26, 2007, for the purpose of accelerating the process of building new residential settlements for internally displaced persons and fully liquidating their tent camps of temporary residence, the Fund's 2007 expenditure item for financing activities and measures designed to alleviate the social and economic and settlement issues of internally displaced persons and refugees was increased from AZN124 161.0 thousand to AZN154 161.0 thousand, while the expenses allotted for the financing of the Baku-Tbilisi-Kars new railway project were decreased from AZN50 000.0 thousand to AZN30 000.0 thousand and the expenses for implementing the project of laying a water pipeline from Oguz-Gabala district to Baku were decreased from AZN183 620.0 thousand to AZN173 620.0 thousand.

**Revenues.** The Oil Fund's actual revenues in 2007 exceeded the budgeted amount (AZN 1555 739.6 thousand) by 21.2% and totaled **AZN1 886 164.8** thousand. The breakdown of the revenues by source is presented in *Table 8*.

In 2007, the State Oil Fund received **AZN1 675 019.1** thousand or **USD1 954.6** million from sales of the Republic of Azerbaijan's share of hydrocarbon resources. These revenues exceeded the budgeted amount (AZN1 429 724.2 thousand) by **17.2%**. The 17.2% excess revenues from sales of profit oil and gas versus projections are mostly attributable to substantially higher actual oil prices compared with the budgeted price. Thus, the Fund's budget projected oil price was USD50 per barrel of crude oil in 2007, while, in reality, the average weighted net price was approximately USD64 per barrel of the Oil Fund's share of oil (less transportation and marketing costs), which, in turn, caused the excess in the revenues.

**Acreege fees paid by foreign investors for using contract areas for development of hydrocarbon resources** totaled **AZN5 594.7** thousand or approximately **USD6.6** million, which indicates that the Fund's budgeted revenues under this particular income item (AZN5 561.6 thousand) were executed in the scope of 100.6%.

**Revenues from transportation of oil and gas through the territory of Azerbaijan Republic (transit fee)** were budgeted at **AZN14 620.0** thousand for 2007. Since the Baku-Supsa oil export pipeline was not restored and put back in operation and, consequently, was not used for trafficking crude oil during the year, no transit fees were paid to the Fund.

Revenues **from bonuses paid by investors to the State Oil Company of Azerbaijan Republic or other relevant authorities** in 2007 amounted to **AZN58 068.0** thousand or **USD68** million. The Fund's budgeted amounts for bonus payment revenues (AZN17 200.0 thousand) were exceeded by 237.6%. Due to delays in production and commercial activities in the Shakhdeniz field caused by technical deficiencies in the wells, the Fund received a bonus of USD45 million in 2007 that was supposed to have been paid in 2006, which constituted an additional source of income under the bonus payment revenue item of the Fund's budget for the reporting year. The remaining part of the bonus payments in the reporting year was paid by Middle East Petroleum Garachuhur for Garachuhur field (USD1.0 million), Lukoil Overseas for D-222 (USD20 million), and Russneft Absheron Investments Limited for Zig and Hovsan fields (USD2.0 million).

Pursuant to the Law "On 2007 State Budget" as well as the Memorandum of Agreement signed in the reporting year between the Ministry of Finance, Ministry of Economic Development, State Oil Fund and State Oil Company, payments made to the Oil Fund due to the **differences between the contract price and domestic wholesale price of crude oil** whenever the actual contract price of crude oil produced in and exported from the Republic of Azerbaijan is higher than the budgeted price, constituted yet another source of the Fund's revenues. The Fund's revenues from this source amounted to **AZN59 961.0** thousand or **USD70.3** million during the reported year. USD14.4 million (USD16.5 million) is the portion of the price differences assessed for 2006. Due to carry over of this amount in early 2007 on one hand, and, on the other hand, because crude oil export prices remained high during the year, this particular revenue item of the Fund's budget exceeded the budgeted amount (AZN33 366.4 thousand) by 79.7%.

**The State Oil Fund's revenues from asset management in 2007** exceeded the budgeted amount (AZN55 067.4 thousand) by 31.3% and totaled **AZN72 285.3** thousand. Outturns of the State Oil Fund's budgeted revenues are presented in *Table 7* below.

*Table 7*

Execution of State Oil Fund's 2007 budgeted revenues  
AZN thousand

№	Revenue items	Revenue amounts		Execution percentage
		Budgeted	Actual	
1.	Net flows from sales of Azerbaijan's share of hydrocarbon resources (less hydrocarbon transportation costs, banking, customs clearance, independent supervision (surveyor), marketing and insurance costs, as well as revenues of the State Oil Company as investor, shareholder or counterpart in relevant projects it participates in)	1 429 724.2	1 675 019.1	117.2
2.	Acreege fees paid by investors for the use of contract areas in connection with development of hydrocarbon resources	5 561.6	5 594.7	100.6
3.	Revenues from transportation of oil and gas through the territory of Azerbaijan Republic	14 620.0	0.0	0.0
4.	Bonuses paid by investors to the State Oil Company of Azerbaijan Republic or relevant authorities in connection with signing or execution of oil and gas contracts	17 200.0	58 068.0	337.6
5.	Payments to the State Oil Fund for the difference between the contract price and the domestic wholesale price of crude oil produced in and exported from Azerbaijan Republic	33 366.4	59 961.0	179.7
6.	Revenues from investment and management of the Fund's assets	55 067.4	72 285.3	131.3
7.	Other revenues and receipts	200.0	1 288.9	644.5
8.	Revenues from revaluation of the Fund's assets		13 947.8	
	<b>Total revenues</b>	<b>1 555 739.6</b>	<b>1 886 164.8</b>	<b>121.2</b>

During the reported year the State Oil Fund organized sales of assets (aged or unused pipes, metal scrap) delivered by investors (foreign oil companies) under the oil and gas contracts and gained **AZN1 288.9** thousand of proceeds from sales of such assets (sales proceeds were budgeted at AZN200 thousand).

**Expenditures.** During the reported year the Oil Fund's total expenditures amounted to **AZN1 061 203.5** thousand, which means 95.1% execution of the budgeted level (AZN1 115 566.9 thousand).

In 2007, pursuant to the relevant Presidential Decrees, a total of **AZN154 116.6** thousand was allocated for the **financing of measures and activities designed to address the social and economic and settlement conditions of refugees and internally displaced persons**. This expenditure item was executed to the extent of 100.0% against the budgeted amount (**AZN154 161.0** thousand).

**The expenditures associated with the transfers to the state budget of Azerbaijan Republic in 2007** were executed in full - 100% - against the budgeted amount (AZN585 000.0 thousand).

The expense item for the financing of constructing a water pipeline from Oguz-Gabala region to Baku was executed in the scope of AZN132 906.5 thousand or 76.6% against the budgeted amount (AZN173 620.0 thousand).

The Fund's budgeted expenses for financing the project of reconstruction of the Samur-Absheron irrigation system (AZN76 900 thousand) were executed in full - 100.0%.

The budgeted expenses for financing the Baku-Tbilisi-Kars new railway project (AZN30 000.0 thousand) were executed at AZN20 712.5 thousand or 69.0%.

The Fund's budgeted expenses for addressing some issues relating to the State Oil Company's share in the project of joint development of the deep underground parts of Azeri-Chirag fields and Guneshly field (AZN88 500.0 thousand) were executed at AZN87 559.0 thousand or approximately 100.0%.

State Oil Fund's administration and operating expenditures were executed to the extent of AZN4 008.9 thousand or 54.3% of the budgeted amount (AZN7 385.9 thousand), yielding savings of AZN3 377.0 thousand. This amount was saved primarily because the amounts allocated to pay the fees of external managers in the Fund's cost budget were left unused during the year.

The execution percentages of the State Oil Fund's budgeted expenditures are presented in Table 8 below.

Table 8

Execution of Oil Fund's 2007 budgeted expenditures

AZN thousand

№	Expense items	Expense amounts		Execution percentage
		Budgeted	Actual	
1.	Expenses related to the financing of measures designed to address the social and economic conditions and settlement problems of refugees and internally displaced persons	154 161.0	154 116.6	100.0
2.	Transfer to the state budget of Azerbaijan Republic in 2007	585 000.0	585 000.0	100.0
3.	Constructing of a water pipeline from Oguz-Gabala region to Baku	173 620.0	132 906.5	76.6
4.	Financing of the Samur-Absheron irrigation system reconstruction project	76 900.0	76 900.0	100.0
5.	Financing of the "Baku-Tbilisi-Kars new Railway" project	30 000.0	20 712.5	69.0
6.	Regulation of some issues related to the State Oil Company's share in the joint development of the deep underground parts of Azeri-Chirag fields and Guneshly field	88 500.0	87 559.0	98.9
7.	State Oil Fund's administration and operating expenditures	7 385.9	4 008.9	54.3
	<b>Total</b>	<b>1 115 566.9</b>	<b>1 061 203.5</b>	<b>95.1</b>

4

## Oil Fund's Management System

The Supervisory Board that represents the government and general public is responsible for discharging the oversight of the Fund's operations.

In 2007 the Supervisory Board adopted a number of decisions with respect to the Oil Fund's operations. The Oil Fund's Supervisory Board meeting held on June 13, 2007 reviewed the State Oil Fund's 2006 annual performance report, audit report on the financial statements, Oil Fund's 2006 budget performance and outturn and considered proposed changes to the Fund's 2007 budget. Based on the changes made to the Fund's budget, additional expenditure items were incorporated in the State Oil Fund's 2007 budget in the amount of AZN50 000.0 thousand to provide financing of the "Baku-Tbilisi-Kars new Railway" project, and AZN88 500.0 thousand to address some issues relating to the State Oil Company's share in the project of joint development of the deep underground part of Azeri-Chirag fields and Guneshly field, whereby the Fund's total budgeted expenditures rose from AZN977 066.9 thousand to AZN1 115 566.9 thousand. The Supervisory Board found the Fund's 2006 annual performance report and the independent auditor's report (Ernst&Young) on the Fund's 2006 financial statements satisfactory and recommended submission of the State Oil Fund's 2006 budget performance/outturn report to the President of Azerbaijan Republic for approval.

The Supervisory Board meeting held on November 20, 2007 discussed the proposed draft 2008 budget for the Fund, amendments to the Oil Fund's 2007 budget as well as revisions to the Fund's Supervisory Board's regulations. Thus, the Fund's 2007 expenditure item for financing activities and measures designed to alleviate the social and economic and settlement issues of internally displaced persons and refugees was increased from AZN124 161.0 thousand to AZN154 161.0 thousand, while the expenses allotted for the financing of the Baku-Tbilisi-Kars new railway project were decreased from AZN50 000.0 thousand to AZN30 000.0 thousand and the expenses for implementing the project of laying a water pipeline from Oguz-Gabala district to Baku were decreased from AZN183 620.0 thousand to AZN173 620.0 thousand.

Prime Minister of Azerbaijan Republic Mr. A. Rasizadeh was re-appointed as the Chairman of the State Oil Fund's Supervisory Board.

