

Working paper

Resource Nationalism Trends in Azerbaijan, 2004–2009

Vugar Gojayev
Independent Consultant
Vugar55@yahoo.com

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Executive summary

The collapse of the Soviet Union in 1991 gave birth to not only to dozens of new independent states, but also a new set of major oil- and gas-producing countries. The energy resources of the Caspian basin have become a key force, driving greater international engagement in the region.

Azerbaijan has not attempted to revamp its oil policies through nationalizing or quasi-nationalizing its sizeable oil assets. This is because the country has a strong economic and political interest in maintaining a presence by Western oil companies. Instead, it has continued to encourage major oil company investments in new plant or exploration projects, as the government understands that the energy development and foreign capital investments represent the main direct foreign presence in the country and constitute the pillar of government's plans for economic development. Despite the worries about a possible shift of leverage, the recent global crisis and high prices of oil have not led to an imbalance between energy-producing Azerbaijan and international oil companies.

In September 1994, independent Azerbaijan signed the massive multi-decade offshore oil deals known as the 'contract of the century', with a consortium of international oil companies to develop the country's Caspian oil reserves. Since its independence from the Soviet Union, Azerbaijan has signed 26 Production Sharing Agreements (PSA) with a wide range of international oil companies. Those transnationals have been attracted to the region not only by the size of the energy reserves, but also because, like most other Caspian countries and unlike the Gulf states, Azerbaijan has needed considerable foreign funding and expertise to exploit its hydrocarbon resources. Those oil companies could provide access to Western markets, technology and skills. This cooperation with Western oil companies has been intended to promote not only greater prosperity, but, equally important, a degree of sovereignty, stability and energy security for Azerbaijan.

Azerbaijan has been producing oil for more than 160 years, but its energy industry has been dominated by powerful regional actors. Seeking to lessen its traditional dependency on its powerful northern neighbour, Russia, independent Azerbaijan, with strong political and financial backing of the USA, managed to realize giant pipeline projects, the BTC (Baku-Tbilisi-Ceyhan) and the BTE (Baku-Tbilisi-Erzurum), to export its oil and gas to Western markets. Those pipelines have served to reinforce the independence and geopolitical standing of Azerbaijan in comparison with other post-Soviet countries that must still export their oil and gas through Russian territory.¹

¹ Rovshan Ibrahimov, 'Azerbaijan's role in regional energy security', *Azerbaijan Diplomatic Academy publication*, Vol 1, No.10, June 2008, <http://ada.edu.az/biweekly/issues/150/20090327030158055.html>

The rise in world oil prices from USD 11 per barrel in 1998 to USD 140 in 2008 increased the record inflow of petro-dollars to the country, which was hailed as the world's fastest growing economy. Although a former importer of natural gas from Russia, Azerbaijan has been a gas exporter since 2007, selling mainly to Turkey, Georgia and Greece, and is currently at the core point of the US and EU plans to build the Nabucco Gas pipeline².

Like many other oil-producing countries, Azerbaijan, despite its abundant energy resources, has failed to translate the oil-derived wealth into better lives for its citizens. International and local economic analysts warn that the government has no plan master plan for managing the oil windfall, or a strategy for the post-oil period. With an economy highly dependent on the oil sector, Azerbaijan could prove highly vulnerable to external shocks. The monopoly structure of the economy and one of the highest corruption levels in the world obstruct the possibility of building up a robust, diversified and sustainable economic system in the country.

Though the country's authorities argue that the oil money is being spent to ease poverty and improve living standards, implementation of these national projects has lagged well behind the rhetoric. In the context of developing abundant hydrocarbon resources in the absence of mature democratic institutions, it will be challenging to dismantle the corrupt patronage network that drives the economy and political system by skimming off substantial funds from the oil business. It will be hard to stem the already growing social discontent unless the ruling regime can reform its self-interested economic policies. However, it would appear that the authoritarian regime with patronage politics and all effects of the 'paradox of plenty' and 'resource curse' is steering Azerbaijan into a cycle of oppression, poverty and inequity reminiscent of such unstable oil-producing as Iran, Venezuela and Nigeria.

Introduction

Azerbaijan, an oil-rich country in the Southern Caucasus, is in the midst of a dizzying period of economic expansion. The country has registered dramatically high GDP growth for the past several years, reaching a record high rate of 34.5% in 2006.³ This sudden growth in the economy is inextricably tied to increasing oil exports and the influx of gigantic revenues. Statistics show that gas, crude oil and related products had a share of 92,5 percent in the overall exports volume in 2009.⁴

² The Nabucco pipeline is a proposed new gas pipeline connecting the Caspian region, Middle East and Egypt via Turkey, Bulgaria, Romania, Hungary with Austria and further on with the Central and Western European gas markets. [Azerbaijan](#) is expected to be the major supplier in cooperation with [Turkmenistan](#), [Iraq](#) and [Egypt](#). Currently, the project has been stalled by questions about financing, profitability and reliable suppliers

³ Economic Intelligence Unit, Country Analyses and Forecasts, http://countryanalysis.eiu.com/Azerbaijan_economy_growth/

⁴ State Statistics Committee report for December 2009, provided by Public Finance Monitoring Centre; In 2009, oil revenues made up around 65 % of the country's state budget incomes. Interview with Zohrab Ismayil, Director of Assistance to Free Economy, March 2010, Baku.

Azerbaijan is one of the oldest oil-producing countries in the world.⁵ It produces oil and gas from, and has oil reserves in, the Caspian Sea, where it is second only to Kazakhstan.⁶ The country's main proven oil reserves are concentrated in the Azeri-Chirag-Guneshli deposit, while its natural gas reserves are in the Shah Deniz deposit. Azerbaijan has proven oil reserves of 7 billion barrels, and its gas reserves are estimated at 1.37 trillion cubic meters.⁷ Statistics show that the accumulation of oil revenues for the nine-year period from December 1999 to January 2009 amounted to about USD 20 bln.⁸

The Baku-Tbilisi-Ceyhan (BTC) oil pipeline became fully operational in mid-2006, transporting oil from Azerbaijan to the Turkish harbour of Ceyhan, from where oil tankers carry the oil to European markets. Since its launch, BTC throughput capacity has increased steadily, reaching one million barrels of oil per day in mid-2008; by March 2009 this had further risen to 1.2 mln barrel a day.⁹ Since 2007, the gas pipeline Baku-Tbilisi-Erzurum (BTE), or South Caucasus Pipeline (SCP), has followed roughly the same route carrying gas from Azerbaijan's Shah Deniz¹⁰ field to Turkey. SCP throughput during the first half of 2009 was about 17 million cubic meters of gas per day.¹¹

With the boom in the energy sector, Azerbaijan's budget has become heavily dependent on transfers from the State Oil Fund (SOFAZ). The oil and gas industry provides more than half of the country's GDP. The 2009 consolidated state budget set spending at USD14.8 bln, an increase of about 16% over 2008. More than 40% of revenues were to be provided by transfers from the SOFAZ based on an estimated oil price of USD 70 per barrel.¹² Overall budget spending has increased considerably since

⁵ The world's first drilled oil well was in Azerbaijan in 1846; its first oil boom was in the 1870s. Azerbaijan produced 19,979 mln tons of the world's total production of 22.5 mln tons in 1901. Production stabilized in the 1920s and reached a peak in 1940 not exceeded until 2005, when new offshore fields were developed. During the Second World War, Azerbaijan provided 63.2% of total Soviet oil production, contributing to the victory of Soviet Union.

⁶ A. Beloposky & M. Talwani, 'Geological basins and oil and gas reserves of the Greater Caspian region', in Y. Kalyuzhnova, A. Jaffe, D. Lynch and R. Sickles (eds), *Energy in the Caspian region: Present and Future*, Palgrave Macmillan, 2001

⁷ 'Fighting corruption, Strengthening governance: The role of civil society in the Extractive Industries Transparency Initiative', Princeton University, Woodrow Wilson School of Public and International Affairs, February 2009. According to *Oil and Gas Journal*, the country has 850 billion cubic metres (Bcm) of proven gas reserves; according to BP 1,369Bcm. It has about the same percentage of world reserves as oil (0.6 to 0.8%).

⁸ Half of this USD 20 bln has been spent in the period between 2003 and 2009, or in only five years. Leyla Aliyeva, 'Azerbaijan: Power in the Petro State', in Michael Emerson and Richard Youngs (eds) *Democracy's plight in the European neighborhood: Struggling Transitions and Proliferating Dynasties*, Center for European Policy Studies, Brussels, 2009

⁹ The BTC Co. shareholders are: BP (30.1%); AzBTC (25%); Chevron (8.9%); StatoilHydro (8.71%); TPAO (6.53%); ENI (5%); Total (5%), Itochu (3.4%); INPEX (2.5%), ConocoPhillips (2.5%) and Hess (2.36%)

¹⁰ Shah Deniz participating interests are: BP (operator – 25.5%), StatoilHydro (25.5%), SOCAR (10%), LUKOIL (10%), NICO (10%), Total (10%), and TPAO (9%). www.bp.com/caspian

¹¹ www.bp.com/caspian;

¹² US Department of State, Bureau of European and Eurasian affairs, 'Background note on Azerbaijan', October 2009 <http://www.state.gov/r/pa/ei/bgn/2909.htm>

2004 with the growth in oil revenues, but much of the spending is ineffective, and some practices even act to impede economic development. The non-oil sector remains weak and neglected due to the insufficient investment. Agriculture, which is the livelihood for many Azeris, remains outmoded.

Economists argue that the government has failed to develop a comprehensive strategic plan to manage the windfalls from oil and gas sales. It is crucial to the welfare of population that the government reduce its heavy dependence on oil and diversify economy. The monopolization of the economy and institutionalized corruption prevent the possibility of building up any kind of diversified and sustainable economic system. Half-hearted and partial economic reforms have been adopted, but these have very often aimed to concentrate resources in yet fewer hands, giving almost unlimited power to the regime, and subordinating the economy to the private interests of the ruling elite.

Azerbaijan is to be commended for establishing the State Oil Fund (SOFAZ) and joining the Extractive Industry Transparency Initiative (EITI). SOFAZ resources have grown from roughly USD 1.2 billion in 2006 to over USD 19 bln by 2008.¹³ As of November 2009, the assets of SOFAZ stood at USD 14.2 bln. However, as long as the oil revenues serve the ruling elite for strengthening the network of political patronage and further grip on power, more and more remains to be done to promote accountability, transparency and fair distribution of revenues. The massive transfer to infrastructure projects can be a positive sign in general, but the country's long record of misusing such projects by corrupt institutions and lack of a proper watchdog to secure transparency on expenditures remain pressing concerns.¹⁴

With the rise in oil wealth, corruption has much deepened. Recent studies have revealed dramatic backsliding in corruption in Azerbaijan, which ranks as one of the world's 25 most corrupt countries, according to Transparency International's 2008 Corruption Perception Index.¹⁵ According to a report by Freedom House, the country's growing oil revenues have bolstered patronage networks, and new wealth 'appears to reinforce the position of deeply entrenched, corrupt elites, hindering hopes that Azerbaijan might change into transparent society from its current state as an opaque economy.'¹⁶

SOCAR, the State Oil Company of Azerbaijan, has been branching out of Azerbaijan, with involvement in giant projects overseas. SOCAR has been blamed for non-transparent management and often-institutionalized

¹³ State Oil Fund website, www.oilfund.az

¹⁴ Interview with Azer Mehtiyev, Head of Assistance to Economic Initiatives, November 2009, Baku

¹⁵ In 2009, Azerbaijan was ranked 143th out of 180 countries. Transparency International, *2009 Corruption Perceptions Index*, Transparency International, http://www.transparency.org/alac/pressrel/Press%20Release_Nov17-09.pdf

¹⁶ Freedom House, 'Nations in Transit' report, 2006

corruption.¹⁷ Although various measures have been adopted to combat corruption, they have often been tentative, and reforms on paper only.

