

## THE POLITICAL ECONOMY OF OIL IN AZERBAIJAN

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## Continuity and Change in Azerbaijan's Energy Diplomacy

By Murad Ismayilov, Baku

### Abstract

Azerbaijan's perceptions about the great powers and its place in the world have changed over time. In the initial post-independence period, Azerbaijan placed great hope on the west in securing its three main goals: retaining independence, restoring territorial integrity, and securing economic recovery and self-sufficiency. Since then, however, it has become disappointed in the west's ability and desire to address its key interests and has begun to diversify its ties, including to Russia and Iran.

### Changing Perceptions

The end of the Cold War and the collapse of the Soviet Union unleashed what is commonly referred to as the “new great game” in Central Eurasia, a contest among great powers—first and foremost the United States, Russia, Turkey, the European Union, China, and Iran—for the control over energy resources in the Caucasus (namely, Azerbaijan) and Central Asia (namely, Kazakhstan, Turkmenistan, and Uzbekistan), as well as—given the landlocked nature of the states in the region—transportation routes for those riches. The outcome of this struggle is largely believed to determine who will dominate Central Eurasia in the 21st century, just as the results of the 19th century great game between Great Britain and Russia in Central and South Asia were largely contingent on the control over, and ownership of, the railroad networks.

Azerbaijan entered the “new great game” with a clear set of objectives in mind, ones that defined the country's initial approach to pipeline diplomacy and conditioned the pipeline choices it made at the early stage of its independence. The pipeline politics, and security practices that came with it, however, provided for a contextual framework which constrained some practices and enabled others, thus prompting a whole array of regional processes unintended originally by the strategists in any of the states involved with the energy politics in the broader region. These security practices and their unintended effects, on the one hand, and the gradual consolidation of the regional states on the other—both associated with the pipeline politics and some broader structural forces (e.g. unexpectedly high energy prices in the 2000s)—worked in conjunction to engender the change in key objectives driving Azerbaijan's energy politics, a process conditioned by the evolution of perceptions Azerbaijan has been holding of the regional and international system, as well as of its potential place therein. This shift in goals and perceptions has worked to define the extent to which

Baku's gas diplomacy today is different from its oil politics in the 1990s.

This being so, this article is an attempt to analyze the ways in which, and the mechanisms through which, Baku's pipeline diplomacy affected and was itself affected by the change in those perceptions.

### Key Objectives behind Azerbaijan's Pipeline Diplomacy

At least three principal objectives were guiding Azerbaijan's pipeline diplomacy—as well as its foreign policy—in the early aftermath of its independence: retaining independence, restoring territorial integrity, and securing economic recovery and self-sufficiency.

First and foremost, Azerbaijan's survival as an independent fully-functioning state was not something that the leaders in Baku could or did easily take for granted. At a minimum, upholding the independence Baku had just secured from Moscow seemed as challenging as gaining it. The danger of losing independence loomed especially large among Azerbaijanis—politicians and civil society alike—in light of the tragic experience that their first statehood suffered in 1920, when Azerbaijan, following a short-lived independence, was forcefully incorporated into the Soviet Union. Fresher memories of what came to be known as “Black January”—an influx of Soviet troops in Baku on January 20, 1990 that left at least 137 people dead—added to the agony of the early post-independence years.

Second, in an effort to secure western support for its territorial integrity in the conflict with Armenia over Nagorno-Karabakh, Baku hoped to instrumentalize pipeline diplomacy and get the west to put pressure on Armenia to withdraw from Azerbaijani territory.

And third, suffering from a severe economic disruption in the early post-independence years, Baku sought to secure the western financial support that proved essential in boosting the Azerbaijani economy in those

years, support that no other side—not even Moscow—was capable of providing at the time.

This triad of objectives upon which Azerbaijan's pipeline diplomacy rested in the early 1990s, was itself rooted in, and derivative of, three underlying realities—perceptual and factual—characteristic of the time: the belief—in Baku and the broader region—that the west, and the US in particular, was committed to the independence and territorial integrity of the post-Soviet states and had the capacity to uphold this commitment; the conviction that western involvement with Azerbaijan and the broader region, unlike Russian, was not driven by colonial or neo-colonial impulses; and the recognition—both by Baku and by other countries in the broader region—of the inherent weaknesses—economic, military and political—of their young polities and, related to that, their incapacity to address on their own the challenges that faced their young post-colonial statehoods at the early stage of independence.

These basic realities, and the multitude of interests and objectives they worked to generate, have overlapped and intersected to create a complex contextual framework in which Baku's decision for westbound export routes was made in the 1990s. Three energy transportation projects—the Baku–Supsa and the Baku–Tbilisi–Ceyhan oil pipelines and the Baku–Tbilisi–Erzerum gas pipeline—were born as a result, effectively linking Azerbaijan, Georgia and Turkey to each other and to the west. The successful completion of the three pipelines, ones that make up the core of the US-inspired east-west energy corridor, led many to suggest that US engagement with the region heralded an approaching end to Russia's historical predominance in this part of the world, with the regional states, including Azerbaijan, ostensibly committed to unconditional and unidirectional pursuit of institutional, economic, cultural and political integration with the west. The post-9/11 American intrusion into Central Asia only worked to reinforce this line of thinking.

### Disappointments

The transformation of, and the evolution in, the perceptual and factual realities that underpinned Azerbaijan's energy diplomacy in the 1990s, however, ensured that these calculations proved rather misleading. The process that those changes worked to unleash engendered the shift in the content and direction of Baku's pipeline and overall energy diplomacy in the 2000s.

There are at least four ways in which the realities of the 1990s have experienced profound transformation over the period of the past two decades. First, as much

as it had hoped its pipeline diplomacy would produce a different result, Baku has failed to secure explicit recognition, either by Washington or by Brussels, of the fact that Armenia occupies part of its territory. The reality of this situation is demonstrated in the voting record on United Nations General Assembly Resolution 10693 (passed on 14 March 2008), reaffirming the territorial integrity of Azerbaijan and demanding “the immediate withdrawal of all Armenian forces from all occupied territories there.” The United States and France voted against, while other EU states chose to abstain in the vote; none of them voted in favour of the resolution. Lack of movement in this direction has significantly undermined both Azerbaijan's interest in the west and the perceived role that pipeline diplomacy could play in addressing Baku's major foreign policy objectives. Azerbaijan's sophisticated energy diplomacy has apparently failed to create a collateral effect leading to a quick resolution to the conflict over Nagorno-Karabakh on terms favorable to Baku; no longer, therefore, does Baku view energy diplomacy as a panacea for all its problems. And the west—no longer viewed as an honest and almighty broker—is now seen as either unwilling or unable to bring about what Baku would consider a fair resolution to the conflict.

Second, Russia's challenge to Georgia's territorial integrity in August 2008, combined with the west's demonstrated inability to block or repel Moscow on that point, have effectively worked to further undermine the credibility of the west, in that it served to jeopardise both the west's commitment to the regional states' security and territorial integrity and its capacity to live up to that commitment. Not only did the west, including the United States, fail to prevent the Russian assault, but—in its aftermath—NATO failed to extend a long-planned invitation for Georgia to join its Membership Action Plan (MAP) and rather chose to delay the country's membership in the organization for an indefinite future.

Third, with multi-billion dollar oil revenues flooding the Azerbaijani economy, Baku has gone through a period of exceptionally strong GDP growth, a fact that immeasurably boosted the country's economy, raised the level of its self-sufficiency and self-reliance, and, consequently, has given Baku the self-confidence that it can make its own way, something Azerbaijan earlier lacked. If anything, Azerbaijan's move to finance the construction of the Baku–Tbilisi–Kars railway in light of both Washington's and Brussels' refusal to do so, is a case in point. On the one hand, both the EU and the United States declined to fund the project and did so for politi-

cal reasons, calling attention to a reality that the west—like Moscow—would not always act in Baku’s best interests and, hence, full reliance on the latter may not be the best strategy for Azerbaijan to employ in the pursuit of its national interests. On the other hand, Azerbaijan’s move to cover a significant portion of project costs on its own highlighted the level of self-sufficiency and independence that Baku had reached over the last two decades.

