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Partnership for Environment and Growth



This project is funded by the EU

## Scaling up green investment and finance in Azerbaijan







# SCALING UP GREEN INVESTMENTS AND FINANCE IN AZERBAIJAN

CAN PRIVATE INVESTORS FINANCE THE GREEN,  
LOW-CARBON AND ENERGY EFFICIENT DEVELOPMENT  
IN AZERBAIJAN

**OVERVIEW OF GREEN FINANCE IN AZERBAIJAN**

**Background paper**



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## Abbreviations

|        |   |
|--------|---|
| CBA    | Central Bank of Azerbaijan                                |
| CEEP   | EBRD Caucasus Energy Efficiency Programme                 |
| DAC    | OECD Development Assistance Committee                     |
| EaP    | Eastern Partnership                                       |
| EBRD   | European Bank for Reconstruction and Development          |
| EU     | European Union  |
| FMSA   | Financial market Supervision Agency                       |
| GDP    | Gross domestic product                                    |
| GGF    | Green for Growth Fund                                     |
| IBA    | International Bank of Azerbaijan                          |
| IFC    | International Finance Corporation                         |
| IFI    | International Finance Institution                         |
| INDC   | Intended Nationally Determined Contribution               |
| MRV    | Measurement, reporting and verification                   |
| MSME   | Micro, small and medium-sized enterprise                  |
| NAMA   | Nationally appropriate mitigation action                  |
| NAP    | National adaptation plan                                  |
| NPL    | Non-performing loan                                       |
| OECD   | Organisation for Economic Co-operation and Development    |
| PIP    | Public Investment Programme                               |
| PPA    | Power Purchase Agreement                                  |
| SAARES | State Agency for Alternative and Renewable Energy Sources |
| SME    | Small and medium-sized enterprise                         |
| TANAP  | Trans-Anatolian natural gas pipeline                      |
| TAP    | Trans-Adriatic pipeline                                   |
| USD    | United States dollar                                      |

### Units of measure

|                 |                |
|-----------------|----------------|
| CO <sub>2</sub> | Carbon dioxide |
| GW              | Giga watt      |
| MW              | Mega watt      |





## Overview of Green Finance in Azerbaijan

This report reviews the development of the market for environmental finance in Azerbaijan. Beginning with an overview of recent macro-economic performance, it then sets out the developing situation in Azerbaijan's banking and financial markets. The report provides an overview of policies and targets that support green investment, before detailing examples of green finance and associated projects. It concludes with a set of questions that help frame a discussion on scaling up green finance the country.

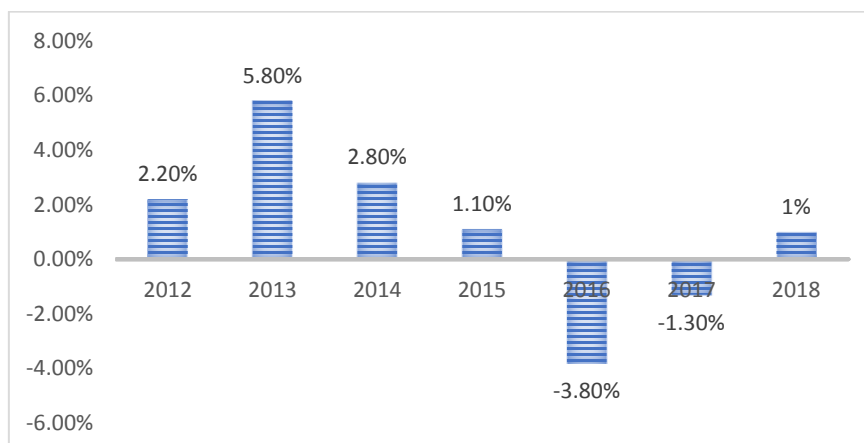
The report aims to support discussion at the workshop on green finance in Azerbaijan to be held on 4 April 2018 in Baku. The workshop is financed by the European Union (EU) "Greening Economies in the Eastern Neighbourhood" (EaP GREEN) Project which is being implemented by the Organisation for Economic Co-operation and Development (OECD) in conjunction with its partners United Nations Economic Commission for Europe (UNECE), UN Environment and United Nations Industrial Development Organization (UNIDO).