Azerbaijan's economy is likely to grow further in the next few years, but is predicted to reach its peak in 2012. After then, the country's oil reserves are set to decline and the transport of Central Asian energy will increasingly replace the revenues from national production. Energy experts have criticized the government for having no clear-cut strategy for post-oil period.¹⁸ Azerbaijan stands out as a clear case of the 'resource curse' or 'paradox of plenty'. Activists in Baku claim that the mismanagement of revenue spending is turning the nation's oil resources from a blessing into a curse. The country also shows signs of being a rentier state, with its increasingly authoritarian political elites focused more on getting the lion's share of hydrocarbon revenues than promoting sustainable development.

The large inflow of oil revenues into Azerbaijan's economy has been accompanied by a consistent trend towards further consolidation of the power and greater restriction of fundamental freedoms. The flood of the colossal oil wealth has gone hand in hand with the further deterioration of human rights during the reign of Ilham Aliyev. Human rights campaigners say the oil wealth has also been spent to sweep political opposition from the political scene and silence outspoken media by putting regime critics behind bars.¹⁹ Oil money has enabled the regime to keep the police force and other 'power' ministries well-paid and fit, extensively used in hunting down political opponents.²⁰ According to a Western diplomat, 'sudden and greater wealth has significantly weakened the ruling authoritarian regime to liberalize the economy, conduct reforms and create democratic state. [...] These failures detrimentally contributed to the already parlous state of freedoms in the country.'²¹ While hopes for establishing democracy and the rule of law are rapidly waning, Azerbaijani society is largely deprived of the financial benefits of the country's oil revenues. Opinion polls reveal that public accessibility and transparency in the use of oil revenues by SOFAZ or other government agencies are seen as inadequate. In a survey by the Centre for Economic and Social Development, 'about 81% of respondents interviewed pointed to ineffective use of oil revenues and lack of transparency on revenues'.²²

The Azerbaijan elite's mismanagement of energy wealth, as evidenced by growing government expenditures on expensive projects and lack of transparency, will worsen the already serious problems of high inflation and pervasive corruption in the country, together with the corresponding negative implications for democratization and human rights. Without

¹⁷ Interview with Mirvari Gahramanly, head of the Committee to Protect the Rights of Oilmen, December 2009, Baku.

¹⁸ Partnership for Transparency Fund (PTF) and Centre for Economic and Social Development 'How are oil revenues effectively used in Azerbaijan?', 2007

¹⁹ Interviews with 'Dalga' youth movement activists, December 2009, Baku

²⁰ Farid Guliyev, '[End of Term Limits, Monarchical Presidencies on the Rise](#)', *Harvard International Review*, 28 February 2009

²¹ Interview with a high-level European diplomat, December 2009, Baku

²² 'Empirical Study: Are Oil Revenues Used Effectively In Azerbaijan', CERD, 2006

transparent and accountable management of revenues, Azerbaijan will further slide into the 'resource curse', with reduced economic growth, greater inequality and heightened vulnerability to economic and political shocks.

Gains of oil deal: barrier to resource nationalism

The vast oil-rich concessions in Azerbaijan have allowed large international oil companies to capture a substantial part of the economic rents. In signing oil deals since 1994, Azerbaijan attempted to design its petroleum regime to fit its economic and political needs. Economically, as Hoffman puts it, 'the oil turned to be the only viable, export-capable economic lever independent Azerbaijan has ever known', because the young country was far beyond from filling the state budget sufficiently, due mainly to economic incapacity, poor tax collection and an opaque legal regime²³. Unlike the governments of Russia, Turkmenistan and Uzbekistan, which rejected or nominally allowed the direct involvement of international actors in developing oil and gas reserves, Azerbaijan maintained full state ownership over its energy reserves and invited foreign oil companies to assume a direct role in developing its energy assets.

Politically, the internal chaos and several coup attempts in the mid-1990s led then-president Heydar Aliyev to consolidate, fortify and secure his personal position in power, essentially by embracing close cooperation with the Western powers and their oil companies. In this he succeeded, as such strategic collaboration significantly fortified Aliyev against internal and external opponents and also eventually secured the transfer of power to his son in 2003 without serious international criticism.

One aspect of the political attempts in forming closer ties with oil companies was to convert the country's energy resources into a diplomatic tool. The failure in war with Armenia in the early 1990s and growing pressures of the powerful Armenian diaspora in the West led Azerbaijan to open its oil resources to foreign exploitation as a lure for attracting strategically significant foreign investors and achieving more sympathetic relations with their home countries, seeking to gain their support to the interests of Azerbaijan on the international stage.

With a strong economic and political interest in Western oil companies, Azerbaijan has not attempted to revamp its oil policies through nationalizing or quasi-nationalizing its sizeable oil assets. Instead, it has continued to encourage major oil company investments in new plant or exploration projects, as the government understands that the energy development and foreign capital investments represent the main direct foreign presence in the country and constitute the pillar of government's plans for economic development. Despite the worries about a possible shift of leverage, the recent global crisis and high prices of oil have not led to an im-

²³ David Hoffman, 'Oil and development in post-Soviet Azerbaijan', *Energy, wealth and development in Central Asia and Caucasus*, National Bureau of Asian Research, August 1999

balance between energy-producing Azerbaijan and international oil companies.²⁴ In connection with ‘resource nationalism’, analysts warn that Azerbaijan could lose access to the foreign technology and expertise it will need to access the hard-to-reach petroleum deposits that could reverse the country’s predicted declining output after 2011.

The government is well aware that resource nationalism could pose political risks if it pursued virulently populist policies towards oil companies. That could have a destabilizing and chilling effect, depriving the regime of revenue streams necessary for the long-term survival of its authoritarian establishment. According to O. Bayulgen, ‘the durability of some authoritarian regimes in the developing world is partly a function of this external legitimation from foreign investors.’²⁵ The relationship between the political regime and foreign investment found in Azerbaijan supports the long-studied affinity between oil and authoritarianism.

Oil contracts and profits

In the waning years of the Soviet empire and after independence in October 1991, Azerbaijan held negotiations with foreign companies on joint exploitation of oil fields, to sell Azeri oil to world markets. That was a time when the economy was in recession and the country was at war with neighbouring Armenia on Nagorno-Karabakh, an enclave of Azerbaijan with a large Armenian minority.²⁶

As an ambitious and new-born independent country, Azerbaijan was keen to achieve macro-economic stability, hoping to emerge from the economic crisis and also gain political dividends from the countries of foreign oil companies when it came to resolution of the Karabakh conflict. The political turmoil, fierce war and two political power changes delayed the major deal with foreign oil companies until September 1994,²⁷ when Azerbaijan concluded the ‘Contract of Century’ with Western oil majors to exploit and develop the deepwater part of the Azeri-Chirag-Guneshli

²⁴ Interview with economy expert Azer Mehtiyev (see fn 14 above), December 2009, Baku

²⁵ Bayulgen O. ‘Foreign investment, oil curse, and democratization: A comparison of Azerbaijan and Russia,’ *Business and Politics*, 7 (1), 2005

²⁶ Fighting between Azerbaijan and Armenia over the Nagorno-Karabakh region killed between 18,000 and 40,000 people and left up to one million Azerbaijanis displaced in the early 1990s. Nagorno-Karabakh was an autonomous region inside Azerbaijan with a sizeable ethnic-Armenian population. Nagorno-Karabakh and seven districts around it have remained under Armenian occupation since the volatile ceasefire of 1994. The internationally mediated talks under the OSCE Minsk Group since 1994 are yet to produce any progress. See International Crisis Group, ‘Nagorno Karabakh: Viewing the Conflict from the Ground’, *Europe Report* No. 166; Thomas de Waal, *Black Garden: Armenia and Azerbaijan through Peace and War*, New York: New York University Press, 2003.

²⁷ Each new successive government suspended the oil talks in order to get familiar with the draft contract details and work process. The ‘Contract of Century’ was signed under the late Heydar Aliyev’s rule, four months after a ceasefire between Azerbaijan and Armenia was reached on 12 May 1994.

oil fields.²⁸ The oil from these fields is considered among the lightest in the world, making refining less expensive.²⁹

Azerbaijan has signed a total of 26 oil contracts since 1994. They are all Production Sharing Agreements (PSA), which are internationally-recognized mechanisms that encompass standard stability and arbitration measures. Luong and Weinthal point out that, in contrast to standard tax-and-royalty schemes, PSAs in Azerbaijan ‘provide a physical mechanism for rendering to the Azerbaijani state its share of profits, while allowing foreign energy companies to recoup their investments’.³⁰ All these PSAs have been signed by SOCAR and subsequently ratified by the national parliament. David Hoffman claims that the first 16 PSAs since 1994 ‘have consistently favored terms for the Azerbaijani side’ because SOCAR’s participation in those contracts ‘has, at its insistence, steadily risen while its up-front expenses are carried by other consortia members’.³¹

According to Sabit Bagirov, former president of SOCAR, the reason why Azerbaijan preferred PSAs was that ‘they provided better guarantee for the state’s right to own natural resources.’ PSAs allow the host state to collect profits that it accumulates from the foreign investment in energy and allow investors to redeem their capital and operational contribution by taking part in crude-oil operations. Foreign participants in Azerbaijani PSAs recover their capital and operating costs in the form of share of crude production at the beginning of the production cycle. The remainder of a field’s oil output is then split between the state and its foreign partner (s) according to a formula agreed for each individual PSA.

Bagirov argues that the financial constraints of Azerbaijan as a young country made it impossible to use other types of contracts that would have brought in more revenues to the host country. Moreover, the newly independent country’s very low credit rating prevented it from getting loans from foreign credit institutions at the time.

The PSAs provide a physical mechanism for rendering to the Azerbaijani state its share of profits, while allowing international oil companies to recoup their investments. Azerbaijan’s PSAs operate on a profit oil basis, which means sharing the volumes of oil produced between the contractor and the host government.

²⁸ The Azeri field lies 113 km offshore, Chirag 94 km and Guneshl 82 km.

²⁹ Azeri crude weighs 36.7 degrees average API gravity, even lighter than Saudi Arabia’s which weighs 34. Nasser Sagheb and Masoud Javadi, ‘Azerbaijan’s contract of century finally signed with Western oil consortium’, *Azerbaijan International* magazine, September 1994

³⁰ Pauline Jones Luong and Erika Weinthal. (2001). ‘Prelude to the Resource Curse: Oil and Gas Development Strategies in Central Asia and Beyond’, *Comparative Political Studies*, 34 (4): 367–399

³¹ David Hoffman, ‘Oil and development in post-Soviet Azerbaijan’, *Energy, wealth and development in Central Asia and Caucasus*, National Bureau of Asian Research, August 1999

Some oil companies later sold their shares in the ‘Contract of Century’ agreements. The following companies today have Azeri-Chirag-Guneshli participating interests: BP (operator – 34.1%), Chevron (10.2%), SOCAR (10%), INPEX (10%), StatoilHydro (8.6%), ExxonMobil (8%), TPAO (6.8%), Devon (5.6%), ITOCHU (3.9%), Hess (2.7%).³² Under certain conditions, all the oil contracts agree to introduce changes in the composition of participating companies. Those contractors of the oil contracts established the Azerbaijan International Operating Company (AIOC) to conduct daily management, coordination and implementation of oil and gas operations.³³

The agreed oil contracts stipulate that the period of development and production on offshore deposits is 25 years. Only three contracts have different periods: Azeri-Chirag-Guneshli and Shah Deniz deposits (30 years) and the Nakhchivan deposit (35 years).