Finally, with the support—both financial and political—that the west, and the United States in particular, provide being increasingly conditioned upon instituting democratic forms of governance and with the western criticism of Azerbaijan’s performance in this respect becoming ever more persistent, Baku has now come to view this as no less of a threat to its sovereignty—which it has so dearly cherished—as Moscow’s perceived attempts at reversing the collapse of the Soviet Union in the early part of the 1990s. Just as Moscow’s alleged efforts to instrumentalize its energy resources, as well as what is commonly referred to as the “frozen” conflicts in the broader region, have long been perceived as derivative of, and serving, Russia’s neo-imperial ambitions, the way in which, and the extent to which, the west has come to use democratic discourse in its relations with its partners in the east and south, has come to be viewed among the elites in Baku as a mechanism through which western neo-imperialist penetration and control are being effected. In the eyes of Azerbaijan’s political elite, western democratic knowledge, akin to Russian neo-imperialism, has come to be seen as directly threatening regime stability, on the one hand, and constraining the state in its ability to exercise “full” sovereignty and enjoy autonomy in its domestic and foreign policies, on the other, two objectives that formed the rationale behind Baku’s energy politics—and their nearly exclusive western orientation—during the 1990s. Both Moscow and Washington, therefore, have now come to be perceived as neo-imperial powers in pursuit of dominance and control.

### Strategy Change

This transformation of realities on the ground has had a significant bearing on the nature of Azerbaijan’s energy policy at the onset of the twenty-first century, an evolution that can be seen in the very different way Baku is pursuing gas diplomacy now compared to the way it played oil diplomacy in the past. In a regional and international context in which any choice of route and destination for energy exports has come to be perceived as one creating opportunities, but also fraught with challenges,

Azerbaijan’s energy policy has evolved to be guided by two major precepts.

First, in an open effort to further diversify its linkages with the outside world and the ensuing dependencies and interdependencies that come from them, Baku is now keen to have its gas distributed among as many players in the region as possible, rather than limiting its exports to a single (western) market only. In practice, that means engaging in efforts to develop eastern and southern dimensions to the east-west energy transportation network that the first stage of Azerbaijan’s energy policy has produced. And second, economic considerations—more than anything else—have come to drive Baku in its choice of routes through which its gas would be exported. While Baku’s commitment to further develop the western dimension of the energy corridor of which it is a part still holds—something reflected in the country’s unwavering support for the Nabucco gas pipeline project—the evolution of Azerbaijan’s energy policy toward at least two countries—Russia and Iran—is expressive of this change.

With Azerbaijan driven by these two tenets, Russia has now been allowed a greater role in Baku’s energy export calculations, a change reflected in the move by the latter’s state oil company to enter—in late 2009—into a short-term contract with Russia’s Gazprom on export—for market prices—of no less than 500 mcm of Azerbaijani gas annually (1 bcm of gas is actually expected to be exported to Russia in 2010). Guided by the same set of principles, Baku has now moved to open up—if slowly—to Iran, a country that the US has long sought to isolate: the east-west transport corridor was designed to bypass Iran as much as it was meant to undermine Russia’s monopoly over regional transport routes. Azerbaijan’s move to export some of its oil through Iran during and after the August 2008 crisis, as well as the short-term contract it signed with Iran’s National Gas Export Company in January 2010 on the export of 100 mcm of gas to Iran annually through the existing Gazi-Magomed–Astaras gas pipeline is a reflection of Baku’s increasing willingness to develop the southern dimension of its energy diplomacy. In its quest for alternative export routes for its gas, Azerbaijan has now also reached out, in one way or another, to Bulgaria, Italy, Greece and Romania in the west; Israel and Syria in the south; and China in the east.

### Conclusion

The efforts by Azerbaijan to diversify its energy exports should be viewed in a broader context of Baku’s attempts to diversify its economy, including in the non-energy

sector, and expand the range of its partners. The latter, in turn, is a reflection of a growing conviction in Baku

that independence is not only about freedom of land, but is also about freedom of choice.

*About the Author:*

Murad Ismayilov (email: [mismayilov@ada.edu.az](mailto:mismayilov@ada.edu.az)) has recently completed an MSt Program in International Relations at the University of Cambridge and currently serves as Program Manager for Research and Publications at the Azerbaijan Diplomatic Academy. This contribution has been prepared for the research project entitled “The Energy Sector and the Political Stability of Regimes in the Caspian Area: A Comparison of Kazakhstan and Azerbaijan”, conducted by the Research Centre for East European Studies at the University of Bremen and funded by the Volkswagen Foundation.

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## The State Oil Company SOCAR: A Microcosm of Azerbaijani Development?

By Heidi Kjærnet, Oslo

### Abstract

Baku has not shown signs of moving towards resource nationalism, but Azerbaijan’s national oil company SOCAR plays an important role in the country’s petroleum sector. In addition to being partner to the international oil companies present in Azerbaijan, the company is an actor in policy formation. Close ties between the government and the company ensure that SOCAR, in addition to being one of the biggest taxpayers in Azerbaijan, also carries out political and social tasks for the government. At the same time, commercial tasks are intertwined with petroleum policy and regulation, and the Azerbaijani national petroleum sector seems to be moving in a more opaque direction.

### SOCAR as a Microcosm of Azerbaijan

Regimes pursuing resource nationalist policies generally make the national oil companies (NOCs) an important vehicle for increased control over the petroleum sector. Azerbaijan has not followed Russia and Kazakhstan’s example in curtailing the international oil companies’ presence in the country. Studying the national oil company SOCAR nevertheless provides interesting insights into the Azerbaijani regime. Viewed as a microcosm of the challenges that Azerbaijan itself is facing, SOCAR can shed light on the country’s prospects for modernization or stagnation.

### Azerbaijani Petroleum Policy

Petroleum resources have been paramount in Azerbaijan’s economic and political development since independence. The significance of the international oil companies’ (IOCs) presence in Azerbaijan is marked particularly by two events: the signing of the so-called “Contract of the Century” with an international consortium to develop and produce oil from the Azeri-Chi-

rag-Guneshli fields in the Caspian Sea in 1994, and the construction of the Baku–Tbilisi–Ceyhan (BTC) pipeline transporting oil from Baku to Ceyhan in Turkey by a BP-led consortium, which ended the Russian monopoly on the transport of energy resources from the Caspian region. SOCAR was established in 1992 as a merger of Azerneft and Azneftkimiya, two companies with historical roots in the Azerbaijani Soviet Socialist Republic. The company is the national partner to the IOCs in all the production sharing agreements (PSAs) that exist between Azerbaijan and foreign partners. As such SOCAR has a 25 per cent stake in the BTC oil pipeline and in the South Caucasus Gas Pipeline (SCP), and it is partner to over 20 PSAs. Some of the PSAs have been abandoned due to unsatisfactory exploration results. SOCAR manages the production and sale of oil and gas from the old Soviet-era fields in Azerbaijan. These make up a very small share of the country’s total oil and gas production and exports, and SOCAR’s output has been declining by around 1 per cent a year. 80 per cent of the country’s

oil output in 2007 came from the Azerbaijani International Oil Consortium's (AIOC) fields.

The Azerbaijani leadership emphasizes the significance of the international presence in the petroleum sector, and has not displayed any signs of moving in the resource nationalist direction that Kazakhstan and Russia have. It is generally assumed that a mature extraction industry can lead to the kind of changes predicted by the obsolescing bargain literature and spur governments in resource-rich countries to renege on contracts in order to capture a larger share of revenues or gain more control of the petroleum sector. Since Azerbaijan's oil production, according to some forecasts, may peak as soon as 2011 or 2012, one could possibly expect Baku to make steps in a resource nationalist direction. However, apart from some very recent threats to reconsider its relationship with Washington in light of U.S. support for the Armenian-Turkish rapprochement, Azerbaijan's leadership has overall expressed a strong willingness to cooperate with the IOCs and even made the international presence of the IOCs an inseparable part of its foreign policy. Azerbaijan's ambitions for regional leadership in the South Caucasus also presuppose the support of international partners, thus making a resource nationalist turn unlikely.

### Give and Take

Even if Azerbaijan does not make a move towards resource nationalism, SOCAR still has an important role to fill in the country's petroleum policy. As the national partner in all the PSAs in Azerbaijan, SOCAR is the spearhead of Azerbaijani interactions with the international oil industry. Since the signing of the first PSA in Azerbaijan, in which the company had a 10 per cent share, the company's share in subsequent PSAs has been increasing. In more recent PSAs, SOCAR's share is generally between 20 and 50 per cent. This could be a sign of increased financial ability and technological competence on the company's side coupled with the political will to strengthen the company's role in the Azerbaijani petroleum sector through increasing local content.

SOCAR's political and social obligations beyond petroleum production are perhaps less known. As one of the biggest taxpayers in Azerbaijan, its success is crucial to the country's continued economic growth. But SOCAR also takes on social responsibilities directly through large-scale programs focusing on building hospitals, schools, and creating recreational opportunities for various groups of beneficiaries. The list of beneficiaries of the government's social programmes and SOCAR's social work is strikingly similar. Typically, a

school or clinic that is built by SOCAR will be opened by President Ilham Aliyev under the auspices of the Heydar Aliyev Foundation (a foundation run by the current president's wife in the name of his father, the former president). This way, the lines between the company's and the government's tasks and roles are blurred, and the company helps create an image of the oil revenues being spent for the public good.

