PROJECT FINANCE

# Azerbaijan

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## SECTION 1: Market overview

### 1.1 Please provide an overview of the project finance market in your jurisdiction.

It should be noted that there is no domestic legislation specifically governing the legal aspects of project financing other than the 2016 law on build-operate-transfer (BOT) projects. In the absence of a developed legal framework governing project finance, projects are mainly regulated by general provisions of the Civil Code of Azerbaijan, contractual arrangements between the lenders, borrowers and project sponsors. On the project finance fronts, MGB's recent experience extends to advising a consortium of international and investment banks and a credit agency in the downstream financing of a multi-million-dollar facility for the development and construction of a major refinery in Turkey (Project Star), where the State Oil Company of Azerbaijan acted as the sponsor.

To date, there have not been many project finance deals in Azerbaijan apart from very few examples in the petrochemical sector, such as the construction of a polymer producing plant in Sumgait city. Most projects in the public and private sectors, mainly in energy, have been financed through traditional secured and unsecured loan arrangements. It is expected that in the coming years, the Azerbaijani government will be interested in attracting financing for infrastructure based on the BOT model, as the law on BOT is already enacted in the country.

### 1.2 What is the composition of the market in terms of the types of active lending institutions and has this been evolving?

Active lending institutions in Azerbaijan include local and international banks and international financial institutions (IFIs) such as the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank and the DEG. The role of local banks in financing business in Azerbaijan has dramatically decreased since the financial crisis hit the local economy in 2015. In 2018, it is expected

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**About the author**

Over the last 23 years, Ismail Askerov has been regularly advising oil and gas corporations, export credit agencies and international financial institutions on corporate, investment, contracts, project finance, licensing and compliance issues. His recent experience extends to advising a consortium of international and investment banks and credit agencies for downstream financing in connection with a multi-million-USD denominated facility for the development and construction of a major refinery in Turkey (Project Star). MGB Law Office's team, led by Askerov, has also advised international clients on major regional projects, including: the financing of cross-border pipeline projects; the European Bank of Reconstruction and Development (EBRD)'s non-energy sector lending; aircraft financing; and financing upstream developments in Caspian Sea.

The independent status of MGB has been critical in establishing a positive basis for successful participation in many major projects. In recent projects, the team provided comprehensive legal support to the foreign lenders on the syndicated financing of the BTC project and acquisition financings in the aviation sector.

Askerov is highly recommended as a top tier lawyer in a number of legal directories published outside Azerbaijan for his work. These include The Legal 500 and the IFLR1000.

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Meltem Novruzova's experience primarily focuses on corporate, trade & commerce and lending. She extensively acts as a legal counsel for international financial institutions on secured and unsecured, subordinated and syndicated loan transactions, debt restructuring and security perfection issues. Novruzova has been extensively advising multinational financial institutions such as EBRD on non-energy sector finance.

that international banks and other financial institutions will significantly increase their financing to local businesses in the oil (including development of major offshore oil and gas fields in Caspian sea) and non-oil sectors such as machine building, petrochemical, food processing, agricultures and that such an increase will make them one of the most important elements supporting country's economy together with financing from local resources ie from the Azerbaijani State budget and private business groups.

### 1.3 Please describe any major current projects or initiatives that are influencing activity.

In the non-oil sector, Azerbaijan's government has been playing an active role in the implementation of the Silk Road Economic Belt, which will connect China and other neighbouring countries with the EU. Azerbaijan is the forerunner in the rejuvenation of the ancient Silk Road in terms of the re-development of multiple large-scale transnational transport systems and has already built a major international port at Caspian Sea and railroad connecting Azerbaijan, Georgia and Turkey.

In 2018, Azerbaijan's government will also continue to finance the Azerbaijan-Iran railroad project, which is a part of transnational North-South Transportation Corridor.

In addition, Azerbaijan has been expanding a unique air-space programme, to develop, build and operate the Azerspace Programme and satellite control centre, marking the second Azerbaijani satellite with external financing to be secured by a sovereign guarantee.

In November 2017, the President of the Republic of Azerbaijan established the Credit Guarantee Fund (which was subsequently merged with the Mortgage Fund) in order to support business entities by guaranteeing their loans against local banks.

## SECTION 2: Transaction structures

### 2.1 Please review some recent notable transactions involving your market and outline any interesting aspects in their structures.

There has been a multi-billion-dollar downstream project financing provided by consortium of international and investment banks and a credit agency in connection with the development and construction of a major refinery. Also, the EBRD has extended a multi-million-dollar financing to a local confectionary producer, secured by a mortgage over the plant and guarantees from local shareholders of the borrower.

### 2.2 What might the projects above mean for the market and have you noted other noteworthy developments in the way project finance transactions are being structured for a) energy projects and b) infrastructure development?

