

## AZERBAIJAN

PART ONE

Monday, August 6, 2007

## AZERBAIJAN OIL SECTOR

## Socar: the multiplier effect

**F**or a country the size of Azerbaijan (pop. 8.12 million), the numbers can sometimes be staggering. In 2005, GDP grew to \$13 billion, or a whopping 26 percent. Crude oil, the country's major export, is currently fetching \$70 per barrel in international markets. The outlook is for prices to remain high. Azerbaijan's state-owned oil company, Socar, lifted 7.8 million tons of crude oil and 4.35 billion cubic meters of natural gas in 2006. Once the Baku-Tbilisi-Ceyhan (BTC) pipeline is fully operative, GDP figures will effectively double, setting off a new round of multipliers. That could happen as soon as 2008, according to the U.S. Department of Energy.

Following the collapse of the Soviet Union in 1991, Azerbaijan's GDP contracted by more than 60 percent. It took the country hard thinking (and large inflows of FDI) to get back on its feet. A territorial conflict with neighboring Armenia only served to fuel discord. Things began to take a turn in 1994, when the economy hit rock bottom. Then President Heydar Aliyev signed a raft of production-sharing agreements (PSAs) with oil majors on the condition they invest \$7.5 billion. The government also launched economic reforms backed by the World Bank/IMF. Oil and gas were behind an 8



Socar is a partner in the Baku-Tbilisi-Ceyhan pipeline consortium, possibly the most important project ever realized in oil transportation. The BTC pipeline goes from Azerbaijan to Turkey via Georgia.

percent average GDP growth in the late 1990s. By then, SOCAR was already seen as a beachhead for Azeri investment. The BTC pipeline was about to give the country a second wind.

"My vision is with those who carry out hard transactions. The BTC is something that can be praised by the Europeans and by the international community alike. It's a strategic, long-term and transparent project," says Rovnag Abdullayev, the President of Socar.

The first commercial oil crude flowed through the pipeline last summer. Since June 2006, the government of Kazakhstan has committed to export 25 million tons of its crude via the BTC.

According to Abdullayev, a connection for a trans-Caspian gas pipeline is already complete from its inputs in the mid-Caspi-

an Sea to Erzurum, in Turkey. "No other transit country, including Russia, Ukraine or Belarus, can provide energy transit the way we do," he says.

Socar has managed to broaden Azeri horizons in phased installations. Now the question is how to manage the galloping growth to avoid inflation. Mon-

ey multipliers should be directed at education, health, poverty reduction and industrial promotion.

Created as a State Oil Fund in 1999, it had accumulated more than \$1.3 billion as of 2006. It could soon be worth \$200 billion.

In the meantime, the city of Baku is being renewed. Soviet-era structures fade away as Socar

keeps remodeling historic monuments to restore their turn-of-century glamour.

Amidst the glitz, Socar officials have not forgotten to map in alternative energies. "We have wind and solar energy, especially in the Absheron Peninsula. Baku is like Chicago—always windy," says Abdullayev.

## In brief

- ▶ **SOCAR** was established in September 1992 following the merger of Azerbaijan's two state oil firms.
- ▶ **THE PUBLIC COMPANY** employs 61,000 people and is headed by Rovnag Abdullayev.
- ▶ **PROVEN** crude oil reserves range between 7 and 13 billion barrels, according to industry journals.
- ▶ **THE COUNTRY'S LARGEST** hydrocarbon structures are located offshore in the Caspian Sea.
- ▶ **MONTHLY** oil production grew by 150,000 barrels in 2005, driven by Azeri-Chirag-Guneshili (ACG).
- ▶ **AZERBAIJAN** has signed over 20 PSAs with 30 foreign oil companies from 15 countries.

## AZERBAIJAN

# 'Natural gas has a bright future'

President of Socar, Rovnag Abdullayev speaks about the strong potential of natural gas in the overall development of the company

Azerbaijan can rightfully lay claim to being the birthplace of the oil industry. The world's first crude oil pipeline was built here in 1901. Baku was also the first port to load oil onto a tanker in the early 20th century. The Soviet era, an interstice of history, is rapidly fading. In 2007, Azerbaijan is seen as a keystone piece in the energy corridor linking Central Asia and the Caspian Sea to Western markets. For Socar, the challenge is to guarantee supplies. Although state-owned, Socar is a profit-maximizing entity. As the country's largest employer, it is tasked with increasing GDP. This year, Azerbaijan's output is projected to grow at a galloping 29.2 percent, according to the IMF. For Rovnag Abdullayev, the President of Socar, geopolitical realities are just as important. He points to the 1,056-mile Baku-Tbilisi-Ceyhan (BTC) pipeline as proof that Azerbaijan is committed to a strong energy partnership with the United States. U.S.-based Chevron, ConocoPhillips and Amerada Hess are all part of the BTC consortium. By

2010, the region will be exporting up to 4.7 million barrels per day (mbd). With proven natural gas reserves that match those of Saudi Arabia, Socar is fast becoming a competitor to Russia's Gazprom. For Abdullayev, higher dependence on Azeri resources in Europe and the U.S. means added political stability at home. In the meantime, the company is busy implementing an alternative en-



Headquartered in Baku, Socar is set to play a leading role in the global oil and gas markets.

ergy scheme to free up more hydrocarbons for export—as well as to green up its image.