Energy experts interviewed for this study say the government has dragged its feet in renegotiating the oil contracts and raising its revenues, even though the prolific PSAs were agreed on at a time when the country was politically and economically weak and disadvantaged.³⁴ Experts believe that any change in the oil contracts will ‘cause protests from the foreign companies involved in PSAs.’³⁵ Others argue that the government has been avoiding confrontation with the Western oil companies, because ‘there are couple of subcontracting companies attending PSAs which indirectly belong to powerful ministers or oligarchs close to the ruling Aliyev family.’³⁶

Bagirov argues that the problem in conflict of interests on PSAs has to do with the ‘dual role play’ of SOCAR – as SOCAR is not only a contractor, but also represents the government in those PSA contracts. In order to renegotiate contracts, the status of ‘government representative’ should be lifted from SOCAR and transferred to the relatively recently-founded Ministry of Industry and Energy (MIE).³⁷ Established in 2001, MIE was intended as the major state agency negotiating PSAs and monitoring the process. But, in reality, MIE has been accorded only nominal responsibility for concluding PSAs, so SOCAR still enjoys considerable power and influence over the oil and gas sector.

The EITI experts argue that SOCAR’s role as both a commercial entity and as a government representative represents a potential conflict of in-

³² www.bp.com/caspian; Initially, in 1994, the following foreign companies had signed the contract: BP (UK), Amoco (USA), Lukoil (Russia), Pennzoil (USA), Unocal (USA), Statoil (Norway), McDermott (USA), Ramco (UK), TPAO (Turkey), Delta Nimir (Saudi Arabia) and SOCAR (Azerbaijan).

³³ All the contractor companies have their representatives in the council of directors, which is supreme managing body of AIOC.

³⁴ Interview with Azer Mehtiyev (see fn 14 above), December 2009, Baku.

³⁵ Sabit Bagirov, former president of SOCAR

³⁶ Interview with economists and political experts, December 2009, Baku

³⁷ As there was no Ministry of Energy when many of the PSAs were concluded, SOCAR was the major body interacting and holding negotiations with foreign oil majors.

terest and technical loophole leading to confusion regarding revenue reporting.³⁸

Taxation

The oil contracts include points on tax payments mechanisms. Additionally, the contractors and the Working Commission under the Azerbaijani Cabinet of Ministers have concluded several protocols on tax payment regulations, among them ‘On the payment of taxes by foreign contractors’, ‘On the export–import duties and taxes of the Azerbaijan Republic’, ‘on the payment of taxes by employees and private individuals’.

Under these agreements, the contractor (foreign oil companies) are to pay only taxes specifically mentioned in the contract. Tax payments by those companies are performed through SOCAR, that is to say that the oil companies do not have direct relations with the Tax Ministry of Azerbaijan. As a contractor, an oil company can name an audit company to check the payment of its taxes via SOCAR. All the contracts support a zero VAT system. The tax-related conditions of the oil contracts prevail over other tax-related legislative acts of the country. Agreements between governments on avoiding dual taxation make it to apply tax concessions.

The PSAs regimes include tax exemptions, so goods imported for hydrocarbon activities are exempt from import and export duties and VAT. At customs control points, no customs duty is applied on materials, devices, means of transport, food and other things brought into Azerbaijan in connection with oil and gas operations. On the other hand, foreign oil companies are subject to realizing per acre payments, which consider the payment for square kilometre of the contractual territory.³⁹

SOCAR: Azerbaijan’s Emerging GAZPROM

SOCAR, the State Oil Company of the Republic of Azerbaijan, is the state-owned energy giant responsible for all aspects of exploration and development related to oil and gas fields, both onshore and offshore. SOCAR, with its monopoly position on the management of the country’s oil industry and as a contractor in PSAs, is entitled to considerable revenue streams.

Founded in 1992, SOCAR has some 70,000 employees – four times more than British Petroleum worldwide. SOCAR produces some 180,000 barrels of oil a year at its own fields in Azerbaijan, but its most important upstream assets are its minority stakes in the Azeri and Shah Deniz projects.⁴⁰ As the country’s largest employer and taxpaying company,

³⁸ http://www.eiti-az.org/ts_gen/eng/feal/eng_f11_CoalitionOpinion2006feb.pdf.

³⁹ Per acre payment is carried out in the exploration period. While 3 PSAs out of total 26 PSAs provide for an annual per acre payment to the tune of USD 1200 for each square kilometre, the other PSAs supports annual \$2000 per year. Sabit Bagirov, ‘Oil of Azerbaijan: Revenues, Expenses and Risks’, Baku, 2007

⁴⁰ Isabel Gorst, ‘State Oil Company: burning ambition to compete on global stage’, *Financial Times*, 24 January 2008

SOCAR produces about 9 million tons of oil and 8 billion cubic meters of natural gas annually.⁴¹ In June 2009, for the first time publicly, under new corporate statutes the registered capital of SOCAR was defined as approx. USD 750 million, but its capital assets remain undefined.⁴²

During the Soviet period, country's oil and gas industry, including SOCAR were always managed from Moscow. As noted above, since 1994, SOCAR has signed a total of 26 Production Sharing Agreements (PSAs) with consortiums of foreign oil companies on major export pipeline agreements, primarily the Baku-Tbilisi-Ceyhan (BTC) and Baku-Tbilisi-Erzurum pipelines. Though, since 2004 the Ministry of Industry and Energy (MEI) was given nominal responsibility for conclusion of PSAs, but SOCAR still keep the authority on conclusion of PSAs, the fact that denotes SOCAR's significant power and influence on oil and gas sector.⁴³

Since 2006, SOCAR has been headed by Rovnag Abdullayev, 45, former chief of the Baku Oil Refinery and a former MP.⁴⁴ With almost two decades of professional life in the oil sector, Abdullayev is seen as a powerful member of the Nakhchivan clan that has dominated the economic and political life of the country since 1993. (See below.) Opponents accuse Abdullayev of nepotism and allowing the widespread abuses within SOCAR that have made it the heart of the corruption in Azerbaijan.⁴⁵

Azerbaijan's political system is dominated by a tight series of patronage networks or clans, centred on President Aliyev, which serve to reinforce economic and political interests of the ruling elite. Being able to start a business or run an economic enterprise depends on good connections or membership in one of the two main clan networks, the Nakhchivan and the YerAz clan. The two groupings compete with each other for control of a pyramidal sharing structure that makes it possible for sizeable funds to be skimmed from the oil and other large businesses they run. The ruling Aliyev family is of the regionally-defined Nakhchivan clan, as are most members of the family inner circle and power ministries. The ruling party, New Azerbaijan Party (NAP) and its board are dominated by powerful figures from these two clans.⁴⁶ SOCAR President Abdullayev, like other influential ministers, is granted broad leeway in pursuing profitable economic ventures and extending personal wealth, thus ensuring loyalty to the incumbent power. SOCAR has always enjoyed considerable proximity to the seat of political power.

⁴¹ Shahin Abbasov, 'For SOCAR, bigger means better with Azerigas takeover', Eurasianet, 27 July 2009

⁴² Ibid.

⁴³ US State Department, Bureau of Economic, Energy and Business Affairs, 2009 Investment Climate Statement – Azerbaijan. February 2009;

⁴⁴ Rovnag Abdullayev replaced Natig Aliyev, who was named Azerbaijan's Minister of Industry and Energy in 2006.

⁴⁵ Interview with Mirvari Gahramanly (see fn 17 above), December 2009, Baku.

⁴⁶ The Party was established in 1991 in Nakhchivan by Heydar Aliyev. As YAP membership is a precondition for employment in the public sector, the role of the party is similar to that of the Communist Party of the Soviet era.

SOCAR has been directly controlled by the ruling Aliyev family since 1994, when Heydar Aliyev arranged for his son, the current President Ilham Aliyev, to be vice-president of SOCAR. Holding that post from 1994 to 2003, Aliyev Jr. acted as the head man, with authority above that of the SOCAR president and CEO.⁴⁷ President of Azerbaijan since 2003, Aliyev Jr. still supervises and has the final say in the final phase of negotiations on any major oil deal or project in the petroleum sector. All oil contracts are to be ratified by Azerbaijan's parliament – but this body has never introduced even the slightest change or indicated resistance to any of the approved 26 PSA contracts. Once the president has agreed to sign a contract, the parliament would never express any serious resistance.⁴⁸

Privatization of SOCAR is not on agenda, though international financial institutions have recommended that step. Given the current growing importance of SOCAR as a source of patronage for key government and business figures, it is unrealistic to expect any privatization in the near future. In the early and mid-1990s, Azerbaijani officials had pledged to privatize the company, allegedly leaving international investors disgruntled after they had purportedly offered bribes for shares. In 2003, a New York federal court claimed that controversial Swiss lawyer Hans Bodmer had 'paid bribes and authorized the payment of bribes' to four unnamed 'senior officials' in Azerbaijan in a scheme to influence the privatization of SOCAR.⁴⁹

SOCAR has been likened to a 'state within a state' and is widely accused of secrecy and corruption. According to one activist working to protect the rights of oil workers, many higher officials in SOCAR have founded their own private companies, often indirectly or through their relatives, to win tenders in the oil field. 'SOCAR submits some orders, tenders and construction works amounting millions of dollars to the subcontractor firms, which are owned by SOCAR managers or by their relatives.'⁵⁰

SOCAR is heavily engaged in construction, reconstruction and repairing works, but more than half of the allocated funding is reported to get lost to corruption in implementing such projects.⁵¹ SOCAR is also criticized for intentionally dismissing many low-profile employees, filling the vacancies with people who pay bribes ranging from USD 500 to 5000.⁵²

⁴⁷ On 4 August, Ilham Aliyev resigned from SOCAR, becoming Prime Minister in a move carefully designed to ensure that he would succeed his ailing father as the country's leader.

⁴⁸ Interview with Azer Mehtiyev (see fn 14 above), December 2009, Baku

⁴⁹ In 2003, Western media, including the *Financial Times*, reported that two of the Azerbaijani officials involved in the scheme were President Heidar Aliyev, and his son, Ilham. Azerbaijani government officials have vigorously denied that either of the Aliyevs received illicit payments from Bodmer. See 'Azeri president implicated in bribery probe', *Financial Times*, 13 September 2003; 'Lawsuit over oil deal accuses Azerbaijan father-son presidents of bribery', *Chicago Tribune*, 4 November 2003; 'Corruption case sharpens US policy conundrum towards Azerbaijan', Ariel Cohen, Eurasianet 18 September 2003.