It is not uncommon for NOCs to take on non-commercial tasks like this. In the Azerbaijani case it appears to be part of SOCAR's political obligations towards the president, in a system where loyalty to the president is a precondition for economic activity. SOCAR's special role in the Azerbaijani petroleum sector is thus a matter of both give and take. There are limits, however, to how many hospitals and schools an efficient oil company can build. Estimates of SOCAR's performance are based on limited access to quantitative data on the company's performance (see the suggested reading section), but generally indicate that the company stands out even among underperforming NOCs as terribly inefficient. SOCAR, as many NOCs, operates according to competing logics: It needs to be commercially successful, and it needs to deliver on some specific social and political tasks. Employment policies can serve as an example of the company's challenges with regard to economic efficiency: whereas Russia's Gazprom produces 17,102 barrels of oil equivalents (BOE) per employee, SOCAR only produces 2,610. It has 70,000 employees and provides them with flats, preferential summer vouchers, kindergartens, and health care services in designated hospitals. Even though petroleum sector revenues make up 59 per cent of total revenues in Azerbaijan, this economic sector only creates a very limited number of jobs, and the unemployment rates in Azerbaijan are high. In a context where the government is seeking legitimacy through increased employment rates, SOCAR's employment policies could be an indication that the company is taking on social responsibilities to alleviate the pressure on government. It could however, also be the case that the size of the company is not a conscious strategy, but rather a result of its functioning like an expanding bureaucratic structure lacking strategies and control over its own employment practices. In any case, the high levels of employment are an indicator of the company's poor economic efficiency.

Close ties between the company and government is another common characteristic of government-NOC relations in post-Soviet states. President Ilham Aliyev came to office not only as the son of the former president, but as a former vice president of SOCAR. Formally, it is the Ministry of Industry and Energy, estab-

lished twelve years after SOCAR, which is tasked with supervising SOCAR's activities. In reality the ministry's role is severely limited by the PSAs, which have the status of law and regulate all aspects of the IOCs' presence in Azerbaijan as well as the consortia's activities from production through Corporate Social Responsibility (CSR) obligations, to taxation and local content. The PSAs, and SOCAR's strong position and close ties to the president, leave little room for the ministry to engage directly with the petroleum sector.

Over time, the conflict between commercial and non-commercial goals within SOCAR could stimulate competition between groups inside the company coupled with groups in government circles favouring reform to increase efficiency and others favouring the status quo. For now, the social work of SOCAR may be a sign of its political subservience to the president. However, the competition between commercial and other goals could change if forces within the company or government unite to promote reform of the company, or if the goals set for the company are altered altogether in a political effort to modernize it. For the time being, however, despite Azerbaijan's status as an implementing country under the Extractive Industries Transparency Initiative (EITI), SOCAR is moving in the complete opposite direction, concealing more information than before. For instance, in the annual report for 2008, which was published significantly later in 2009 than has been the case with previous annual reports, SOCAR did not reveal its revenues from the sale and export of oil and petroleum products, which have figured in earlier reports. Further, SOCAR does not have a board of directors. The company's presidents and vice-presidents are appointed by the president of Azerbaijan. A board could potentially separate political and commercial decisions and translate the political influence in a more transparent manner than today, but plans to establish one have not yet materialized.

### **SOCAR's Role in Petroleum Policy Formation**

Historically, SOCAR has played a special role in Azerbaijani petroleum policy formation. Under the short-lived Popular Front government in 1992–1993, SOCAR was responsible for negotiations with foreign partners over the extraction of resources in the Caspian. There was a short intermission when Heydar Aliyev came to power and the company's seat at the negotiating table was given to one of his close allies, but SOCAR regained its role shortly after. SOCAR was at the time the only body in the newly-independent state that had the com-

petence to negotiate with international partners over oil production. To this day, the company has a dual role in the Azeri-Chirag-Guneshli contract, both as a company and as a government agency, strengthening the impression that commercial interests on the one hand, and policy formation and regulation on the other, are not dissociated in the Azerbaijani petroleum sector. SOCAR is currently negotiating with Turkish counterparts on the transport of Azerbaijani gas from the Shah Deniz field via Turkey to Europe. Transport of gas is an issue with significance beyond the field of energy, since the export routes of energy are an important part of foreign policy. Most likely, SOCAR's negotiating positions are decided in close cooperation with the president. Having a seat at the negotiating table is, however, an indicator of the company's strong position in Azerbaijan's petroleum policy formation.

### **Conclusion**

There is a profound lack of separation of commercial and political tasks in the relationship between the Azerbaijani government and the Azerbaijani national oil company SOCAR. SOCAR has established itself as a strong actor in the sector, seemingly acting in close cooperation and agreement with the president, who keeps a close eye on the petroleum sector and has his trusted allies in the company's management.

Having been the sole body in the country with competence to deal with international partners in the oil business in the early 1990s, SOCAR has since been able to retain a strong role in Azerbaijani petroleum policy formation. This has resulted in a situation where the government body charged with oversight of the company, the Ministry of Industry and Energy, has neither the authority nor the political strength needed to control SOCAR. However strong the company's role in petroleum policy formation has been historically, it would nevertheless seem that SOCAR's special role in the petroleum sector is premised upon its subservience to Azerbaijani petroleum and foreign policy, as well as delivery of certain social goods. Hence, an emancipation of SOCAR does not appear imminent. Due to the potential competition between commercial and non-commercial goals set out for the company, we may, however, see a development where SOCAR, in pursuit of greater commercial efficiency, may need to cut back on its social and political obligations. For the time being however, SOCAR is not displaying any signs of imminent reform. Rather, the movement seems to be in a more opaque direction.

*(Information about the author and further reading overleaf.)*

#### *About the Author*

Heidi Kjaernet is a Research Fellow at the Fridtjof Nansen Institute in Norway. She is currently writing a PhD thesis on the national oil companies of Azerbaijan, Kazakhstan and Russia for the University of Tromsø, and recently co-edited *Caspian Energy Politics. Azerbaijan, Kazakhstan, Turkmenistan* (Routledge, 2010) and co-authored *Russian Renewable Energy* (Ashgate, 2009).

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## Oil and Gas Revenues Management in Azerbaijan: Crude Dependence and Its Consequences

By Kenan Aslanli, Baku

### **Abstract**

Azerbaijan’s macroeconomic and fiscal indicators during the global economic crisis reflect the dependence of the Azeri economy on oil and gas. The addiction will continue to increase from year to year. The country’s rising oil dependence might upset macroeconomic and fiscal equilibriums, and intensify the risk of civil unrest among vulnerable social groups. Social repercussions are possible if oil and gas revenues are managed poorly or distributed unjustly.

### **Increased Oil and Gas Dependence in Azerbaijan’s Economy**

At a time when Azerbaijan’s dependence on energy revenue is increasing, the government is spending money in non-transparent ways. Unfortunately, there is little societal oversight to check these tendencies.

Azerbaijan’s revenues from oil and gas are expected to total \$198 billion in net present value terms through 2024. This sum will flow from the annual growth of oil and gas extraction on the basis of the joint development of oil and gas deposits in the Azerbaijani sector of the Caspian Sea and higher prices in the world oil market. As the mission statement of the State Oil Fund of Azerbaijan Republic (SOFAZ), established in 1999, points out, part of the projected income will be sterilized in the domestic economy, while another part should be saved for future generations, and it will be invested in the inter-

national securities market. For this purpose, SOFAZ cooperates with the Reserve Assets Management Program (RAMP) of the World Bank, which has been in existence for more than 40 years. Today, the World Bank manages \$114 million of Azerbaijan’s money.

In 2009, the strategic currency reserves of the country increased by \$1.8 bn., and taking into consideration the assets of SOFAZ, totaled \$20 bn. Revenue obtained from foreign exchange assets management totaled \$430 million, of which \$287.7 million went for national foreign debt servicing. As a result, earnings obtained from assets management exceeded payments for loans by a factor of 1.5. But, at the same time, foreign trade turnover fell to approximately a third of previous levels and exports declined from \$47 billion (2008) to \$14 billion (2009). SOFAZ has been actively working to provide greater transparency and accountability leading to

improved rankings in respected measures, such as the Linaburg-Maduell Transparency Index.

