

## AZERBAIJANI OIL: GLIMPSES OF A LONG HISTORY

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This article is intended to introduce to the reader some of the major events in Azerbaijan's oil industry and to what is going on in this small country rich in mineral resources. This article does not claim full coverage and analysis of all the important and instructive events that have happened in Azerbaijan, both since its independence five years ago and before. This can not be done in a short article. Nevertheless, it is hoped that the information given here can help the reader learn about and understand this country, which has become a vital area of interest for the world's powers in their struggle for spheres of influence and energy resources.

### I. EARLY EXTRACTION

Azerbaijan is one of the world's few regions where oil has been extracted and used for a thousand years.

As far back as 1877 Charles Marvin wrote that there was irrefutable proof that 2500 years ago oil was exported from the Apsheron peninsula, where Baku is located, to Iran, Iraq, India and other countries. This was reported by such well known historians and travellers as Prisk of Pontus (fifth century), Abu-Istakhri (eighth century), Ahmed Balazuri (ninth century), Masudi (tenth century), Marco Polo (thirteenth-fourteenth centuries) and O'Learius (seventeenth century).

According to Marco Polo, the Apsheron peninsula was dotted with oil wells and the oil extracted was used for lighting and for healing purposes.

It was used for military purposes as well. Ancient Greeks and Alexander the Great knew about these qualities of oil.

The Apsheron was also well known as a holy land for followers of the ancient religion Zoroastrianism. Followers of Zoroaster worshipped the eternal fire and held their rites here. It was here that they erected the famous temple of fire-worshippers which still attracts crowds of tourists to Suraxani village near Baku.

In order to extract oil, the villagers dug wells, just as they did for water. According to historical data, in 1594 a person named Nur Oglu, who lived in the Apsheron, dug a simple well to a depth of thirty-five metres. By 1806 there were fifty oil wells on the Apsheron peninsula, by 1821 there were one hundred and twenty. The average depth of the wells in the 1860s varied from two to three metres. In Suraxani village, near Baku, the depth of the oil well was twelve metres and it looked like an upturned multi-level pyramid. In the middle of the last century, the most productive oil well could provide little more oil than ten barrels per day (bpd). Once extracted the oil was stored in stone-lined holes and, after setting and refining, it was delivered to state-owned storehouses. In 1870 there were fourteen storehouses in Baku.

### II. THE BEGINNING OF COMMERCIAL DEVELOPMENT

In the Apsheron this method of simple oil extraction was used until 1872. A well drilled in 1871 produced 50bpd, ending forever more primitive methods of oil extraction.

It took twenty-three years for the new technology of oil well drilling to take over. The world's first oil well was drilled in 1848 in Apsheron. This event took place eleven years prior to the drilling of the first oil well in Pennsylvania.

In the early 1870s the drilling of oil wells was widespread all over Azerbaijan. By that time engineering and technology had improved and was governed by new legislation. This signalled an era of industrial development which spread through all of Russia.

By 1913 there were 3500 wells in and around Baku.

1871 and 1872 were not only years of dramatic change in oil development technologies in Apsheron, but also a time when the old iltizam, tenant relations between the owner of the oil springs (at that time the Russian government) and the actual oil producers were abolished. Iltizam was a system of mutual obligations where the oil-bearing land could be rented under certain conditions from khans (the historic owners) granting the lessee temporary use of oil wells, salt lakes, dye works, storehouses, etc. After annexation of the Apsheron, the Russian government also used this system until the early 1870s.

The rental agreement, usually for a five-year term, was signed by an authorised representative of the owner and the lessee. The system for selecting lessees was similar to the modern day tender with the highest offer being successful. The basic minimum rent was announced by the government and those wishing to participate were obliged to give a pledge consisting of half of the annual rent.

The lessee had the right to export the oil and could fix his own price paying an agreed amount originally to the khans and thereafter to the treasury of the Russian state. According to available records, the net profit of the lessee was about 14-15 per cent.

In 1872, iltizam was replaced by a new system of property relations in the oil industry introduced by two very important legislative acts adopted then. These were:

- The Law on Oilfields and Liability for Excise Tax on Oil Products
- The Law on the Auction Sale of Oilfields Belonging to Leaseholders to Private Persons.

After these laws were adopted, the new Caucasus Directorate of Mining Industry was formed and was authorized to solve all issues related to oil in the Caucasus. In 1872, the oilfields were grouped and sold to private individuals. A number of the oilfields were not purchased, however, and another auction was held for those in 1880.

Oil fever infected Baku

In accordance with these laws, exploration on both private and public land could only be carried out with the permission of the landowner. Oil exploration on lands owned but unused by the state were governed by the following regulations: anyone who wished to begin such work chose his piece of land by hammering in a stake to which he attached a board with his name and the date; within a week an application was to be submitted to the local authorities; the application had to specify the location of the site, its dimensions and its distance from the nearest populated area. If approval was granted, the land was rented for a period of twenty-four years at a rent of ten gold roubles for one tenth of a hectare. If the search for oil was not successful, the leaseholder could return it on agreed terms.

