Pipe dreams

why public subsidies for Lukoil in Azerbaijan will not reduce EU dependency on Russia

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Glossary

BCM - BILLION CUBIC METRES
EBRD - EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT
EIB - EUROPEAN INVESTMENT BANK
EU - EUROPEAN UNION
EUR - EUROS
IAP - IONIAN-ADRIATIC PIPELINE
KTOE - KILO-TONNES OF OIL EQUIVALENT
MTOE - MILLION TONNES OF OIL EQUIVALENT
PCIS - PROJECTS OF COMMON INTEREST – PRIORITY ENERGY AND TRANSPORT PROJECTS DESIGNATED BY THE EUROPEAN COMMISSION.
PRG - POLITICAL RISK GUARANTEE
PSA - PRODUCTION SHARING AGREEMENT
SCPX - SOUTH CAUCASUS PIPELINE EXTENSION
TAP - TRANS-ADRIATIC PIPELINE
TANAP - TRANS-ANATOLIAN PIPELINE
USD - US DOLLARS

Executive summary

The Deepwater Gunashli platform, offshore in Azerbaijan's part of the Azeri-Chirag-Gunashli field. Photo by BP.

After years of discussions about diversifying Europe's gas supply to reduce dependence on Russian imports, during the last year the EU has prioritised the Southern Gas Corridor or Euro-Caspian Mega Pipeline, as it has been dubbed by civil society groups. Estimated at USD 45 billion, this chain of projects would bring gas to Europe from the Shah Deniz offshore gas field in Azerbaijan, owned by BP, Russia's Lukoil, and Azerbaijan's SOCAR, among others. The corridor would pass through Georgia, Turkey, Greece, Albania and Italy to other EU markets, and consist of the South Caucasus Pipeline extension (SCPx), Trans-Anatolian Pipeline (TANAP), Trans-Adriatic Pipeline (TAP) and other branch lines. Later it may also include the Trans-Caspian Pipeline (TCP), which would enable the export of Turkmen gas to the EU.

The preference for the Southern Gas Corridor has been given additional bearing by the conflict between Ukraine and Russia, and although the projects are mostly carried out by private sector companies (except SOCAR which is owned by the state of Azerbaijan), the EU looks set to take on many of the risks: the Southern Gas Corridor will be backed with public money via the Connecting Europe Facility, potentially the European Investment Bank (EIB) and the Project Bonds Initiative, and indirectly via a loan by the European Bank for Reconstruction and Development to Lukoil for the second phase of developments at Shah Deniz, a loan set to be approved in early 2015. Export credit agencies from EU countries may also back the Corridor.

This brings financial risks for the EU and its Member States, which could end up costing taxpayers, gas consumers, and the people in exporting and transit countries.

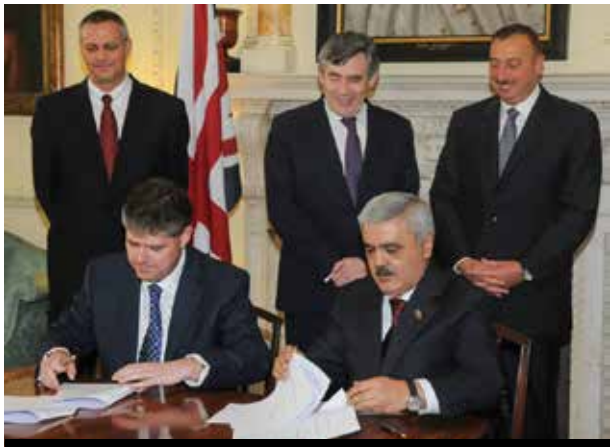
If new gas import infrastructure is the wrong answer, it is partly because the wrong questions are being asked. Someone who asks "How much energy can we save? How do we do it? What does it cost? Down to what level can we reduce our energy demand?" and works to achieve these goals will end up saving energy. Someone who asks "From which country can we get gas that isn't Russia?" will end up dancing with repressive regimes of all shades like those in Azerbaijan, Turkey and Turkmenistan, and looking around for money to pay for expensive pipeline projects.

That the EU has not prioritised energy savings sufficiently is epitomised by the recent disappointing, non-binding energy efficiency target of 27 percent by 2030. But even if this target is accepted as sufficient, the EU has not sufficiently analysed how much gas is really needed in a decarbonised EU. It has prioritised a whole series of huge gas import projects in its list of Projects of Common Interest (PCIs), of which the Southern Gas Corridor is the largest, but its own Energy Roadmap 2050 shows that we simply do not need so much gas during the coming decades if the EU is to reduce its use of fossil fuels. The impact assessment for the adoption of energy efficiency targets for 2030 show the same thing.