### Recent economic situation

After many years of growth, supported by oil revenues, the Azerbaijani economy was impacted in 2015 by a fall in oil prices, resulting in higher inflation and strains on the financial sector. In February 2015 and December 2015, Azerbaijan announced devaluations of the manat against the dollar reducing the value by 35% and 50%, respectively. Policy makers had reportedly used more than two thirds of foreign currency reserves in 2015 to support the manat before shifting to a managed floating exchange rate. Interest rates were raised to 15 percent to support the currency.

The devaluation aimed to restore some of Azerbaijan's lost trade competitiveness following the recent devaluations or depreciations in the currencies of Azerbaijan's neighbours and major non-energy trading partners, although many of Azerbaijan's regional competitors have also gone through devaluations themselves.

Figure 1: Azerbaijan GDP Growth 2012-18 (projected)

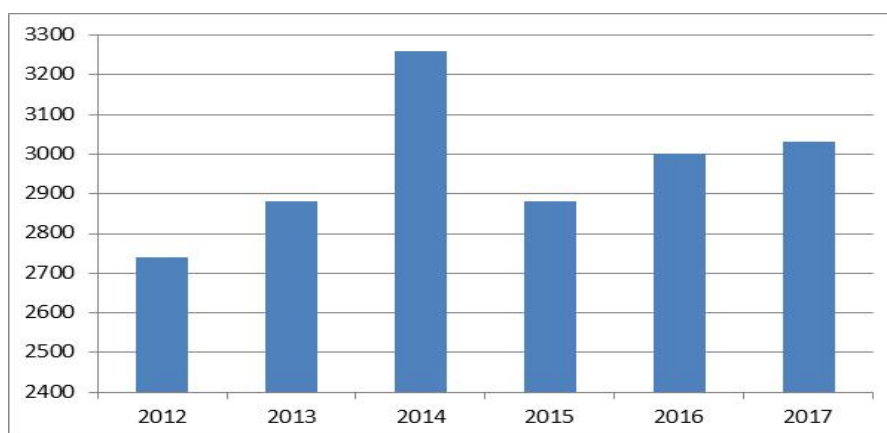


Source: World Bank, World Development Indicators database.

The economy shrank by 3.8% in 2016, and continues to contract in 2017 by an estimated 1.3%, with significant reduction in economic output in industry (mining and refineries), oil production and construction. Services continue to expand however. The World Bank expects a return to moderate growth of 1% in 2018.

Despite economic contraction, the level of capital investments in the economy has been on the rise since 2017. This most likely reflects new investments in the oil and gas sector.

Figure 2: Azerbaijan's *Gross fixed capital formation 2012 - 2017 (Azn million)*



Source: State Statistical Committee of the Republic of Azerbaijan.

Annualised inflation (which had been between 2-4%) jumped rapidly following the devaluation in December 2015 to c. 13-14% where it has remained since. The Central Bank has indicated its intention to reduce inflation to c. 6% in 2018.

In terms of economic policy, Azerbaijan is in the process of redefining its medium-term development strategy by supporting private sector development and improving the enabling environment. In December 2016, it launched a strategic roadmap for development of the national economy and 11 key sectors, with medium and long-term goals for reforms and sustainable development. There is also a focus on regional connectivity, transit and trade (e.g. Baku–Tbilisi–Kars and Trans-Anatolian Natural Gas Pipeline (TANAP) and Trans-Adriatic Pipeline (TAP)).