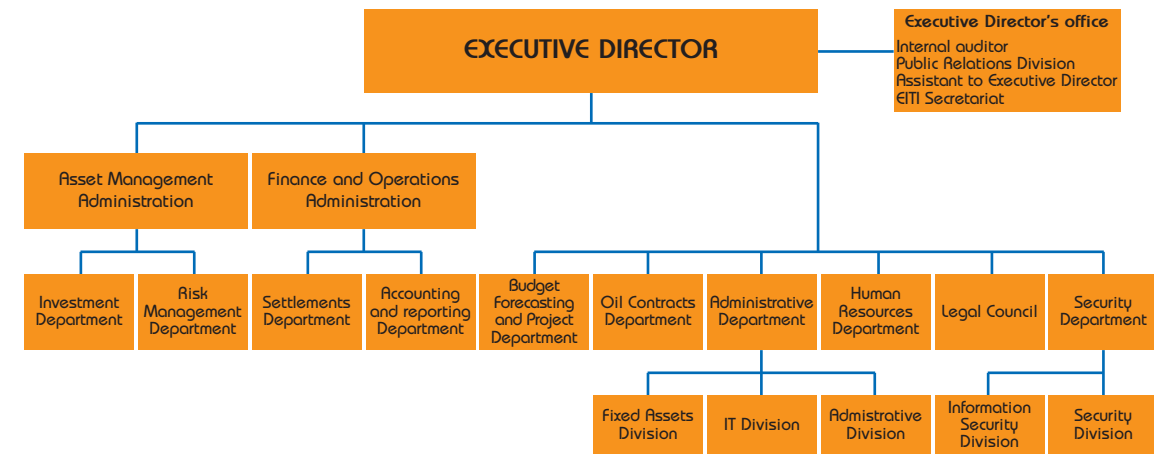
During the reporting year the Oil Fund's executive discipline was further strengthened, compliance with the internal disciplinary rules and guidelines was ensured and authority division between the business units within the Fund has been further improved.

The new organizational structure of the State Oil Fund was approved in 2007.

State Oil Fund's new organizational structure is presented in *Scheme 2* below.

*Scheme 2*

**Organizational Structure of the State Oil Fund of the Republic of Azerbaijan**



In 2007, the State Oil Fund took a number of well-devised steps towards improving the investment portfolio management system, promoting broader applications of the state-of-the-art technologies and techniques employed by international investment funds as well as enhancing the Fund's own qualifications and expertise in international finance.

Furthermore, the Oil Fund was active during the reported year in implementing the state-of-the-art information technologies and improving information security. To this end, a project was designed and implemented for Inventory, Standardization, Improvement and Monitoring of the State Oil Fund's Information Technologies and Settlement Network in 2007. The Inventory phase of the project focused on examining the hardware and software components of the State Oil Fund's computers, seeking to identify and remove any deficiencies and problems that may hinder their normal operation. The Standardization component of the project served the purpose of bringing the Fund's existing IT infrastructure into a single, common domain and setting up back-up copies of the Fund's Servers. The EventLog Analyzer Web Client application was installed on the Servers to keep track and monitor events and occurrences. Also, based on the National Bank's Information Technology Standard the Fund developed its own IT standards and the related information security policy. This information security policy framework of the Fund combines a number of different policies and procedures such as the password policy, emergency recovery policy, software policy, anti-virus/firewall policy, and Internet and e-mail policy.

## Development of the Oil Fund's human resources

In 2007 the Oil Fund implemented a number of important measures aimed at developing its human capital and staffing its office.

During the reported year, personnel of the Oil Fund's relevant business units attended a number of training seminars and courses organized by the Fund's partner investment banks as well as international financial institutions.

Selection and professional qualification of specialized staff members in order to staffing of the Oil Fund's office continued in 2007.

In 2007 various measures were taken to improve the Oil Fund's salary and motivation system. To this effect, regulatory documents were developed that define the new staff remuneration and motivation system of the Fund, and submitted to the President of Azerbaijan Republic for approval. As per the Presidential Decree No.2071 of March 30, 2007, a new classification was provided for the Fund's staff positions and a spreadsheet was endorsed, which outlines the division of responsibilities by grades. The new remuneration system divides all positions into categories and the salary entitlements of the Oil Fund's staff members will be determined in correspondence with these categories. The new remuneration system is designed to ensure proper and accurate evaluation of performance of the Fund's staff members with due consideration to the positions they hold, scope of work and degree of responsibility.

In 2007, the Oil Fund continued to take efforts aimed at improving the social welfare and conditions of its staff members such as provision of medical insurance and payment of bonuses.

## Reporting system

In 2007 the State Oil Fund put a strong emphasis on improvement of, and enhancement of transparency of the reporting mechanisms.

A significant safeguard for the transparency of the Oil Fund's operations and the reporting system is a regular audit of the Fund's financial statements by an independent auditor. The Oil Fund's 2007 financial statements were audited by Deloitte and Touche. Thus, to audit the Oil Fund's 2007, 2008 and 2009 (separately for each year) financial statements, the State Oil Fund carried out a tender in 2007 based on requests for quotations, in accordance with the applicable public procurement laws of Azerbaijan and, following the evaluation of bids submitted by reputable audit firms based on the requests for quotations they had received, the Azerbaijani office of Deloitte and Touche was selected as the winning bidder. According to the Oil Fund's Regulations and the Presidential Consent of August 17, 2007, the winning bidder was appointed to audit the Fund's financial activities in 2007, 2008 and 2009.

The Oil Fund attaches specific importance to increasing the awareness of the public about its operations. The State Oil Fund regularly advertises information regarding its operations, projects it finances and decisions by the Fund's Supervisory Board through the Fund's web-site, and makes periodic disclosures to the press and general public. The Fund's Executive Director held quarterly press conferences to report to the public the Oil Fund's operations and its EITI activities and accomplishments.

In 2007 the Fund's web-site ([www.oilfund.az](http://www.oilfund.az)) posted press-releases, in both Azerbaijani and English, about the Fund's revenues and expenditures.

A major step towards improvement of the Oil Fund's information management system was the development of the State Oil Fund's information policy in 2007, which was approved on April 20, 2007. The document titled "Information Policy of the State Oil Fund of Azerbaijan Republic" is designed to ensure that the Fund's public relations are properly coordinated and managed in an effective manner, the general public's information requirements with respect to the Fund are satisfied and the Fund's perception as a transparent governmental entity is preserved and maintained, all in accordance with the Law of Azerbaijan Republic "On acquisition of information".

The document lays out the basic principles of the policy, the Fund's principal duties and responsibilities in conformity with the objective of the information policy, and classifies information and data that the Fund is expected to share with the public under its information policy. The "Information Policy of the State Oil Fund of Azerbaijan Republic" is available on the Fund's web-site.

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## Oil Fund's International Relations

Oil Fund furthered its international relations and took efforts to ensure stronger cooperation with various financial and banking institutions in 2007.

Application, learning and sharing of best international practices and experience is specifically essential for the development and promotion of the Oil Fund's international relations. At the first conference of the USA-Azerbaijan Economic Partnership Commission held on Baku on February 7, 2007 TDA and SOFAZ signed a grant agreement for provision of USD855 075 worth of technical assistance to SOFAZ for implementation of the 2nd phase of the SOFAZ Institutional Development Project. Based on this agreement a Contract was signed with "Overture Financial Services" on February 8, 2007 that will implement this project in conjunction with SOFAZ.

Under the second phase of the project Overture Financial Services provided SOFAZ with advisory services on selecting a company to design an investment portfolio management system and a central accounting system (General Ledger). To this end, a competitive procurement procedure (tender) was carried out to select appropriately qualified and suitable companies fit to fulfill the task. The company evaluated the bids of the potential candidates, including the cost effectiveness factor of the proposed software and the possibility of integrating the General Ledger system into the local accounting system, and provided advice on selecting the appropriate candidates.

Thomson Financial Limited was the winning bidder in two tenders carried out by SOFAZ under the project in 2007 in order to procure software products for the SOFAZ's portfolio management system and general ledger system (central accounting/record-keeping system). The winning bidder was awarded the contract and signed an agreement with SOFAZ on June 22, 2007.

Next year SOFAZ is planning to proceed with the 3rd phase of the institutional development project. This phase will include selection of external managers and establishment of supervision procedures with respect to external managers, improvement of the risk monitoring and management system and delivery of relevant training seminars and courses for SOFAZ personnel.

The Oil Fund continued to cooperate with international financial institutions in 2007; International Monetary Fund and World Bank representatives visited the Oil Fund regularly and met with the Fund's expert counterparts. Discussion topics included the State Oil Fund's role and position in the country's macroeconomic regulation policy, development of the public finance system, applications of international practices and modern economic regulation mechanisms and tools as well as the Fund's investment policy. Since the State Oil Fund's accomplishments in the Extractive Industries Transparency Initiative have always been a matter of interest of internationally renowned non-governmental organizations, measures were taken to build relations with such organizations, meetings were regularly held with a number of internationally reputable non-governmental organizations to share views and opinions concerning issues of their interest.

The Oil Fund continually studies international experiences in assessment of oil revenue impacts on macroeconomic dynamics and assigns a high degree of significance to application of the latest economic mechanisms and tools in this particular field of expertise. Under a memorandum signed between BP and SOFAZ, application of the SOFAZ-Oxford macroeconomic model was continued in 2007. Thus, actual and forecast indicators of relevant government bodies (Ministry of Economic Development, Ministry of Finance, and

National Bank) were collected in the reporting year for the macroeconomic model developed by the Oxford Economic Forecasting (OEF) group, updating its database, and an expert was engaged who will operate and upgrade/update the model.

On September 6, 2007 OEF delivered a presentation titled "Evaluation of oil revenue impact on the economy" grounded in that model, for the senior management and authorized representatives of the major economic bodies of Azerbaijan Republic, including the Ministry of Economic Development, Ministry of Finance, National Bank.

Six training/education seminars were delivered during the year in the training laboratory of the Azerbaijan State Economic University for the working group that would be responsible for applying the SOFAZ-Oxford macroeconomic model, with the technical experts of the relevant state bodies also present.

The working group went on study tours to London and Oxford, Great Britain, on December 10-15, 2007 to be exposed to the best international practices of macroeconomic forecasting and budgeting. During the tours the working group members were treated to discussions and presentations at the Oxford Energy Research Center, Treasury of Great Britain, Department of Revenues and Taxes, Ministry of Energy.

#### Accomplishments in implementation of the Extractive Industries Transparency Initiative

Special attention has always been given to ensuring and promoting transparency in the Oil Fund's operations. The results achieved under the Extractive Industries Transparency Initiative (EITI) at the initiative of the President of Azerbaijan Republic Ilham Aliyev already set examples for other countries to follow. Reports by the EITI Commission established by the Cabinet of Minister's Resolution on the government's total extractive industries revenues and an international auditor's opinion on these reports is regularly disclosed to public and Azerbaijan has become the leader in this particular activity. The Commission has already disclosed 7 reports and auditor's opinions on these reports.

Absheron Investments Ltd., a company that opened for business in Azerbaijan quite recently signed the accession protocol to join the Memorandum of Understanding concerning Azerbaijan's implementation of the Extractive Industries Transparency Initiative (EITI) on February 6, 2008. By signing the "Accession Protocol" Absheron Investments Ltd., will join the other companies that have acceded to the Memorandum in disclosing its payments to the government of Azerbaijan Republic in the next, eighth reporting period (annual for 2007). Thus, there are now 27 companies that have become signatories to the Memorandum of EITI application in Azerbaijan, with all mining industry companies involved in the EITI implementation process.

The Memorandum has been signed by 21 foreign and local extractive industry (oil and gas) companies that joined the process of implementing EITI in Azerbaijan on November

24, 2004, including the State Oil Company of Azerbaijan Republic, BP Azerbaijan, Exxon, Statoil, Total, Lukoil, Chevron, Shell, and Devon Energy. Thereafter the Memorandum was signed by four more companies: Inpex Azerbaijan, Binagadi Oil, RAFI Oil and NICO.

In 2007, the EITI Commission presented two reports (sixth and seventh reports) on the total revenues generated by the mining industry. Thus, on August 24, 2007 the EITI Commission disclosed the sixth report of the Government of Azerbaijan Republic (2006 annual report, January through December) and the associated audit report.

On December 18, 2007 the EITI Commission disclosed the seventh report (semi-annual for the first 6 months of 2007). These reports include also audit reports developed based on the reviews and analyses of the individual reports submitted by the production (oil and gas) industry operators. .

