



SOFAZ: PRESERVING OIL WEALTH

IN AN INTERVIEW WITH THE AZERI OBSERVER MAGAZINE, ADVISOR TO THE CEO OF THE STATE OIL FUND OF AZERBAIJAN (SOFAZ), NARGIZ NASRULLAYEVA-MUDUROGLU, TALKS ABOUT THE MAIN CURRENT GOALS OF THE ORGANIZATION, ITS ACTIVITIES AIMED AT AZERBAIJANI ECONOMY DIVERSIFICATION, FUTURE INVESTMENT PLANS AND SOCIOECONOMIC IMPORTANCE OF THE PROJECTS FUNDED BY SOFAZ.

BY KATIE DUSTMAN
AZERI OBSERVER EDITOR

Question: *What is the primary mission of the State Oil Fund of Azerbaijan?*

Answer: The State Oil Fund of Azerbaijan (SOFAZ) was established in 1999 as a backbone of the National Leader of Azerbaijan Heydar Aliyev's National Oil Strategy. This strategy aims to mobilize the domestic potential of the country and efficiently use the abundant oil reserves for the prosperity of the Azerbaijan people. The three pillars of the National Oil Strategy include attraction of foreign investments and expertise in the development of the country's oil and gas resources; establishment of multi-optional export routes; and efficient and transparent management of generated revenues. Creation of the State Oil Fund established that prudent oil revenue management framework in anticipation of substantial revenues generated from the development of the country's oil fields.

The primary strategic goal and mission of SOFAZ is the transformation of depletable hydrocarbon reserves into financial assets generating perpetual income for current and future generations. SOFAZ's main objectives are the preservation of macroeconomic stability in the country, ensuring intergenerational equality and financing of major social and infrastructure projects that benefit the society as a whole and support socioeconomic progress.

Q.: How does SOFAZ help stabilize the economy of Azerbaijan? In particular, how did it sustain the economy in the period of economic crisis after the oil prices fell in 2015-2016?

A.: Preserving fiscal and macroeconomic stability was assigned in the statute of SOFAZ as one of its prime responsibilities. In the Azerbaijani context, it predominantly requires shielding the economy from oil price shocks caused by their rapid fluctuations. Hence, SOFAZ reserves act as a buffer against price fluctuations, ensuring macroeconomic stability and monetary discipline.

During the 2015-2016 crisis, the abundance of assets accumulated through the country's substantial oil income played a positive role in continuing operations. The uninterrupted transfer to the state budget made it possible to sustain all of the necessary

current expenditures, securing timely payments of salaries to public sector employees and stable provision of public services. In 2017, SOFAZ took responsibility for ensuring the stable amount of foreign currency in circulation, making a payment of 2.3 billion USD to the Central Bank as a one-off measure.

Q.: Have the assets of SOFAZ suffered greatly during the crisis?

A.: The initial shock to SOFAZ from the oil price downfall was huge. Throughout 2015, SOFAZ's assets fell from 37.1 billion USD (in 2014) by 9.5% to 33.6 billion USD, and then by an additional 1.3% in 2016. However, a combination of rising oil prices with successful optimization of the state budgetary expenditures that enabled a significant decrease of the SOFAZ transfer (in 2017, it equaled 3.54 billion USD as opposed to 11.9 billion USD in 2014) enabled the rapid recuperation of the SOFAZ's assets, which are now at an all-time peak level of 38.9 billion USD.

Q.: What is the medium- to long-term outlook for SOFAZ regarding the assets under management and encouraging economic diversification?

A.: Our medium- and long-term projections for the SOFAZ revenues are based on a reasonable estimation of the oil price at 60 USD per barrel. According to our current forecasts, by the end of 2022, SOFAZ's assets will reach the level of 50.8 billion USD.

Speaking of economic diversification, the newly adopted fiscal rule of Azerbaijan specifically targets this goal. It envisages that the share of the non-oil deficit (the difference between non-oil budgetary incomes and expenditures) in the non-oil GDP in any given year must not exceed the respective indicator of the previous year. Since the transfer from the fund falls into the oil income category, it must adhere to the condition that consolidated budgetary expenditures may only increase if the country's non-oil GDP is growing. At the same time, consolidated budget expenditures in any given year must not exceed the previous year's level by more than 3%. These measures are meant to protect the fund's reserves from depletion and gradually decrease the economy's dependence on them.

Q.: Could you tell us about the main economic projects which SOFAZ is now implementing? How will these projects contribute to the economic and social development of Azerbaijan?

Mrs. Nargiz Nasrullayeva-Muduroglu
Advisor to the CEO of the State Oil Fund of Azerbaijan



A.: The major economic projects currently sponsored by SOFAZ, are the construction of the Baku-Tbilisi-Kars railway and the reconstruction of the Samur-Abshehon irrigation system. Their socioeconomic significance is immense. The Baku-Tbilisi-Kars line will serve as one of the crucial components in turning Azerbaijan into a regional transport hub, spurring economic diversification and foreign investment. It will be particularly important in bringing Azerbaijan's mutually beneficial economic ties with Turkey to a qualitatively new level and raising trade turnover between the two countries. As of September 30, 2018, SOFAZ's contribution to the Baku-Tbilisi-Kars railway has equaled 651.9 million USD or 589.2 million AZN.