### Financial markets overview

The financial sector in Azerbaijan is dominated by banks, which hold 95% of financial sector total assets. The International Bank of Azerbaijan (IBA) remains the leading bank in the country, and the government continues to be its largest shareholder. IBA has undergone a USD 3.3 billion debt restructuring, having defaulted on its debt repayments in May 2017. It is swapping debt for sovereign bonds, and the government has stated its intention to privatise the bank in 2018. It had previously been restructured in 2016 with non-performing assets (estimated at up to 70% of total assets) transferred to the state-owned organisation Agrocredit.

Eleven banks were either closed or consolidated following the December 2015 devaluation, as a result of non-performing loans, lack of liquidity, and overall economic downturn. The remaining banks in Azerbaijan are privately owned with some having foreign investment.

An increasing number of private banks have attracted foreign equity investors, and the European Bank of Reconstruction and Development (EBRD), International Finance Corporation (IFC), and German financial institutions have all taken equity stakes in selected institutions. For example, in June 2017, EBRD and KfW announced they would convert USD 26 million of debt for equity to support Unibank, taking their combined shareholding in the bank to 47.6%.

The Central Bank of Azerbaijan (CBA), formerly known as the National Bank of Azerbaijan, is the central regulatory body. In February 2016, the government created a new financial watchdog, the

Financial Markets Supervision Agency (FMSA), to improve regulation and governance. The CBA continues to focus on monetary policy and exchange rate stability. Substantial state involvement in the banking sector and weak regulatory oversight had previously led to weak lending standards, corruption and inadequate capitalisation. New capital adequacy requirements came into force in January 2015 and all banks were either able to comply or given additional time to come into compliance.

Many banks were hit by the devaluation in 2015, together with a weakening in the oil price and its impact on the Azerbaijani economy. Devaluation expectations prompted many savers and companies to convert their deposits into dollars. This created a mismatch in the profile of banks loans vs. deposits, the result of which was that many banks were operating with unhedged foreign exchange positions. This in turn forced them to absorb losses during further devaluation, exposing loan books that were already of questionable credit quality. As a result, banks have seen their asset quality, capitalisation and profits decline sharply over the last 3 years.

The banking system continued to struggle in 2017-18. The exchange-rate adjustment has increased the cost of external debt service and pushed up the failure rate on banks' foreign-currency loans. According to official data, the volume of non-performing loans (NPLs) rose to 13% of the loan stock at the end of June 2017, up from 9% at the end of 2016, although this figure may in reality be higher due to under reporting. High dollarisation of deposits has restricted domestic-currency lending, and banks are likely to be reluctant to lend in foreign currency owing to enduring concerns about further devaluation of the manat. Capital levels and profitability remain weak.

Most banks offer short-term trade financing, long-term project financing, mortgages, and other modern banking products. However, the overall lack of medium to long-term capital is a constraint to financing private business in Azerbaijan. Credit supply is constrained which in turn prevents the development of small and medium-sized enterprises (SMEs) in the country. SMEs struggle with getting access to affordable credit lines due to high collateral requirements and high interest rates. Long-term trade and project financing remain under developed. Leasing in Azerbaijan remains limited, but might offer a good basis for developing company finance going forward.

Looking forward, the government has the option to recapitalise the banking sector should it be necessary due to its relatively small size. However, asset quality is likely to continue to decline. Capital adequacy levels may deteriorate further, and more bank closures are possible. There are reports of ongoing discussions around a further 5 banks which are currently experiencing difficulties. It is challenging, however, for the financial supervisory agency to enforce corporate governance standards at banks with strong political connections. Tight monetary policy (aimed at reducing dollarisation of the economy) is likely to result in overall lower lending. The banking sector remains uncompetitive, with spreads between lending and deposit rates significantly higher than in similar emerging markets.

The non-banking financial sector, particularly the micro-finance sector, is underdeveloped (representing only about 5% of the value of the financing market) but remains an important source of finance for SMEs. There are 47 Non-Bank Credit Organisations (NBCOs) as of March 2018, including several former banks whose credit licenses had previously been withdrawn. They are unable to accept deposits from consumers. The credit supply is far too small to provide a suitable environment for the development of SMEs in the country.