Also, the volatility of the dollar and the euro since early 2010 affected the size of SOFAZ assets. The fund's assets amounted to \$14.9 billion in early 2010 (an increase of 32.8% compared to early 2009). By the middle of March, their sum exceeded \$16 billion. Despite the increase in assets, SOFAZ has no plans to expand its use of foreign money managers. In 2009, the volume of Azerbaijan's currency market increased by 8.3%. Owing to the flexible regulation of the currency market and thanks to the Central Bank's (CB) intervention, the exchange rate of Azerbaijan's currency, the manat (1 USD = 0.8 AZN), remained stable, falling only 0.26% in relation to the US dollar in 2009. The drop in the Central Bank's currency reserves observed today is connected with a reevaluation of its reserves.

According to the last fiscal statement of the National Budget Group (NBG), a Baku-based budget research and advocacy group, there is serious concern that the country's economy and national budget are not sustainable in the context of the great volatility in energy prices during recent years. The government is not achieving its goal of decreased dependence on oil; to the contrary, Azerbaijan's dependence has increased. In fact, at the end of 2008, approximately 97% of total exports were crude oil and oil products. Even low oil prices during the global financial crisis did not reduce this dependence. Serious changes in the budget indicated the government's lack of an effective medium- or long-term budget policy. In other words, when energy prices are high, the government tends to spend more money, and when prices drop, it simply "controls" this appetite. Most countries stimulated their economy through deficit spending during the global financial crisis, while the Azerbaijani government considers reducing spending in most spheres as the only possible remedy.

Recent Azerbaijani budgets indicated that the dependence of the country's economy on oil and gas will increase in coming years. Generally, these problems are most visible when we observe upwards trends in oil and gas production from the fields covered by Production Sharing Agreements (PSA), and particularly the Azeri-Chirag-Gunashli site. Azerbaijan's budgets during the crisis also indicated that the reaction of the Azeri government to international economic conditions was not appropriate. In 2009, state revenues were 10.3 billion manat compared to a projected 12.2 billion manat (84%). They fell by 4.1%, compared to the same period in 2008. Public budget expenditures decreased by 1.9 percent and made up 10.6 million manat (just

85.5% of a projected 12.4 million manat). The budget deficit totaled 241.1 million manat (just 0.7% of GDP). Also, state budget expenses will decrease in 2010. The drop will be 8.8% in comparison to 2009 and it will mainly affect the social sphere, agriculture, investment, transport, communications, as well as the reserve funds. However several budget items will be increased, such as general funding for public sector personnel, law enforcement and defense institutions, transfers to the State Social Defense Fund, roads, and the Fund for State-Guaranteed Debts. If it makes sense to cut funding for several important social spheres, such as education and health, during a crisis, there is no logic to increasing expenditures on law enforcement and defense institutions by 4.9%. The anticipated reduction in corruption in this sphere after the state increased salaries was not observed; to the contrary, the situation has deteriorated considerably.

According to the 2010 SOFAZ budget, revenue is supposed to be 5.963 billion manat and expenses should be 5.428 billion. This indicates that SOFAZ will spend almost all its revenue – 91%. The majority of its outlays (82%) will be transferred to the state budget. The growing dependence of the state budget on state oil fund transfers is an issue of concern. This means that the state oil fund is turning into the main contributor to the state budget and this dependence is reaching a dangerous level, which will threaten sustainable economic development.

It is not only the increasing amount of transfers, but also the decision of the government to spend the vast majority of the State Oil Fund budget that causes concern. It is worth mentioning that the Presidential decree on the "Long-term Strategy for Oil Revenue Management" of September 27, 2004 states that at least 25% of oil revenues should be saved for future generations at the peak of the oil boom. Unfortunately, the Strategy does not provide a specific mechanism for achieving this goal. The absence of such a mechanism makes it difficult to measure oil revenue management in accordance with the Presidential decree. In any case, the fact that the government is spending a huge portion of oil revenues indicates its intention to address its lack of money in an "easy" way.

To prevent such excessive use of SOFAZ incomes, the legislature should have greater control over the budget. However, transparency and accountability regarding budget expenses have deteriorated. At present, the International Budget Partnership is paying increased attention to the growing number of budget expenditures that are not classified. This lack of transparency

will cause a drop in Azerbaijan's ranking in the Open Budget Index (prepared by the International Budget Partnership, USA) for the next period. In such a situation, the relevant state agencies (the Economic Commission of the Parliament and the Chamber of Accounts) should initiate investigations.

Another important point is that the budgets of 2009 and 2010 have unreasonably large deficits compared to the surpluses of recent years. These were 0.7% of GDP in 2009 and 4% of GDP in 2010. In the context of budget surpluses during recent years, these figures seem too high. The current priority for budget expenditures are public investments which lack transparency (unfortunately, international initiatives designed to increase transparency, such as the Extractive Industry Transparency Initiative [EITI] do not cover public investment issues). This expense line should be decreased in the upcoming years. International loans allocated for infrastructure will be added to the budget. Also, the decreasing share of tax revenue in the budget from year to year requires serious reforms in the fiscal system. State-level measures are needed to remove obstacles in the tax system that make investments in the non-oil economy unattractive. Since the share of income tax from the population in the budget is small, society is passive in monitoring the budget process.

### **Factors Causing Poor Oil and Gas Revenue Management in Azerbaijan**

Several factors facilitate the poor management of oil and gas revenues in Azerbaijan. One of the most important ones are underdeveloped democratic institutions. The undemocratic electoral process and the ineffective public administration are weakening Azerbaijan's democratic institutions. The fact that newly created institutions, such as the human rights ombudsman and municipal governments, quickly lose public respect indicates the feebleness of public trust in such elements of democratic governance.

A poorly-functioning division of power also contributes to poor management of oil and gas revenues, as the absence of checks and balances has a negative impact on the budget process. Hence, there is a well-established public belief that the main player in the decision-making process is the Presidential Administration rather than the Parliament. Such concerns are strengthened due to little public participation in the decision-making process. The main reason why people are not actively involved in the budget process is the above-mentioned public distrust and a traditional culture of low participation.

In addition, the present structure of the Cabinet of Ministers (CM) prevents it from managing affairs effectively. Addressing this problem requires an evaluation of the entire structure and a more clear definition of functions. Despite the fact that certain measures have been taken within the various technical assistance projects of the European Union, USAID and World Bank, they did not produce any results. In fact the structural reform of the CM is impossible without clear political will. The CM either does not have a strategic plan or it is not open to public involvement since it was designed to be accountable to a limited group of people. The Cabinet of Ministers' failure to coordinate and define the strategic actions of the economic ministries and committees affects them as well. All this is consequently reflected in the ineffective management of public finances.

The closed classification of numerous budget expenditures and lack of proper fiscal forecasting complicate any control mechanisms. If the first factor that causes a non-transparent budget is the gaps existing in the budget legislation, the second one is the pressure the Parliament faces in this direction. The fact that Azerbaijan ranked 50th among 85 countries included in the 2008 Open Budget Index proves that budget classifications do not fully cover the various types of expenses.

Moreover, the high level of corruption in the country makes all state control measures directed at the budget or other economic fields ineffective. And a market economy has not been completely established yet in the country. Obstacles to liberalization, such as the persistence of monopolies and state interference into the market, prevent the normal functioning of market economy laws. Consequently the "shadow economy" becomes larger and the state budget is deprived of considerable funds. Also, state monopolies, such as the State Oil Company (SOCAR), intensify nationalistic and protectionist attitudes in economy.

### **Priorities of Public Expenditure**

The budget has become more dependent on oil lately. As the state budget becomes increasingly dependent on oil, more of the non-oil parts of the budget are being cut. At least 50% of the 2010 budget is forecast to come from the oil sector. This shift means that the budget relies for its revenue on a few companies and this change has a dramatic impact on the budget process. In particular, it means that citizens play a small role in creating the budget and defining how it is spent.

Moreover, a regional disbalance of the budget can be observed as a result of the oil boom. 90% of the state budget income comes from Baku and the Absheron pen-

insula. There is also an interurban disbalance, which is found in the frequent change of the expense priorities of the budget.

The share of social protection and provision expenses in the budget as a share of GDP fell from 3% to 1.9% from 2003 to 2007 and then increased again to 3% and 3.7% during 2009–2010. Significantly increased amounts of social protection and provision expenses were allocated to pensioners, refugees and internally displaced persons (IDP); other needy layers of population also received benefits. Overall, the government planned to spend 1,192 million AZN on social expenses in 2010, despite the adverse impacts of the ongoing crisis on the entire economy. 2010 will be a “lost year” for salary and pension raises. We can observe drops in the amount of funds for salaries in comparison with 2009. Taking into account that the 2009 budget will be implemented with a deficit, it becomes clear funds for salaries in 2010 will be at the same level as they were in 2009. This means that there will not be sufficient increases in the salaries of public sector employees. Any increase will come from increasing the minimum wage and only affect citizens receiving extremely low salaries. A 5.3% increase in transfers from the State Social Protection Fund will increase the minimal pension level. In the 2010 budget, allocations to education will be 5.6% less than compared to 2009. The absolute amount of social expenses in the state budget of Azerbaijan is dynamically growing. However, its share in the structure of overall budget expenditures is decreasing. The indicator for 2010 is 10.6%.