Much of the existing EU gas import infrastructure, especially for liquid natural gas (LNG), is under-utilised at the moment, and demand is not expected to increase significantly in any of the EU's scenarios in its Energy Roadmap 2050. In reality, EU consumption of gas has been in decline for the last decade, even before the economic downturn began. All of this means that if not used at maximum capacity, the pipeline projects risk being uneconomic and the EU risks wasting its money, which will ultimately be paid for by taxpayers, gas consumers and those living along the route of the pipeline.

The irony of lending money to Russia's Lukoil to increase independence from Russia should not be overlooked, especially since Lukoil is one of the companies on the US sanctions list at the time of writing (December 2014). However this is not the only reason to avoid lending to Lukoil, which has this year been subject to a vote to throw it out of the Komi territory in Russia due to its poor environmental record. Neither are its consortium partners much better: BP may have a larger PR budget but who can think of BP without thinking of the Deepwater Horizon spill in the Gulf of Mexico? Many people in the Caucasus and Turkey also have their own more personal experience with BP and its Baku-Tbilisi-Ceyhan oil pipeline, in which improper compensation and militarisation of the corridor were among the many negative impacts.

Many Azeri people already blame oil wealth for solidifying the position of the ruling Aliyev family, and the new projects look set to strengthen the regime further. To be sure, Aliyev has increased in confidence over the last year in throwing political opponents and civil society activists into prison.



UK prime minister Gordon Brown and President Aliyev watch the inking of a deal to develop Azeri oil, July 2009. Photo by 10 Downing Street.

Decisions made now by the EU will cement in infrastructure that may last for the next 40-60 years. However it is not too late to change. Preventing the use of public money for massive fossil fuel projects such as the Southern Gas Corridor can open space for more serious efforts on energy efficiency and sustainable forms of renewable energy. For example, the total investments needed to utilise the potential for energy efficiency and renewable sources in seven CEE countries studied by Bankwatch in its recent study No Half Measures amount to EUR 25 billion annually. This is what we need to achieve if we are to keep the EU on the decarbonisation path and achieve real energy security.

1. Introduction - the Southern Gas Corridor and the Shah Deniz gas

In its quest to secure its energy supply, the EU has a priority project: the Southern Gas Corridor, or Euro-Caspian Mega-Pipeline as it is sometimes known. This corridor includes several gas infrastructure projects aimed at bringing natural gas from the Caspian region to Europe. The gas is to come (at least initially[1]) from the offshore Shah Deniz gas field in the Caspian Sea and then travel via the South Caucasus Pipeline (SCPX) through Azerbaijan and Georgia, entering the Trans Anatolian Pipeline (TANAP), which crosses Turkey, followed by the Trans Adriatic Pipeline (TAP) across Greece and Albania to Italy[2], from where it will be distributed further. There is also a possibility that an Ionian-Adriatic Pipeline (IAP) will be constructed as a branch from TAP to reach southern Croatia, Albania/Kosovo, Montenegro and Bosnia and Herzegovina.

This combination of gas pipelines will stretch to nearly 3500 kilometres, over elevations of 2500 metres, and to depths 800 metres below the sea. It is supposed to bring 16 billion cubic metres (bcm) per year of new sources of gas from the Caspian region to Europe. The different parts of the project involve several major energy companies including BP (UK), SOCAR (Azerbaijan), Lukoil (Russia), Statoil (Norway), BOTAS and TPAO (both Turkey), Fluxys (Belgium), Enagás (Spain), Total (France), Naftiran Intertrade (Iran), Petronas (Malaysia) and Axpo (Switzerland).

The total investment needs are estimated at approximately USD 45 billion, according to the website of TAP[3]. In terms of the origin and amount of gas, the list of Projects of Common Interest (PCI), defined as strategic by the Commission for the EU, identifies additional supplies. One such project is the Trans-Caspian Gas Pipeline (TCP), a 300 kilometre offshore pipeline with a capacity of 32 BCM/year, branching off either at a connection with the East-West pipeline in Turkmenistan or from a collection point of offshore Caspian production in Turkmenistan[4]. Thus, Turkmen gas may be part of the equation, too.