In addition, the State Oil Fund of the Republic of Azerbaijan (SOFAZ) acts as an investor in large-scale domestic and international infrastructure projects. It is capitalised from revenues from Azerbaijan's

state-owned energy assets and is currently capitalised to the value of USD 35 billion. Typical investments include energy infrastructure, rail, water and irrigation systems as well as socio-economic activities (education, refugees). It also supported the original capitalisation of the Azerbaijan Investment Company.

### Green investment policy

The government of Azerbaijan has prepared several policy documents setting ambitious targets and creating a framework to encourage investment in low-carbon, climate-resilient development.

- Azerbaijan 2020 highlights the possible impacts of climate change on the country’s society and economy, and the importance of preparing necessary policy measures. It also states that the amounts of energy and CO<sub>2</sub> used to produce one unit of GDP should be in line with the appropriate OECD member country benchmarks by 2020.
- Azerbaijan’s Intended Nationally Determined Contribution (INDC) outlines some of the priority sectors in mitigation. These priorities include residential and commercial buildings, fugitive gas from the oil and gas sector, and transport sector.
- The Strategy of Development of Renewable and Alternative Energy Sources in 2012-2020 aims to increase the share of electricity consumed to 20% by 2020, with a total of 9.7% of total energy consumption to be met by renewable energy sources.

The stated aim is to raise USD 7 billion in alternative energy investments by 2020, and to install 2GW of new capacity (equivalent to 20% of the overall power needs). Target technologies are wind and solar. A new strategy for renewable energy up to 2030 is now under development.

A number of policy measures are in place to support investment. For renewable energy, these have included the provision of feed-in tariffs, Power Purchase Agreements (PPA), facilitated grid connection, accelerated licensing (> 1 MW), grants and soft loans, and investment promotion certificates (income, land, property and custom tax exemptions). However, there is a lack of a general legal framework, and the Regulations on Use of Electricity do not address renewable energy.

For energy efficiency, there remains a lack of a general policy framework. Energy efficiency is mentioned in the Urban Development and Construction code and regulations were adopted in 2014 although a responsible body was not defined. Azerbaijan continues to suffer from reluctance to invest in energy-efficient technologies and materials. Despite energy price increases in 2017, the incentives to invest remain limited, although there is interest from industry due to issues of competitiveness.

*Table 1: Summary of main environmental policy measures in Azerbaijan (OCED 2016)*

| Policy  | Description   |
|---|---|
| Azerbaijan 2020: Look to the Future   | Approved in 2012 by President Ilham Aliyev. The Azerbaijan 2020 highlights the possible impacts of climate change on the country’s society and economy, and the importance of preparing necessary policy measures. It also states that the amount of energy used to produce one unit of GDP as well as the amount of CO <sub>2</sub> will need to be in line with the appropriate indicators of OECD member countries towards 2020. |
| Action Plan on improvement of ecological situation and efficient use of natural resources for 2015-2020 | The Plan highlights the importance of developing, amongst others: (i) National Adaptation Plan (NAP), and (ii) nationally appropriate mitigation action (NAMA) that incorporates elements relating to Measurement, Reporting and Verification (MRV) systems.  |