The real poverty level is still very high, regardless of official statistics setting it at 11% for 2009. During

the crisis, the income of the population grew every year, but prices went up as well. In the long run, there was no change in the real incomes or social welfare level of the population. The large weight of refugees and IDPs in the total number of population (12%) should also be considered.

Income tax from physical persons comprises only 11% of total budget revenue (2008). The tax burden on the economy is 15% (2009). The underdeveloped budget discipline and budget culture should also be mentioned here. The population’s lack of participation in budget formation is related to the underdevelopment of small and medium-sized businesses. The coordination and management of oil and gas revenues from a single center is very weak. The first impression might be that a single center controls the management system of an over-centralized state finance system. An over-centralized budget system is undoubtedly a serious obstacle for local financial opportunities and for their producing positive economic outcomes.

### Conclusion

Even if oil and gas prices bottom out in the current decade, the forecasted levels of production, if realized, would still make it possible to increase Azerbaijan’s revenues from petroleum development. This trend might upset the macroeconomic and fiscal equilibrium, and intensify the risks of civil confrontation among vulnerable social groups. If the government manages its oil and gas incomes poorly and distributes the profits unjustly, there are likely to be some social repercussions.

### *About the Author*

Kenan Aslanli is a policy analyst examining fiscal, macroeconomic and energy issues based in Baku, Azerbaijan and a local contractor for the International Budget Partnership (Washington DC, USA). This contribution was prepared as part of the research project entitled “The Energy Sector and the Political Stability of Regimes in the Caspian Area: A Comparison of Kazakhstan and Azerbaijan”, conducted by the Research Centre for East European Studies at the University of Bremen and funded by the Volkswagen Foundation.

### *References*

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- National Budget Group’s fiscal policy recommendations: <http://www.nbg.az>
- The Statement of the Central Bank of Azerbaijan Republic about the Main Directions of Monetary Policy in 2010: [http://www.cbar.az/assets/1122/Monetary\\_2010.pdf](http://www.cbar.az/assets/1122/Monetary_2010.pdf)

**Table and Diagram**

## The Significance of the State Oil Fund of Azerbaijan Republic for the Budget of Azerbaijan

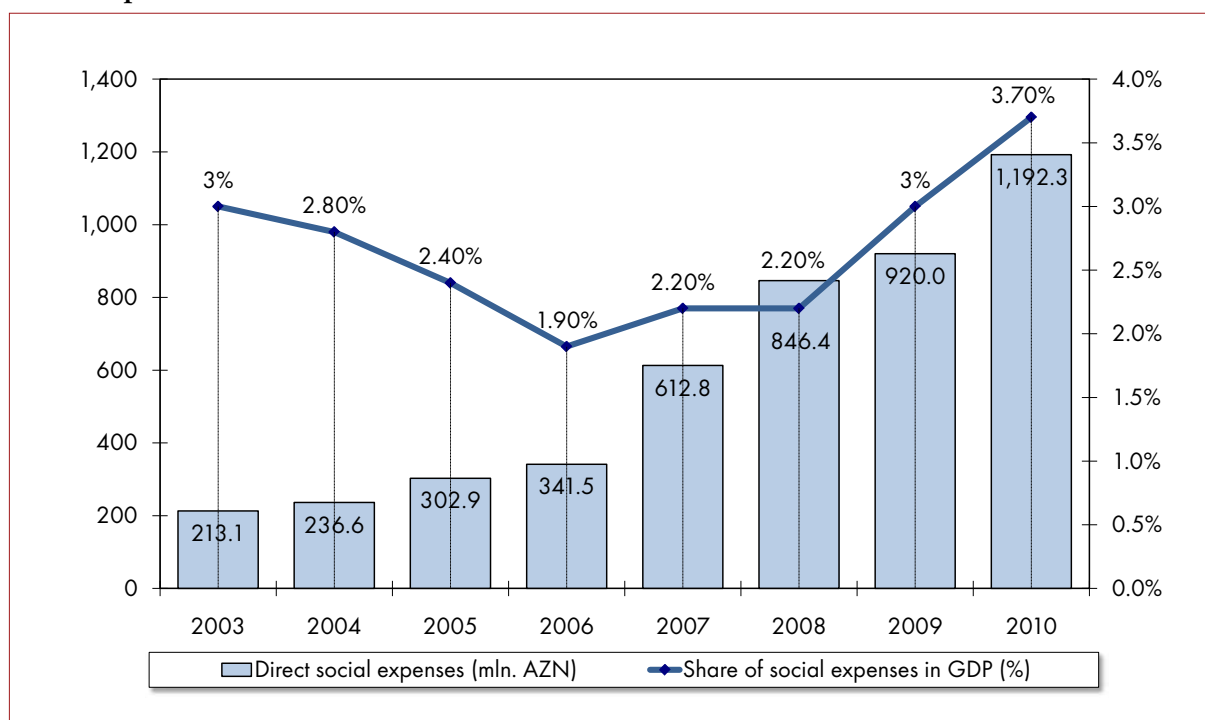
### Transfers from the State Oil Fund of Azerbaijan Republic to the Budget 2003–2010

Year	Amount of transfers to budget (in million AZN)	Increase from previous year (%)
2003	100	-
2004	130	30.0%
2005	150	15.4%
2006	585	290.0%
2007	585	0.0%
2008	1,100	88.0%
2009	4,900	345.5%
2010	4,915	0.3%

Note: 1 USD = 0.8 AZN

Source: Statement by National Budget Group, [http://www.osi.az/index.php?option=com\\_content&task=view&id=1880&Itemid=449](http://www.osi.az/index.php?option=com_content&task=view&id=1880&Itemid=449)