As a major accomplishment in terms of implementing the Transparency Initiative in Azerbaijan, special mention should be given to the Oil Fund winning the 2007 UN Public Service Award for Improvement of Transparency, Accountability and Responsibility in Public Service. Thus, at the 7th Global Forum for "Restoring confidence in government" held in the UN Headquarters in Vienna on June 26-29, 2007, the Oil Fund was awarded the UN Public Service Award for Improvement of Transparency, Accountability and Responsibility in Public Service. The award was presented to the State Oil Fund's Executive Director by the UN Deputy Secretary General Asha-Roze Migiro.

The State Oil Fund is the first entity to have received the UN Public Service Award for Improvement of Transparency, Accountability and Responsibility in Public Service among the Eastern European and CIS countries.

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## Audit Report on the State Oil Fund's 2007 Financial Statements

## Independent Auditors' Report

To the State Oil Fund of the Republic of Azerbaijan:

**Report on the Financial Statements**

We have audited the accompanying financial statements of the State Oil Fund of the Republic of Azerbaijan (the "Fund"), which comprise the statement of financial position as at 31 December 2007, and the statement of financial performance, statements of changes in net assets and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

The financial statements of the State Oil Fund of the Republic of Azerbaijan as at 31 December 2006 were audited by another auditor, whose report dated 7 March 2007, expressed an unqualified opinion.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Public Sector Accounting Standards ("IPSAS") issued by the Public Sector Committee of the International Federation of Accountants. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

**Auditors' Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements present fairly, in all material respects the financial position of the State Oil Fund of the Republic of Azerbaijan as at 31 December 2007, and its financial performance and cash flows for the year then ended in accordance with International Public Sector Accounting Standards.

7 April 2008  
Baku

## Financial Statements for the year ended 31 December 2007

**STATEMENT OF FINANCIAL POSITION**

(Amounts are presented in thousands of Azerbaijani Manats, unless otherwise indicated)

	<i>Notes</i>	<b>31 December 2007</b>	<b>31 December 2006</b>
<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash and cash equivalents	<b>3</b>	<b>316,210</b>	69,930
Securities at fair value through profit or loss	<b>4</b>	<b>1,776,219</b>	1,198,026
Contributions receivable		<b>761</b>	14,365
Advance payments and other current assets		<b>989</b>	311
<b>TOTAL CURRENT ASSETS</b>		<b>2,094,179</b>	1,282,632
<b>NONCURRENT ASSETS</b>			
Property and equipment, net	<b>5</b>	<b>5,706</b>	1,948
Intangible assets, net		<b>89</b>	66
Other assets		<b>138</b>	134
<b>TOTAL NONCURRENT ASSETS</b>		<b>5,933</b>	2,148
<b>TOTAL ASSETS</b>		<b>2,100,112</b>	1,284,780
<b>CURRENT LIABILITIES</b>			
Payables to the State Budget		<b>12,608</b>	–
Other current liabilities		<b>27</b>	511
<b>TOTAL CURRENT LIABILITIES</b>		<b>12,635</b>	511
<b>NET ASSETS</b>		<b>2,087,477</b>	1,284,269
<b>NET ASSETS / EQUITY</b>			
Contributed capital		<b>1,948,628</b>	1,219,687
Revaluation reserve		<b>5,314</b>	1,488
Accumulated surplus		<b>133,535</b>	63,094
<b>TOTAL NET ASSETS / EQUITY</b>		<b>2,087,477</b>	1,284,269

The notes on pages 56-71 form an integral part of these financial statements.  
The Independent Auditors' Report is on pages 50

**STATEMENT OF FINANCIAL PERFORMANCE***(Amounts are presented in thousands of Azerbaijani Manats, unless otherwise indicated)*

	Notes	31 December 2007	31 December 2006
Interest income	6	77 687	48 743
Net (loss)/gain on financial assets at fair value through profit or loss	7	(5 402)	7 210
Net gain/(loss) on foreign exchange operations	8	13 948	(17 497)
<b>TOTAL OPERATING INCOME</b>		<b>86 233</b>	38 456
<b>Operating expenses</b>	9	<b>(2 663)</b>	(1 612)
<b>SURPLUS BEFORE INCOME TAX</b>		<b>83 570</b>	36 844
<b>INCOME TAXES</b>	10	<b>(13 129)</b>	–
<b>NET SURPLUS FOR THE YEAR</b>		<b>70 441</b>	36 844

The notes on pages 56-71 form an integral part of these financial statements.  
The Independent Auditors' Report is on pages 50

**STATEMENT OF CHANGES IN NET ASSETS***(Amounts are presented in thousands of Azerbaijani Manats, unless otherwise indicated)*

	Notes	Capital contributions / Transfers	Revaluation reserve	Accumulated surplus	Total
<b>Balance at 31 December 2005</b>		1,256,876	1,488	26,250	1,284,614
Contributions to Fund	11	943,001	–	–	943,001
Net surplus for the period		–	–	36,844	36,844
Transfers to the State Budget	12	(585,000)	–	–	(585,000)
Transfers to the State Refugees Committee and Internally Displaced Peoples' Social Development Fund	12	(110,032)	–	–	(110,032)
Transfers to Azerbaijan Investment Company to form the charter capital	12	(90,000)	–	–	(90,000)
Transfers for the construction of water pipeline Oguz-Gabala-Baku	12	(82,749)	–	–	(82,749)
Transfers in respect of Azerbaijan (BTC) Limited	12	(75,409)	–	–	(75,409)
Transfers for the reconstruction of the Samur-Apsheron Irrigation system	12	(37,000)	–	–	(37,000)
<b>Balance at 31 December 2006</b>		1,219,687	1,488	63,094	1,284,269
Contributions to Fund	11	1,786,136	3,826	–	1,789,962
Net surplus for the period		–	–	70,441	70,441
Transfers to the State Budget	12	(585,000)	–	–	(585,000)
Transfers to the State Refugees Committee and Internally Displaced Peoples' Social Development Fund	12	(154,117)	–	–	(154,117)
Transfers for the construction of water pipeline Oguz-Gabala-Baku	12	(132,907)	–	–	(132,907)
Settlement with regard to SOCAR participation shares in Azeri-Chirag-Guneshli project	12	(87,559)	–	–	(87,559)
Transfers for the reconstruction of the Samur-Apsheron Irrigation system	12	(76,900)	–	–	(76,900)
Transfers for the construction of new Baku-Tbilisi-Kars railway line	12	(20,712)	–	–	(20,712)
<b>Balance at 31 December 2007</b>		<b>1,948,628</b>	<b>5,314</b>	<b>133,535</b>	<b>2,087,477</b>

The notes on pages 56-71 form an integral part of these financial statements.  
The Independent Auditors' Report is on pages 50

**STATEMENT OF CASH FLOWS***(Amounts are presented in thousands of Azerbaijani Manats, unless otherwise indicated)*

	Notes	Year ended 31 December	
		2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Surplus before income tax		<b>83,570</b>	36,844
Adjustments to reconcile surplus to net cash used in operating activities:			
Interest income		<b>(77,687)</b>	(46,211)
Depreciation of property and equipment		<b>135</b>	132
Amortization of intangible assets		<b>5</b>	8
Foreign exchange loss/(profit) on cash and cash equivalents		<b>1,193</b>	(2,966)
Changes in operating assets and liabilities:			
Increase in securities at fair value through profit or loss (Increase)/decrease in advance payments and other current assets		<b>(566,405)</b>	(681,866)
(Decrease)/increase in other current liabilities		<b>(678)</b>	374
Interest received		<b>(484)</b>	193
Income tax paid		<b>65,899</b>	43,386
		<b>(521)</b>	-
<b>Net cash used in operating activities</b>		<b>(494,973)</b>	(650,106)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment		<b>(67)</b>	(66)
Purchase of intangible assets		<b>(28)</b>	(3)
Other noncurrent assets		<b>(4)</b>	(28)
<b>Net cash used in investing activities</b>		<b>(99)</b>	(97)

The notes on pages 56-71 form an integral part of these financial statements.  
The Independent Auditors' Report is on pages 50

**STATEMENT OF CASH FLOWS (Continued)***(Amounts are presented in thousands of Azerbaijani Manats, unless otherwise indicated)*

	Notes	2007	2006
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Contributed capital		<b>1,799,740</b>	929,915
Transfers to the State Budget	<b>12</b>	<b>(585,000)</b>	(585,000)
Transfers to the State Refugees Committee and Internally Displaced Peoples' Social Development Fund	<b>12</b>	<b>(154,117)</b>	(110,032)
Transfers for the construction of water pipeline Oguz-Gabala-Baku	<b>12</b>	<b>(132,907)</b>	(82,749)
Settlement with regard to SOCAR participation shares in Azeri-Chirag-Guneshli project	<b>12</b>	<b>(87,559)</b>	-
Transfers for the reconstruction of Samur-Apshehon Irrigation system	<b>12</b>	<b>(76,900)</b>	(37,000)
Transfers for the construction of new Baku-Tbilisi-Kars railway	<b>12</b>	<b>(20,712)</b>	-
Transfers to Azerbaijan Investment Company to form the charter capital		-	(90,000)
Transfers to the treasury of Azerbaijan (BTC) Limited		-	(75,409)
<b>Net cash provided by/(used in) financial activities</b>		<b>742,545</b>	(50,275)
Effect of exchange rate changes on cash and cash equivalents		<b>(1,193)</b>	2,966
Net increase in cash and cash equivalents		<b>247,473</b>	(700,478)
Cash and cash equivalents, beginning of the year		<b>69,930</b>	767,442
<b>CASH AND CASH EQUIVALENTS, END OF THE YEAR</b>		<b>316,210</b>	69,930

**Significant non-cash transaction:**

During the year ended 31 December 2007 the Fund received the plant from the government free of charge for its new office at the amount of 366 thousand AZN.

The notes on pages 56-71 form an integral part of these financial statements.  
The Independent Auditors' Report is on pages 50

## Notes to the Financial Statements

(Amounts are presented in thousands of Azerbaijani Manats, unless otherwise indicated)

### 1. FUND INFORMATION

The State Oil Fund of the Republic of Azerbaijan (the "Fund") was established by Decree #240 of the President of the Republic of Azerbaijan on the "Establishment of the State Oil Fund of the Republic of Azerbaijan" ("the Decree") dated 29 December 1999. The purpose of the Fund is to ensure the accumulation, effective management, and use of income and other inflows generated from agreements related to oil and gas exploration and development, as well as, from the Funds' own activities for the benefit of citizens of the Republic of Azerbaijan and future generations.

In accordance with Decree and the Regulations, the Fund is an extra-budget institution, formed as a separate legal entity, which is accountable and responsible to the President of the Republic of Azerbaijan.