⁵⁰ Interview with Mirvari Gahramanly (see fn 17 above), December 2009, Baku

⁵¹ Interview with Ilham Shaban (see fn 3 above), December 2009, Guba

⁵² Interview with Mirvari Gahramanly (see fn 17 above), December 2009, Baku

In the domestic market, the sale of oil products is mainly carried out by SOCAR, Azpetrol (private company), ABU petrol (private company) and Lukoil. Natural gas distribution was executed by Azerigaz JSC until July 2009, when President Aliyev abruptly ordered Azerigaz to merge with SOCAR, an act which experts saw as the government's attempt to make SOCAR as an international symbol of hydrocarbon might, like Russia's Gazprom. The takeover has also been seen as monopolization of oil and gas sector in Azerbaijan by the gigantic SOCAR.⁵³

With a reputation for non-transparent management, SOCAR is often associated with claims of corruption and unethical business conduct. The company has adopted various transparency measures, but very often these have been tentative and paper reforms. Critics say the SOCAR has never published a full and open account of its operations, shareholders and payable dividends, though it continues to share figures on revenue volumes and credit transfers to the SOFAZ.⁵⁴ SOCAR data have been subject to international standards since 2007, and its first audit report was published in December 2008.

SOCAR is extensively used by the ruling YAP Party for political purposes. The company has recently built grandiose premises for the ruling party in Nizami District and constructed many parks and hospitals named after Heydar Aliyev or his late wife, Zarifa Aliyeva.⁵⁵

SOCAR is extensively used as a major financier of the pre-election campaigns of the ruling regime.⁵⁶ SOCAR's annual social expenses are often so enormously high that independent experts have claimed that the allocated amount for social expenses largely gets lost to corruption.⁵⁷ Frequently sponsoring ostentatious and extremely expensive entertainment projects, SOCAR allocated millions of dollars to support the concert of the British composer and singer Elton John in Baku in September 2009. The necessity of such flamboyant projects is often questioned, but, because of government repression of the media and the dangerous environment for investigative journalists, it is increasingly challenging for civil society groups to seek to hold SOCAR and public officials accountable.⁵⁸

⁵³ Interview with experts at National Budget Group NGO, December 2009, Baku. See also 'For SOCAR, bigger means better with Azerigas takeover' (see fn 63 above)

⁵⁴ Rovshan Ismayilov, 'Azerbaijan: Socar's westward expansion could hamper Russia's Caspian plans', Eurasianet, 2 April 2008.

⁵⁵ For instance, the Heydar Aliyev Park and also the Heydar Aliyev Museum in the Zagatala and Sheki districts have been built at the expense of the State Oil Company of Azerbaijan Republic. <http://www.today.az/view.php?id=47669>

⁵⁶ SOCAR routinely finances entertainment programmes as part of the ruling party's election campaign.

⁵⁷ Interview with Ilham Shaban (see fn 3 above), Baku, December 2009

⁵⁸ Since 2005, the media and freedom of expression have become a growing concern, with many outspoken journalists attacked and jailed. Azerbaijan was recently the only OSCE member state with a large number of journalists in prison. The government has also initiated several criminal and civil libel suits against journalists and editors. Human Rights Watch and Amnesty International in their annual reports have written that freedom of the media has deteriorated, with increasing violence against and arrests of journalists, as well as numerous defamation cases orchestrated by government officials.

SOCAR's internationalization

Since oil is seen as 'strategic' SOCAR is an instrument for getting not only economic, but also political dividends. With the hike in oil prices and the cash accumulated by oil and gas production, SOCAR ambitiously started to expand abroad and establish an international profile, with offices in London, Geneva, Istanbul, Tbilisi, Bucharest, Astana and Singapore. Since 2007, SOCAR has extended its investments and stakes in the economies of Georgia and Turkey, as well as in several other countries.

Georgia: SOCAR has established a Georgian subsidiary, SOCAR Georgian Company, and continues to open petrol stations throughout Georgia. In early 2007 it renovated export facilities at the Georgian Black Sea port of Kulevi in order to develop alternative routes for exporting oil and oil products.⁵⁹ With an annual handling capacity of 10 million tons of oil, these facilities can ship the oil to European markets. The company is also extensively engaged in the privatization of the Georgian gas distribution network. As of November 2009 it had bought up 29 of these, supplying natural gas to 1 million people outside of capital Tbilisi.⁶⁰ Following the Russian–Georgian war in August 2008, SOCAR signed a five-year bulk-supply gas contract with privileged rates for residential customers in Georgia starting in 2009.

Turkey: In 2007, SOCAR expanded its investments in Turkey, which became a facilitator for SOCAR's trading operations in Europe. Entering a strategic partnership with Turcas, the giant gas and oil distributor of Turkey, the two established a new company, SOCAR&Turcas Energy (STEAS), which later gained a majority stake in Turkey's petrochemical company Petkim for USD 2.04 bln.⁶¹ Petkim has become a ready market for a considerable part of SOCAR's gas production. Additionally, SOCAR has invested USD 4 bln in constructing an oil refinery in Turkey's Ceyhan, which, with its planned capacity of 10 mln tonnes per year, will surpass Rotterdam as Europe's major oil trading hub.⁶²

Ukraine: SOCAR has begun to enter the distribution market and build refineries in several Central European countries, primarily in Ukraine, where it announced that its target is 'refine Azerbaijani oil at Ukrainian refineries and sell oil products on the Ukrainian market'.⁶³ In October 2009, SOCAR started talk to buy Kherson refinery, the Ukraine's third-

⁵⁹ Several experts have questioned if Azerbaijan will have enough oil to keep the Kulevi terminal running without interruption and to recover its massive investment.

⁶⁰ Sabit Bagirov, 'Oil of Azerbaijan: Revenues, Expenses and Risks', Baku, 2007

⁶¹ The third shareholder in Petkim is Saudi Arabia's Injaz Projects Company. The consortium comprising SOCAR, TURCAS and Injaz got the bid of USD 2.04 bln for a 51% stake in Petkim. 'Turkey awards Petkim stake sale to Azerbaijan's SOCAR, Turcas and Saudi's Injaz', 11.09.2007, Forbes, www.forbes.com/feeds/afx/2007/11/09/afx4321826.html

⁶² Isabel Gorst, 'State Oil Company: burning ambition to compete on global stage', *Financial Times*, 24 January 2008; Rovshan Ibrahimov, 'State Oil Company of Azerbaijan: Transition from national to transnational company or demand of time?', *Journal of Turkish Weekly*, 18 February 2007

⁶³ 'Socar sets up representative office in Ukraine,' Today.az, 12 October 2009 <http://www.today.az/news/business/56464.html>

largest refinery in terms of capacity.⁶⁴ Through another agreement, SOCAR arranged to supply another large Ukrainian company, Kremenchug, with 240,000 tonnes of Azeri light crude a month.⁶⁵

Moldova: Since 2007, SOCAR has undertaken several needs assessment missions to Moldova, which is interested in the technical assistance that SOCAR can provide in prospecting for oil and gas fields, primarily in the Dobrujigabagi region.⁶⁶

In general, SOCAR's engagement with Georgia, Ukraine and Moldova has been seen as aimed not only at building a market for future Azerbaijani oil and gas exports, but also at further reinforcement of the political position of Azerbaijan and alliances like the regional GUAM, of which it is a member.⁶⁷

Business environment and corruption

For foreign investors and businesses, political and economic conditions in Azerbaijan continue to constitute a challenging environment. Corruption remains a pervasive problem, affecting all levels of society, threatening the economic growth as well as the social and political development of the country. Recent international surveys have reported serious backsliding in the corruption records of Azerbaijan, which accounted as among the most corrupt countries in the world. The 2009 annual Corruption Perception Index of Transparency International ranked Azerbaijan 143th out of 180 countries.⁶⁸

With the rise in oil wealth, corruption has deepened. According to a 2006 report by Freedom House, Azerbaijan's rising oil revenues have bolstered patronage networks; further, new wealth 'appears to reinforce the position of deeply entrenched, corrupt elites, hindering hopes that Azerbaijan might change into transparent society from its current state as an opaque economy'⁶⁹. Numerous law and regulations to combat corruption are not applied in practice, making corruption highly pervasive in the judiciary, health, law-enforcement, customs, licensing and tax systems.⁷⁰ The Anti-Corruption Department of the Prosecutor General's Office and the Anti-Corruption Commission are totally ineffective, staffed with personnel

⁶⁴ 'Azeri SOCAR wants to buy Ukraine refinery', Reuters, October 13, 2009 <http://uk.reuters.com/article/idUKLD29047220091013>

⁶⁵ Ibid.

⁶⁶ In 2010, SOCAR will reportedly start test drilling in several oil fields of Moldova. See http://caspianoilgas.az/en/2007/news_items/socar_oilgas-moldova/index.html

⁶⁷ Established on 10 October 1997, GUAM is a regional organization of four post-Soviet countries – Georgia, Ukraine, Azerbaijan and Moldova – to promote political, strategic and economic ties among those countries. GUAM's establishment is also viewed by some as an attempt to limit Russian influence on the four countries, although this is officially denied.

⁶⁸ In 2008, the country's corruption score went from bad to worse, dropping to 158th out of 180 countries, whereas it ranked 150th out of 179 countries in 2007. Transparency International, *2009 Corruption Perceptions Index, Transparency International*, http://www.transparency.az/alac/pressrel/Press%20Release_Nov17-09.pdf

⁶⁹ Freedom House, 'Nations in Transit' report, 2006

⁷⁰ World bank document, Country partnership Strategy FY07 for republic of Azerbaijan, 8 November 2006

from government ministries, with no representation from civil society or the media. According to one investigative journalist, those state-run commissions are ‘cosmetic and are headed by the high-ranking officials, who are infamous for being country’s top corrupted’.⁷¹

Problems in the reliability and transparency of governance, as well as abuse of the regulatory system, lack of competition and poor contract enforcement, significantly impede the ability of many companies to do business in Azerbaijan. This has driven many companies, including some major Western ones, from the market.⁷² According to the 2009 Index of Economic Freedom, corruption remains a deterrent to investment in Azerbaijan, as ‘lingering government interference and control, both formal and informal, hurt overall monetary stability and hinder foreign investment.’⁷³ In recent years, several local and foreign companies experienced Yukos-style collapse and faced pressure from the authorities. Shortly before the parliamentary elections of 2005, Azpetrol – the private petrol giant and the country’s first private oil company – was taken over. Its president, Rafik Aliyev, (not related with Azerbaijan’s President) was jailed together with his brother, Minister of Economic Development, Farhad Aliyev.⁷⁴ The Turkish-run power company Barmek, was pressurized to close down and several senior employees were imprisoned, as was its Turkish director, Huseyin Arabul.⁷⁵

Not only the pervasive corruption, but also the weak legal institutions, ineffective judiciary, deteriorating property rights and the regulatory practices that favour monopolies are pressing concerns for anyone interested in doing business in Azerbaijan. Many were surprised when a World Bank report, ‘Doing Business 2009’, proclaimed Azerbaijan as ‘Number One’ reformer and world record-holder in reforming its economic and business regulation in 2008.⁷⁶ The report rated Azerbaijan 33rd overall in a survey of business climates in 181 countries, and primarily referred the simplified procedures for starting a business.

Azerbaijan has indeed started using a ‘one-stop’ (one-window) system for registering new businesses, reportedly aimed at avoiding bureaucracy by removing unnecessary procedures and paperwork.⁷⁷ However, independ-

⁷¹ Interview with Natig Javadly, a journalist with opposition ‘Bizim Yol’, December 2009

⁷² US Department of State, Bureau of Economic, Energy and Business Affairs, 2009 Investment climate statement, February 2009

⁷³ Heritage Foundation and Wall Street Journal, 2009 Index of Economic Freedom, <http://www.heritage.org/Index/country/Azerbaijan>

⁷⁴ Azpetrol had over 60 gas stations in Azerbaijan, 2 oil terminals and vast investments in Moldova. The Azpetrol president was arrested together with several high-ranking government officials, including two ministers, when authorities claimed they were attempting a coup.