### Social Expenses and GDP 2003–2010



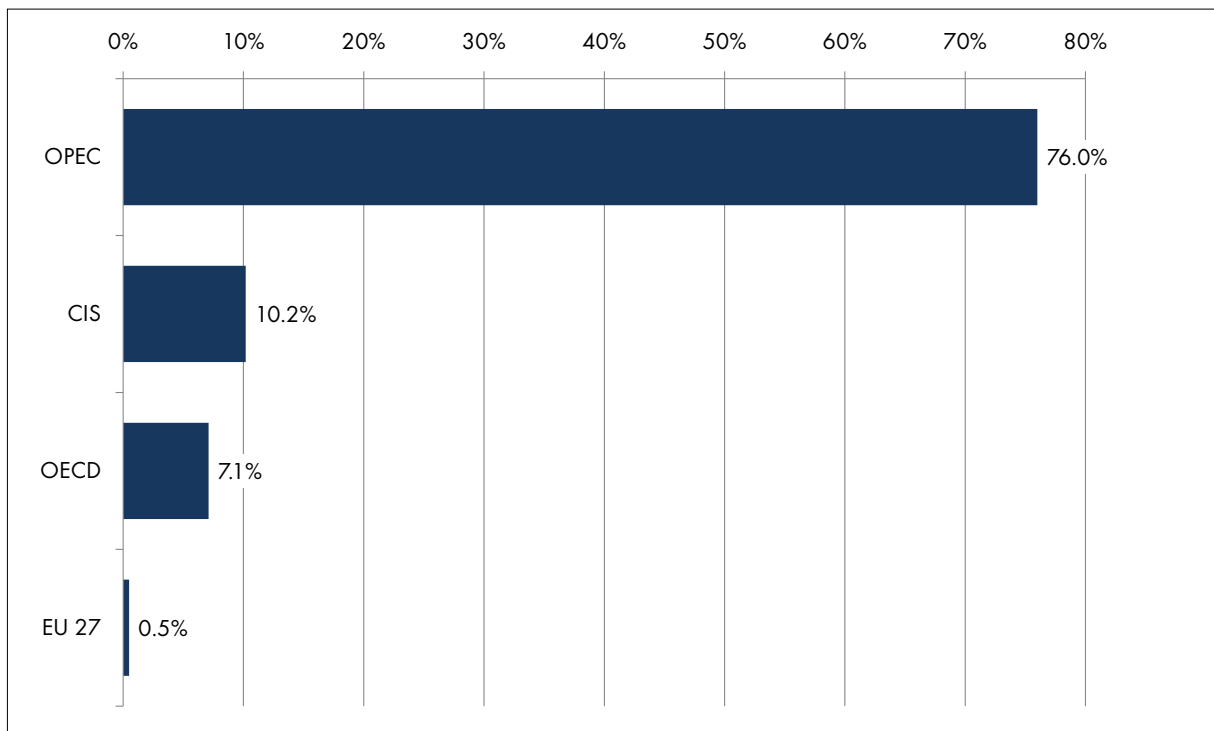
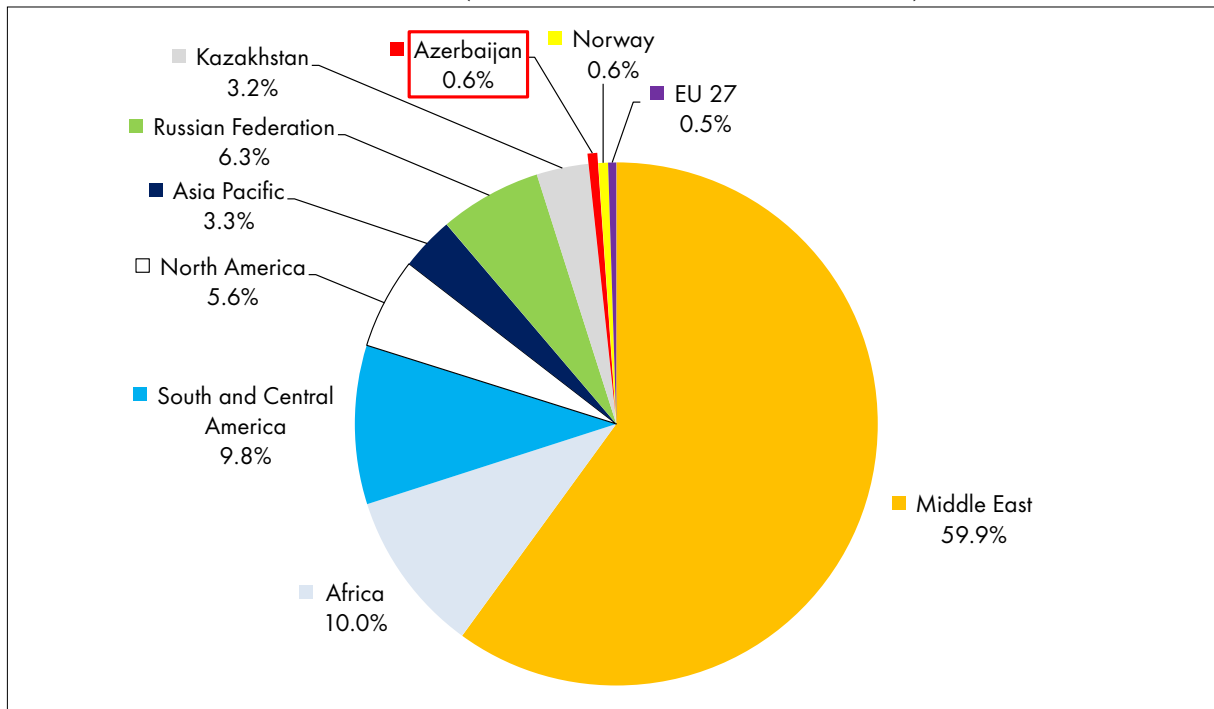
Note: 1 USD = 0.8 AZN

Sources: State Statistical Committee of Azerbaijan Republic, <http://www.azstat.org>  
National Budget Group, <http://www.nbg.az>

Statistics

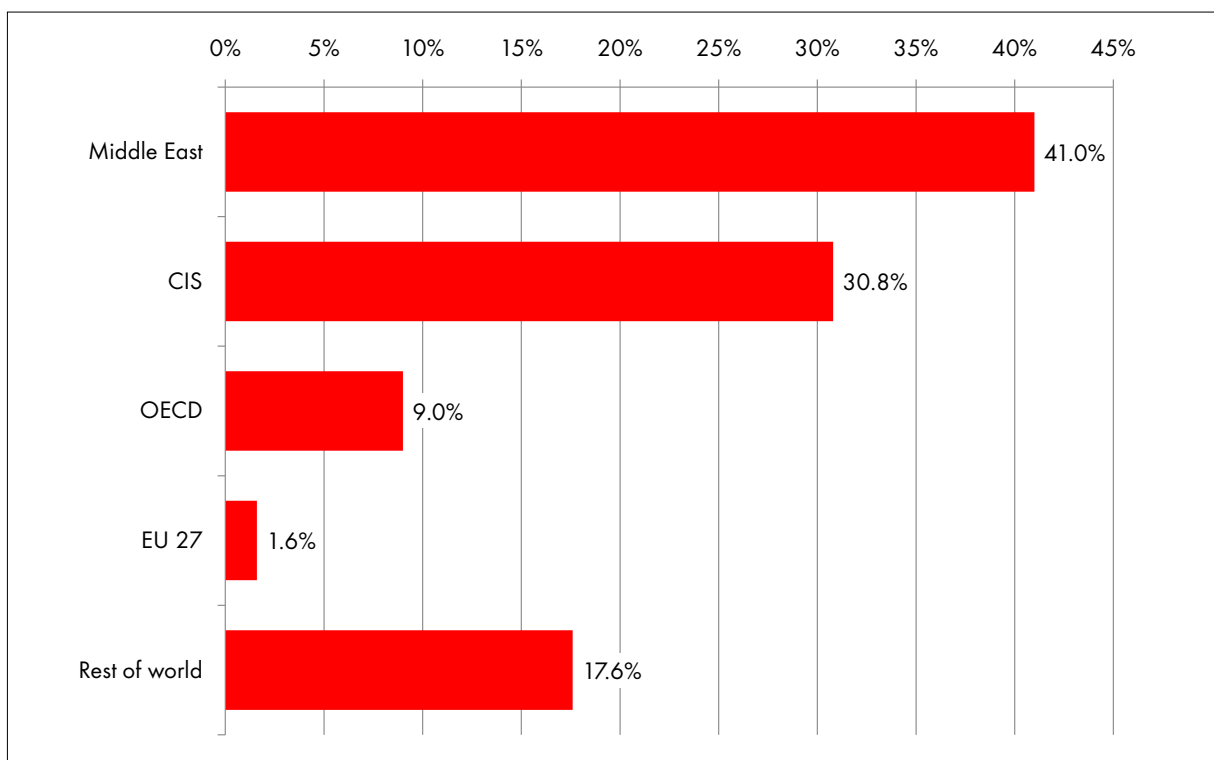
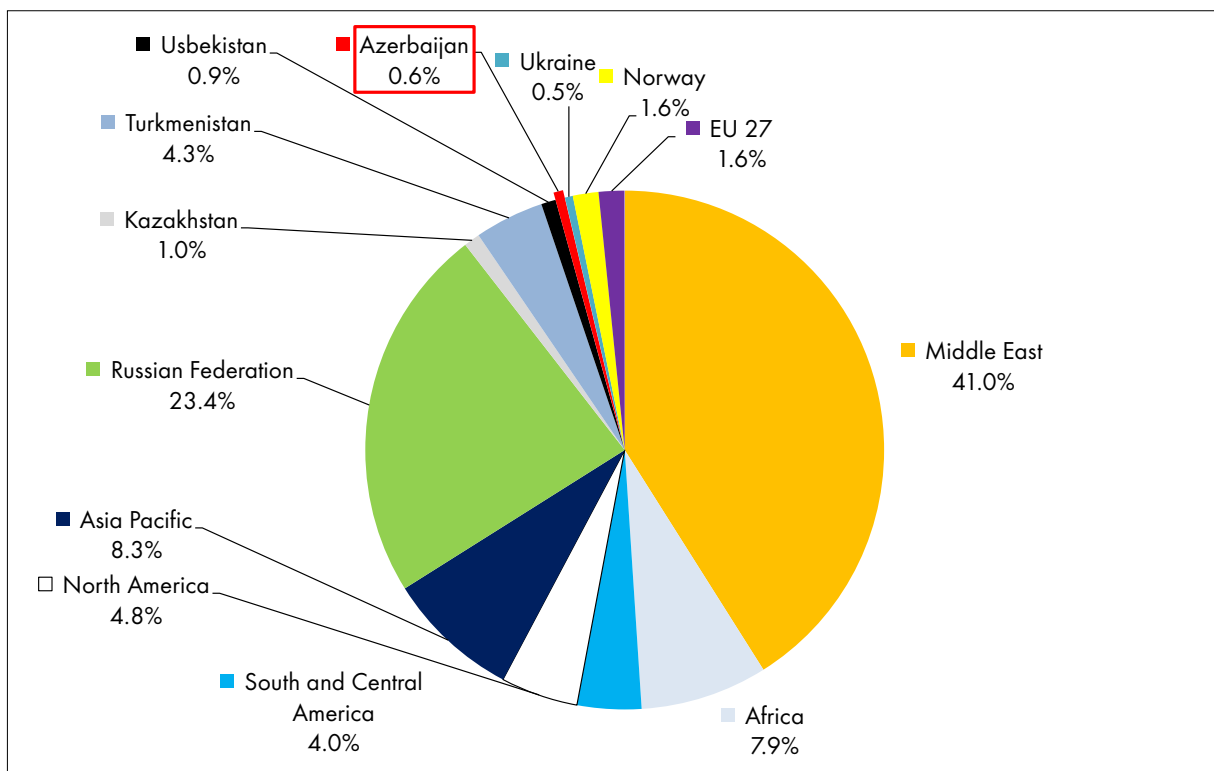
## Oil and Gas Reserves and Production – International Comparison