### III. OIL BOOM AT THE END OF THE NINETEENTH CENTURY

New economic conditions, technology and engineering broadened the scale of oil exploration and extraction, refining and transportation, leading to the development of the infrastructure of Azerbaijan's industrial, cultural and educational systems.

1873 saw the launch of the exploration and development of the world's largest deposits with a volume of 500m tons of oil capable of being extracted from the Ramani, Sabunchi, Balakhani and Bibi-Heibat oilfields. In twelve years they produced 6.2m tons.

This was followed by an expansion in oil refining with the first oil refinery being built as early as 1859 in Baku and by 1867 there were fifteen crude oil refineries. After the abolition of the excise tax on oil products, many new factories were built in Azerbaijan with new technologies allowing the production of new types of refined products. In 1879 and 1881, two refineries were built to produce lubricants.

In 1878 an oil pipeline was built connecting the Balakhani oilfields with the oil refinery in Baku. It was 12km long with pipes 75mm in diameter. By the end of 1898 there were 230km of pipes with an annual throughput of one million tons of oil.

Between 1896-1906, the Baku-Batumi pipeline was built with a length of 833km and a diameter of 200mm to transport 900,000 tons of kerosene a year.

A decision on drainage works in Bibi-Heibat bay, near Baku, to enable oil wells to be drilled was taken in 1901. Since ancient times people had known about the rich oil deposits here. At the beginning of the nineteenth century there were two oil wells located only nineteen metres from each other. According to Kerim Cafarov, these oil wells were originally dug in the sixteenth century and were located on the shore. But later, as the water table in the Caspian rose they were submerged by the encroaching waters. The owners resorted to erecting wooden barriers, but by 1824 they were totally submerged.

The decision to fill the bay was the first such exercise in the world and in 1906 a competition was announced to prepare appropriate drainage projects. In 1909 the project commenced and in 1910 the Russian Sormovo factory began the production of 23 special vessels to transport and distribute filling materials. By 1916 their assembly was completed and by 1918, 193 hectares were filled in. The work continued in the 1920s and by 1927 some 300 hectares had been reclaimed. It is worth noting that this project ranks as the second largest in the world after the Panama Canal project and during those years the region achieved considerable success in developing oil extraction technology. Azerbaijan was a base for the development and implementation of new techniques and pioneering inventions.

The well pumps designed by Ivanitsky were tested in the oilfields of Azerbaijan some 15 years before similar technology began to be used in America.

By the end of the 1870s Azerbaijan had become one of the world's leading financial centres. In the 1880s the Rothschilds began to make large-scale capital investments and by the end of 1890 they controlled some 42 per cent of oil exports from Baku.

By 1910 more than 60 per cent of the oilfields were under the control of three large organisations: Shell, the Oil Production Society of the Nobel Brothers, and the Russian General Oil Society, which was supported by French and English capital with headquarters in London.

Between 1874 and 1899, twenty-nine joint stock societies (some of them with the participation of foreign capital) were established in Azerbaijan. All these events reflected the growing demand for petrol in world industrial centres and led to a major increase in oil extraction in Azerbaijan. At the beginning of the twentieth century more than 10m tons of oil were extracted annually which accounted for half of the world's production at that time.

#### IV. NATIONALIZATION OF THE OIL INDUSTRY AND THE SOVIET PERIOD

After the Russian revolution of 1917, Soviet power was established in Baku. In 1918, following a decision taken by the Bolshevik government in Moscow, 165 independent oil companies were nationalized in Azerbaijan. In the same year, after the declaration of the independent Azerbaijani Republic (1918-1920), the Azeri government issued a decree denationalizing the oil industry and returning the enterprises to their owners. In 1920 the Russian Red Army invaded Azerbaijan and the oil industry was nationalized once again.

The Soviet period saw ups and downs in the oil industry of Azerbaijan. A rapid drop in oil production took place, falling to 3245m tons in 1918, less than half the total extracted in the previous year. Nationalization of the oil industry and the political changes were responsible for this downturn.

1919 saw some growth in oil extraction largely due to the stabilisation of the political situation and denationalization of its oil industry. The two subsequent years saw a further decrease in oil extraction caused by political instability and the re-nationalization of the oil industry. In 1921 the oil output amounted to 70 per cent of the 1919 level.

The Soviet government, which realized the importance of Azerbaijan's oil riches all too well, started to take active steps in order to revitalize oil extraction. The young Bolshevik Russia did not have strong financial resources. However, Russia did invest in Baku because it was sure that the costs would be reimbursed and that the development and sale of the 'black gold' would bring enormous revenues. The lack of financial resources was compensated for by the slavish labour of the workers, some of whom were intimidated while others believed the Bolshevik propaganda about the communist paradise that was close at hand. Soon the results became evident.

After 1922 the oil output steadily grew to reach a record level of 23,482,000 tons in 1941.