To date, most infrastructure developments have been financed by the Azerbaijani government without the support of foreign investors. However, the reliance of the government on the state budget has diminished since the oil price has dropped. Under the circumstances, the government would be interested in financing infrastructure projects from private sources, although we have not come across to infrastructure private sector financing in 2017.

In the oil and gas sector, Azerbaijan's government has already secured significant financing from the ADB and other IFIs in order to complete the TAP-TANAP pipeline, which connects the Azerbaijani gas field Shakhdaniz with EU customers. The recent $500 million financing has been secured by sovereign guarantee.

## SECTION 3: Legislation and policy

### 3.1 Describe the key legislation and regulatory bodies that govern project financing in your jurisdiction.

In principle, the core legislation applicable to financing projects, as well security instruments available under such projects, is the Civil Code of Azerbaijan. The Law on Currency Regulation and regulations of the Central Bank on exchange control and money transfers abroad will also apply to financing projects to some extent. The main legislative power of Azerbaijan is the Parliament (Milli Majlis). Furthermore, certain regulations issued by the Financial Market Supervisory Authority, the Central Bank and the Ministry of Finance may also be considered by the parties to financing projects.

### 3.2 Have there been any recent changes to regulations or regulators that may impact the finance structuring in terms of guarantee and security regimes, local currency rules and foreign investment restrictions.

Recently, Azerbaijani Parliament has adopted a new Law on Security over Movable Property, which introduced a registration mechanism for security over movable property such as inventory, machinery and other movables. Previously, security interest over movable property could be registered only with respect to certain categories of movable properties which are subject to state registration (vehicle, aircraft, shares and participatory interests only).

### 3.3 Please describe the regime governing renewable energy investment.

On October 21 2004, the Azerbaijani government introduced a special State Program on Use of Alternative Sources of Energy. The functions of implementation and control over the use of alternative sources of energy are assigned to the State Agency on Alternative and Renewable Sources of Energy. However, since 2005 there have been no significant investments made in the renewable energy sector.

### 3.4 Does your jurisdiction have incentive schemes in place for various types of energy or infrastructure project development?

As discussed above, Azerbaijani Parliament recently, adopted a new Law which introduced use a BOT model in Azerbaijan. The BOT model envisages the repayment of investment costs (including incomes) under investment projects in the sphere of construction and infrastructure to an investor by way of the purchase of goods and services from the investor by customers and designated executive bodies in accordance with a contract.

Investors may also benefit from investment promotion certificates, which will grant certain tax and customs privileges. In order to obtain these certificates, investors and their projects must meet certain criteria, regarding the specific sector of the economy, the value of the investment and location of the investment.

### 3.5 Are there any rules, legislation or policy frameworks under discussion that may impact project finance in your jurisdiction?

We are not aware of any proposed legislative changes under discussion that may impact project finance lenders or borrowers in Azerbaijan. However, recently certain legislation has been adopted by the relevant authorities in respect of the credit bureau in order to establish a reliable source for creditors to check the history of debt obligations of local borrowers.

## SECTION 4: Market idiosyncrasies

### 4.1 Please describe any common mistakes or misconceptions that exist about the project finance market in your jurisdiction.

One should note the issue of loans convertible into shareholding interests in Azerbaijan. Certain statutory restrictions apply to creditors of a local company if they intend to convert their rights to claim the loaned amount and interest under a loan agreement into shares of the borrower in order to become a shareholder of the borrower company.

The absence of domestic legislation specifically governing the legal aspects of project finance would be unlikely to lead investors into being unprotected under Azerbaijani law. General principles protecting the rights and interests of investors are established by the Azerbaijani Civil Code; the Law on Protection of Foreign Investments; and the Law on Investment Activity. Furthermore, the Azerbaijani parliament regularly attempts to adopt new laws and make changes and improvements to the existing laws in order to attract more investors and project sponsors to the country.

Generally, to some extent foreign investors have a sufficient level of protection against adverse changes in Azerbaijani legislation. A clear example of such favourable treatment is the grandfathering provisions contained within the Law on Protection of Foreign Investments. The said Law states that should subsequent legislation of the Azerbaijan Republic adversely affect the interests of foreign investors, the previous law (granting more favourable treatment) will remain applicable for a subsequent period of 10 years. However, these provisions will not be applicable to amendments made in the areas of national security and public order, credit and finance, environmental protection, public moral and healthcare. The Law on Investment Activity does not limit the period to 10 years and guarantees that the previous, more favourable legislation, will be applicable for the entire duration of the agreement entered into among the subjects of the investment activity. This is not consistent with the provisions of the Law on Protection of Foreign Investment and we are of the view that the provisions of the Law on Investment Activity would prevail on the basis that it was adopted later in time.