1.1 THE SHAH DENIZ GAS FIELD

The primary source of gas will be the Shah Deniz gas field in the Caspian Sea, the largest gas field in Azerbaijan, located approximately 70 kilometres south-east of Baku.

Corridor and field

The field was discovered in 1999 after a production sharing agreement between seven oil companies and the Azerbaijani authorities was signed in June 1996. The field is owned by a consortium that includes BP (28.8%), Turkish Petroleum Overseas Company (19%), SOCAR (16.7%), Petronas (15.5%), Lukoil (10%), and the Iranian NIOC (10%).

Al Cook, BP's Vice President for Shah Deniz described the field at the 2013 annual meetings of the EBRD: "Our Shah Deniz field is the size of Manhattan Island, the largest gas field BP ever discovered."

The field is estimated to hold 40 trillion cubic feet (over one trillion cubic metres) of gas. Capital expenditures to date for the first phase of development of the Shah Deniz stage one, which started production in December 2006, is estimated at USD 6 billion. As of 2013, the field has produced 47.3 billion standard cubic metres (1671 billion standard cubic feet) of gas and 99.5 million barrels of condensate[5].

Shah Deniz gas and condensate are transported to the Sangachal terminal south-west of Baku. From there condensate is delivered via the Baku-Tbilisi-Ceyhan (BTC) pipeline to the port of Ceyhan on the Mediterranean. Gas is delivered to the market through the South Caucasus Pipeline (SCP) via the Georgian capital of Tbilisi to the Turkish border, and then routed to Erzurum through a system belonging to Turkish pipeline operator Botas.

In order to be able to feed the amounts of gas needed into the Southern Gas Corridor pipeline, the consortium wants to develop the second stage (stage two) of Shah Deniz, also called full field development. The final investment decision for Shah Deniz II was announced in December 2013 and welcomed by the Commission[6]. It is hoped that production will start in 2018. With this added capacity, the consortium hopes to add an additional 16 bcm/year of gas to the approximately 9 bcm/year produced by Shah Deniz stage one.

The plans include:

- two new bridge-linked offshore platforms;
- 26 gas production wells that will be drilled with two semi-submersible rigs;
- 500 kilometres of subsea pipelines will link the wells with the onshore terminal;
- upgrades of offshore construction vessels; and
- the expansion of the Sangachal terminal to accommodate new gas processing and compression facilities[7].

Initially SOCAR, BP and Statoil were the leading companies in the Shah Deniz consortium, with several other European companies participating. However, most of the European majors have gradually exited the consortium, first with Italian ENI selling its 5 per cent share to Lukoil in June 2004. France's Total sold its share in May 2014, and Norway's Statoil divested at first 10 per cent in December 2013 and its final 15 per cent in October 2014.

LUKOIL OVERSEAS

Lukoil Overseas Shah Deniz Ltd is a fully owned daughter company of Lukoil Overseas Holding Ltd that manages the company's activities in the Shah Deniz project. Lukoil Overseas is a 100 per cent subsidiary of the second-largest private oil company in Russia OAO Lukoil. Founded in 1997 and headquartered in Dubai, Lukoil Overseas manages the company's international upstream projects. Lukoil Overseas has operated exploration, development and production in oil and gas projects in Azerbaijan, Colombia, Cote D'Ivoire, Egypt, Ghana, Iraq, Kazakhstan, Romania, Saudi Arabia, Sierra Leone, Venezuela, Vietnam and Uzbekistan. The net profit of Lukoil Overseas amounted to 1 billion in 2013. Following Kazakhstan and Uzbekistan, its Azeri developments generated the third highest revenues for the company in 2011. (Source: Lukoil Annual Report 2012)

Lukoil, as part of the consortium owning Shah Deniz, approached the EBRD for financing of its share in stage two. The EBRD and the Asian Development Bank (ADB) were appointed by Lukoil as Mandated Lead Arrangers for the proposed transaction. The EBRD is supposed to arrange USD 500 million, while the ADB is expected to pitch in USD 450 million.