## What is your projection for Socar exports of natural gas?

**Rovnag Abdullayev:** Natural gas has a bright future ahead in Azerbaijan. We first need to reduce our domestic consumption. As of January 2007, Azerbaijan had one of the highest gas consumption rates in the world with a population of just over eight million. Shah Deniz Stage 1 is now producing 5.5 million cubic meters of natural gas per day. That's not enough. By the end of the year, five additional wells will go on-stream. In 2012, we will start the production of gas from Shah

Deniz Stage 2. This new volume of gas will meet demand in Azerbaijan, Greece, Italy and Turkey.

## How does the trans-Caspian gas pipeline fit in Socar's long-term strategy?

The trans-Caspian pipeline is a proposal by the Kazakh government to build a conduit that would carry natural gas [from Central Asia] through the territory of

Azerbaijan, together with an international consortium. Azerbaijan's whole infrastructure is ready from the mid-Caspian to the end of the gas pipeline in Erzurum, Turkey. It is in the interest of the European Union.

## Is it in the interest of Azerbaijan to step up domestic refining capacity?

Refining means little in terms of political value. It's not something that can be praised by the Europeans or by the international community. The Baku-Tbilisi-Ceyhan (BTC) pipeline, in contrast, is a strategic, long-term pipeline. Refineries produce oil products for the population in nearby areas. If we compute the money by looking at the map, you would have to move the refined product 950 km (590 miles) from Baku to the nearest Black Sea port at a cost of \$31 per ton, including trans-shipment. If you move oil crude there, you pay only \$7 per ton. So we're actually saving \$24 by moving crude. Therefore, why would it be in our interest to build more refineries?

## Socar is exploring alternative energy sources. What is the economic rationale behind the plan?

We are ready to implement al-

## A model for CSR

Despite the country's ascendancy as global energy provider, some 45 percent of Azerbaijan's population lives below the poverty line according to the IMF. In emerging market contexts, large public companies often target the government's socio-economic goals. As the largest taxpayers, their codes of corporate social responsibility (CSR) serve as industry models. Thus, Socar may have produced 7.84 million tons of oil crude in 2006. But the first beneficiaries are always its 61,000 employees and their families. In addition, Socar has signed the UK-sponsored Extractive Industries Transparency Initiative (EITI), which is a major driving force in the fight against corruption in oil-producing economies.

ternative power sources. The reason is that we have seen how consumer countries such as Norway, Germany or Denmark actually save money by integrating renewable sources into their energy mix. The less we consume of our own natural resources, the more money we will make from energy exports. We have huge potential in wind and solar energy, particularly in the Absheron Peninsula. I don't think there is another place in the world that is as sunny and windy year-round. In addition, water here is plentiful. It makes sense for us to build power generators that are not dependent on hydrocarbon resources.



**ROVNAG ABDULLAYEV**  
President of Azerbaijan state oil company Socar

## AZERBAIJAN

# A big hitter in the little league

Valued at \$20 billion, Socar is no shrinking violet when it comes to business transactions. It is also a vital partner for Western countries in dire need of a stable and secure oil and gas provider

It may be ranked 68th in the list of world oil companies, but it plays like a little league Major. Valued at \$20 billion, its operating profits are among the top twenty in the ranking. Its most lucrative market for crude is distant Germany. Greece, Turkey and Italy buy the bulk of its natural gas. The State Oil Company of Azerbaijan (Socar) is no shrinking violet when it comes to business transactions. As the flagship enterprise of a new state, it borrows structural leverage from its neighbors to play up its geo-strategic qualities. The Baku-Tbilisi-Ceyhan (BTC) pipeline project, in which it has a 25 percent stake, is proof that Socar has made it to partnership status.

"If you look at the map, there are only three countries (Russia, Iran and Azerbaijan) from the Barents Sea to the Persian Gulf. That essentially divides the natural gas [and oil crude] resources from West

European markets. If someone has problems dealing with gas transfer, or [political] problems with Iran, Azerbaijan is here to provide stable, long-term, transparent and accountable transactions," says Rovnag Abdullayev, President of Socar. Abdullayev may be all for energy conservation and the reduction of CO2 emissions, but it comes with a twist. "Save the earth, save energy," he says. "But we will provide you with the necessary gas and oil."