In 1940 Azerbaijan provided 71.5 per cent of the total oil output of the USSR.

From the beginning of the 1920s until the beginning of World War II, Azerbaijan remained a world centre for oil science and technology. Over this period, hydrocarbon deposits were discovered here, the immense project of filling up Bibi-Heibat bay was finished (1927), construction of the 834km-long Baku-Batumi pipeline was finished (1925, the pipes were 250mm in diameter and had 13 pumping stations), and the world's first offshore oil well was drilled from a small artificial islet on wooden piles. One should also note a dramatic growth of the factories which produced oil equipment.

During the period between 1941 and 1945 Azerbaijan provided 63.2 per cent of the output of the USSR, and this oil played the decisive role in the USSR's victory over Germany.

Along with this, Moscow was afraid lest the oil-producing Baku region should be seized by Germans and carried out an unprecedented transfer of Azerbaijan's industrial petroleum capacities to the oilfields of Talariya, Bas>kiriya and other eastern areas of Russia including almost the entire personnel (approximately 11,000 oil workers, engineers and geologists, etc.), oil equipment, manufacturing facilities and even the disassembled Baku-Batumi pipeline. Parts of this pipeline were later used to build the Astrakhan-Saratov pipeline.

Thus, while the industry of the USSR's western regions was destroyed by the war, Azerbaijan's industry suffered the same fate -but here this was done by Moscow.

As a result of such policies, by the end of the war oil production started to decrease. Once again tremendous efforts were made to stabilize it. Although the pre-war level of oil production was never reached, the period between 1947 and 1963 was a period of steady increase in oil production.

From 1964 to 1968 output was running at 21m tons of oil per year.

From 1969 to 1985 the gradual decrease in Azeri oil production was followed by a period of stabilisation when oil extraction levelled out at 13m tons per year. The following factors were responsible for the decrease during the period:

- First, the resources of the constantly exploited onshore oilfields were exhausted and none of the newly discovered fields could prove their profitability. At the same time, extraction from the known fields became increasingly expensive.

- Second, enormous fields were discovered in western Siberia, western Kazakhstan and other areas. Azerbaijan's share of Soviet oil output dropped from 39.1 per cent in 1950 to 12.0 per cent in 1960 to 5.7 per cent in 1970 and 2.4 per cent in the 1980s. It was not surprising that Moscow showed less interest in Azeri oil production at that time.

Among important events of the post-war period in the development of Azerbaijan's oil industry, one can mention the discovery and exploitation of a number of new and sometimes huge oilfields, an intensive development of commercial oil and gas production on the Caspian shelf and the growth of oil machine building plants and oil refineries.

By 1971, Azerbaijan had accumulated one billion tons of oil. As of today, the accumulated land oil production is 925m tons and offshore is 400m tons. In 1993, 218bn cubic metres of gas onshore and 281bn cubic metres of gas offshore was accumulated.

The year 1990 signalled the start of a new stage in oil production with a fall in output caused by the profound economic decline in the Soviet economy of the 1980s, the weakening of the economically unsound ties between the republics of the former Soviet Union and by the reorientation of the economy towards a free market.

#### V. OIL INDUSTRY TODAY: ITS STATE AND PROBLEMS

Oil and gas production and crude oil refining is performed by a huge industrial complex called the State Oil Company of the Azerbaijani Republic (SOCAR).

Following a decree issued by President Ebulfez Elcibey of 13 September 1992, Azerbaijan's old oil industry got this name and, with it, acquired a different quality. This decree started the transformation of the country's oil industry, which until then was an adjunct of the USSR's oil industry. Now SOCAR subsumed refineries and the related enterprises under its structure. For the first time in the former Soviet area, the idea of the creation of a Western-type integrated oil company started to be realized. The oil company's structure was reorganized soon in order to increase its management efficiency and to transform it into a share-based company. The system of labour relations started to change, too, with the introduction of contracts between the company and the employees.

Today, the major industrial unions are under the company's umbrella:

- onshore oil and gas production;
- offshore oil and gas production;
- machine building;
- oil pipeline transportation;
- geophysics and engineering geology;
- oil refining - 'Azneftyaq';
- oil refining - 'Azneftyanacaq';
- construction of deep-water offshore platforms.

Besides these, SOCAR includes construction trusts, auto-transportation enterprises, an oil fleet, complex adjustment and automation enterprises as well as research and project institutes.