⁷⁵ He was released in 2009; all equipment and commodities of his company were confiscated and handed over to local state-run Azerenergy company.

⁷⁶ The World Bank, “Doing Business 2009: Azerbaijan is World’s Top Regulatory Reformer”, September 10, 2008.

<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/AZERBAIJANEXTN/0,,contentMDK:21914314~menuPK:50003484~pagePK:2865066~piPK:2865079~theSitePK:301914,00.html>

⁷⁷ Under the new system all the necessary paperwork for starting business is formalized only in the Ministry of Taxes. See also Fariz Ismailzade, ‘Azerbaijan leaps forward in

ent experts in Baku disagree, saying the methodology of the World Bank report focuses on only ‘regulatory changes’ without assessing how those technical changes are really implemented on the ground and how deep-rooted the corruption is.⁷⁸ One economist questions, ‘How country can be world’s top reformer with being one of top corrupted country in the world?’⁷⁹ According to a 2009 US State Department report, there have been credible accounts that the Ministry of Justice of Azerbaijan has demanded of some investors that they pay bribes while registering their enterprises.⁸⁰

‘Underground’ oil companies, ‘dark’ PSAs

Politically-connected business interests benefit greatly from their control of lucrative fields, primarily oil and gas sector. Ilham Shaban, head of the Oil Studies Centre, argues that information on several recently-signed PSA contracts and participating new oil companies is intentionally kept undisclosed from the public. Such an argument bolsters the speculations among the general public that some of the oil companies are indirectly owned or related to powerful ministers and have simply been registered overseas. These little-known new foreign oil companies never seem to provide information on their activities or production interests.

According to Shaban, three PSA contracts ratified by the Parliament on 22 May 2009 were shrouded in mystery, as SOCAR and the Ministry on Industry and Energy (MIE) did not inform the public of the PSAs or the oil companies involved. That was the first time in the history of the country that PSA agreements have been signed surreptitiously and without considerable pomp. Shaban’s research found that the PSAs were actually signed on the SOCAR premise on 3 February 2009 – a full 104 days before they were submitted to parliamentary procedures, and the public was kept uninformed. Two PSAs were concluded with a little-known oil company represented by a Russian citizen by the name of Igor Ivanovich Kir-doda. Moreover, under the contract, the oil company’s share will be a 80% stake, whereas that of SOCAR will be only 20%. This offshore oil company, ‘Global Energy Azerbaija Ltd’,⁸¹ has been kept as a ‘secret’ company as regards the public and the media, even if continues to exploit some 17 oil fields of Azerbaijan.

Shaban has listed below the ‘secret companies’ that never publish any information on their activities:

making its economy attractive to business’, Jamestown Foundation, 22 September 2008

⁷⁸ http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=33960
Shahin Abbasov, ‘Two reports paint sharply different picture of Baku’s business climate’, Eurasianet, 3 October 2008,

<http://www.eurasianet.org/departments/insight/articles/eav100308a.shtml>

⁷⁹ Eurasianet interview with Azer Mehtiyev, head of Economic Research Centre, <http://www.eurasianet.org/departments/insight/articles/eav100308a.shtml>

⁸⁰ The Azerbaijani government does not employ formal screening mechanisms for general foreign investment, but the process of registering a foreign company with the Ministry of Justice is *de facto* screening process. See US Department of State, Bureau of Economic, Energy and Business Affairs, 2009 Investment climate statement, February 2009

⁸¹ It is registered in the British Virgin Islands.

Secret Oil Companies		
Subcontractor	Oil fields	Operator
Absheron Operating Company	Zig and Hovsan	Global Energy (registered in British Virgin Islands)
Karasu Operating Company	Kelametdin and Mishovdagh	Global Energy
Kura Valley Operating Company	Padar-Heremi	Global Energy
Binagadi Oil Company	Bineqedi, Qırmakı, Çaxnaqlar, Sulutepe, Masazır, Fatmai, Şaban-dağ and Sianşor	Global Energy
Shirvanoil Operating Company	Kürovdağ	Global Energy
Neftçala Operating Company	Neftçala, Xıllı, Durovdaq-Bazanan	Global Energy
Salyanoil Operating Company	Kürsemgi and Qarabağlı	CNPC (China)
Gobustan Operating Company	Cenub-qerbi Qobustan	CNPC
Garachukhur Operating Company	Qaraçuxur	Noble Sky (Saudi Arabia)
Surakhany Operating Company	Suraxanı	RAFI Oil (Saudi Arabia)
AzShengli Operating Company	Pirsaat	Shengli Oil (China)
AzGerneft JV	Ramanı	Grunewald (Germany)

Source: Ilham Shaban, Oil Studies Centre

State oil fund (SOFAZ) and oil revenues

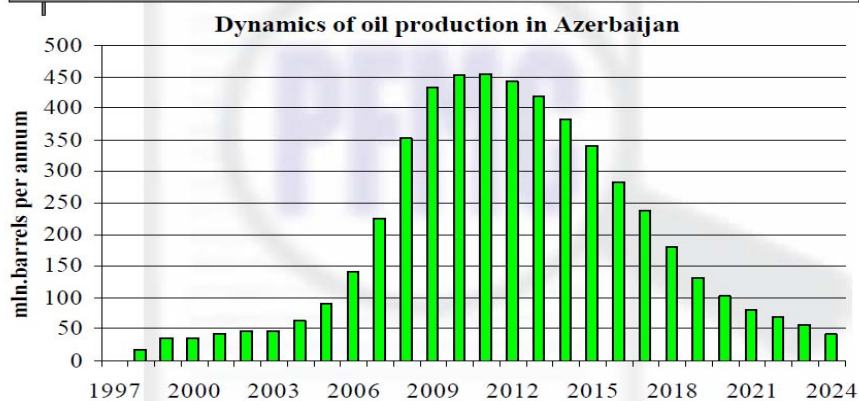
Azerbaijan's windfall gains are short-lived, as oil production is projected to peak sometime between 2009 and 2012, drying out by 2025. (See chart below.) Gas production is set to follow a similar trend, as the gas from the Shah Deniz gas field is expected to peak at 20 bln cubic meters in 2010. For that reason, Azerbaijan needs to have clear strategy on sustainable economy. Here, the State Oil Fund holds the key to the future of the country. It is essential to the well-being and benefit of the population that the government can manage to reduce its heavy dependency on oil and diversify the economy.

In an effort to avoid the resource curse and to save windfall resources for future generations, Heydar Aliyev established the State Oil Fund of Azerbaijan (SOFAZ) in 1999, where the colossal oil revenues coming

from the oil fields operated under the PSAs were to be accumulated. The government planned to promote stabilization, avoid ‘Dutch disease’ by insulating the economy against volatile oil revenues, guarantee savings and put aside a share of the energy profits for long-term investment in public infrastructure, implementing social welfare programmes. SOFAZ’s sterilization effect on the Azeri economy is restricted, as it does not cover SOCAR.⁸² In 2004, President Ilham Aliyev signed the ‘long-term strategy on the management of oil and gas revenues’, a document which hailed as a road map for spending colossal revenues.

Well before the inauguration of the multibillion-dollar Baku-Tbilisi-Ceyhan and the Baku-Tbilisi-Erzurum pipelines, government officials had promised that a fair share of the profits would be used to raising living standards in the country. With around one fifth of the population living in poverty, international financial organizations recommended Azerbaijan to improve its social services, infrastructure, generate many jobs and develop its non-oil economy.⁸³ As the oil sector occupies less than 1% of the labour force, the overwhelming share of employment in Azerbaijan needs to come from agriculture, non-oil industry and services.

Oil production in Azerbaijan is set to reach the peak in 2011 and then taper off



Source: Ingilab Ahmedov, Public Finance Monitoring Centre

⁸² US State Department, Bureau of Economic, Energy and Business Affairs, 2009 Investment Climate Statement – Azerbaijan. February 2009;

⁸³ Kenan Aliyev, ‘Whither Azerbaijan’s oil profits’, Eurasianet, 20 September 2006; Rovshan Ismayilov, ‘Wanted: Investment strategy for Azerbaijan’s oil strategy’, Eurasianet, 14 April 2006; Guy Chazan, ‘Azerbaijan: from boom to bust and back’, *Wall Street Journal*, 29 November 2005

In 2007, the United Nations Public Service Award was given to SOFAZ for 'improving transparency and accountability'. All SOFAZ's assets are kept in overseas banks. Even if SOFAZ might serve as a role model for other ministries in Azerbaijan in terms of routine reporting on transfers and revenues, it remains under the strict control of the President, who appoints its head and advisory council; moreover, the Fund itself is accountable only to the President. There are substantial reports in opposition media that the ruling Aliyev family, primarily the Heydar Aliyev Foundation, take benefit of the Fund's assets.⁸⁴

Though SOFAZ was aimed to promote economic diversification from oil, it transferred about USD 353 mln to Azerbaijan's share of debt for BTC construction in 2007.⁸⁵ According to Azer Mehtiyev of the Assistance to Economic Initiatives, not only does SOFAZ lack parliamentary oversight, also its board does not include anyone from civil society, such as journalists or representatives of NGOs.

Due to the skyrocketing increase in oil profits and other payments from oil companies, SOFAZ resources have mushroomed, from roughly USD 1.2 billion in 2006 to over USD 19 bln in 2008. As of November 2009, the assets of the SOFAZ stood at USD14.2 bln.⁸⁶ SOFAZ planned to provide over 7 billion USD in support of the total 2009 budget.⁸⁷

From 2001 to 1 January 2009, the Oil Fund spent about USD9 bln. With dramatic revenues in 2009, about USD6.5 bln was spent only in a year. Strikingly, the expenditures of one year – 2009 – are nearly equal to the total expenditures of the past eight years – from 2001 to 2009. The table below, provided by the Oil Studies Centre, compares the expenditures of these two periods:

⁸⁴ Shahin Abbasov, 'Azerbaijan: Foundation finances renovations at Versailles, Strasbourg', 27 August 2009; 'Where our oil is spent', *Bizim Yol* daily, 14 November 2008

⁸⁵ Kenan Aliyev, 'Whither Azerbaijan's oil profits?', EurasiaNet, 20 September 2006

⁸⁶ State Oil Fund website, www.oilfund.az

⁸⁷ Azerbaijan Business Centre report, December 2009; <http://abc.az/eng/news/40551.html>

Targets of Transfers from State Oil Fund	Expenditures, 2001 to 1 January 2009 (USD 1=0.802 AZN)	Expected expenditures in 2009 (USD 1=0.802 AZN)
Improving conditions for IDPs/refugees driven out from their native lands due to the Nagorno-Karabakh conflict	USD 652.11 mln	USD 99.75 mln
Financing SOCAR's share in Baku-Tbilisi-Ceyhan oil pipeline project	USD 371.19 mln	--
Financing 'Baku-Tbilisi-Kars' railway	USD 32.41 mln	USD 99.75 mln
Reconstruction of the irrigation system Samur-Absheron	USD 292.39 mln	USD 137.15 mln
Installation of Oguz-Gabala water pipeline, to provide Baku with potable water	USD 533.04 mln	USD 124.68 mln
State budget transfers	USD 6670.82 mln	USD 6128.42 mln
Charter capital of the State Investment Company	USD 112.21 mln	--
Payment to SOCAR for revenues from oil profits	USD 109.22 mln	--
Financing state programme on the education of Azerbaijani youth abroad, 2007–2015	USD 2.86 mln	USD 12.46 mln
Financing SOFAZ operations and staff	USD 19.32 mln	USD 30.54 mln
TOTAL	USD 8795.57 mln	USD 6632.79 mln