The Fund's assets are contributed in accordance with the Regulations of the Fund as amended by Presidential Decrees #849 and #202 on "Amending Certain Legislative Acts Regulating the Operations of the State Oil Fund of the Republic of Azerbaijan" effective from 7 February 2003 and 1 March 2005, respectively, and Article 2.3 of the "Regulations on Development and Implementation of the Annual Program of Income and Expenses (Budget) of the Fund" as amended by the above Decrees. Pursuant to the Regulations of the Fund, its assets are contributed from the following sources:

- a) Revenues generated from implementing agreements on exploration, development and production sharing for oil and gas fields in the territory of the Republic of Azerbaijan including the Azerbaijan Sector of the Caspian Sea, as well as the other agreements on oil and gas exploration, development and transportation entered into between the State Oil Company of the Republic of Azerbaijan ("SOCAR") or other authorized state body and investors, including:
  - i) Net revenues from the sale of hydrocarbons related to the share of the Republic of Azerbaijan (net of expenditures incurred for hydrocarbons transportation, customs clearance and bank costs, marketing, insurance and independent surveyor fees) excluding revenues related to the participating interest or investment of SOCAR in a project in which SOCAR is an investor, participant or a contracting party;
  - ii) Bonuses paid by investors under the production sharing agreements to SOCAR or an authorized state body in connection with oil and gas agreements;
  - iii) Acreage payments due to SOCAR and/or an authorized state body of the Republic of Azerbaijan from investors for the use of the contract area in connection with oil and gas exploration and development;
  - iv) Dividends and profit participation revenues related to the share of the Republic of Azerbaijan in connection with oil and gas agreements, excluding revenues related to a participating interest or investment of SOCAR in a project in which SOCAR is an investor, participant or a contracting party;
  - v) Revenues generated from oil and gas transported over the territory of the Republic of Azerbaijan with the use of the Baku-Supsa, Baku-Tbilisi-Ceyhan ("BTC") and Baku-Tbilisi-Erzurum export pipelines;
  - vi) Revenues generated from transfer of assets from investors to SOCAR and/or an authorized state body within the framework of oil and gas agreements.
- b) Revenues generated from investment, management, sale and other disposal of the Fund's assets (including financial assets and assets contributed by investors within oil and gas agreements), other non-sale revenue or revenue from revaluation of the Fund's assets in its reporting currency (Azerbaijani manats), etc.
- c) Grants and other free aids.
- d) Other revenues and receipts in accordance with the legislation of the Republic of Azerbaijan.

Under the provisions of the Fund's Regulations approved by the President of the Republic of Azerbaijan, SOCAR or an authorized state body implements the collection of the fees and revenues listed above and their transfer to the Fund.

The Regulations exclude the followings from the list of sources of the Fund's revenue and assets:

- ♦ the rental fees from the use of state property under contracts with foreign companies;
- ♦ revenues from the sale of hydrocarbons related to the participating interest or investment of the State Oil Company of the Republic of Azerbaijan ("SOCAR") in any project in which SOCAR is an investor, participant or a contracting party;
- ♦ other revenues generated from joint activities with foreign companies.

Transfers to the State Budget, as well as state institutions, state-owned entities and companies are made in accordance with the Law of the Republic of Azerbaijan "On the State Budget for 2007" dated 28 December 2006, Decree #505 of the President of the Republic of Azerbaijan "On Ratifying the Budget of the State Oil Fund of the Republic of Azerbaijan for the year 2007" dated 28 December 2006, Program on Expensing of Assets of the State Oil Fund of the Republic of Azerbaijan for 2007 as approved by the Order #1878, dated 28 December 2006, the Law of the Republic of Azerbaijan #601 "On Amendments to the Law of the Republic of Azerbaijan on the State Budget for the year 2007" dated 28 June 2007, Decree # 686 "On Amendments to the Budget of the State Oil Fund of the Republic of Azerbaijan for the Year 2007" dated 26 December 2007.

In 2007, the Fund was a party to two custody agreements with the Bank of New York and Clariden Leu Ltd. (in 2006 - three - the Bank of New York, Clariden Leu Ltd. and State Street Corporation) and three investment management agreements with financial institutions with Deutsche Asset Management International GmbH, Clariden Leu Ltd. and International Bank for Reconstruction and Development (IBRD - World Bank Group) (in 2006 - two - Deutsche Asset Management International GmbH and Clariden Leu Ltd.). Under the custody agreements the financial institutions hold securities purchased by the Fund, whereas in accordance with the investment management agreements the financial institutions manage the Fund's investments based on general investment policies established by the Fund.

The Fund's registered office address is: 20, Bulbul Avenue, Baku, Azerbaijan, AZ1014.

These financial statements for the year ended 31 December 2007 were authorized for issue by the Fund's Management on 7 April 2008.

### 2. SIGNIFICANT ACCOUNTING POLICIES

#### Basis of presentation

The financial statements of the Fund have been prepared in accordance with International Public Sector Accounting Standards ("IPSAS") issued by the Public Sector Committee of the International Federation of Accountants. IPSAS are developed by adapting International Financial Reporting Standards ("IFRS") to the public sector context.

IFRS comprise standards and interpretations approved by the International Accounting Standards Board, and IFRS and Standing Interpretations Committee interpretations approved by the International Accounting Standards Committee. The public sector refers to national governments, regional governments, local governments and related governmental entities.

The Fund has elected to apply every IPSAS issued as at 31 December 2007 and 2006, respectively. As permitted by IPSAS, the Fund follows the provisions of IFRS pronouncements in the absence of equivalent IPSAS.

The financial statements have been prepared on the historical cost basis, except for the measurement at fair value of certain financial instruments and measurement of building at revaluated amount according to International Accounting Standard ("IAS") No. 16 "Property, Plant and Equipment".

The Fund maintains its records in Azerbaijani Manats ("AZN"). Although the majority of the Fund's assets and income are denominated in foreign currencies, the Fund's measurement currency is AZN as all the costs and distributions are incurred or priced in AZN and the valuation of the Fund's financial performance is compared against an annual budget measured in AZN.

In accordance with IPSAS No. 4 "The Effects of Changes in Foreign Exchange Rates" transactions and balances denominated in currencies other than AZN (primarily US Dollar and Euro) have been re-measured into AZN. Income and costs in currencies other than AZN are translated at historical exchange rates. Capital and non-monetary assets and liabilities are translated at historical exchange rates prevailing on the transaction dates. Monetary assets and liabilities are translated at exchange rates prevailing on the balance sheet date. Exchange gains and losses arising from the remeasurement of monetary assets and liabilities that are not denominated in AZN are credited or charged to operations.

AZN is not a fully convertible currency outside the territory of the Republic of Azerbaijan. Within the Republic of Azerbaijan, official exchange rates are determined daily by the National Bank of the Republic of Azerbaijan. Foreign exchange rates may differ from the official rates but the differences are, generally, within narrow parameters monitored by the National Bank of the Republic of Azerbaijan. As at 31 December 2007 and 2006, the official rates of exchange were:

	31 December 2007	31 December 2006
AZN/1 US Dollar	0.8453	0.8714
AZN/1 Euro	1.2450	1.1471
AZN/1 British Pound	1.6876	1.7113

#### Use of estimates

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, income and expenses, contributions and distributions, and related disclosures. On an on-going basis, the management evaluates their estimates, including those related to income recognition and contingencies. The management bases their estimates on various market specific assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making assumptions about the carrying values of assets that are not readily apparent from other sources. Actual results may differ significantly from these estimates under different assumptions or conditions.

#### Recognition of financial instruments

A purchase or sale of financial assets is recognized using trade date accounting (Resolution #32 dated 13 June 2007 issued by the Supervisory Board of the State Oil Fund of the Republic of Azerbaijan). The trade date is the date that Fund commits to purchase or sell an asset. That is, the value change is not recognized

for assets carried at cost or amortized cost; it is recognized in net profit or loss for assets classified as assets at fair value through profit or loss; and it is recognized in net assets/equity for assets classified as available for sale. Financial assets and liabilities are initially recognized at cost.

**Cash and cash equivalents**

Cash and cash equivalents are defined as cash on hand, deposits maturing within three months from the financial statements date and short-term, highly liquid investments readily convertible to known amounts of cash and subject to low risk of changes in value, with an original maturity of three months or less, except for government securities carried at fair value through profit or loss, which may be converted within short period of time. Cash on hand, cash in banks and deposits are carried at cost plus interest.

**Securities at fair value through profit or loss**

Securities, which are (i) purchased principally for the purpose of generating a profit from short-term fluctuations in price or dealers' margin; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; (iii) derivatives; and (iv) managed and performance of which is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy of the Fund are classified as securities at fair value through profit or loss. Securities at fair value through profit or loss are initially recognized and are subsequently measured at fair value, based on market values as of the balance sheet date. Realized and unrealized gains and losses resulting from operations with securities at fair value through profit or loss are recognized in the statement of financial performance as part of net dealing gains/losses. Interest earned on securities at fair value through profit or loss is reported as interest income.

In determining estimated fair value, securities are valued at the last bid price if quoted on an exchange. When market prices are not available or if liquidating the Fund's position would reasonably be expected to impact market prices, fair value is determined by reference to price quotations for similar instruments traded in different markets or management's objective and reliable estimates of the amounts that can be realized.

**Fair values of financial instruments**

Fair value is defined as the amount at which an instrument could be exchanged in a current transaction between knowledgeable willing parties on arm's length conditions, other than in forced or liquidation sale. Judgment is necessary in arriving at fair value, based on current economic conditions and the specific risks attributable to the instrument. The estimates presented herein are not necessarily indicative of the amounts the Fund could realize in a market exchange from the sale of its full holdings of a particular instrument.

**Property and equipment**

The Fund's property and equipment are tangible assets held for administrative purposes with an expected useful life of more than one accounting period and with the cost exceeding 100 AZN. Except the administrative building, the Fund's property and equipment is stated at historical cost less accumulated depreciation.

The carrying values of property and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Any revaluation surplus is credited to the revaluation reserve for property and equipment included in net assets, except to the extent that it reverses a revaluation decrease of the same asset previously recognised in the statement of financial performance, in which case the increase is recognised in the statement of financial performance.

If the book value of the asset decreases as the result of revaluation, it is recognised as expense. A revaluation deficit is recognised in the statement of financial performance, except that a deficit directly offsetting a previous surplus on the same asset is directly offset against the surplus in the revaluation reserve for property and equipment.

Assets are depreciated to residual values using the straight-line method over their estimated useful lives. Useful lives of property and equipment from various groups are as follows:

	Years
Buildings	50
Vehicles	7
Office equipment	4
Furniture	5
Other fixed assets	3

Depreciation is charged starting from the month when the asset was put into use until its disposal or sale.

**Net assets/Equity**

Transfers to the State Budget, as well as state institutions, state-owned entities and companies are recognized at the fair value of the consideration paid by the Fund to the government and government-controlled entities on the date of payment.

As discussed in Note 1, in accordance with the Decree and the Regulations, the Fund is an extra-budgetary organization. All decisions regarding contributions to and transfers from the Fund are made by its ultimate owner. Contributions/transfers received/made by the Fund represent owner's contributions/withdrawals and, accordingly, are recognized through net assets.

All transfers are made within the approved budget of the Fund and transferred to the State Treasury of the Republic of Azerbaijan for payments to eligible budgetary beneficiaries (state institutions, state-owned entities and companies) based on their requests for payments.

**Income and expense recognition**

Income is recognized to the extent that it is probable that the economic benefits will flow to the Fund and the income can be reliably measured. Interest income is recognized on an accrual basis using the effective interest method. The effective interest method is a method of calculating the amortized cost of a financial asset (or group of financial assets) and of allocating the interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset.

Expenses are recognized on accrual basis, i.e. when they are incurred.

**Income tax**

Income tax expense represents the sum of the current and deferred tax expense.

The current tax expense is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Fund's current tax expense is calculated using tax rates that have been enacted during the reporting period.

The Fund has registered as a taxpayer effective 1 January 2003.

Deferred income tax is provided, using the liability method, on all temporary differences at the balance sheet date between the tax basis of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax assets are recognized for all deductible temporary differences and carry-forward of unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carry-forward of unused tax losses can be utilized.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilized.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates and tax laws that have been enacted or substantially enacted at the balance sheet date.

**Retirement and other employee benefit obligations**

The Fund does not have any pension arrangements separate from the state pension system of the Republic of Azerbaijan, which requires current contributions by the employer calculated as a percentage of current gross salary payments; such expense is charged in the period the related salaries are earned. In addition, the Fund has no post-retirement benefits or significant other compensated benefits requiring accrual.