Since the late 19th century, Baku has been the staging ground for what came to be known as The Great Game. There are no John D. Rockefeller or Nobel Brothers surveying the acreage off the Absheron Peninsula today. But perhaps there should be. While brown-field production is in decline, there is plenty of optimism regarding the Azeri-Chirag-Guneshli (ACG) mega-structure. It has been driving

**What sets Azerbaijan apart from other oil provinces is its liberal tax regime, which favors production-sharing agreements with international operators**



The BTC pipeline now connects Central Asia's huge oil and gas resources with Western markets.

production growth since 1997, when Socar officials created the Azerbaijan International Operating Company (AIOC). The AIOC signed more than 20 PSAs with 30 companies. At the ACG field, British Petroleum and Amoco operate the offshore field. According to Socar, the ACG complex contains up to 6.9 billion barrels of crude, up from the 5.4 billion barrels estimated by BP.

According to the U.S. Department of Energy, Socar dominion involves anywhere between seven and 13 billion barrels of oil crude.

Socar's own figures put the number at 17.5 billion barrels, including offshore blocks in the Caspian Sea that are not fully proven. Established in 1992, shortly after the breakup of the Soviet Union, Socar emerged out of two state-run companies: Azerineft and Azneftkimiya. Today, its subsidiaries produce oil crude and natural gas. Socar is also tasked with exporting hydrocarbons, all of it while it operates state-run refineries and the pipeline. It is a handful, but keeps 61,000 Azeris employed. As a result, the company, headed by Abdullayev Rovnag, is the country's largest taxpayer.

What really sets Azerbaijan apart from other oil provinces, however, is its liberal tax regime. Each PSA is regarded as state law. And companies such as BP, Chevron or ExxonMobil pay only a profit tax on the taxable profit, which is drawn from overall sales. This profit tax varies from a scale of 25 percent to 32 percent, figures in sharp contrast to the high take-in of jurisdictions like the Russian Federation.

## MCCI: pure Azerbaijan

"WE DON'T JUST KNOW how to do things, we know how not to do them." Indeed, as Daniel M. Houser, President of McDermott Caspian Contractors, Inc. (MCCI) says, the exceptional experience his company brings to Azerbaijan has as much to do with working procedures as with technological know-how. MCCI is a subsidiary of J. Ray McDermott, S.A., an offshore oil and gas construction segment of McDermott International, a world's leading engineering and construction company (20,000 employees in 23 countries), and is a key player in the Caspian providing services such as project management, en-



**DANIEL M. HOUSER**  
President  
McDermott Caspian  
Contractors Inc

gineering, procurement, offshore construction and pipelay. MCCI is consolidating and expanding its presence in the region. Recently, MCCI signed new pipeline contracts with AIOC and Socar, and, in Russia, a new deal with LUKOIL. MCCI has also opened two new offices in Kazakhstan. "Our collaboration with Socar is complimentary. Socar has a lot of assets, and the methods we have developed to execute the work are where we bring added value," comments Houser. "Our president in Houston told me he wanted me to develop a sustainable business here, and that is just what we are doing."

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THE STATE OIL COMPANY OF THE REPUBLIC OF  
AZERBAIJAN (SOCAR) IS ONE OF THE LARGEST

OIL COMPANIES IN THE WORLD.

AS THE GOVERNMENT-OWNED ENTITY

RESPONSIBLE FOR ALL ASPECTS OF

EXPLORATION AND DEVELOPMENT RELATED

TO THE OIL AND GAS FIELDS, BOTH ONSHORE

AND OFFSHORE, WE HERE AT SOCAR

ARE DEDICATED TO IMPROVING THE

INDUSTRY'S MANAGEMENT STRUCTURE

AND FOSTERING THE EXPANSION OF THE PE-

TROLEUM ENERGY COMPLEX.

WITH AN ENVIABLE PRODUCTION STRENGTH

AND WORLD-CLASS SCIENTIFIC AND

TECHNICAL POTENTIAL, WE HAVE

BRANCHED OUT AND GONE BEYOND THE OIL

INDUSTRY TO OFFER AN EXTREMELY

WELL-DEVELOPED SERVICES SECTOR.

# Much more than oil



BUT WE ARE MUCH MORE  
THAN AN INSTITUTION,  
MUCH MORE THAN A  
LIVING, BREATHING  
COMPANY. WE ARE PART  
OF AZERBAIJAN- A  
DRIVING FORCE BEHIND  
THE NATION'S GROWTH  
AND FUTURE.

AS A MAJOR WORLD ENERGY  
PRODUCER, WE NOT ONLY  
CONTRIBUTE TO THE AZERBAIJANI  
ECONOMY BUT TO GLOBAL ENERGY  
SECURITY AS WELL.

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