### 4.2 What measures should be taken to best prepare for your market idiosyncrasies?

Foreign court judgments may be enforced in the Republic of Azerbaijan only if there is a valid bilateral agreement between the Republic of Azerbaijan and a relevant country as to enforcement of the judgment of a court delivered in one country in respect of the other country-signatory. Thus, parties to a project finance should consider this fact if they choose to apply to a foreign court for the settlement of a dispute.

It should also be noted that the process of enforcement of security (on the basis of a notarial writ or decision of lower court) may be in practice protracted if the borrower/security provider uses delaying tactics during litigation process.

## SECTION 5: Practical considerations

### 5.1 How established is the legislative framework and authorities that govern public-private partnerships (PPP) and where have PPP structures most successfully been applied?

There are no well-established legislative frameworks and regulations implementing PPPs in Azerbaijan. However, the Law introducing the BOT model also regulates PPPs.

Under the Law, PPPs are implemented between public and private partners in Azerbaijan on the basis of the BOT model in the field of construction of facilities such as sea ports, highways, railroads, airports, bridges, tunnels, plants and factories, industrial parks, high technologies parks, agricultural parks, etc.

### 5.2 What are the key considerations relating to foreign investment into projects as regards insurance and tax structures?

The core document regulating taxes and the tax system in Azerbaijan is the Tax Code. At the same time, the Azerbaijani government has entered into a number of double tax treaties (DTT) with different countries. In the event of a contradiction between the Tax Code and any DTT, the provisions of the relevant DTT shall prevail. Furthermore, each of the Production Sharing Agreement and Host Government Agreement and their relevant protocols establish a specific tax regime with respect to companies operating under such agreements. Under the Tax Code, the withholding tax (WHT) rate on interest repayable under the loan is fixed at 10% subject to the terms of a particular Double Tax Treaty.

Azerbaijani law does not envisage different rules with respect to insurance of foreigners investing into projects in Azerbaijan, except that foreigners working under the PSAs and HGSs are exempt from social insurance contributions.

### 5.3 Are there any specific issues creditors should be mindful of regarding a bankruptcy and restructuring scenario?

Under Azerbaijani bankruptcy legislation, claims of secured creditors are subject to satisfaction outside the scope of bankruptcy proceedings, i.e., collateral is not included in the estate of the insolvent debtor and the secured creditor is entitled to enforce its security regardless of how other property of the insolvent debtor is dealt with within the bankruptcy.

On the bankruptcy of a company (other than banks and insurance companies), funds available to meet unsecured claims are applied in the following order of priority: (1) bankruptcy costs; (2) claims of employees for bodily injuries; (3) claims of employees related to the payment of salaries, compensation and allowances due for the period 6 months prior to declaring the entity bankrupt; (4) taxes and social insurance payments falling due during the period beginning one year before the bankrupt debtor was declared bankrupt; and amounts owed to banks and other credit organizations in respect of loans and interest thereon (including those of non-residents) that arose before June 13 1997 (i.e. before the date of the enactment of the Law of the Azerbaijan Republic on Insolvency and Bankruptcy); (5) other unsecured claims; and (6) claims of the entity's owners.

It should be noted that under Azerbaijani law, banks can be declared insolvent by the decision of a court. An out-of-court procedure on the announcement of a bank's insolvency is illegal.

Azerbaijani law establishes the rules for voluntary debt restructuring process of banks, while such a process is not established with respect to companies other than banks. Therefore, debt restructuring process of companies other than banks shall be regulated by the agreement between the relevant parties.

## SECTION 6: Outlook

### 6.1 What are your predictions for the next 12 months in the project development and financing sector and how do you expect legal practice to respond?

Due to the instability in the oil price that we have observed during recent years, it is expected that the Azerbaijani government will be interested in developing other non-energy sectors such as agriculture, food processing, tourism, machine building and petrochemical. Furthermore, the introduction of the BOT model and the investment promotion regulations (as discussed in Section 3.4) may also encourage investors to finance non-energy sector projects.

We also note that the Azerbaijani parliament periodically adopts new laws and makes amendments and developments to existing legislation. We expect that the periodic development of Azerbaijani legislation will create a favourable legal mechanism for investors and this, in turn, will be one of the noteworthy elements attracting local and foreign investors to financing projects in Azerbaijan.

In terms of recent legislative developments, on January 18 2018, the President of Azerbaijan issued a decree to take measures to promote investment activities and protect foreign investors' rights. In order to create a favourable investment climate in Azerbaijan, the President decreed to prepare a new law on Investment Activities taking into account international practice. Such a law must be prepared within three months and will establish mechanisms for the protection of investors' rights and for providing state guarantees thereto. The law will also stipulate rules on compensation for damages, including lost profit caused to investors.