**Offset of financial assets and liabilities**

Financial assets and liabilities are offset and reported net on the balance sheet when the Fund has a legally enforceable right to set off the recognized amounts and the Fund intends either to settle on a net basis or to realize the asset and settle the liability simultaneously. In accounting for a transfer of a financial asset that does not qualify for derecognition, the Fund does not offset the transferred asset and the associated liability.

**Adoption of new standards**

In the current year, the Fund has adopted all of the new and revised Standards and Interpretations issued by the International Accounting Standards Board (the IASB) and the International Financial Reporting Interpretations Committee (the IFRIC) of the IASB that are relevant to its operations and effective for annual reporting periods beginning on 1 January 2007. The adoption of these new and revised Standards and Interpretations has not resulted in significant changes to the Fund's accounting policies that have affected the amounts reported for the current or prior years.

**Adoption of IFRS 7** - Effective 1 January 2007, the Fund adopted IFRS 7 "Financial Instruments: Disclosure" ("IFRS 7"). IFRS 7 establishes new requirements and recommendations on financial instrument disclosure. The Fund disclosed all information required under IFRS 7. Adoption of IFRS 7 did not affect the classification and measurement of the Fund's financial instruments in these financial statements.

Certain new IFRSs will become effective for the Fund from 1 January 2008. Listed below is a new standard which is or in the future could be relevant to the Fund's operations.

**Adoption of IFRS 8** - Effective 1 January 2009, the new IFRS 8 "Operating Segments" will replace IAS 14 "Operating Segments". The management is currently assessing the impact of the adoption of this new Standard on its future financial statements.

**3. CASH AND CASH EQUIVALENTS**

Cash and cash equivalents consisted of the following at 31 December:

	2007	2006
Money market funds	133,445	2,880
Deposits	109,052	6,484
Cash in bank accounts	73,713	60,566
<b>Total cash and cash equivalents</b>	<b>316,210</b>	<b>69,930</b>

**Money market funds**

Investments in money market funds represent share ownership in funds, payable on demand. Investments in money market funds are highly liquid. Money market funds invest their assets in short-term debt and debt related instruments, such as commercial paper, certificates of deposit, bonds bearing floating interests, US treasury bonds, Eurobonds and asset-backed securities. Interest and dividends payable to the Fund are reinvested.

At 31 December the Fund had investments in the money market funds with credit ratings AAA, except for Wachovia STIF Liquidity Fund with credit rating AA-/Aa3:

	2007	2006
JP Morgan Fleming Liquidity Funds	63,188	2
Royal Bank of Scotland, Global Treasury Funds plc	42,822	670
Barclays Global Investors Funds plc	25,106	2
Goldman Sachs GBP Liquidity Funds	1,490	-
Wachovia STIF Liquidity Funds	839	-
DWS Portfolio USD Liquidity Fund	-	2,201
HSBC Global Liquidity Funds Plc	-	2
Deutsche Global Liquidity Managed Fund	-	3
<b>Total</b>	<b>133,445</b>	<b>2,880</b>

**Deposits**

	2007	2006
UBS AG, London	33 830	-
Societe Generale, Paris	29 600	-
Deutsche Bank, London	21 246	-
BNP Paribas	21 189	-
UBS AG, London	1 695	-
UBS AG, London	1 492	-
Credit Suisse, London	-	6 484
<b>Total</b>	<b>109 052</b>	<b>6 484</b>

At 31 December 2007, the Fund had six deposits placed with different banks with credit ratings ranging from AA/Aa2 to AAA/Aaa (Standard & Poors/Moodys) and maturing in January 2008. Four deposits denominated in US Dollars bore fixed interest from 4.3% to 4.72%. Two deposits denominated in British Pounds bore fixed interest from 5.68% to 6.26%.

At 31 December 2006 the Fund had one deposit denominated in US Dollars with a fixed interest rate of 5.15% placed with a bank with a credit rating AA- (Standard & Poors). This deposit was placed by the Fund's external asset manager, Clariden Leu Ltd.

**Cash in bank accounts**

Cash in bank accounts was denominated in the following currencies at 31 December:

	2007	2006
US Dollars	40,898	32,819
AZN	32,592	27,112
EURO	187	428
GBP	36	206
Other	-	1
<b>Total</b>	<b>73,713</b>	<b>60,566</b>

The Fund's AZN accounts were opened with National Bank of the Republic of Azerbaijan and International Bank of Azerbaijan. Other accounts originated in foreign currency were opened with foreign banks with long-term ratings A, AA- and AA (Standard & Poors).

**4. SECURITIES AT FAIR VALUE THROUGH PROFIT OR LOSS**

Securities at fair value through profit or loss consisted of the following at 31 December:

	2007	2006
Financial institution securities	789,960	761,036
Securities of USA agencies	416,221	97,657
Foreign government securities	359,882	92,739
Corporate debt securities	203,881	170,155
Mortgage securities	4,131	72,424
Corporate equity securities	2,144	4,015
<b>Total</b>	<b>1,776,219</b>	<b>1,198,026</b>

At 31 December 2007 the Fund held AZN 202,840 thousand (239,963 thousands in US Dollars) under asset management agreements with external institutions (31 December 2006: AZN 109,379 thousand (125,521 thousands US Dollars)). The management fees paid by the Fund to these institutions were AZN 369 thousand and AZN 260 thousand in 2007 and 2006, respectively. The fees for over-performance paid by the Fund for the external managers were AZN 93 thousand and AZN 57 thousand in 2007 and 2006, respectively. At 31 December 2007, the Fund had investments in securities at fair value through profit or loss managed by the Fund's external manager, Deutsche Bank AG, Clariden Leu Ltd. and International Bank for Reconstruction and Development (World Bank Group), held in the custodian Bank of New York.

At 31 December 2006 the Fund had investments in securities at fair value through profit or loss managed both directly by the Fund and the Fund's external manager, Deutsche Bank AG, held in the custodian bank, State Street Corporation, and securities at fair value through profit or loss managed by another external manager, Clariden Leu Ltd, held in the custodian bank, Clariden Leu Ltd.

**Financial institution securities**

Financial institution securities at 31 December 2007 were represented by investments in debt securities issued by various European, Asian and American financial institutions. These securities bear fixed interest ranging from 3.6% to 8.5% and USD LIBOR, GBP LIBOR and EURIBOR with the spread over the LIBOR ranging from +0.03% to +2% and mature during the period from February 2008 to December 2016. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset managers, Deutsche Bank AG and Clariden Leu Ltd.

Financial institution securities at 31 December 2006 were represented by investments in debt securities issued by various European, Asian, Australian, African and American financial institutions. These securities bear fixed interest ranging from 2.75% to 8.5% and USD LIBOR and EURIBOR with the spread over the LIBOR ranging from +0.03% to +2.9% and mature during the period from February 2007 to December 2016. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset managers, Deutsche Bank AG and Clariden Leu Ltd.

**Securities of the USA Agencies**

Securities of the USA Agencies at 31 December 2007 were represented by investments in debt securities issued by Fannie Mae, Freddie Mac and Federal Home Loan Bank. These securities bear fixed interest ranging from 3.25% to 7.25% and mature during the period from November 2008 to November 2011. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset managers, Clariden Leu Ltd. and World Bank.

Securities of the USA Agencies at 31 December 2006 were represented by investments in debt securities issued by Fannie Mae, Freddie Mac, Federal Home Loan Bank, Federal Farm Credit Bank. These securities bear fixed interest ranging from 3.75% to 6% and mature during the period from July 2007 to February 2013. These securities were held in the portfolio managed both directly by the Fund and the Fund's external asset manager, Clariden Leu Ltd.

**Foreign government securities**

Foreign government securities at 31 December 2007 were represented by investments in debt securities issued by various sovereign and international organizations of Europe, Asia, Africa and America. These securities bear fixed interest ranging from 3% to 9.5% and USD LIBOR, EURIBOR with the spread over the LIBOR ranging from +0.05% to +0.8125% and mature during the period from January 2008 to February 2013. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset managers.

Foreign government securities at 31 December 2006 were represented by investments in sovereign debt securities issued by various organizations of Europe, Asia, Africa and America. These securities bear fixed interest ranging from 3% to 10% and USD LIBOR, EURIBOR with the spread over the LIBOR ranging from +0.24% to +0.95% and mature during the period from June 2007 to July 2011. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset manager, Deutsche Bank AG.

**Corporate debt securities**

Corporate debt securities at 31 December 2007 were represented by investments in debt securities issued by corporations of Europe, Asia and America. These securities bear fixed interest ranging from 4.125% to 6.875% and USD LIBOR and EURIBOR with the spread over LIBOR ranging from +0.40% to +0.60% and maturing during the period from March 2008 to October 2014. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset managers Deutsche Bank AG and Clariden Leu Ltd.

Corporate debt securities at 31 December 2006 were represented by investments in debt securities issued by European and American corporations. These securities bear fixed interest ranging from 3.125% to 11% and floating interest rates linked to USD LIBOR with the spread over LIBOR ranging from +0.05% to +0.48% and maturing during the period from September 2007 to November 2011. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset managers, Deutsche Bank AG and Clariden Leu Ltd.

**Mortgage securities**

Mortgage securities at 31 December 2007 were represented by investments in debt securities issued by the financial institutions of America bearing fixed interest rate ranging from 3.72% and USD LIBOR with the spread over LIBOR ranging from +0.05% to +0.16% and maturing during the period from July 2009 to May 2038. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset manager, Clariden Leu Ltd.

Mortgage securities at 31 December 2006 were represented by bonds issued by financial institutions of Europe and America bearing fixed interest rate ranging from 2.88% to 5.25% and USD LIBOR and EURIBOR with the spread over LIBOR ranging from +0.05% to +0.43% and maturing during the period from July 2007 to December 2048. These securities were held in the portfolio managed both directly by the Fund as well as the Fund's external asset manager, Clariden Leu Ltd.

**Corporate equity securities**

The carrying value of corporate equity securities consisted of the following at 31 December:

	2007	2006
Finance	539	–
Telecommunication and information technologies	522	475
Healthcare	369	176
Energy	255	350
Consumer	173	884
Industrials	95	524
Utilities	–	500
Other	191	1,106
<b>Total</b>	<b>2,144</b>	<b>4,015</b>

**5. PROPERTY AND EQUIPMENT**

An analysis of activity in property and equipment for the years ended 31 December 2007 was as follows:

	Building	Vehicles	Office equipment	Furniture	Other	Total
<b>At initial/Revalued cost</b>						
31 December 2005	2,047	46	231	110	3	2,437
Additions	–	36	15	15	–	66
<b>31 December 2006</b>	<b>2,047</b>	<b>82</b>	<b>246</b>	<b>125</b>	<b>3</b>	<b>2,503</b>
Additions	366	5	54	8	–	433
Disposal	(366)	–	–	–	–	(366)
Revaluation	3,584	–	–	–	–	3,584
<b>31 December 2007</b>	<b>5,631</b>	<b>87</b>	<b>300</b>	<b>133</b>	<b>3</b>	<b>6,154</b>
<b>Accumulated depreciation</b>						
31 December 2005	(185)	(30)	(156)	(51)	(1)	(423)
Depreciation charge	(41)	(7)	(61)	(22)	(1)	(132)
<b>31 December 2006</b>	<b>(226)</b>	<b>(37)</b>	<b>(217)</b>	<b>(73)</b>	<b>(2)</b>	<b>(555)</b>
Depreciation charge	(81)	(11)	(17)	(25)	(1)	(135)
Revaluation	242	–	–	–	–	242
<b>31 December 2007</b>	<b>(65)</b>	<b>(48)</b>	<b>(234)</b>	<b>(98)</b>	<b>(3)</b>	<b>(448)</b>
<b>Net book value:</b>						
<b>31 December 2007</b>	<b>5,566</b>	<b>39</b>	<b>66</b>	<b>35</b>	<b>–</b>	<b>5,706</b>
31 December 2006	1,821	45	29	52	1	1,948

In accordance with Resolution #99 of Cabinet of Ministers, dated 27 May 2002, Fund has received an administrative building from the Government. As at 31 December 2007 the building owned by the Fund was revalued to market value according to the report of an independent appraiser. The following methods were used for the estimation of their fair value: discounted cash flow method (income approach), integrated cost estimation method (cost based method), method of sales comparison (comparative approach). For the estimation of the final value, certain weights were assigned to the results obtained using different approaches, depending on the degree to which the estimates met the following characteristics: reliability and completeness of the information, specifies the estimated property and other.