|   |  |
|---|--|
| State Strategy on Use of Alternative and Renewable Energy Sources (2012-2020)   | This strategy was prepared to promote development of a range of renewable energy sources in the country. The measures to be taken include: determination of main directions towards 2020 on electric and thermal power production from alternative and renewable sources; enforcement of legislative frameworks; incentive measures (e.g. Feed-in-Tariffs and direct subsidies); implementation of projects on alternative and renewable energy development. |
| State Programme for the Socioeconomic Development of the Regions of Azerbaijan for the period 2014-2018   | This State Programme is effectively the country's national sustainable development strategy, although its primary focus is poverty reduction.  |
| Law on Protection of Atmospheric Air  | The legal framework for establishment of regulations for air pollution and emissions and defines responsibilities of different agencies on elaboration of standards and thresholds for air pollution.  |
| Law of Azerbaijan Republic on utilization of Energy Resources   | The law determines the main direction of implementation mechanism of the legal, economic and social basis of the State policy related to energy resource utilisation and regulates the relation between the State and legal entities in this sphere.   |
| Law on "Energy"   | This law pertains to all areas in the energy sector and materials and products used in the production of energy. It states the objectives of the state energy policies. It contains requirements for the efficient use of energy and also has provisions for the obligations with respect to environmental protection, health and safety.  |
| Action Plan for Energy Efficiency and Reduction of Losses and Technological Consumption of Energy Sector Enterprises regardless of Ownership Form | This decree assigns the Ministry of Fuel and Energy (later the Ministry of Industry and Energy) to oversee the four tasks outlined in the decree. Two of the tasks involve metering and the reduction of technical losses.   |

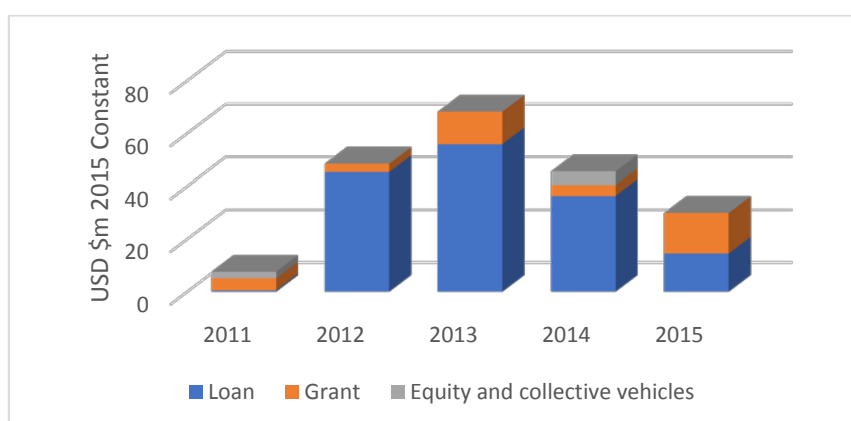
## Financing sources

Azerbaijan has shown interest in investment in green projects. The State Oil Fund of Azerbaijan (the sovereign wealth fund) was established to invest in sustainable income generation. Assets were estimated at USD 35 billion in 2017. The Fund has made several investments into areas such as water supply, irrigation and transport. Public funds are also channelled through the State Agency for Alternative and Renewable Energy Sources (SAARES). A company - Azalternativenerji Ltd. was established with capital of c. USD 30 million under SAARES to develop renewable energy resources. The sovereign wealth fund has also shown interest in longer term investment, for example taking a stake in the IFC-managed Catalyst Fund (private equity and debt investments for climate change companies).

Elsewhere the government finances environmental projects through Public Investment Programme (PIP) and other state-owned corporations. The Asian Development Bank (ADB) estimated the total value of environmentally-related expenditures to be between 2-3% of GDP (or between 6-12% of the PIP) in 2014. The ranges reflect the volatility of state oil revenues, with a proportion going into environmental clean up and municipal infrastructure (e.g. waste management) (ADB, 2014).

Significant financing comes from other large corporate and financial institutions. However, many banks have struggled due to the financial crisis and are currently in discussions for support with the regulator, have required recapitalisation or are considering consolidation.

**Figure 3: Development flow for environmental and climate finance to Azerbaijan 2011-15**



Source: OECD DAC database.

Many of the green investments are supported by international donors. In terms of development finance, the OECD Development Assistance Committee (DAC) estimates approximately USD 200 million of development financial flows relevant to climate change for the period 2011 - 2015 of which more than 75% has been in the form of loans at market or concessional rates, but with also some equity investments. Donors have also provided grants for technical assistance.