Source: Ilham Shaban, Oil Studies Centre, 2009

Critics note that there is no mechanism for overseeing the transfers and expenses of the Oil Fund. Ingilab Ahmedov of the Public Finances Monitoring Centre argues that the vast amounts allocated for the infrastructure projects tend to get lost in corruption, as there is no fixed structure to ensure transparency.⁸⁸

Despite the pledges on fair distribution of oil wealth, many ordinary Azerbaijanis remain pessimistic and sceptical. Opinion polls reveal that the public accessibility and transparency on use of oil revenues by SOFAZ or other government agencies are seen as inadequate. In a survey by the Centre for Economic and Social Development, 'about 81% of re-

⁸⁸ Speech by Ingilab Ahmedov at Baku Political School seminar in Guba, 13 December 2009

spondents interviewed pointed to ineffective use of oil revenues and lack of transparency on revenues'.⁸⁹

The government's control of oil revenues also has political implications, external and internal. Political expert Leyla Aliyeva argues that in term of geopolitics, being at the core of competition between regional actors such as Russia and Iran, Azerbaijan's leadership 'increased the value of the country in the eyes of the West and afforded more room for manoeuvre in which to resist democracy'.⁹⁰ Using oil resources as foreign policy tool, Heydar Aliyev gave the West a major stake in hydrocarbon development in order to 'ensure his government of extensive Western capital and diplomatic backing'.⁹¹

Since the signing of the 'contract of the century' in 1994, government propaganda has often made statements like these: 'The hydrocarbon weapon will ultimately guarantee the return of occupied Nagorno-Karabakh to Azerbaijan's control' or 'The power of oil will get Karabakh back to the Azerbaijani fold'. Though such expectations have yet to come true, Azerbaijan has more than quadrupled its military budget thanks to the soaring oil revenues, making the defence budget equal in size to the total state budget of Armenia.⁹² With its oil-driven economy, Azerbaijan will again increase its military budget in 2010.⁹³

Critics say the ruling elite are accused of misusing oil revenues for their own political and economic interests and for staying in power. Manipulating the Oil Fund and state budget to support grandiose and high-priced projects is seen a tool for the financial gain of the country's political elite. Independent analyst Farid Guliyev points out:⁹⁴

Oil and gas exports have enriched the [Azerbaijani] government's coffers and contributed to regime stability, allowing the government – through patronage, public spending and rent-seeking – to buy public support and to keep the society immobilized and unorganized.[...] Petroleum has already made the incumbent authorities rich and strong enough to pre-empt any challenge to their hold on power.

Since the country's economy is almost totally dominated by state monopolies run by cronies of the president, the effectiveness and necessity of massive allocations for various mega projects, mainly construction, is

⁸⁹ 'Empirical Study: Are Oil Revenues Used Effectively In Azerbaijan', CERD, 2006

⁹⁰ Leyla Aliyeva, 'Azerbaijan: Power in the Petro State', in Michael Emerson and Richard Youngs (ed.) *Democracy's plight in the European neighborhood: Struggling Transitions and Proliferating Dynasties*

⁹¹ International Crisis Group, 'Azerbaijan: Turning over a new leaf?', *Europe Report* No 156, 13 May 2004

⁹² [Azerbaijan](#) increased its defence expenditures from USD 135 million in 2003 to USD 1.85 billion in 2008, although it continues to spend a much smaller percentage of its GDP on the army than Armenia, whose defence budget was USD 410 million in 2008. See Crisis Group Europe Briefing No.50, *Azerbaijan: Defence Sector Management and Reform*, 29 October 2008.

⁹³ International Crisis Group, 'Nagorno Karabakh: Risking War', *Europe Report*, No.187, 14 November 2007

⁹⁴ Farid Guliyev, '[End of Term Limits](#)' (see fn 20 above).

often questioned.⁹⁵ At first sight, capital Baku gives an impression of prosperity with skyscrapers and bridges, but that does not reflect the political monopoly, entrenched corruption and deep poverty of the most of the population, who can hardly make ends meet. Job emigration is considerable. In every country, average salary is the generalized indicator of the level of people's welfare. The State Statistics Committee reports that average monthly salary for October 2009 totalled 296.3 AZN manats (USD 370.37) in Azerbaijan.⁹⁶ Russia had this level in 2006 and Kazakhstan in 2007, whereas the average salary in Russia today is above USD 600, and USD 500 in Kazakhstan.⁹⁷

Dr. Gubad Ibadoglu argues that the creation of a normal business environment and elimination of widespread corruption should take precedence to allocating giant funds for mega-projects – funds which are being misappropriated. The construction of several airports in the country is a clear example of the lack of an appropriate strategy for the effective use of windfalls: Back in 2007, the government allocated enormous funds to build international airports in Lenkeran, Ganja, Sheki and Zakatala. These airports have been built, but most remain closed, because of very low passenger demand.⁹⁸

Experts argue that the public tenders are not held for multi-million grandiose construction projects, primarily extensive highway and bridge projects, and that only the construction companies belonging to powerful senior government ministers act as project contractors. 'Oil money benefits only the ruling elite and its cronies, since information and monitoring of expenses are inaccessible to civil society. That paves the way for the regime to easily embezzle the oil revenues instead of using them for the intended purposes', says Fuad Hasanov of the NGO Democracy Monitor.⁹⁹

Others warn that the risk of insufficient and non-transparent use of oil money will persist unless public monitoring can be reinforced. According to energy expert Vugar Bayramov of Center for Economic and Social Development (CESD) public monitoring is extremely weak despite of the efforts of civil society organizations. Regardless of the legal requirements, the Oil Fund does not ensure the participation of civil society representatives within SOFAZ's Monitoring Council, which in turns makes revenue management opaque to the public. Bayramov argues that the

⁹⁵ Mina Muradova and Khazri Bakinskiy, 'Azerbaijan: Building bridges for President Aliyev's re-election?', Eurasianet, 30 May 2007

<http://www.eurasianet.org/departments/insight/articles/eav053007.shtml>

⁹⁶ *Caspian Business News* report, www.caspianbusinessnews.com/?fn_mode=fullnews&fn_id=135

⁹⁷ Gubad Ibadoglu, 'Current state of Azerbaijan's economy', Economic Research Centre, 2009

⁹⁸ International Crisis Group, 'Nagorno Karabakh: Risking War', *Europe Report*, No187, 14 November 2007

⁹⁹ Interview with Fuad Hasanov, Head of 'Democracy Monitor' NGO, December 2009, Baku

Fund's resistance to public representation 'derives from its having no interest in public monitoring.'¹⁰⁰

According to the former president of SOCAR, the ill-planned strategy for spending oil revenues is linked to the lack of government experience in managing revenue windfalls; imperfect laws; the dependence of the judiciary on the executive branch and the dependence of the legislature and judiciary on the executive branch; and weak democratic institutions, including a feeble civil society and weak independent media.¹⁰¹

In part, the State Oil Fund is a positive exception, as it has been pursuing a relatively transparent policy based on the recommendations of UK-led Extractive Industries Transparency Initiative (EITI) and a Memorandum of Understanding between the government, over 20 oil companies and some 32 NGOs representing the 'Coalition for improving EITI', signed in November 2004.¹⁰² Azerbaijan joined EITI in June 2003, to promote oil revenue transparency and good governance. Azerbaijan was the first country to submit EITI reports and has issued 11 reports so far.¹⁰³ It is currently a 'candidate country' as it has fulfilled the initial EITI criteria, but it will need to carry out more reforms to acquire the status of 'compliant country'. In 2005, an aggregator¹⁰⁴ was appointed to accept the host government's annual report of revenues received from foreign oil companies and the companies' individual reports of revenues paid to the government.¹⁰⁵ The NGO Coalition also works to improve public awareness on oil contracts, revenue and, state expenditures, conducting roundtables and training sessions for NGOs and the mass media.¹⁰⁶

Ilham Shaban of the Oil Studies Centre argues that the EITI work has inadequacies: the initiative requires oil companies to publicly report their

¹⁰⁰ Partnership for Transparency Fund (PTF) and Centre for Economic and Social Development 'How are oil revenues effectively used in Azerbaijan?', 2007

¹⁰¹ Sabit Bagirov, 'Oil of Azerbaijan: revenues, expenses and risks (views from 2007)', 2007

¹⁰² Current EITI participants are: Azerbaijan, Bolivia, Cameroon, Chad, Congo, the Democratic Republic of Congo, Equatorial Guinea, Gabon, Ghana, Guinea, Kazakhstan, Kyrgyzstan, Mali, Mauritania, Mongolia, Niger, Nigeria, Peru, São Tomé and Príncipe, Sierra Leone, Timor Leste, and Trinidad and Tobago. Donor countries include Australia, France, Germany, the Netherlands, Norway, and the United Kingdom. Among industry supporters there are several major international energy companies, including BP, Burren Energy, Chevron, Eni, ExxonMobil, Shell and Statoil. A number of international financial organizations also support the EITI, including the World Bank, the IMF, the OECD, and the European Bank for Reconstruction and Development (EBRD). NGO partners include Global Witness, Transparency International, and the 'Publish What You Pay' coalition

¹⁰³ The EITI idea was generated by Tony Blair and spread through oil-rich countries. Among the countries that have joined the EITI are Azerbaijan, Kazakhstan, Kyrgyzstan, Ghana, Nigeria, Congo, Sao Tome and Principe, and Timor Leste.

¹⁰⁴ An aggregator (sometimes also called Administrator or reconciler) is an independent entity (usually an audit firm) is appointed to audit the host government's annual report of revenues received from foreign oil companies and the companies' individual reports of revenues paid to the government. The aggregator compiles and analyses EITI data as submitted, and compares the totals, checks for obvious errors and publishes the reports.

¹⁰⁵ <http://www.eiti-az.org>

¹⁰⁶ Interview with members of the NGO Coalition on EITI, November/December, 2009, Baku

payments to the Oil Fund, but it does not require recipient governments to make public how funds are spent. For that reason, oil companies' contributions to the Oil Fund can be monitored under the EITI – but not how those finances are used.¹⁰⁷

Curse of oil

Azerbaijan has become a country greatly afflicted with the 'resource curse'. The state has remained in control of the petroleum-dominated economy. In 2009, oil and infrastructure connected to oil and gas products had a share of over 92.5% in the overall volume of exports.¹⁰⁸ According to official sources, inflation rate was in the range of 15 to 20% for 2008, with increased public spending and import monopolies reported as the main drivers of inflation.¹⁰⁹

The country has registered record-high GDP growth for the past several years. Rising oil exports and gigantic revenues have been the major driving force in the implementation of large-scale expenditures, with investments in the oil sector pushing GDP growth up to 26.4% in 2005 and 34.5% in 2006, before dropping to 24.5% in 2007 and 10.8% in 2008. In the first half of 2009, GDP grew by 3.6%.¹¹⁰ Azerbaijan foresees GDP growth of 6.8% in 2010.¹¹¹

However, this oil wealth has not been translated into the improvement of living standards and opening new jobs in the country, and the high unemployment rate continues to have a dramatic negative impact on living standards of Azerbaijan's over 8 million population. There is massive unemployment among the country's up to one million IDP and refugees, who were displaced as a result of the occupation of Nagorno-Karabakh and seven regions adjacent to it by Armenian Armed Forces. Official unemployment rates throughout the country fluctuate between 15 and 20%,¹¹² but are probably higher.