As a result, the carrying value of the buildings amounted to AZN 5,566 thousand and AZN 1,821 thousand as at 31 December 2007 and 2006, respectively. If the buildings were accounted at historical cost less accumulated depreciation, its carrying value would be AZN 502 thousand and AZN 513 thousand as at 31 December 2007 and 2006, respectively.

**6. INTEREST INCOME**

	Year ended 31 December 2007	Year ended 31 December 2006
Interest income on assets at fair value through profit or loss	70,614	36,555
Interest income on assets recorded at amortized cost:		
Interest income on unimpaired assets:		
Income from money market funds	2,989	2,532
Interest on demand deposits	2,173	1,983
Interest on term deposits	1,911	7,673
<b>Total interest income</b>	<b>77,687</b>	<b>48,743</b>

**7. NET (LOSS)/GAIN ON FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS**

	Year ended 31 December 2007	Year ended 31 December 2006
Net (loss)/gain on operations with financial assets designated at fair value through profit or loss comprise:		
Unrealized (expense)/income on revaluation	(4,855)	2,070
Realized (loss)/gain on trading operations	(547)	5,140
Total net (loss)/gain on operations with financial assets designated at fair value through profit or loss	<b>(5,402)</b>	<b>7,210</b>

**8. NET GAIN/(LOSS) ON FOREIGN EXCHANGE OPERATIONS**

	Year ended 31 December 2007	Year ended 31 December 2006
Translation differences, net	15,935	(15,568)
Dealing, net	(1,987)	(1,929)
Total net gain/(loss) on foreign exchange operations	<b>13,948</b>	<b>(17,497)</b>

**9. OPERATING EXPENSES**

	Year ended 31 December 2007	Year ended 31 December 2006
Professional fees	871	567
Bank commissions	687	190
Wages, salaries and employee benefits	558	340
Communication expenses	161	110
Depreciation and amortization	140	140
Business travel expenses	81	55
Publication fees	8	8
Other operating expenses	157	202
Total operating expenses	<b>2,663</b>	<b>1,612</b>

**10. INCOME TAXES**

The Fund provides for taxes based on the tax accounts maintained and prepared in accordance with the tax regulations of the Republic of Azerbaijan and which may differ from IPSAS.

The Fund is subject to certain permanent tax differences due to non-tax deductibility of certain expenses.

Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. Temporary differences as at 31 December 2007 and 2006 relate mostly to different methods of income and expense recognition as well as to recorded values of certain assets.

Composition of income tax expenses for the year ended 31 December was as follows:

	2007	2006
<i>Current income tax:</i>		
Current income tax	13 129	-
<i>Deferred income tax:</i>		
Temporary differences originated and written off	(716)	373
Accumulated losses	-	(7 382)
Valuation reserve for deferred tax asset	716	7 009
Income tax reported in the statement of financial performance	13 129	-

Relationship between tax expense and accounting profit for the year ended 31 December 2007 and 2006 are explained as follows:

	2007	2006
Surplus before income tax	83,570	36,844
At a statutory rate of 22%	18,385	8,106
Deferred tax benefit arising from net operating losses carried forward	(7,382)	(14,661)
Tax effect of permanent differences	1,410	(454)
Valuation reserve	716	7,009
Income tax expenses reported in the statement of financial performance	13,129	-

The Fund has created a valuation reserve for the entire amount of deferred tax asset as management believes that there will be no sufficient taxable profit in the future to utilize the deferred tax asset.

Temporary differences as at 31 December 2007 and 2006 comprise:

	Statement of financial position		Statement of financial performance
	2007	2006	2007
<i>Deferred tax assets</i>			
Temporary difference from valuation of securities	1,593	-	1,593
Accumulated losses	-	7,382	(7,382)
Total deferred tax assets	1,593	7,382	(5,789)
<i>Deferred tax liabilities</i>			
Temporary difference from valuation of property and equipment	(877)	-	(877)
Temporary difference from valuation of securities	-	(373)	373
Total deferred tax liabilities	(877)	(373)	(504)
<b>Net deferred tax assets before valuation reserve</b>	<b>716</b>	<b>7,009</b>	<b>(6,293)</b>
Valuation reserve	(716)	(7,009)	(6,293)
<b>Net deferred tax assets</b>	<b>-</b>	<b>-</b>	<b>-</b>

## 11. CONTRIBUTED FUNDS

Capital contributions for the year ended December 31 include the following:

	2007	2006
Contributions received from sales of profit oil	1,675,019	896,258
Pipeline transit tariffs	-	11,437
Acreage fees	6,356	7,571
Bonuses	58,068	1,798
Price margin from oil sales	45,596	25,338
Other	1,097	599
<b>Total</b>	<b>1,786,136</b>	<b>943,001</b>

In accordance with the Decree of the President of the Republic of Azerbaijan "On Amendments and additions to the Budget of the Fund for 2006" dated 7 June 2006, if in 2007 the contractual cost of the crude oil produced and exported in Azerbaijan exceeded the established price, the payments made to Fund from this amount will

represent proceeds from difference between the contractual prices on exported crude oil produced in the Republic of Azerbaijan and the internal wholesale price, and reflects new a source of income for the Fund for the year 2007 and 2006.

## 12. TRANSFERS BY THE FUND

### Transfers to the State Budget

In 2007, as in previous years, a certain portion of the Fund's assets was transferred to the State Budget to cover the budget deficit. In accordance with the Decree #505 of the President of the Republic of Azerbaijan "On the Budget of the State Oil Fund of the Republic of Azerbaijan for 2007" dated 28 December 2006, as well as the Program on Expensing of Assets of the State Oil Fund of the Republic of Azerbaijan for 2007, as approved by the President Decree #1878, dated 28 December 2006, during 2007 the Fund transferred AZN 585,000 thousand to the State Budget (2006: AZN 585,000 thousand).

### Transfers to the State Refugees Committee and Internally Displaced Peoples' Social Development Fund

In 2007 the amount of AZN 154,117 thousand (2006: AZN 110,032 thousand) was transferred to finance the projects for improvement of social conditions of refugees and internally displaced people. Transfers were made pursuant to the Decree #505 of the President of the Republic of Azerbaijan "On Budget of the State Oil Fund of the Republic of Azerbaijan for 2007" dated 28 December 2006, as well as the Program on Expensing of Assets of the State Oil Fund of the Republic of Azerbaijan for 2007 as approved by the Decree # 686 of the President of the Republic on "Amendments to the budget of the State Oil Fund for 2007" dated 26 December 2007.

Funds appropriated financing for these projects were transferred by the Fund based on supported requests of the State Refugees Committee and the Fund of Social Development of internally displaced people to the accounts of these institutions at the State Treasury and then paid to contractors through the requesting organizations.

### Transfers for the construction of water pipeline Oguz-Gabala-Baku

In accordance with the Decree #505 of the President of the Republic of Azerbaijan "On Budget of the State Oil Fund of the Republic of Azerbaijan for 2007" dated 28 December 2006, as well as the Program on Expensing of Assets of the State Oil Fund of the Republic of Azerbaijan for 2007 as approved by the Order #1878, dated 28 December 2006, and Decree # 686 of the President of the Republic on "Amendments to the budget of the State Oil Fund of the Republic of Azerbaijan for 2007" dated 26 December 2007, the Fund transferred AZN 132,907 thousand (2006: AZN 82,749 thousand) to finance the project for the construction of water pipeline from the Oguz-Gabala zone to Baku.

### Transfer for controlling shares of SOCAR in Azeri-Chirag-Guneshli project

In accordance with Decree #601 "On the Amendments and additions to the Budget of the State Oil Fund of the Republic of Azerbaijan for the year 2007" dated 28 July 2007, amount of AZN 87,559 thousand was transferred to SOCAR in 2007 as the financing of the share of the Republic of Azerbaijan in Azeri-Chirag-Guneshli project.

### Transfers for the reconstruction of the Samur-Apsheron irrigation system

In 2007, part of the Fund's resources was transferred to finance the project for reconstruction of the Samur-Apsheron irrigation system. AZN 76,900 thousand (2006: AZN 37,000 thousand) was transferred to finance the project for the reconstruction of the Samur-Apsheron irrigation system in accordance with Decree #505 of the President of the Republic of Azerbaijan "On the Budget of the State Oil Fund of the Republic of Azerbaijan for the year 2007" dated 28 December 2006 as well as the Program on Expensing of Assets of the State Oil Fund of the Republic of Azerbaijan for 2007 as approved by the Order #1878, dated 28 December 2006.

### Transfer for the construction of the new Baku-Tbilisi-Kars railway line

Starting from 2007, the amount of AZN 20,712 thousand was transferred to finance the project for the construction of the new Baku-Tbilisi-Kars railway line in accordance with Decree #601 "On the Amendments and additions to the Budget of the State Oil Fund of the Republic of Azerbaijan for the year 2007" dated 28 July 2007, as well as the Decree #686 of the President of the Republic of Azerbaijan "On Amendments to the Budget of the State Oil Fund for 2007 dated 26 December 2007.

### Transfers in respect of Azerbaijan (BTC) Limited

As part of implementation of the Budget of the State Oil Fund for 2006, as well as in accordance with Decree #739 of the President of the Republic of Azerbaijan "On financing the participating interest share of the State Oil Company of the Republic of Azerbaijan in the Baku-Tbilisi-Ceyhan Main Export Pipeline project" dated 30 July 2002, Decree #346 of the President of the Republic of Azerbaijan "On the Budget of the State Oil Fund of the Republic of Azerbaijan for the year 2006" dated 28 December 2005, Resolution # 416 "On Amendments to the Budget of the State Oil Fund of the Republic of Azerbaijan for 2006" dated 7 June 2006, the amount of AZN 75,409 thousand was aimed at the financing of the share of the Republic of Azerbaijan in Baku-Tbilisi-Ceyhan main export pipeline named after Heydar Aliyev (the share is financed indirectly by financing 70% share of the Ministry of Economic Development of the Republic of Azerbaijan in Azerbaijan (BTC) Limited. Azerbaijan (BTC) Limited owns 25% share in BTC pipeline company). This project is financed by the State Oil Fund starting from October 2002.

**Transfers to Azerbaijan Investment Company**

In 2006 the amount of AZN 90,000 thousand was transferred by the Fund to finance the formation of the Charter Capital of the Azerbaijan Investment Company established by Resolution of the President of the Republic of Azerbaijan dated 30 March 2006.

**13. FAIR VALUE OF FINANCIAL INSTRUMENTS**

Estimated fair value disclosures of financial instruments are made in accordance with the requirements of IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Measurement". Fair value is defined as the amount at which the instrument could be exchanged in a current transaction between knowledgeable willing parties in an arm's length transaction, other than in forced or liquidation sale. The estimates presented herein are not necessarily indicative of the amounts the Fund could realize in a market exchange from the sale of its full holdings of a particular instrument.

The management believes that the fair value of all financial assets and liabilities approximate the corresponding carrying amount in the balance sheet of the Fund.

**14. RISK MANAGEMENT POLICIES**

Management of risk is an essential element of the Fund's operations. Risks inherent to the Fund's operations are those related to credit exposures, liquidity and market risks. A summary description of the Fund's risk management policies in relation to those risks is discussed below.