In order to give an idea of SOCAR's industrial capacities, here are some figures. It has:

- Nearly 6800 wells in operation in onshore oilfields and nearly 1400 offshore;
- The oil fleet which consists of more than 300 ships of various types (crane ships, supply ships, tug boats, cutters, passenger ships, seismic and exploration ships, oil tankers, pipeline construction ships, self-propelled barges and other ships);
- Two major oil refineries with the combined capacity of 22m tons of crude oil per year;
- A pool of six stationary floating drilling installations (with operational depths of up to 70m and well depths of up to 6500m) and five semi-submerged floating drilling units (with operational depths of up to 200m and well depths of up to 6000m);
- A pool of 80 drilling units of various makes for 2000-5000m-deep inland well drilling;
- A motor pool consisting of more than 5000 cars and trucks;
- A motor pool of specialized vehicles consisting of nearly 2000 tractor cranes, bulldozers, road tankers and other types of vehicles;
- A 1150km-long oil pipeline network and 12 pumping stations with a total capacity of 80,000 tons of oil;
- Four major scientific research institutes, and
- Nearly 80,000 employees of various professions.

The years of the collapse of the USSR and the transition to a market economy were very difficult for SOCAR. As a result of the liquidation of the old system of state financing for the oil industry on the one hand, and the state monopoly on oil production on the other, when all hydrocarbons were immediately appropriated by the government, SOCAR has suffered serious financial difficulties.

Consequently, more oil wells have been unused, the number of newly drilled exploitation and exploration wells has been reduced dramatically, more violations have occurred of hydrocarbon extraction and rational development technology, the equipment has become obsolete (30-40 per cent of all equipment types, means of transport and special equipment require renovation), permanent delays in the payment of salaries and other negative consequences have occurred. As a result of this, oil and gas production decreases on an annual basis. Thus, in 1995, 9.16m tons of oil and 6.64bn cubic metres of gas was produced.

Hopes of an improvement in the situation are linked to contracts with foreign oil companies regarding a number of major oilfields on the Caspian shelf.

## VI. BEGINNING OF A NEW OIL ERA

On 20 September 1994, the Western Oil Consortium and SOCAR signed a contract for the development of the Azeri, Chirag and Guneshli oilfields. It was coined the 'Contract of the Century' by the press.

This contract is the most important historical event directly resulting from the independence of Azerbaijan and its efforts to improve its overall situation. The complicated negotiations began in 1990, during the former Soviet period, between Azeri authorities and Western companies. As the liberalization process tempered Soviet economics to attract Western investment, more Western companies arrived in Azerbaijan drawn by the discovery of the rich mineral resources in the offshore Azeri, Chirag and Guneshli fields and by the well-developed Azeri oil industry.

The Azeri government, lacking the necessary funding to develop the reserves, resolved to find Western finance to assist in the urgent development of various projects. In January 1991 the government put the projects out to competitive tender and British Petroleum (BP) in alliance with Statoil, Amoco, Unocal and other major oil companies, participated. In the summer of 1991 the American firm Amoco was announced the winner, sharing the project with other firms that the government wished to be involved-the consortium had been established with Amoco at its head in conjunction with Unocal, BP and Statoil in alliance, McDermott, and Ramco. A feasibility study and draft contract were completed by October 1992.

During this period important political changes occurred in Azerbaijan. By the end of 1991 Azerbaijan became independent and in the summer of 1992 presidential elections were held leading to a change of government. The new government recognized the importance of foreign investment and on 7 September 1992 an agreement on the joint development of the Chirag oilfield and exploration in the Shakh-Deniz area was signed with the BP-Statoil alliance. During 1992 several further agreements were signed with Pennzoil and Ramco relating to the development of the Guneshli oilfield.

The above agreements required feasibility studies and draft contracts to be prepared within six months on the Chirag and Shakh-Deniz sites and allowed ninety days for the preparation of proposals for rehabilitation and development of the Guneshli field. Further obligations were placed on Western companies including a US\$30m payment by the BP-Statoil alliance payable on the signing of the agreement and a guarantee by Pennzoil of 1.5bn cubic metres of gas per year from the Neft Dashlari and Guneshli fields.

In October 1992, SOCAR decided to create a common infrastructure for the Azeri, Chirag and Guneshli fields both because of their common physical and geographical features and the desire to reduce the enormous infrastructure costs of recovery. In November, five memoranda of mutual understanding were signed regarding the sharing of the supply base, terminals, pipelines, fleet and export pipeline. In accordance with these memoranda groups of specialists were created who were allocated the task of conducting the necessary explorations and preparing technical proposals. This was the commencement of the unification of the oilfields. In May 1993, a sixth memorandum on mutual understanding of a common works programme for the development of the Azeri, Chirag and Guneshli oilfields was signed. In June 1993, the board of directors ratified the decision on the unification of the oilfields.