Only a small percentage of the over 4 million-workforce is employed in the oil sector. According to the statistics of the Oil Studies Centre, 78,000 Azerbaijani work in the oil sector: 70,000 in SOCAR, 2,000 in BP and 6,000 in service companies.¹¹³

Moreover, almost all the activities in the oil and gas sector and the development of energy-related services and infrastructure have been located in

¹⁰⁷ <http://www.eurasianet.org/departments/insight/articles/eav092006.shtml>

¹⁰⁸ Interview with Ilham Shaban, head of Oil Studies Centre, December 2009, Guba city.

¹⁰⁹ US State Department, Bureau of Economic, Energy and Business Affairs, 2009 Investment Climate Statement – Azerbaijan. February 2009;

¹¹⁰ Dr. Gubad Ibadoglu, 'Current state of Azerbaijan's economy', Economic Research Centre, 2009

¹¹¹ <http://en.apa.az/news.php?id=110381>

¹¹² US Department of State, Bureau of European and Eurasian affairs, 'Background note on Azerbaijan', October 2009 <http://www.state.gov/r/pa/ei/bgn/2909.htm>

¹¹³ Interview with Ilham Shaban (see fn 3 above), December 2009, Guba

or close to the capital Baku. As a result, the gap in living standards between Baku and the regions has widened even further.

The non-oil economy remains isolated and underdeveloped, since the government has failed to invest sufficiently in other sectors of the economy. Agriculture, the livelihood for many people, remains unmodernized and poorly invested. As per 2008 final figures, a mere 3% of all investments from all sources into Azerbaijan's economy went to agriculture, despite its 38% share in overall employment and 6% in GDP. Agriculture recorded 7% growth in 2008.

Since 2005, the economy has been showing the symptoms of 'Dutch Disease'. Sharp increases in energy revenues have pushed up the exchange rate, resulting in other industries becoming less competitive.¹¹⁴ The government has failed to build up a reasonably diversified and sustainable economy for the longer term. Statistics from 2005 to 2008 show that the economic areas with the slowest growth were agriculture and the processing industry, while those with the most rapid growth were trade, transport and communications.¹¹⁵

Our interviews show that the police and authorities from the Ministry of Tax and Ministry of Emergency are named as figures with highest level of interference in private business, regardless of oil/ non-oil sector of the country.¹¹⁶ The situation is particularly serious in the regions outside the capital.

Artificial monopolies are observed not only in the lucrative parts of the economy, but also in import of basic commodities, such as bananas. Well-connected business people, oligarchs and ministers are major monopolists. Excessively large powers given to 'power ministries', including the police, tax and customs authorities, and the lack of confidence in the court system all encourage pervasive corruption, as well as making it expensive to do business in Azerbaijan.

Foreign direct investment (FDI) in the economy is declining¹¹⁷, after peaking in 2004 with total USD 4,698 bln. According to the estimates of the Azerbaijan Export promotion and investment foundation (AZPROMO), the FDI has declined since 2004 – to USD 3,627 bln for January–September 2009.¹¹⁸ Ibadoglu argues that the decrease in FDI is

¹¹⁴ The 'Dutch Disease' phenomenon refers to the loss of competitiveness of a nation's economy that occurs when a natural-resource-inspired boom raises the value of the domestic currency (real exchange rate appreciation), making manufactured goods (traditional tradeables), less competitive, increasing imports and decreasing exports.

¹¹⁵ Dr. Gubad Ibadoglu, 'Current state of Azerbaijan's economy', Economic Research Centre, 2009

¹¹⁶ Interview with NGO representatives working on anti-corruption projects, December 2009, Baku

¹¹⁷ In the last decade the total FDI stock in Azerbaijan exceeded USD 25 bln. "Business climate and foreign direct investment in Azerbaijan",

¹¹⁸ <http://russia-agency.eligne.com/26-azerbaijan-business-foreign-direct-investment.html>
FDIs in the Azerbaijani economy represented USD 3.98 bn after 2008. News.az, 'Foreign direct investment reduced', 23 November 2009, <http://www.news.az/articles/3134>

related to the completion of construction works in the Azeri-Chirag-Guneshli offshore oil deposits under the ‘Contract of the Century’ oil deal. ‘Such tendency will lead to less FDI to country’s economy in the next 5–6 years to come’¹¹⁹

The business environment remains hazardous and highly corrupt, making the situation almost impossible for the private sector. Though giant investments were initially expected to develop entrepreneurship and business environment, hopes were dashed because of incorrect and incoherent economic policies, artificial monopolies, lower diversification index of the economy, loss of comparative advantage in international trade, imbalance between tradable and non-tradable sectors in the oil sector, and rapid inflation.¹²⁰ Predatory behaviour on the part of politically connected monopoly interests, wide discretionary powers available to the bureaucracy, and the many decision-making layers and regulations have severely hindered investment outside of the energy sector.

Domestic politics: petrodollars vs. human rights

Just as political power has been tightly concentrated in oil-rich Azerbaijan around the Aliyev family since 1993,¹²¹ also economic resources are entirely under the family’s personal control, through an opaque network of corrupted state institutions and powerful officials.

The inflow of giant oil revenues has a marked correlation with a consistent trend toward greater restriction of human rights, especially during the presidency of Ilham Aliyev. Although the government has worked hard to raise its international image as a reliable energy exporter and stable partner, its democratic credentials have deteriorated and human rights are increasingly under threat.

Ilham Aliyev succeeded his ailing father Heydar Aliyev, a former Soviet politburo member, as president in 2003, a process termed by government critics as the first ‘dynastic succession’ among the post-Soviet states. International observers uniformly deemed the controversial 2003 presidential elections to be neither free nor fair. The opposition protested the highly dubious election outcomes, leading to widespread protest rallies on election night and the following day in Baku. Police used excessive force to crush the opposition, resulting in the death of reportedly a person and the arrest of hundreds of opposition activists.¹²² International criticism was softer, even muted, with many Western states accepting the

¹¹⁹ Dr. Gubad Ibadoglu, ‘Current state of Azerbaijan’s economy’, Economic Research Centre, 2009

¹²⁰ Op.cit

¹²¹ Azerbaijan has been ruled by the strong Aliyev family for most of the past 40 years. Soviet and post-Soviet era strongman Heydar Aliyev ruled the country from 1969 to 1983 as the First Secretary of the Communist Party, and again in 1993–2003. His son, Ilham Aliyev, took office through a controversial and carefully orchestrated power succession in 2003.

¹²² OSCE/ODIHR, ‘Presidential elections of Republic of Azerbaijan, Final report’, 12 November 2003

controversial vote out of fear that developments might otherwise put oil contracts and energy exploration deals in Azerbaijan at risk.¹²³

Many Western democracies hoped that Ilham Aliyev would prove to be a modernizing and liberalizing force in the country, producing reforms and embracing democracy. These hopes were dashed, as the situation further deteriorated under Aliyev Jr.. With his authoritarian rule, Aliyev took Azerbaijan increasingly away from democracy and better human rights standards, tightening his grip on society while prospering from the skyrocketing oil revenues. One Azeri political analyst says the country has been moving steadily ‘to transform itself to a Central Asia style dictatorship, namely Turkmenistan, which seems a role model for country’s leadership, since 2003’.¹²⁴

The accumulated economic wealth has led the ruling elite to seek to maintain political control by any means and in any form. Fearing for the lavish oil revenues, the regime never allows the conduct of free and fair elections. To prevent the possible loss of power, the authorities mobilize all administrative resources, including election commission members, local government offices and police to interfere with the electoral process and ensure that the vote comes out in favour of the ruling party.¹²⁵

The controversial parliamentary elections of November 2005 were certainly a lost opportunity for a bold step away from post-Soviet autocracy towards a democratic future.¹²⁶ Even if the vote was heralded as ‘decisive test’ and ‘historical chance’, the elections were no different from all the other falsified elections conducted since 1993.¹²⁷

President Ilham Aliyev entered his second term in office on 15 October 2008, with no challenge from the weak, totally demoralized and fragmented political opposition and the effectively muzzled media. Since the oil revenues enabled the incumbent to buy public support or silence the opponents, his six rivals in October 2008 presidential election were political nobodies or puppet opposition, who joined the electoral race to give the voting a semblance of being competitive. The Council of Europe rapporteur on Azerbaijan, Andres Herkel, characterized the elections as ‘a very good swimming exercise, but unfortunately, an empty pool.’¹²⁸

The political opposition have faced tremendous challenges under Ilham Aliyev, whose reign is characterized as harsher, more hostile and more intolerant than that his late father towards political opponents. Ilham Aliyev has in fact become so repressive that dissidents and radical opposi-

¹²³ International Crisis Group, ‘Azerbaijan: Turning over a new leaf?’, *Europe Report* No 156, 13 May 2004

¹²⁴ Gorkhmaz Asgarov, ‘Azerbaijan: Turkmenistan of Caucasus’, RFE/RL, 14 January 2009

¹²⁵ International Crisis Group, ‘Azerbaijan’s 2005 parliamentary elections: Lost opportunity’, *Europe Report*, November 2005

¹²⁶ Ibid.

¹²⁷ Valerie J. Bunce and Sharon L. Volchik, ‘Azerbaijan’s 2005 parliamentary elections: A failed attempt at transition’, Center for Democracy, Development and Rule of Law (CDDR), Working Papers, September 2008

¹²⁸ ‘Vote monitor faults election in Azerbaijan’, *New York Times*, 16 October 2008

tion activists now look back on his father's rule 'as a golden age of freedom.'¹²⁹ For instance, the opposition parties were able to hold rallies and manifestations in central areas or in the close environs of Baku during the years of Aliyev Sr. (1993–2003). That has now been *de facto* banned under the reign of Aliyev Jr. The major opposition parties, their newspapers and a news agency were forced to vacate their offices in downtown Baku in November 2006. Recently, Azerbaijan has ranked as the country with highest number of the journalists in jail among the 56 OSCE member states. Since 2003, Freedom House, in its regular survey of political rights and civil liberties, has consistently categorized Azerbaijan as a 'Not Free' country, due to the downward trend in guaranteeing such rights.

In several resource-affluent countries, many of which are in the developing world, regimes try to change their countries' constitutions to their own advantage by removing presidential term limits. Azeri analyst Farid Guliyev argues that the precedents in many other resource-reliant countries have shown that such attempts become success stories for staying in power endlessly. 'By taking advantage of enormous natural resource revenues, it is easy to manipulate public opinion, gain electoral support, and garner political legitimacy, but', he warns, such unlimited presidencies are 'especially dangerous if they emerge in states with a rentier economy.'¹³⁰

In March 2009, through another controversial referendum, the Azerbaijani leadership managed to lift the term limits on the presidency, paving a way for Aliyev to become president-for-life.¹³¹ Shortly before, Hugo Chavez, leader of energy-rich Venezuela, won a referendum allowing him to run for re-election indefinitely when his current tenure ends in 2012. Similarly, in energy-rich Algeria, President Abdelaziz Bouteflika managed to eliminate the two-term restriction barrier in November 2008.¹³²

The issue of media freedom is an increasing source of concern under the rule of Ilham Aliyev, with a sharp rise in violent attacks, intimidation and fatalities aimed at silencing the opposition and independent journalists. The regime has made extensive use of defamation provisions to obstruct investigative journalism, prevent public debate and stifle open criticism of the government. At present, two chief editors of the country's most-read opposition papers, and two bloggers are in jail under charges directly related to their journalistic activity.¹³³

¹²⁹ 'Tony Blair told by Azerbaijan victims: "Give your £90,000 speaker's fee to charity"', *Sunday Telegraph*, 13 December 2009

¹³⁰ Farid Guliyev, '[End of Term Limits](#)' (see fn 20 above).