The EBRD stresses that the development of the project will be led by BP and that despite the potential severe impacts of the project, the bank is optimistic since "BP has demonstrated a responsible approach to environmental and social issues"[8] in past projects like the BTC pipeline and Shah Deniz stage one. BP's Al Cook also stressed this aspect about Shah Deniz stage two: "The real key as to why we can have confidence as we embark on a project like this is our track record in Azerbaijan spanning back 20 years. It demonstrates that we can develop oil and gas fields that provide reliable sources of energy for the countries and the companies that depend upon them."[9]

This view is rather one-sided, ignoring the clear link between the development of Shah Deniz, the existing BTC oil pipeline by BP and the repressive Aliyev regime in Azerbaijan. By providing Aliyev with power and money the oil company's activities have hindered the development of democracy in the country. This has led to a situation where critics of the Aliyev regime risk time in a prison cell or hospital bed[10]. Developing Shah Deniz stage two and the Southern Gas Corridor is likely to cement further the oppressive structures of the Aliyev government.

SOUTH STREAM

The South Stream is a planned gas pipeline to transport Russian natural gas from the Pochinki compressor station in Russia through the Black Sea to Bulgaria, Serbia, Hungary, Slovenia, Tarvisio in Italy and Baumgarten in Austria. A branch line to Republika Srpska in Bosnia and Herzegovina has also been under discussion. However on 1 December 2014 Russia's President Vladimir Putin announced that the project as such would not go ahead and that the gas may be exported to Turkey rather than Europe. Many are sceptical of this statement, and some EU Member States have a continued commitment to the project, so the future for the project is unclear.

South Stream effectively began in 2006 when Gazprom and Italy's Eni entered into a Strategic Partnership Agreement entitling Gazprom to supply Russian gas directly to the Italian market from 2007. Under the agreement, the existing contracts for Russian gas supplies to Italy were extended to 2035.

In January 2008 a special purpose company, South Stream AG, was incorporated in Switzerland by Gazprom and Eni to build the offshore section, and in the following years a series of intergovernmental agreements were signed. From 29 October to 15 November 2012, the final investment decisions about the project were made in Serbia, Hungary, Slovenia and Bulgaria. In June 2014 an agreement was signed between Gazprom and Austria to construct the pipeline there by 2016.

In addition to the countries along the pipeline route, other countries' companies are involved in the project. In September 2011 the Shareholders Agreement for the offshore section of the South Stream

project was signed, in which German Wintershall Holding (subsidiary of BASF) and French EDF each acquired a 15 per cent stake in the offshore section of the South Stream project through a 30 per cent reduction of Eni's stake. As a result, the shareholding structure in the South Stream offshore section is as follows: Gazprom (50 per cent), Eni (20 per cent), Wintershall Holding and EDF (15 per cent each).[11]

While South Stream is clearly seen by the Commission as a rival to the Southern Gas Corridor, individual Member States do not have a unified position. Italy's export credit agency SACE is considering support for the offshore section,[12] and the Stakeholder Engagement Plan for the Bulgarian section of the offshore part states that the environmental impact assessment will be available on the websites of Euler Hermes (the German export credit agency), SACE, the Japan Bank for International Co-operation (JBIC) and the Swiss Export Risk Insurance (SERV), which implies that all of these financial institutions may be interested in the project.[13]

So far South Stream has received less attention from civil society than the Southern Gas Corridor. This should not be taken as a sign that it is considered a better or more necessary project, however the relatively high level of attention from the EU institutions has rendered the watchdog role of civil society less crucial than in other large infrastructure projects.

To make matters more confusing, since the supposed demise of South Stream, there have been discussions about Russian gas being fed into the TANAP pipeline, which, if realised, would completely defeat the stated purpose of the Southern Gas Corridor, which is to diversify away from dependence on imports of Russian gas.[14]

2. The Southern Gas Corridor – an EU priority, but should it be?

In October 2013 the Commission designated a list of 248 energy infrastructure projects as Projects of Common Interest (PCIs). Among these more than 100 projects are for natural gas transmission, storage and LNG, of which at least 15 are aimed at increasing the import of gas into the EU, most notably via the series of projects that make up the Southern Gas Corridor. Only two PCI projects are for smart grids, while the remainder are electricity and gas interconnectors, transmission and storage projects, plus six oil projects, including the construction of an oil terminal in Gdansk and an Italy-Germany oil connection.

PCI investment costs are estimated at about EUR 140 billion for electricity transmission projects and EUR 70 billion for gas. As will be made clear below, the projects will nominally bring in private financing, but in reality they will be dependent on risks being taken by public sources such as the EBRD, EIB and the EU through instruments like the Connecting Europe Facility and the Project Bonds Initiative.

In May 2014 the Commission issued a communication including 'Key Security of Supply Infrastructure Projects', which included 27 gas projects and just six electricity projects,[15] thus tipping even further the balance between gas and electricity investments needed to prepare the European grid for a renewables-based system.