The reconstructed Samur-Abshehon irrigation system will create a reliable source of water supply for the cities of Baku and Sumqayıt, prevent energy losses incurred from water transportation, and use this spare capacity to produce 25 MVT of energy, as well as to boost the irrigation and melioration capacity of Azerbaijan. The surface of the land that will have an improved agricultural potential after the completion of the program constitutes 150 thousand hectares, while 30 thousand hectares of land will be made arable again. As of September 30, 2018, 1.4 billion AZN has been allocated to this program.

Q.: Tell us about SOFAZ's projects in the social and education spheres. In particular, how does the fund support refugees and internally displaced persons (IDPs) and talented Azerbaijani youth?

A.: Given the gravity of the refugee and IDP problem in Azerbaijan, helping them has long been a priority for the Azerbaijani government. Thus, as of September 30, 2018, a total of 2.2 billion AZN has been allocated by SOFAZ to the program on "The Improvement of the Socioeconomic Conditions of Refugees and Internally Displaced Persons" since 2001. In 2018, the expected sum to be spent on it is equal to 200 million AZN (116.3 million USD). By the end of 2017, the program's funds were

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allocated for the construction of 71 residential districts of private houses, 16 residential blocks with 202 multistoried buildings that in total allow for the settlement of 32,480 families. In addition, 76 schools, five hospitals, various music colleges, community centers, administrative buildings, kindergartens, medical centers, an Olympic complex, as well as 49 communication junctions, 773 km of highways, 870 km of water pipelines, 1,640 km of transmission lines, 436 km of gas pipelines, and 84 km of sewerage lines were built within the framework of the program. Finally, an irrigation system covering 11,310 hectares was created. All of these measures provided opportunities for improvement of the socioeconomic conditions of the refugees and internally displaced persons and the reduction of the poverty rate among this population from 75% to 12% (6.2 times) during the last 14 years.

SOFAZ has also been financing the "State Program on Education of Azerbaijani Youth Abroad" from 2007-2015, which aims at transforming black gold into human capital. Overall, SOFAZ has financed the education of 3,454 students within the framework of the state program, where 79% have been funded to study at undergraduate or graduate levels, while 692 students have pursued doctoral or higher medical studies. The fields prioritized by the program include economics and management, medicine, industry, information and communication technologies, and law.





To finance the state program, as of September 30, 2018, SOFAZ has allocated a total of 210.5 million AZN to this venture.

It should be noted that 95% of the graduates are employed in the profession they have acquired, some of them teach at the leading universities in Azerbaijan or share their knowledge via various online course platforms. The positive effects of the state program will be continuously appreciated in the years to come. The beneficiaries of the program are set to exert lasting influence on the socioeconomic development of Azerbaijan.

Q.: What are SOFAZ's future investment plans, taking into account Azerbaijan's eagerness to diversify its economy?

A.: One of SOFAZ's main objectives is the preservation of macroeconomic stability by insulating the economy from oil revenue volatility and decreasing dependence on hydrocarbons. Apart from financing critical infrastructure projects, along with the projects aimed at the socioeconomic development of the country, SOFAZ also assists with the diversification of the Azerbaijan economy. By implementing investment policies which act as a buffer to maintain macro-stability of the economy, as well as, building global investment portfolios that diversify away from the oil and gas industries, SOFAZ provides a shield against decreasing energy prices. In line with a long-term focus strategy, SOFAZ has managed to diversify its investment portfolio. According to this strategy, our current investment portfolio includes investments in fixed income instruments, equities, and real estate in approximately 50 countries. Going forward, SOFAZ will continue deployment of its funds within major asset classes in the quest of maximizing risk-adjusted returns. We regularly track the financial markets, analyze the investment circumstances and opportunities through the research-based methodologies, and evaluate them appropriately.

Q.: What measures do you take to limit SOFAZ's investment risks?

A.: Given that SOFAZ, as an institutional investor, is facing a variety of risks, our risk management framework identifies and effectively manages main sources of risks associated with the

'ONE OF SOFAZ'S MAIN OBJECTIVES IS THE PRESERVATION OF MACROECONOMIC STABILITY BY INSULATING THE ECONOMY FROM OIL REVENUE VOLATILITY AND DECREASING DEPENDENCE ON HYDROCARBONS.'

fund's investment activity that is embedded within "Rules on management of foreign currency assets of SOFAZ" (hereinafter Investment Guidelines), "Investment Policy," and internal procedures. According to these Investment Guidelines, SOFAZ should hold foreign currency assets securely and generate revenues by efficient management. In order to mitigate the fund's foreign currency asset risks, limits are defined in the investment policy of the fund based on several risk classes, including market and credit risk indicators, along with other risk measures.