The declaration stipulated the following for the development of these oilfields, which were of special importance to Azerbaijan:

- The major goals were to be: rational development of oil and gas resources, efficient and thrifty use of capital investments, minimization of the exploitation costs, maximization of the Azerbaijani side's revenues and observance of the sensible economic interests of foreign companies, allowance for Azerbaijan's current and long-term strategic interests and maximization of local industrial capacities, scientific potential and personnel
- The Azerbaijani side, ie. SOCAR, had the highest contract share (30 per cent) of all the companies that were parties to the contract. In addition, SOCAR got more than two years' additional time to find the financial resources to support its 30 per cent share of expenditure

- Ceding by each foreign company of part or all of its participation share to any other company was to be approved by SOCAR
- A very high bonus rate (\$3m) was established for each one per cent of shared participation. A third of that bonus was to be paid no later than ten days after the adoption by the foreign company of the terms of the declaration, and the remaining two-thirds was to be paid thirty days following the contract's coming into force
- A SOCAR representative was to be appointed chairman of the Joint Steering Committee that was then in the process of formation
- Stabilisation of and increase in oil production from the developed part of the Guneshli oilfield was also considered part of immediate tasks
- SOCAR gained the right to take the final decision on the question of operation on the contract territory
- In the shortest possible time, a fund for financing the immediate jobs project was to be created. This fund was also supposed to reimburse the Pennzoil company for its programme for utilizing the natural gas from Guneshli and Neft Dashlari oilfields
- If any of the companies were to refuse to accept the terms of the contract, its share could be retained by SOCAR
- All previous agreements between foreign companies and SOCAR on the Azeri, Chirag and Guneshli oilfields that contradicted the terms of this declaration lost their legal force
- A very short-term (one week) was established for foreign companies to decide on adopting the terms of the declaration.

All companies participating in the future contract adopted the terms of the declaration within a week and officially notified SOCAR to that effect.

In the middle of June, in London, SOCAR's experts started to prepare their version of the contract. The Morgan Grenfeld Bank, then SOCAR's consultant on commercial issues, is based in London. The meeting between SOCAR and the heads of the oil companies was to take place in London too, where contract terms were to be discussed. The process of the alignment of the terms could take several months, and the contract was expected to be signed not later than September 1993.

In Houston, the experts of the oil companies -participants in the future contract- started working out their contract terms.

However, the planned negotiations on the contract terms did not take place in London.

Later that June, the Azeri leadership changed. The new government decided to suspend negotiations giving themselves time to understand the situation.

A specially formed group of experts was formed, which consisted entirely of foreign nationals and was delegated to conduct negotiations with the consortium. SOCAR was totally estranged from the negotiations process. This group completed the negotiations in October of 1993.

One should also mention another event that happened after the negotiations. On 19 November 1993, Yuriy Shafrannik, Russia's minister of fuel and energy, and Vahid Alekberov, president of the Russian oil company Lukoil, visited Baku. During this visit, a number of agreements were signed on cooperation between Azerbaijan and Russia in



energy and oil machine building. Of all the agreements reached, only one was realized, and that was for Azerbaijan to give Lukoil 10 per cent of its share in the future contract on the Azeri, Chirag and Guneshli oilfields. Although the Russian side assumed a number of responsibilities, it never realized them.

The following important events happened after the June coup before the big concession to Russia was made:

- The occupation of more Azerbaijani territory by Armenians living in Nagorno-Karabakh (who were supported from the outside). The area occupied exceeds the territory of Nagorno-Karabakh itself
- Continued annexation of the Azerbaijani territories even after it became a member of the CIS
- Russia raised the issue of the status of the Caspian, which is actually the issue of the ownership of the Caspian shelf hydrocarbon resources.

Thus, the concession was supposed to take into consideration Russia's interests in the development of the hydrocarbon resources of Azerbaijan's Caspian shelf and was made as a result of lobbying Azerbaijan's interests in the Russian government through its fuel and energy complex. There was also a hope that Russia would be neutralized during the return of the occupied Azerbaijani lands through military means.

Later, it turned out that Russia's energy complex did lobby the government to have the contract signed. However, the results of those activities often proved indecisive. Thus, over the period between now and the autumn of 1993, Russia has not recognized Azerbaijan's right to develop the hydrocarbon resources of the Caspian. This policy of Russia's turned out very successful and ensured its wider participation in the projects for the development of Azerbaijan's oil and gas deposits.

We have already mentioned that the expert group appointed by the Azerbaijani government finished the negotiations by the end of October. After this, SOCAR's experts analysed the terms of the future contract and they discovered serious defects. On 4 December 1993, SOCAR sent the foreign oil companies eleven pages of notes. The official response that the companies sent back was written in a uniquely sharp tone.

Nevertheless, in the beginning of 1994, president Haydar Aliyev authorized SOCAR to continue negotiations. In another important decision which further enhanced the signing of the contract, he appointed his son, Ilham Aliyev, as SOCAR's vice-president. As a result of this appointment, the president was now able to constantly follow the negotiations.

One should also mention certain high-ranking Azerbaijani officials' negative attitude to signing a contract with foreign oil companies. For example, the hero of the June and the new prime minister, Surat Huseynov, repeatedly criticized the contract.

In September 1994, a marathon negotiating session ended with the signing of the oil contract - a historic event in the life of the Azeri people and all the regions affected by the oil contract.