Distribution of World Oil Reserves (Proven Reserves, End of Year 2008)

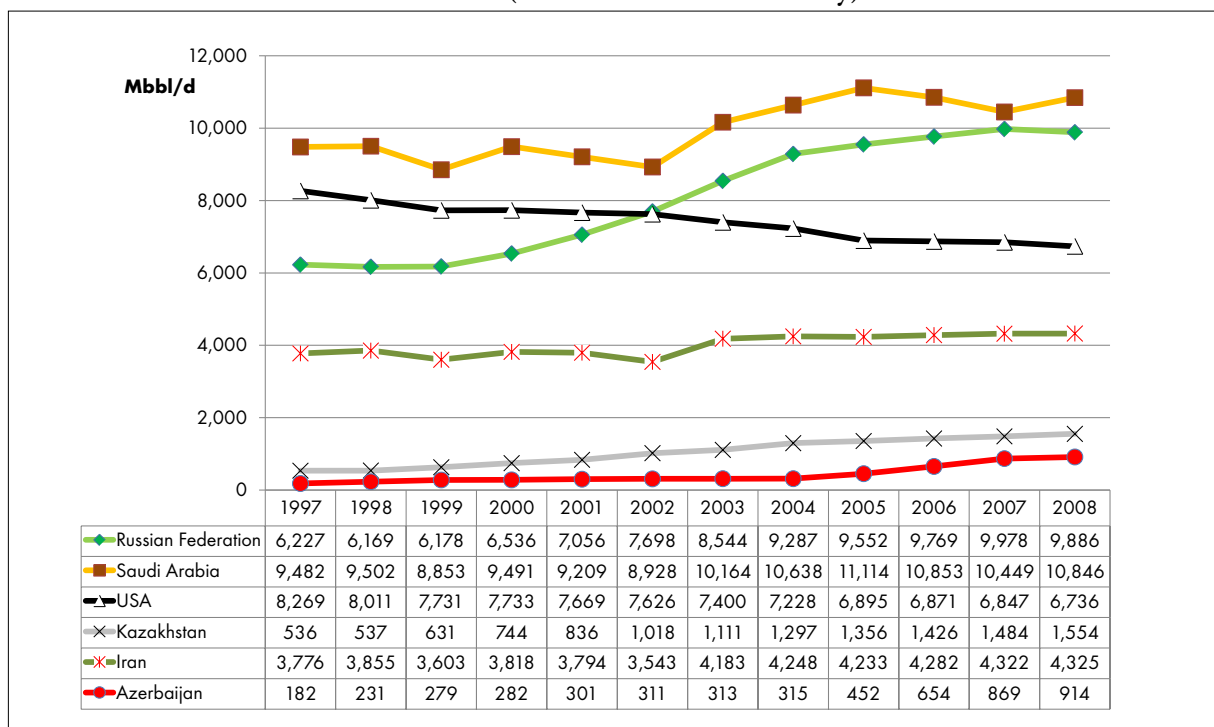
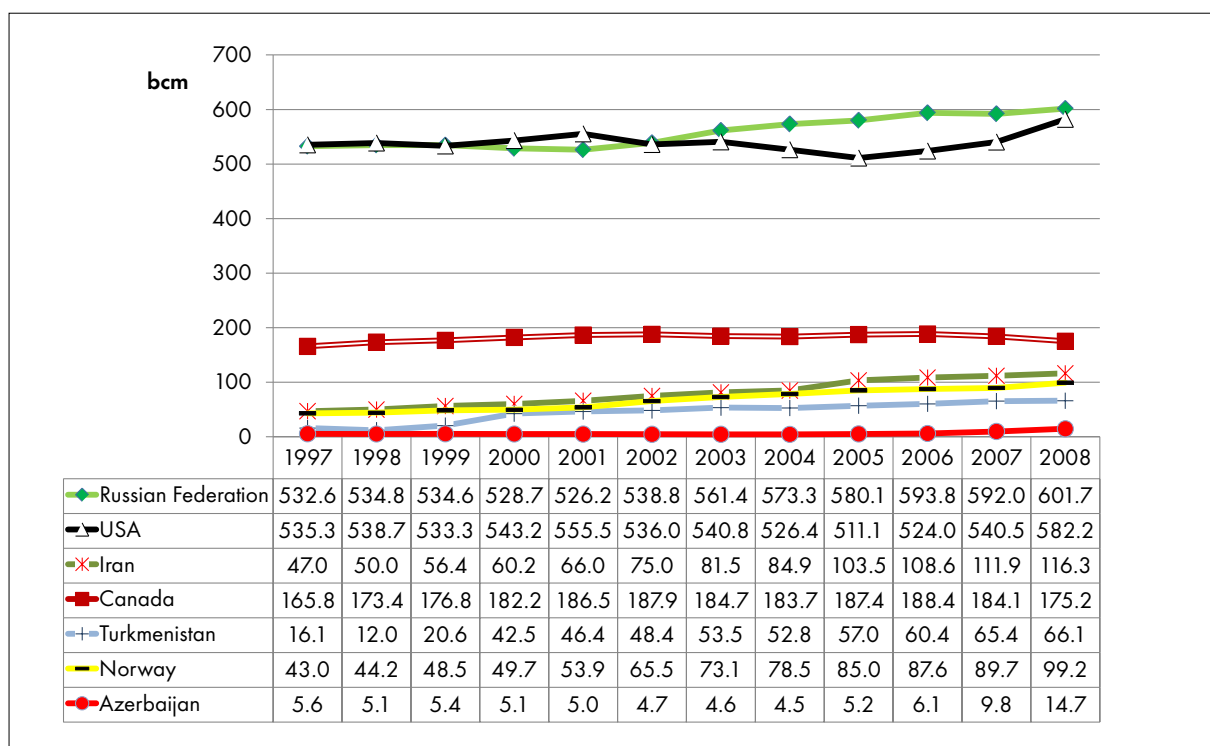


Source: BP Statistical Review of World Energy June 2009, <http://www.bp.com/statisticalreview>

Distribution of World Natural Gas Reserves (Proven Reserves, End of Year 2008)



Source: BP Statistical Review of World Energy June 2009, <http://www.bp.com/statisticalreview>

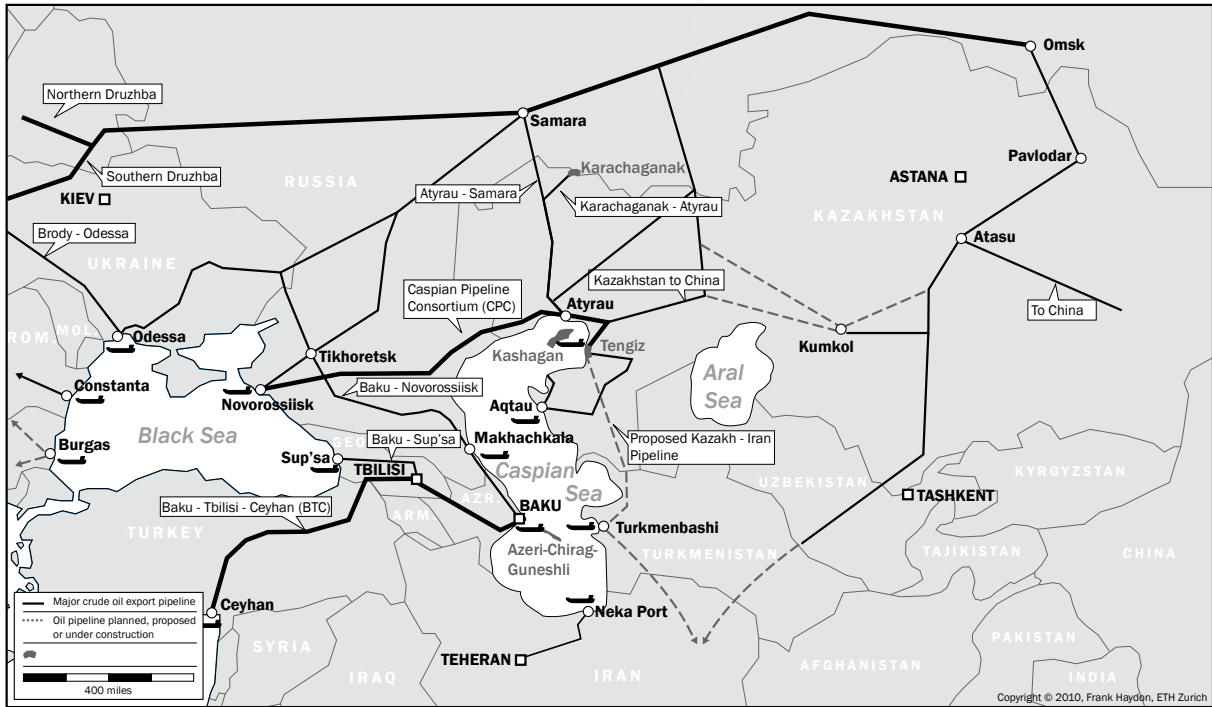
**Worldwide Oil Production 1997–2008 (in Thousand Barrels Daily)**