¹³¹ Opposition parties claimed the vote was an illegal attempt to transform a country into a monarchy. Whereas the government reported that 92% of the voters had approved the abolition of the limits preventing presidents from more than two consecutive terms in office, the opposition said that turnout had fallen below the 25% threshold required to validate the referendum. See Isabel Gorst, 'Azeris pave way for president-for-life', *Financial Times*, 19 March 2009.

¹³² Farid Guliyev, '[End of Term Limits](#)' (see fn 20 above).

¹³³ "EU deputies give Azerbaijan a "wake-up call" on Azerbaijan", Anna Zamejc, RFERL, December 18, 2009.

The investigation of the murder of Elmar Huseynov, editor in chief of the opposition weekly *Monitor*, in March 2005 is yet to produce any results.¹³⁴ The many politically motivated and vicious attacks on regime critics, mainly outspoken journalists, have never been investigated by the police and the culprits remain at large. All this contributes to perceptions of a climate of impunity for violence against civil society activists.

The regime's democracy credentials worsened in early 2009, when the authorities banned the Azeri-language services of foreign radio broadcasters – the BBC, Radio Free Europe/Radio Liberty and Voice of America – from the national frequencies. With all the local media operating under the total control of the authorities, these had been the only media outlets offering a plurality of political views, dissenting voices and alternative information to the public of Azerbaijan.

Resource nationalism: in politics, not in economy

The term 'resource nationalism' is mainly used to refer to efforts by resource-rich nations to shift political and economic control of their energy and mining sectors from foreign and private interests to domestic and state-controlled companies.¹³⁵

In the post-Soviet arena, Russia and Kazakhstan are the most prominent examples of resource nationalism, since these two resource-affluent states have put the squeeze on transnational corporations for energy nationalization.¹³⁶ For instance, Putin pressed oil giants BP and Shell into taking their majority stakes in Russian gas operation to the state-owned Gazprom, while Nazarbayev cited environmental policy and project development problems as grounds for negotiating a larger share in the super-giant Kashagan project for the state oil company Kazmunaigaz (KMG).¹³⁷

Energy experts in Azerbaijan claim that the country has not truly embraced 'resource nationalism', although the self-confidence of the Azeri leadership has been immensely boosted by the rising oil prices and massive oil revenues, mainly since 2004.¹³⁸ According to one government official, at some point in the future Azerbaijan may renegotiate the inadequacies in PSA contracts signed under low-price conditions in 1994,

¹³⁴ http://www.rferl.org/content/EU_Deputies_Give_Azerbaijan_A_WakeUp_Call/1907925.html

¹³⁴ "Azerbaijan remembers a brave journalist", Vugar Gojayev, Azerireport, 02 March, 2010 http://azerireport.com/index.php?option=com_content&task=view&id=2014&Itemid=48

¹³⁵ 'The rise and fall of Resource Nationalism', Ian Bremmer and Robert Johnston, *Survival: Global Politics and Strategy*, 51 (2), 2009, pp. 149–158

¹³⁶ Pauline Jones Luong and Erika Weinthal (2001). 'Prelude to the Resource Curse: Oil and Gas Development Strategies in Central Asia and Beyond', *Comparative Political Studies*, 34 (4): 367–399.

¹³⁷ 'Can public diplomacy counter resource nationalism?', Joshua Kurlantzick, USC Center for Public Diplomacy, 28 September 2006; 'The return of Resource Nationalism', Toni Johnson, Council on Foreign Relations, 13 August 2007

¹³⁸ Interview with Azer Mehtiyev (see fn 14 above), November 2009, Baku; Sabit Bagirov, former President of SOCAR and Ilham Shaban (see fn 3 above), , December 2009, Guba

when the country was in disadvantaged and in a critical condition. ‘Now, the government wants more foreign entrepreneurs to invest. So, it [renegotiation] now can have a chilling effect on the cooperation with oil companies and attracting foreign investment here’.¹³⁹ Western oil companies operating in the country report that the government has never attempted to nationalize their projects or to renegotiate contract terms.¹⁴⁰

Political opposition groups in the past decade explicitly criticized and warned about the involvement of foreign energy companies in the development of Azerbaijan’s oil industry. Late ex-president, then opposition leader, Abulfaz Elchibey singled out the Azerbaijan International Operating Company, a consortium of foreign oil companies, at one point going so far as to hint that opposition Popular Front partisans in Gazakh and Aghstafa districts might take military action against the pipeline ‘if the project did not serve the interests of the Azerbaijani people’.¹⁴¹ However, since then such open criticism has not been heard from other political groups.

Russia privatized its energy sector to domestic capitalists with only minimal international involvement. By contrast, since 1994 Azerbaijan has maintained full state ownership over its energy reserves and invited foreign companies to assume a direct role in developing them.

The recent trend in Azerbaijan resembles a tendency that Bremmer and Johnston term ‘revolutionary resource nationalism’: this is linked to broader political and social upheaval, not necessarily directed at the natural-resource sector¹⁴². After signing the ‘contract of century’ with transnational oil companies in 1994, neither of the Aliyevs (senior or junior) has attempted to assert more control over country’s natural resources through forced renegotiation of existing oil contracts, using perceived historical injustice or alleged environmental or contractual misdeeds by the companies as justification. An important point is that the major PSA contracts, like Azeri-Chirag-Guneshli, have been signed by late president Heydar Aliyev, who managed to pass power to his son, current president Ilham Aliyev, in 2003. Ilham Aliyev has kept sending the message to local and foreign actors that he would continue with the political and economic policies of his father and would not amend the oil contracts signed by him. The message has been crystal clear: there would be no significant departure from existing oil policies or the politically-motivated redistribution of energy resources. External powers who, fearing the loss of power and instability could put oil contracts and exploration deals at risk, have supported Ilham Aliyev, turning a blind eye to the worsening human rights situation.¹⁴³

¹³⁹ Interview with senior government official, December 2009, Baku

¹⁴⁰ Interview with BP and Statoil, November, 2009 Baku

¹⁴¹ David Hoffman, ‘Oil and development in post-soviet Azerbaijan’, in *Energy, wealth and development in Central Asia and Caucasus*, National Bureau of Asian Research, August 1999

¹⁴² ‘The rise and fall of Resource Nationalism’, Ian Bremmer and Robert Johnston, *Survival: Global Politics and Strategy*, 51 (2), 2009, pp.149–158

¹⁴³ Bunce and Volchik (see fn 27 above).

Political observers in Baku argue that where ‘resource nationalism’ has appeared, it is in the political life of the country, not its economic life. According to the New York-based human rights monitor Freedom House, resource nationalism in Azerbaijani politics has emerged as ‘a guiding theme for the country’s leadership’ when Ilham Aliyev entered office in 2003.¹⁴⁴ Human rights groups say the oil revenues have given substantial confidence to Aliyev Jr. to do as he pleases in sidelining international human rights norms and defying the country’s democracy commitments. In a July 2008 speech to the foreign ambassadorial corps, Aliyev warned international organizations and Western states not to criticize Azerbaijan concerning human rights or democratization: ‘Azerbaijan does not need financial support or recommendations from the international community. The government knows well what it is doing and will not allow those institutions to interfere in internal affairs of Azerbaijan [...] Azerbaijan cooperated with EU not because it wanted something. New members of EU receive billions of dollars as an assistance from EU. We do not need it. So our policy is independent even in energy diplomacy.’¹⁴⁵ Such speeches are widely taken as a sign that Azerbaijan’s abundant energy wealth has enabled it to adopt a more recalcitrant attitude towards domestic reforms and foreign scrutiny. Human rights watchdogs argue that Aliyev’s ‘resource nationalism’ style of rhetoric with the outside world, mainly with Western democracies, may end up reinforcing the bargaining power of the Azerbaijani government, which could levy pressure on the international oil companies in re-negotiating contract terms and the division of profits.¹⁴⁶

It is only in democratic countries that free and fairly elected governors would come under intense domestic pressure to use the country’s natural wealth primarily for internal development and poverty relief. In oil-rich post-Soviet countries like Azerbaijan, Turkmenistan, Kazakhstan and Russia, energy resources and hefty revenues are under the total control of the corrupted rulers of those states. The people live in fear compounded by deep social inequality, powerless to pressure their governments – not only for equitable distribution of oil revenues, but also to change existing oil contracts and the division of profits.

Conclusions

For the next few years, Azerbaijan’s revenue windfall will remain substantial, despite fluctuating oil and gas price estimates. The government should use this opportunity to diversify the economy away from its excessive reliance on extracting energy, and towards the economic welfare

¹⁴⁴ ‘Azerbaijan’s Growing Contradictions between Economic and Democratic Development’, Freedom House Director of Studies Christopher Walker speech at Commission on Security and Cooperation in Europe, 29 July 2008
<http://www.freedomhouse.org/uploads/CSCETestimony072908.pdf>

¹⁴⁵ Azerireport, ‘Ilham Aliyev gives belligerent speech at meeting with Azeri diplomats’, 8 July 2008,
http://azerireport.com/index2.php?option=com_content&do_pdf=1&id=309

¹⁴⁶ Interview with members of the Monitoring Group of NGOs, a local coalition. December 2009, Baku

of population. The non-oil economy needs to be developed more rapidly than it has been to date.

The lack of economic freedom has left civil society in Azerbaijan with a dearth of financial resources, effectively hindering their activity. The massive state revenues and extensive government spending have led to considerable apathy among the population as to the country's future, political process, good governance and democratization. Over-investment in grandiose and prestige projects has been an almost total waste, due to widespread institutionalized corruption. Moreover, such multi-million construction projects are a questionable necessity to ordinary Azerbaijanis. Instead, the regime should commit SOFAZ revenues to kick-start a 'knowledge economy', with a focus on developing healthcare, education, effective institutions and, not least, a stable democracy.

Western countries with oil and gas interests in Azerbaijan have been only too willing to tone down criticism or avoid it altogether, in return for continued access to the vast natural resources and safe transport of oil. Western governments and the transnational oil companies must recognize that the key to Azerbaijan's longer-term stability will be the development of the rule of law and respect for human rights. Otherwise, instability may emerge as the result of accumulated political frustration and public discontent with government policies and international indifference to them. Today's superficial stability should not obscure the fact that unrest is a strong possibility in Azerbaijan.

To avoid the worst effects of the 'Dutch Disease', President Aliyev will need to dismantle the deeply entrenched monopolies, cut back on budget spending, break up the business empire-building of his inner circle and effectively promote anti-corruption with strong political will and the establishment of the rule of law. Unless today's economic mismanagement and corruption can be eliminated, the country seems set to face serious economic and political challenges in the near future, as its energy resources become depleted. A report from the International Crisis Group has warned that the government may decide to resume the Nagorno-Karabakh war in 2011, in order to divert anger and distract attention from the economic hardships caused by the decline in revenues.¹⁴⁷

As long as the deeply corrupt patronage networks continue to drive the country's political and economic systems, siphoning off revenues from the energy sector, Azerbaijan will remain a rentier state struggling to achieve democratic change.

¹⁴⁷ International Crisis Group, 'Nagorno Karabakh: Risking War', *Europe Report*, No. 187, 14 November 2007