Here are the contract's main parameters:

- Capital expenditure - \$7.4bn;
- Development expenditure - \$5.9bn;
- Term of the contract - 30 years;

- Area covered by the contract - 432.4km square;
- Location of the contract territory - within 192km offshore east of Baku at a depth of 140m and more;
- Expected oil recovery - 511m tons (of which 130m tons is assured reserves);
- Petroleum gas reserves - 70bn cubic metres (of which 12bn cubic metres is assured reserves);
- Bonus to be paid by the foreign companies to the government of Azerbaijan for each one per cent of shared participation is \$3m; the contractor is obliged to pay half of the bonus within thirty days of the contract's ratification. The rest is to be paid after as much as 40,000 barrels of oil is recovered from the territory of the contract and within 60 days of the operation of the main export pipeline.

The contract is modelled on a production-sharing form, which is accepted universally throughout the world.

As the heads of SOCAR and the consortium repeatedly stated, over the whole period of the contract's term, Azerbaijan is expected to get nearly 80 per cent of all the oil profit. Money-wise, Azerbaijan will receive nearly \$80bn. This amount will accumulate further from value added taxes, royalties and SOCAR's share of the income.

The following table shows the parties to the contract and their present shared participation in the project.

Name of Company Shared Participation in the Project

BP EXPLORATION (CASPIAN SEA) LIMITED (BP) 17.1267%

AMOCO CASPIAN SEA PETROLEUM LIMITED (Amoco) 17.0100%

STATE OIL COMPANY OF THE AZERBAIJANI REPUBLIC (SOCAR) 10.0000%

LUKOIL JOINT STOCK COMPANY (Lukoil) 10.0000%

PENNZOIL CASPIAN CORPORATION (Pennzoil) 4.8175%

UNOCAL KHAZAR LTD. (Unocal) 9.5200%

DEN NORSKE STATS OLJESELSKAP as (Statoil) 8.5633%

TURKIYE PETROLLERI AO (TPAO) 6.7500%

EXXON 5.0000%

ITOCHU 7.4500%

RAMCO HAZAR ENERGY LIMITED (Ramco) 2.0825%

DELTA NIMIR KHAZAR LIMITED (Delta) 1.6800%

One should note that, compared to the pre-June 1993 version of the contract stipulated by the Utilization Declaration, certain terms of the new contract were less beneficial to

Azerbaijan. This came as a result of the difficult situation in Azerbaijan when the contract was signed in September 1994. This led to the growth of the risk factor and justifiably increased claims by the foreign oil companies.

In the signed contract, SOCAR initially owned a 20 per cent share. However, in the spring of 1995, five per cent was ceded to Exxon (until then Exxon did not participate in the contract) and another five per cent was ceded to TPAO (TPAO's initial share was 1.75 per cent). SOCAR ceded 10 per cent of its share because it did not have the financial resources to finance its participation share in the programme of minimum compulsory jobs as well as for political reasons.

Exxon and TPAO assumed an obligation to pay a \$173.2m bonus and guarantee SOCAR's credits to finance the remaining 10 per cent of its participation share.

The Japanese company Itochu joined the consortium in early 1996 with its purchase of a 2.45 per cent share previously held by the American company McDermott and another five per cent from the American company Pennzoil.

The signing of the contract became an important event in Azerbaijan's history and will have a strong impact on the nation's future.

After its ratification by parliament, the contract started to play a positive role in stabilizing the political situation in Azerbaijan and strengthening the position of the government. The leading Western countries and financial institutions started to approach Azerbaijan with increased trust. However, this became manifested only in the beginning of 1995. Before then, immediately after signing of the contract in September 1994 and until the end of that year, the situation in Azerbaijan deteriorated dramatically. Another state coup was attempted, but Haydar Aliyev should take the credit for brilliantly taking control of the situation and protecting the government-and the contract-not only from internal, but from foreign threats and nonacceptance as well.

One cannot but mention the negative reaction of the Russian Ministry of Foreign Affairs to the signing of the contract. Immediately after the signing ceremony, the Ministry issued a statement saying that Russia did not recognize the contract.

In the beginning of 1995, in accordance with the terms of the contract, a steering committee for the realization of the project was formed. The committee consists of SOCAR representatives and ten representatives of the foreign companies (one from each). Azerbaijan International Operation Company (AIOC) was created as well. AIOC was created on the basis of the Agreement on Joint Operations (AJO) signed by the parties to the contract. This agreement declares the AIOC to be the operator for the jobs performed in the territory of the contract and is delegated to carry out daily administration, coordination, realization and to conduct oil and gas operations.

Based on the AJO, a Committee for Contractor Administration (CCA) was created with a representative from each company. The CCA controls AIOC's major activities.

The AJO also gives an outline of the order of decision making and for putting issues to vote, approval of yearly working programmes, lists of participants in tenders and considers the issues of ceding participation shares.

AIOC's budget is provided by the oil companies that are parties to the contract proportionate to their shares in the contract.

The president of AIOC is Terry Adams of British Petroleum. The senior vice-president for commercial issues is Art McHaffie of Amoco. Amoco and BP representatives will replace each other in these positions every five years.