Market risk is analyzed at different levels (currency, asset class, and other factors), and one of the key tools to manage this risk is diversification within these levels. Hence, our investment portfolio construction process incorporates diversification that takes into account the risks of individual assets as well as correlations between asset classes, while considering other investment related constraints. Measures we use to assess market risks include Value at Risk, tracking error, scenario analysis, stress tests, etc. For the purpose of internal risk management, Value at Risk is a commonly and valuably used process to find the total risk.

Credit risk management is another crucial part of SOFAZ's risk procedures. The fund's "Investment Guidelines" and "Investment Policy" set restrictions and thresholds on the credit ratings of issuers and securities including the maximum weight that can be allocated to one issuer or holding. Additionally, internal models have been developed to handle the credit risk of the investment portfolio.

Apart from the abovementioned investment risks, SOFAZ takes into account other non-investment risks (operational, reputational, strategic, etc.) by adhering to relevant norms and procedures.

Q.: There are only several funds in the world similar to SOFAZ. How has their experience helped you develop your activity?

A.: While SOFAZ has a unique mission and objectives, there are various sovereign wealth funds worldwide sharing common characteristics with SOFAZ. SOFAZ closely follows activities of its peers and engages in knowledge-sharing with them.

Being one of the founding members of the International Forum of Sovereign Wealth Funds (IFSWF), SOFAZ is an active member of the IFSWF and has systematically participated in its meetings. This organization has more than 30 global sovereign wealth funds as its members which commit to working together and strengthening the community through dialogue, research, and self-assessment. Since IFSWF facilitates cooperation among its members, SOFAZ and its employees get access to the best practices and benefit from international experience.



SOFAZ also cooperates with large and influential international organizations, investment banks, and other financial institutions such as World Bank, IFC, Black Rock, Bank of New York Mellon, etc. and continually participates in various training, conferences, and workshops. These activities help SOFAZ's employees build up a strong practical knowledge and apply it to further the development of the fund as an organization, improving its investment activity and achieving strategic goals within its objectives.

Q.: How has SOFAZ served to the growth of influence of Azerbaijan in the international arena?

A.: Since its creation, SOFAZ has sponsored several strategic projects contributed considerably to raising the international role of Azerbaijan. The Baku-Tbilisi-Ceyhan (BTC) oil pipeline, completed in 2005, was a breakthrough in the development of independent Azerbaijan, making it a global player at the energy market and raising global interest in the security and stability of South Caucasus region. The successful completion of the BTC pipeline, achieved on time despite various pressures, demonstrated the success of a balanced foreign policy strategy pursued by Azerbaijan.

In the recent years, SOFAZ has funded two other large projects: the Baku-Tbilisi-Kars railway, which was partially launched in October 2017, and the Southern Gas Corridor pipeline, which is in the final stage of construction and is set to start functioning very soon. These projects contributed to the strengthening of Azerbaijan's role in ensuring European energy security and gave new momentum to the country's economic development. The Baku-Tbilisi-Kars project, almost exclusively built at the cost of three countries – Azerbaijan, Turkey, and Georgia – reflected their commitment to developing friendly and mutually beneficial relations. Overall, Baku's ambition is to become a transport hub of strategic importance, benefiting from the country's geographical location and carefully balanced foreign policy.

On the other hand, being an institutional investor, SOFAZ invests in various asset classes, holds minority shares of the largest companies around the world, and cooperates closely with powerful organizations and investment companies. The fund owns numerous real estate objects in the central districts of London, Paris, Seoul, Tokyo, Milan, and Moscow and acts as a reliable partner in co-investments with widely-recognized investors. It is important to highlight that SOFAZ has been included in the list of 100 most significant, resilient, and impactful asset owners and public executives of 2018. In this globally recognized list, SOFAZ has been ranked 10th amongst the hundred most impactful public investors.

SOFAZ also actively participates in numerous conferences representing Azerbaijan and its sovereign wealth fund. In 2009, SOFAZ hosted the inaugural meeting of IFSWF in Baku. As I mentioned earlier, since the establishment of IFSWF, SOFAZ has been an active member, participated in all of its annual meetings, and has actively contributed to the work of its committees. In March 2016, SOFAZ hosted the first knowledge-sharing workshop on the Generally Accepted Principles and Practices (GAPP) for sovereign wealth funds known as Santiago Principles.

The noteworthy event in the short history of SOFAZ is the United Nations Public Service Award in the category of "Improving transparency, accountability, and responsiveness in the Public Service" in 2007. Considering the UN Public Service Award is the most prestigious international recognition of excellence in public service, this event is considered a substantial achievement for Azerbaijan. SOFAZ is the first governmental agency granted this award among the governmental institutions of the Eastern Europe and CIS countries. Additionally, SOFAZ is placed among the top sovereign wealth funds in the Linaburg-Maduell transparency index, developed at the Sovereign Wealth Fund Institute, and "Accountability and Transparency" category of Sovereign wealth fund scoreboard, published by Peterson Institute for International Economics.