**Credit risk**

The Fund is exposed to credit risk which is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. The Fund is subject to credit risk from its portfolio of cash and cash equivalents and its investments. The Fund manages its credit risk in accordance with the "Rules on Holding, Placement and Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan" approved by Decree #511 of the President of the Republic of Azerbaijan dated 19 June 2001 as amended by Decree #607 dated 21 December 2001, #202 dated 1 March 2005, as well as Investment Policy (investment trend) of the State Oil Fund for the year 2007 as approved by the Order #1878 of the President of the Republic of Azerbaijan dated 28 December 2006.

Per Investment Policy of the Fund, the maximum weight of one financial institution or one investment in the investment portfolio is set at 15% of total amount of the investment portfolio. Foreign currency assets of the Fund could be placed into assets or issuer that have rating not less than investing credit rating (Baa3 (Moody's) or BBB- (Standard & Poor's, Fitch)).

Risk management and monitoring is performed within above set limits, by the Investment Committee and the Fund's Management. All recommendations/decisions are proposed/made by the Investment Committee and subsequently are subject to the approval of the management of the Fund. Daily risk management is performed by the Risk Management Department.

The following table details the credit ratings of financial assets held by the Fund. The credit rating issued by internationally regarded agencies Standard and Poors and Moodys. If an asset has different credit ratings, the highest one was used.

	AAA	AA	A	BBB	BB	Total at 31 December 2007
Cash and cash equivalents	166,436	116,313	839	-	32,622	316,210
Financial assets at fair value through profit or loss	853,966	548,914	278,818	57,769	36,752	1,776,219
	AAA	AA	A	BBB	BB	Total at 31 December 2006
Cash and cash equivalents	679	42,020	66	-	27,165	69,930
Financial assets at fair value through profit or loss	220,099	340,448	336,006	301,473	-	1,198,026

As of 31 December 2007 and 2006, the minimum long term credit ratings of securities or their issuers were Baa3 (Moody's) or BBB- (Standard & Poor's). Issue of bonds of Turanalem BM in the amount of AZN 36,752 thousand was considered as an exceptional case (BB/Ba1 Standard & Poor's, Moody's). At the date of purchase by the Fund, the bonds of Turanalem BM had an investment credit rating. Credit rating of securities was decreased from Baa3 to Ba1 rating by "Moody's" agency at 01 November 2007.

**Bank accounts**

In accordance with the "Rules on Holding, Placement and Management of Foreign Currency Assets of the State Oil Fund of the Republic of Azerbaijan" approved by Decree #511 of the President of the Republic of Azerbaijan dated 19 June 2001 as amended by Decree #607 dated 21 December 2001 and # 202 dated 1 March 2005, currency settlement accounts of the Fund may be held in banks with long-term credit ratings not lower than A- (Standard & Poors, Fitch) or Aa3 (Moody's).

At 31 December 2007 the Fund had AZN 31,998 thousand and AZN 624 thousand, held at bank accounts in the National Bank of the Republic of Azerbaijan and International Bank of the Republic of Azerbaijan, respectively (2006: AZN 26,963 thousand and AZN 202 thousand), which are rated BB. The Fund is allowed to maintain funds in the country only in the National Bank of the Republic of Azerbaijan and International Bank of the Republic of Azerbaijan.

**Depositary services**

In accordance with the "Rules on Holding, Placement and Management of Foreign Assets of the State Oil Fund of the Republic of Azerbaijan" approved by Decree #511 of the President of the Republic of Azerbaijan dated 19 June 2001 as amended by Decree #607 dated 21 December 2001 and # 202 dated 1 March 2005, the Fund's depositary services may be provided by commercial banks and other financial institutions with long-term credit ratings not lower than A- (Standard & Poors, Fitch) or A3 (Moody's).

**Financial market counterparties**

In accordance with the "Rules on Holding, Placement and Management of Foreign Assets of the State Oil Fund of the Republic of Azerbaijan" approved by Decree #511 of the President of the Republic of Azerbaijan dated 19 June 2001 as amended by Decree #607 dated 21 December 2001 and # 202 dated 1 March 2005, the Fund's counterparties at international financial markets may involve commercial banks and other financial institutions within investment credit ratings (not lower than Baa3 (Moody's) or BBB- (Standard & Poors, Fitch)).

**External managers**

In accordance with the "Rules on Holding, Placement and Management of Foreign Assets of the State Oil Fund of the Republic of Azerbaijan" approved by Decree #511 of the President of the Republic of Azerbaijan dated 19 June 2001 as amended by Decree #607 dated 21 December 2001 and # 202 dated 1 March 2005, when an external manager is engaged in management of the Fund's currency assets, the external manager or its principal founder should have investment credit ratings (not lower than Baa3 (Moody's) or BBB- (Standard & Poors, Fitch)) or have at least five years of positive history of management of assets, or be experienced in managing assets with a value not less than one billion US Dollars.

**Currency risk**

Currency risk is defined as the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Fund is exposed to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows.

The Investment Policy of the Fund for 2006 as approved by the Order #1878 of the President of the Republic of Azerbaijan dated 28 December 2006, specified requirements for Investment Policy (investment trend) of the Fund for 2007 and currency basket of the Fund's portfolio for 2007. In accordance with these requirements, 55% of the total amount of the investment portfolio of the Fund invests in assets denominated in US Dollar, 35% in assets denominated in Euro, 5% in assets denominated in GBP, whereas 5% of the total amount of the investment portfolio, the Fund invests in assets denominated either in currencies of countries with the long-term country ratings (sovereign debt) not less than the credit ratings A (Standard & Poors, Fitch) or A2 (Moody's), or in US Dollars, Euro and GBP based on their percentage in the weight, or entirely in US Dollars. In case of noncompliance the Fund is to rebalance the portfolio during 10 business days subsequent to the end of each quarter. As of 31 December 2007, 61% (31 December 2006 - 55%) of the Fund's assets was denominated in USD dollar, 34% (31 December 2006 - 37%) in Euro and 4% (31 December 2006 - 5%) in GBP. On 16 January 2008, currency classification of the Fund's investment portfolio was rebalanced pursuant to the diversification criteria defined in the Investment Policy.

The Fund's exposure to foreign currency exchange rate risk is presented in the table below:

	31 December 2007				
	AZN	USD	EUR	GBP	Total
<b>ASSETS:</b>					
Cash and cash equivalents	32,592	253,610	25,295	4,713	316,210
Financial assets at fair value through profit or loss	-	1,016,250	677,076	82,893	1,776,219
Contributions receivable	-	761	-	-	761
Advance payments and other current assets	989	-	-	-	989
<b>Total current assets</b>	<b>33,581</b>	<b>1,270,621</b>	<b>702,371</b>	<b>87,606</b>	<b>2,094,179</b>
Property and equipment	5,706	-	-	-	5,706
Intangible assets	89	-	-	-	89
Other assets	138	-	-	-	138
<b>Total non-current assets</b>	<b>5,933</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>5,933</b>
<b>TOTAL ASSETS</b>	<b>39,514</b>	<b>1,270,621</b>	<b>702,371</b>	<b>87,606</b>	<b>2,100,112</b>
<b>LIABILITIES:</b>					
Payables to the State Budget	12,608	-	-	-	12,608
Other current liabilities	27	-	-	-	27
<b>TOTAL LIABILITIES</b>	<b>12,635</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>12,635</b>
<b>NET POSITION</b>	<b>26,879</b>	<b>1,270,621</b>	<b>702,371</b>	<b>87,606</b>	<b>2,087,477</b>
	1%	61%	34%	4%	

	AZN	USD	31 December 2006			Total
			EUR	GBP	Other	
<b>ASSETS:</b>						
Cash and cash equivalents	27,112	41,579	1,032	206	1	69,930
Financial assets at fair value through profit or loss	-	651,948	474,752	71,204	122	1,198,026
Contributions receivable	-	14,365	-	-	-	14,365
Advance payments and other current assets	311	-	-	-	-	311
<b>Total current assets</b>	<b>27,423</b>	<b>707,892</b>	<b>475,784</b>	<b>71,410</b>	<b>123</b>	<b>1,282,632</b>
Property and equipment	1,948	-	-	-	-	1,948
Intangible assets	66	-	-	-	-	66
Other assets	134	-	-	-	-	134
<b>Total non-current assets</b>	<b>2,148</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,148</b>
<b>TOTAL ASSETS</b>	<b>29,571</b>	<b>707,892</b>	<b>475,784</b>	<b>71,410</b>	<b>123</b>	<b>1,284,780</b>
<b>LIABILITIES:</b>						
Other current liabilities	141	370	-	-	-	511
<b>TOTAL LIABILITIES</b>	<b>141</b>	<b>370</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>511</b>
<b>NET POSITION</b>	<b>29,430</b>	<b>707,522</b>	<b>475,784</b>	<b>71,410</b>	<b>123</b>	<b>1,284,269</b>
	<b>2%</b>	<b>55%</b>	<b>37%</b>	<b>5%</b>	<b>1%</b>	

Risk management and monitoring is performed within above set limits, by the Investment Committee and the Fund's Management. All recommendations/decisions are proposed/made by the Investment Committee and subsequently are subject to the approval of the management of the Fund. Daily risk management is performed by the Risk Management Department.

#### Currency risk sensitivity

The following table details the Fund's sensitivity to a 1% increase and decrease in the USD, Euro and GBP against the AZN. 1% is the sensitivity rate used when reporting foreign currency risk internally to key management personnel and represents management's assessment of the possible change in foreign currency exchange rates. The sensitivity analysis includes cash and cash equivalents as well as financial assets at fair value through profit or loss. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and adjusts their translation at the end of the period for a 1% change in foreign currency rates.

	AZN/USD		31 December 2007 AZN/EUR		AZN/GBP	
	+1%	-1%	+1%	-1%	+1%	-1%
Impact on net surplus for the year	12,706	(12,706)	7,024	(7,024)	876	(876)

	AZN/USD		31 December 2006 AZN/EUR		AZN/GBP	
	+1%	-1%	+1%	-1%	+1%	-1%
Impact on net surplus for the year	7,075	(7,075)	4,758	(4,758)	714	(714)

#### Geographical concentration

The geographical concentration of the Fund's assets and liabilities is set out below:

	Azerbaijan	Europe	America	Asia	Others	31 December 2007
						Total
<b>ASSETS:</b>						
Cash and cash equivalents	32,622	242,886	40,702	-	-	316,210
Securities at fair value through profit or loss	-	602,733	1,004,292	99,987	69,207	1,776,219
Contributions receivable	-	-	761	-	-	761
Advance payments and other current assets	989	-	-	-	-	989
Property and equipment	5,706	-	-	-	-	5,706
Intangible assets	89	-	-	-	-	89
Other assets	138	-	-	-	-	138
<b>TOTAL ASSETS:</b>	<b>39,544</b>	<b>845,619</b>	<b>1,045,755</b>	<b>99,987</b>	<b>69,207</b>	<b>2,100,112</b>
<b>LIABILITIES:</b>						
Payable to the State Budget	12,608	-	-	-	-	12,608
Other current liabilities	27	-	-	-	-	27
<b>TOTAL LIABILITIES:</b>	<b>12,635</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>12,635</b>
<b>NET FINANCIAL POSITION</b>	<b>26,909</b>	<b>845,619</b>	<b>1,045,755</b>	<b>99,987</b>	<b>69,207</b>	<b>2,087,477</b>

	Azerbaijan	Europe	America	Asia	Others	31 December 2006
						Total
<b>ASSETS:</b>						
Cash and cash equivalents	27,165	13,217	29,548	-	-	69,930
Securities at fair value through profit or loss	-	633,935	474,400	79,974	9,717	1,198,026
Contributions receivable	-	-	14,365	-	-	14,365
Advance payments and other current assets	311	-	-	-	-	311
Property and equipment	1,948	-	-	-	-	1,948
Intangible assets	66	-	-	-	-	66
Other assets	134	-	-	-	-	134
<b>TOTAL ASSETS:</b>	<b>29,624</b>	<b>647,152</b>	<b>518,313</b>	<b>79,974</b>	<b>9,717</b>	<b>1,284,780</b>
<b>LIABILITIES:</b>						
Other current liabilities	141	-	370	-	-	511
<b>TOTAL LIABILITIES:</b>	<b>141</b>	<b>-</b>	<b>370</b>	<b>-</b>	<b>-</b>	<b>511</b>
<b>NET FINANCIAL POSITION</b>	<b>29,483</b>	<b>647,152</b>	<b>517,943</b>	<b>79,974</b>	<b>9,717</b>	<b>1,284,269</b>

#### Interest rate risk

At 31 December 2007 and 2006, deposits and debt securities were interest-bearing and, therefore, were exposed to the interest rate risk. Depending on the market conditions the Fund is managing this risk by gradually increasing or decreasing the duration of assets in the investment portfolio.