There are the following six major parts to AIOC's activities:

- Commercial issues (administration, financial control, planning, personnel, taxes, legal issues, contracts, auditing, information, communications);
- Issues of development (seismic issues, survey of the territory, drilling, infrastructure);
- Issues of health protection, labour, environment and security;
- Projects (early oil recovery, the full development of the oilfields);
- Issues of oil export (transportation and commerce);
- Issues of logistics and cargo transportation within CIS.

The programme for the development of the oilfields is conditionally divided into three stages:

- Stage 1 - realization of the Minimum Programme of Compulsory Operations (performance of a three-dimensional seismic survey of the Contract Area, drilling of three oil wells for confirmation of the expected oil resources, environmental research into the alternative main export oil pipelines and a number of other operations)
- Stage 2 - early oil production and transportation
- Stage 3 - full-scale development of the oilfields.

As of today, a number of projects of the Minimum Programme of Compulsory Jobs Operations have already been realized, others are still being realized.

Today, total expenditures within the Minimum Programme of Compulsory Jobs Operations is estimated at \$221m for the period between 1994-1997. Of that sum, \$77.63m was spent in 1994-1995. It is planned to spend in 1996 an estimated \$107m.

In 1995, \$48.58m was spent on various operations within the early oil production project. It is expected that \$298.70m will be spent on operations related to the construction of the Sangacal terminal, the northern route for the early oil transportation and offshore oil development.

In February 1996, it became absolutely obvious that it would be impossible to start early oil production in June 1996 as had been scheduled and that, at best, may only happen in the spring or summer of 1997.

The reason for this break down in the plan for early oil production is the Azerbaijani government's delay in deciding on the oil's export route. This decision was supposed to have been made by the beginning of June.

Only on October 9, based on the Azerbaijani government's decision, could the AIOC decide on two pipeline routes for the early oil; the northern one to the Russian terminal in Novorossiysk and the western one, to the Supsa terminal in Georgia.

One can make guesses as to the reasons of the delay in adopting the decision on the early oil transportation. One of the possible explanations is the problem of the settlement of the Chechen conflict. The situation in Chechnya did not allow a decision on the northern route to be made until the summer of 1995. Only by autumn, when a ceasefire was established after long negotiations between the Russian government and Chechen's representatives, did

such a decision become a possibility. As to the decision on the Georgian route, it was confirmed during a 2 October telephone conversation between the US and Azerbaijani presidents.

The decision on two pipeline routes can be considered the optimum one as it takes into consideration both economic and political factors. It clearly reflects the specifics of today's geopolitical situation in the region.

These are the positive aspects of this decision:

- Offering more guarantees for the smooth export of oil and, consequently, reducing the chances of financial losses related to irregularities in the oil export;
- Competition between pipelines;
- Taking into consideration the interests of not only one but two neighbouring countries in the steady oil extraction from the Contract Area;
- Perspectives, although not very big ones, for further neutralization of Russia in the Caspian's status issue and others.

Among the negative aspects, one should note the growth of expenses, as two pipelines instead of one will have been built.

A successful realization of both routes for early oil transportation may serve as a pretext for Russia and a number of the consortium member companies to start discussions as to whether there is any need at all to build the main pipeline to the Turkish terminal in the Mediterranean Sea.

Their reasoning may be based on the following estimations. In peak production years, the consortium will produce a little more than 30m tons of oil a year from the Azeri, Chirag and Guneshli oilfields. During these periods of peak production, the foreign companies will export a maximum of 22m tons of oil, including the oil that will cover the capital and exploitation expenses and their share of the profit oil. If Azerbaijan decides to export a certain part of its share of the remaining oil, one might expect a total of 25m tons of oil exports every year. This fits in with the combined 24m tons transit capacity of the Baku-Batumi-Supsa (7m tons) and Baku-Novorossiysk (17m tons) pipelines.

However, analysis shows that this reasoning will not suffice to talk the Azerbaijan government and the consortium into rejecting the idea of constructing a Baku-Ceyhan oil pipeline. There are much stronger reasons in favour of the Turkish route and here they are:

- Reconstruction of the Baku-Novorossiysk oil pipeline would require much more financial input than the \$50m shown in the economic justification of the northern route;
- The realization and successful operation of the northern route needs immediate and final settlement of the Chechnya conflict though today it does not look as if the conflict will ever come to an end;
- Export of 17m tons of Azerbaijani oil and an even greater export of Kazakhstan's oil from the Tengiz oilfield will require doubling the transit capacity of the Novorossiysk oil terminal which is practically unrealizable within the terminal's location due to its geographic relief. Construction of a new terminal off Novorossiysk would require a much higher financial input;

- The weather conditions in this part of the Black Sea are so harsh that the terminal has to stand idle nearly one-third of the year, which means that additional money will have to be spent on the reservoir pool;
- There is a problem of relocating Russia's Black Sea Navy, and Novorossiysk is one of the most likely candidates to harbour the fleet
- There are problems of the limited transit capacity of the Bosphorus and Dardanelles and a threat of an environmental catastrophe in the Istanbul area;
- The problem of oil exports from Azerbaijan's Caspian shelf, Kazakhstan and Turkmenistan will have to be solved;
- From the economic point of view, Russia, too, would benefit from exporting its oil directly to the Mediterranean Sea through the Ceyhan terminal. In the spring of 1993 Russia's Ministry of Fuel and Energy officially expressed its consent to participate in the construction of the Baku-Ceyhan oil pipeline.