Development partners often fund environmental finance through local financial institutions. The EBRD's Caucasus Energy Efficiency Programme (CEEP) is active in Azerbaijan and since 2014 has supported 4 local banks (Demirbank, Muganbank, FINCA and Unibank) with credit lines totalling USD 16.5 million since 2014. In addition, the Green for Growth Fund (GGF) has concluded credit lines with two further banks (Accessbank and Muganbank). These credit lines help local companies and households to buy and install more energy-efficient equipment, appliances and materials, together with small scale renewable technologies. These include modern production facilities, double-glazed windows, insulation, gas boilers, solar water heaters and rooftop solar panels. Credit lines come with technical assistance support where necessary to help design and appraise projects.

**Table 2: Summary of IFI funded environmental credit lines to local FIs in Azerbaijan**

| Year | Donor     | Recipient FI    | Value (million USD) | Target            |
|------|-----------|-----------------|---------------------|-------------------|
| 2015 | EBRD CEEP | Unibank         | 1.5                 | Retail, corporate |
| 2014 | GGF       | Muganbank       | 5.0                 | Residential, MSME |
| 2014 | EBRD CEEP | Demirbank       | 5.0                 | Retail, corporate |
| 2014 | EBRD CEEP | Muganbank       | 3.0                 | Retail, corporate |
| 2014 | EBRD CEEP | FINCA           | 6.0                 | Micro, SME (MSME) |
| 2014 | GGF       | Accessbank      | 15.0                | MSME              |
| 2013 | IFC       | Bank Respublica | 15.0                | SME               |
| 2013 | EBRD      | Accessbank      | 4.2                 | Direct investment |

Source: EBRD, GGF, IFC websites.

There have been several large-scale capital investments in Azerbaijan in renewable energy and energy efficiency, together with investments in underlying technology development as well as a number of renewable energy turnkey contractors. Some of the most prominent examples are set out in Table 3.

**Table 3: Examples of large scale renewable and energy efficiency investments**

|                                       |   |
|---------------------------------------|---|
| Hybrid power plants                   | Gobustan Experimental Polygon and Training Center (5.5 MW)  |
| Solar power plants                    | Pirallahy Solar Power Plant (2.8 MW)<br>Surakhany Solar Power Plant (2.8 MW)<br>Sumghait Solar Power Plant (2.8 MW)<br>Nakhchivan Solar Power Plant (20 MW) |
| Wind power plants                     | Yeni Yashma Wind Farm (50 MW)<br>Sitalchay Wind Farm (3.6 MW)<br>Hokmaly Wind Farm (8 MW)<br>Wind Island 1 (200 MW) – Under development                     |
| Biomass power plants                  | Biomass co-generation on Oghuz and Agjabedi (16 MW)   |
| Industrial energy efficiency          | USD 257 million investment in efficiency of the Garadagh Cement Plant (2009)<br>Reducing fugitive emissions (e.g. Lukoil Shah Deniz Stage II (2015))        |
| Technology development and production | Azguntex Solar Panel plant was opened in 2012 with a view to producing panels to a volume of 50 MW/year<br>Sumgait High Tech Park Project                   |
| Renewable energy turn-key contractors | Alten Group<br>SOCAR  |

### Key questions for discussion

On the basis of this analysis, a number of key questions arise for discussion:

- How does the current economic situation and financial sector development support and/or constrain the scale up of green finance in Azerbaijan?
- What policy or market barriers exist to developing a more active community of financial institutions and other investors, and how might they be overcome?
- What best practices exist to help scale up green investment within the region and can these lessons be transferred to Azerbaijan?
- What should be the respective roles and responsibilities for policy makers, financial institutions and project developers to improve financing flows into green infrastructure?

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The report was prepared to support discussion at a workshop on green finance in Azerbaijan which was held on 4 April 2018 in Baku.

### **For more information:**

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