Risk management and monitoring is performed within above set limits, by the Investment Committee and the Fund's Management. All recommendations/decisions are proposed / made by the Investment Committee and subsequently are subject to the approval of the management of the Fund. Daily risk management is performed by the Risk Management Department.

The following table presents a net impact of change of the fair value of financial assets, when market interest rate changed by 1%. Sensitivity analysis of interest rate risk has been determined based on "reasonably possible changes in the risk variable". The level of these changes is determined by management and is contained within the risk reports provided to key management personnel.

Impact on surplus before tax:

	As at 31 December 2007		As at 31 December 2006	
	Interest rate +1%	Interest rate -1%	Interest rate +1%	Interest rate -1%
<b>Assets</b>				
Cash and cash equivalents	4	(4)	-	-
Financial assets at fair value through profit or loss	(22,309)	22,309	(8,299)	8,299
<b>Net impact on surplus before tax</b>	<b>(22,305)</b>	<b>22,305</b>	<b>(8,299)</b>	<b>8,299</b>

#### Limitations of sensitivity analysis

The above tables demonstrate the effect of a change in a key assumption while other assumptions remain unchanged. In reality, there is a correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results.

The sensitivity analyses do not take into consideration that the Fund's assets and liabilities are actively managed. Additionally, the financial position of the Fund may vary at the time that any actual market movement occurs. For example, the Fund's financial risk management strategy aims to manage the exposure to market fluctuations. As investment markets move past various trigger levels, management actions could include selling investments, changing the investment portfolio allocation and taking other protective action. Consequently, the actual impact of a change in the assumptions may not have any impact on the liabilities, whereas assets are held at market value on the balance sheet. In these circumstances, the different measurement bases for liabilities and assets may lead to volatility in net assets.

Other limitations in the above sensitivity analyses include the use of hypothetical market movements to demonstrate potential risk that only represent the Fund's view of possible near-term market changes that cannot be predicted with any certainty; and the assumption that all interest rates move in an identical fashion.

#### Liquidity Risk

Management's guiding policies are to maintain conservative levels of liquidity to ensure that the Fund has the ability to meet its obligations under all conceivable circumstances.

An analysis of the liquidity risk of balance sheet items is presented in the following table:

As at 31 December 2007:

Assets	Up to 1 month	1 month to 3 months	3 month to 1 year	1 year to 5 years	Over 5 years	Total
Cash and cash equivalents	316,331	-	-	-	-	316,331
Financial assets at fair value through profit or loss	18,706	109,084	192,626	1,583,271	84,450	1,988,137

31 dekabr 2006-cı il tarixinə:

Assets	Up to 1 month	1 month to 3 months	3 month to 1 year	1 year to 5 years	Over 5 years	Total
Cash and cash equivalents	69,930	-	-	-	-	69,930
Financial assets at fair value through profit or loss	35,160	111,239	473,608	590,036	58,696	1,268,739

#### Price risk

Price risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security or its issuer or factors affecting all securities traded in the market. The Fund is exposed to price risks of its products which are subject to general and specific market fluctuations.

The Fund manages price risk through periodic estimation of potential losses that could arise from adverse changes in market conditions and establishing and maintaining appropriate stop-loss limits and margin and collateral requirements.

Risk management and monitoring is performed within above set limits, by the Investment Committee and the Fund's Management. All recommendations/decisions are proposed/made by the Investment Committee and subsequently are subject to the approval of the management of the Fund. Daily risk management is performed by the Risk Management Department.

#### 15. RELATED PARTIES

Related parties or transactions with related parties, as defined by IAS 24 "Related party disclosures", represent parties that directly, or indirectly through one or more intermediaries: control, or are controlled by, or are under common control with, the Fund; have an interest in the Fund that gives them significant influence over the Fund; and that have joint control over the Fund.

Settlements with related parties consisted of the following at December 31:

Related party		Receipts from related parties	Transfers to related parties	Payables to the related parties	Receivables from related parties	Bank accounts with related parties	Off- balance sheet commitments
The State Refugees Committee and Internally Displaced Peoples' Social Development Fund	2007	-	154,117	-	-	-	-
	2006	-	110,032	-	-	-	-
Azerbaijan (BTC) Limited	2007	-	-	-	-	-	-
	2006	-	75,409	-	-	-	-
The State Budget	2007	-	585,000	12,608	-	-	-
	2006	-	585,000	-	309	-	-
Reconstruction of the Samur-Apshehon irrigation system	2007	-	76,900	-	-	-	-
	2006	-	37,000	-	-	-	-
Construction of the new Baku-Tbilisi-Kars railway line	2007	-	20,712	-	-	-	-
	2006	-	-	-	-	-	-
Controlling shares of SOCAR in ACG projects	2007	-	87,559	-	-	-	-
	2006	-	-	-	-	-	-
Construction of water pipeline Oguz-Gabala- Baku	2007	-	132,907	-	-	-	-
	2006	-	82,749	-	-	-	-
Azerbaijan Investment Company	2007	-	-	-	-	-	-
	2006	-	90,000	-	-	-	-
SOCAR	2007	1,675,019	-	-	-	-	-
	2006	921,596	-	-	-	-	-
National Bank of the Republic of Azerbaijan	2007	-	-	-	-	31,998	-
	2006	-	-	-	-	26,963	-
International Bank of the Republic of Azerbaijan	2007	-	-	-	-	624	-
	2006	-	-	-	-	202	-
Ministry of Finance of the Republic of Azerbaijan	2007	-	-	-	-	-	535,000
	2006	-	-	-	-	-	398,000

Transactions with related parties are fully described in Note 11, 12 and 16.

#### Key management personnel

The senior management group consists of the Fund's Executive Director and heads of administrations. The aggregate remuneration of members of the senior management group and the number of managers determined on a full-time equivalent basis receiving remuneration within this category are:

	2007	2006
Aggregate remuneration	39	34
Number of persons	2	2

#### 16. COMMITMENTS AND CONTINGENCIES

##### Off-balance sheet transactions

On 11 August 2006 the Fund signed an Asset Management Agreement on "Granting free budget (balance) funds to trustworthy management" with the Ministry of Finance of the Republic of Azerbaijan. According to this agreement free budget funds of the Ministry of Finance of the Republic of Azerbaijan are to be transferred to and managed by the Fund within the asset management rules set in the agreement with the Ministry of Finance. The Fund manages these assets free of charge, on its own behalf and in favor, at the expense and at the risks of the Ministry of Finance. As at 31 December 2007 assets received under above agreement were AZN 535,000 thousand (571 million US Dollars and 31 million Great Britain Pounds (2006: AZN 398,000 thousand (457 million USD)) including accrued interest.

##### Legal proceedings

In 2004, a legal action totalling approximately six million US Dollars was brought against the government of the Republic of Azerbaijan along with a number of Azerbaijan governmental institutions, including the Ministry of Communications of the Republic of Azerbaijan, the State Oil Company of the Republic of Azerbaijan and the Fund. This legal action was brought by a foreign bank in the District Court of Rotterdam, the Netherlands. The Fund's management believes this legal action is without merit and that the Republic of Azerbaijan will prevail. However, at the date of these financial statements the outcome of the legal action is uncertain. These financial statements do not include any adjustments which could result from the possible outcome of this uncertainty.

##### Taxation

The calculation of profit tax in Azerbaijan tax legislation can be subject to various interpretations and this may lead to certain possible additional obligations of the Fund, including additional taxes, penalties and interest. Tax years for the calculation of profit tax, Value Added Tax, personal income tax, withholding taxes and other taxes remain open to review by the tax authorities for three years. Management believes that the Fund has already made all necessary tax payments due, and therefore no provisions have been made in these financial statements for any other potential liabilities.

##### Operating environment

The Fund's principal business activities are within the Republic of Azerbaijan. Laws and regulations affecting the business environment in the Republic of Azerbaijan are subject to rapid changes and the Fund's assets and operations could be at risk due to negative changes in the political and business environment.

#### 17. SUBSEQUENT EVENTS

##### Receivables and transfers

In accordance with Decree #687 on "Ratifying the Budget of the State Oil Fund of the Republic of Azerbaijan for 2008" dated 26 December 2007, the Fund's budgeted income and expenses for 2008 estimated at AZN 3,609,361 thousand and AZN 1,680,853 thousand respectively. The following types of expenses for the year 2008 are budgeted:

- Financing of the measures for improvement of social conditions of refugees and internally displaced people - AZN 145,000 thousand;
- Transfer to the State Budget of the Republic of Azerbaijan for 2008 - AZN 1,100,000 thousand;
- Construction of water pipeline from Oguz-Gabala zone to Baku city - AZN 211,820 thousand;
- Reconstruction of the Samur-Apshehon irrigation system - AZN 120,600 thousand;
- Construction of the new Baku-Tbilisi-Kars railway line - AZN 88,682 thousand;
- Financing the State Program on "Education of Azerbaijan youth in foreign countries" during 2007-2015 - AZN 5,000 thousand.

## STATEMENT OF MANAGEMENT'S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007

The following statement, which should be read in conjunction with the independent auditors' responsibilities stated in the independent auditors' report set out on pages 2-3, is made with a view to distinguishing the respective responsibilities of management and those of the independent auditors in relation to the financial statements of the State Oil Fund of the Republic of Azerbaijan (the "Fund").

Management is responsible for the preparation of the financial statements that present fairly the financial position of the Fund at 31 December 2007, the results of its operations, cash flows and changes in net assets for the year then ended, in accordance with International Public Sector Accounting Standards ("IPSAS").

In preparing the financial statements, management is responsible for:

- ♦ Selecting suitable accounting principles and applying them consistently;
- ♦ Making judgments and estimates that are reasonable and prudent;
- ♦ Stating whether IPSAS have been followed, subject to any material departures disclosed and explained in the financial statements; and
- ♦ Preparing the financial statements on a going concern basis, unless it is inappropriate to presume that the Fund will continue in business for the foreseeable future.

Management is also responsible for:

- ♦ Designing, implementing and maintaining an effective and sound system of internal controls, throughout the Fund;
- ♦ Maintaining proper accounting records that disclose, with reasonable accuracy at any time, the financial position of the Fund, and which enable them to ensure that the financial statements of the Fund comply with IPSAS;
- ♦ Maintaining statutory accounting records in compliance with legislation and accounting standards of the Republic of Azerbaijan;
- ♦ Taking such steps as are reasonably available to them to safeguard the assets of the Fund; and
- ♦ Detecting and preventing fraud, errors and other irregularities.

The financial statements for the year ended 31 December 2007 were authorized for issue on 7 April 2008 by the management of the Fund.