Obviously, the Azerbaijani government and the Consortium have quite a few reasons to make a decision in favour of the construction of the Baku-Ceyhan pipeline.

However, Russia continues to do everything not to allow any pipeline construction in Ceyhan's direction. In order to weaken the above mentioned reasoning in favour of the Turkish route, Russia would first of all need to win time so that it could:

- Solve the Chechnya problem in one way or another;
- Settle the problems within the Caspian Pipeline Consortium project (in which Oman, Russia and Kazakhstan are participants), which envisages the construction of an export pipeline from Kazakhstan's Tengiz oilfield to Novorossiysk;
- Settle multiple questions regarding the Burgas (Bulgaria)-Alexandropolos (Greece) pipeline;
- Ensure a considerable participation by Russian oil companies in all projects for the development of Kazakhstan's, Azerbaijan's and Turkmenistan's hydrocarbon resources;
- Achieve political and economic stability and a subsequent steady development of the Russian state.

We should pay attention to the fact that Russia has succeeded in hindering various decisions by the Azerbaijani and Kazakh governments, which it deems unfavourable from its own geopolitical and economic point of view, due to the Karabakh conflict in Azerbaijan and separatist threats in Kazakhstan's northern provinces which is mostly populated by ethnic Russians. Besides, starting from the autumn of 1993, Russia began to actively raise at international level the unresolved issue of the Caspian's status.

Lukoil and other Russian oil companies have entered into contracts for the development of Azerbaijan's, Kazakhstan's and Turkmenistan's hydrocarbons over the past two and a half years.

Developments in recent years allow the supposition that unless the Karabakh conflict is settled, it will be very difficult for the Azerbaijani government to decide on the Turkish route for the early oil export, despite all the advantages of such a pipeline.

The dramatic episodes in the history of Azerbaijan's oil described above have, nevertheless, not hindered the interest of foreign investors in the development of Azerbaijan's hydrocarbons. And the process continues.

The Azerbaijani government did not stop at signing the contract on the Azeri, Chirag and Guneshli oilfields.

On 10 November 1995, a new oil contract was signed in Baku on the Karabakh oilfield.

Parties to the contract are LUKOIL (Russia), AGIP (Italy), PENNZOIL (US), and SOCAR (Azerbaijan) with the following participations: SOCAR and LUKOIL - 7.5 per cent each, AGIP - 5.0 per cent, PENNZOIL - 30 per cent and the LUKOIL-AGIP Joint Venture - 50 per cent. The Contract is modelled on a production sharing basis.

The Karabakh oilfield is located under Azerbaijan's Caspian shelf and bears an estimated 80-120m tons of oil.

The contract territory covers 427km square. During the exploration of the structure of the Karabakh oilfield, the contractors will pay \$1200 per year for every square kilometre of the contract territory.

The parties to the contract (except Pennzoil) are to pay a total bonus of \$75m. Of that sum, \$8m is to be paid to SOCAR within 30 days of the contract coming into effect. They are to pay another \$25m within 30 days of SOCAR's approval of the oilfields development programme (ie. after the oilfield's exploration and the time allotted for the program's preparation is over). The remaining \$42m will be paid 60 days after the stable production of 12bpd. Pennzoil will not pay bonuses, since SOCAR is indebted to it for the project of the utilization of gas from Guneshli and Neft Dashlari oilfields.

Preparatory obligations for the Karabakh oilfield's exploration will start immediately after the signing of the agreement. Geological exploration will continue for three years. Over this period at least three exploration wells are to be drilled. Based on results of the drilling, the contractors' and SOCAR's approval, exploration operations may be extended for another eighteen months.

The oilfield will be developed for 25 years and, if all sides consent, this may be extended by another five years.

Signing of this contract will be followed by signing another one on the Sah-Deniz oilfield.

The preparation of this contract has yet to be completed and it is expected to be signed in the first half of 1996.

Based on preliminary data, BP (Britain), STATOIL (Norway), TPAO (Turkey), SOCAR (Azerbaijan) and a Russian oil company (most likely LUKOIL) will be parties to the contract. Iran will be invited to participate in the contract, too. However, Iran has abstained from giving its consent which hinders the process of signing the contract, since the Azerbaijan government wants Iran to participate.

The Sah-Deniz oilfield is also located on the Caspian shelf. According to preliminary assessments, it is a gas condensate deposit. It has an estimated 500bn cubic metres of natural gas, 200m tons of gas condensate and 100m tons of oil.