**Worldwide Natural Gas Production 1997–2008 (in Billion Cubic Meters)**


Source: BP Statistical Review of World Energy June 2009, <http://www.bp.com/statisticalreview>

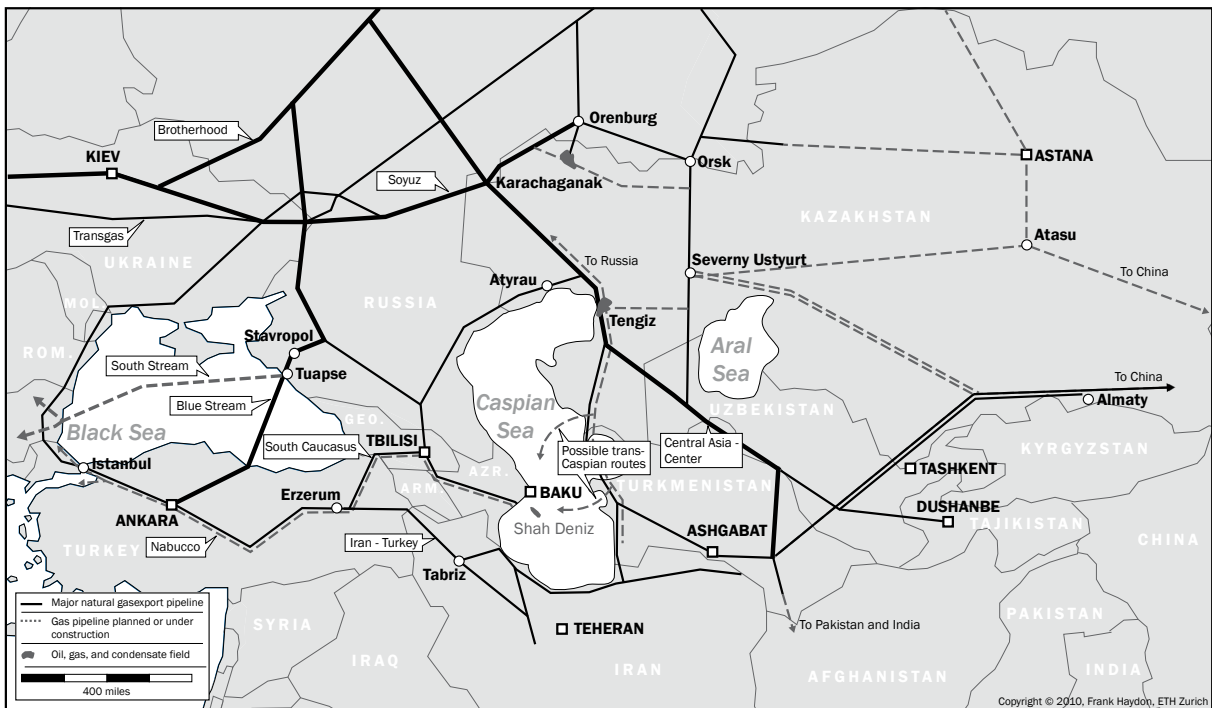
**Map**

## Major Oil and Natural Gas Pipelines Around the Caspian Sea

### Major Oil Pipelines



### Major Natural Gas Pipelines



## Chronicle

### From 16 March to 20 April 2010

16 March 2010	Georgian President Mikheil Saakashvili meets with Russian opposition figure Garry Kasparov in Tbilisi
17 March 2010	President of the European Commission Jose Manuel Barroso says that he is "concerned" over the fake TV report of a Russian invasion of Georgia broadcast by the TV channel Imedi
18 March 2010	The EBRD will allocate a 180 million Euro loan to Georgia for two projects: a new railway route and a high-voltage power transmission line
21 March 2010	Nowruz is declared a national holiday in Georgia
23 March 2010	Three inmates are transferred from the detention facilities in Guantanamo to Georgia
24 March 2010	The Georgian authorities reject an application for citizenship of St. Petersburg based businessman and presidential hopeful Aleksandr Ebraelidze
25 March 2010	Georgian President Mikheil Saakashvili meets with NATO Secretary General Anders Fogh Rasmussen in Brussels
26 March 2010	Georgian protesters ask for a street named after former US President George W. Bush in Tbilisi to be renamed
31 March 2010	The Georgian Foreign Ministry protests Russian plans to build heliports in the breakaway region of South Ossetia
6 April 2010	US President Barack Obama thanks Georgia for its significant contribution to the Afghan deployment
7 April 2010	A Georgian battalion is sent to Afghanistan
7 April 2010	Azerbaijan conducts counter-terror operations along the border with Russia
8 April 2010	Russia and the breakaway region of South Ossetia sign an agreement on Russia's operation of a military base in the region for 49 years
8 April 2010	The Georgian Parliament approves Irakli Kavtaradze as the new Georgian ambassador to Azerbaijan
9 April 2010	Georgian President Mikheil Saakashvili's spokesperson Manana Manjgaladze says that Russia is interfering in Kyrgyzstan's internal affairs
9 April 2010	EU Commissioner for Enlargement and European Neighbourhood Policy Stefan Fule visits Azerbaijan
9 April 2010	The State Oil Company of Azerbaijan (SOCAR) says that Russia has become the largest importer of Azerbaijani gas with Georgia ranked second and Iran ranked third
11 April 2010	11 April is declared a day of national mourning in Georgia to commemorate the death of late Polish President Lech Kaczynski
11 April 2010	Baku commemorates the Jewish victims of the Holocaust
12 April 2010	Head of Adjara Autonomous Republic's government Levan Varshalomidze criticizes Georgian Prime Minister Nika Gilauri for ignoring his requests to delegate technical functions to Adjara's local authorities
13 April 2010	Armenian President Serzh Sargsyan and US President Barack Obama meet on the sidelines of the nuclear security summit in Washington
13 April 2010	US President Barack Obama urges Turkey and Armenia to "make every effort" towards the normalization of relations
14 April 2010	Georgian President Mikheil Saakashvili addresses the nuclear security summit in Washington
14 April 2010	The Georgian Interior Ministry says that it has seized a small amount of highly enriched uranium
14 April 2010	Chinese MPs and members of the China-Azerbaijan interparliamentary friendship group visit Baku
15 April 2010	EU Commissioner for Energy Günther Oettinger visits the State Oil Company of Azerbaijan (SOCAR) headquarters in Azerbaijan
16 April 2010	Opposition leader Levan Gachechiladze says that he will not run for the Tbilisi mayor's office during the next local elections in May and will not support any of the opposition candidates
16 April 2010	Azerbaijan and Russia reach an agreement on the delimitation of state borders
16 April 2010	Head of Legislation and Legal Expertise Department of the Azerbaijani Presidential Administration Shahin Aliyev says that Azerbaijan faces a shortage of lawyers
18 April 2010	Georgian President Mikheil Saakashvili attends the state funeral of Polish President Lech Kaczynski
20 April 2010	Georgian Trade Unions start a miners' warning strike in Zestafoni and Chiatura in Western Georgia to demand better safety conditions to counter an increasing number of accidents

## About the Caucasus Analytical Digest

Editors: Iris Kempe, Matthias Neumann, Robert Orttung, Jeronim Perović, Lili Di Puppo

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Research Centre for East European Studies • Publications Department • Klagenfurter Str. 3 • 28359 Bremen • Germany

Phone: +49 421-218-69600 • Telefax: +49 421-218-69607 • e-mail: [fsopr@uni-bremen.de](mailto:fsopr@uni-bremen.de) • Internet: [www.res.ethz.ch/analysis/cad](http://www.res.ethz.ch/analysis/cad)