Among the discussions about diversification of energy supply, few have noticed that these gas projects are not justified by the actual needs identified by the EU's own Roadmap 2050.

2.1 DO WE NEED MORE GAS IMPORT INFRASTRUCTURE IN AN ERA OF DECARBONISATION?

There is much talk about the need to diversify away from Russian gas imports yet in reality there is limited scope for reducing overall European dependence on Russian gas before the mid-2020s. Up until that point European companies are contractually obliged to import at least 115 bcm/year of Russian gas (approximately 75 per cent of the 2013 import level).[16]

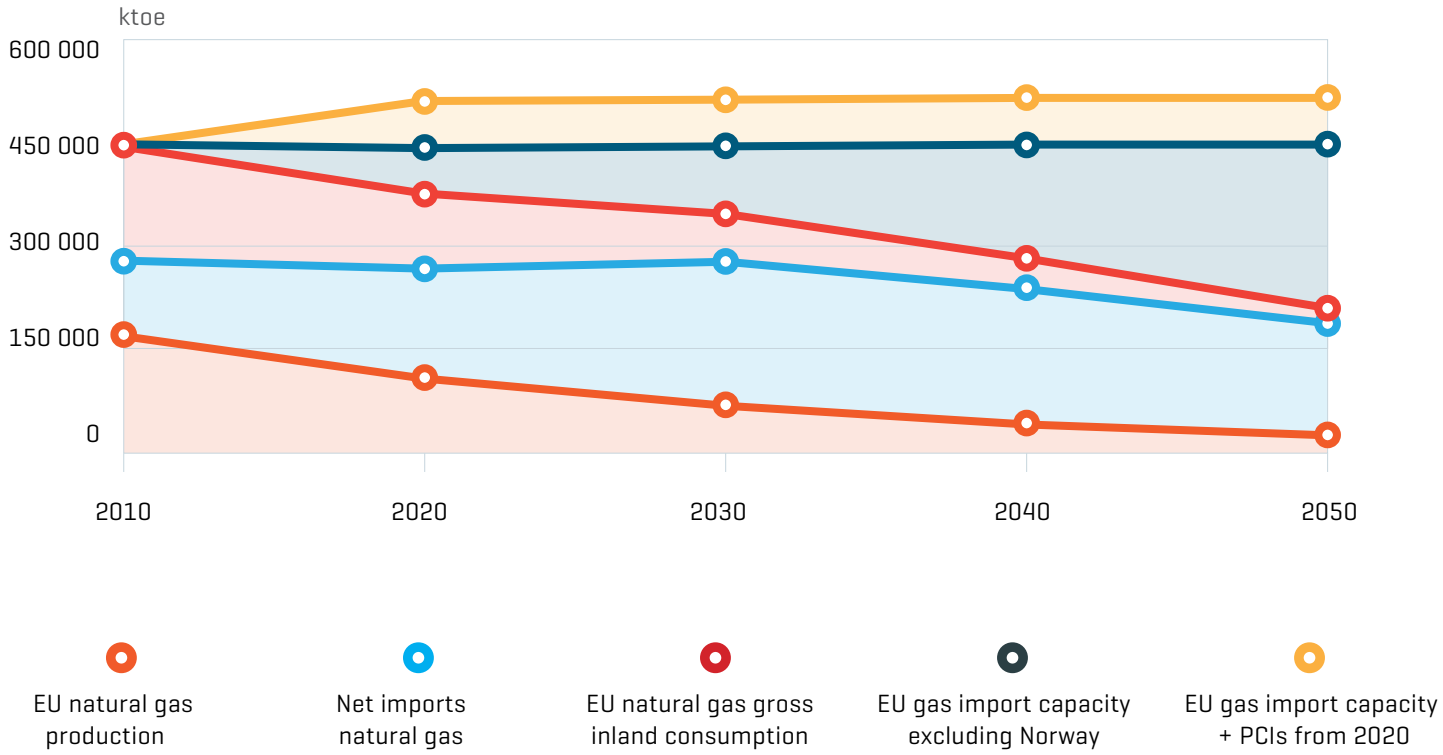
The real need is to decarbonise energy supplies. In 2013 the International Energy Association concluded that *"No more than one-third of proven reserves of fossil fuels can be consumed prior to 2050 if the world is to achieve the 2 °C goal"*[17]. European decision-makers need to decrease dependency on the overall import of gas, an idea that has not been given nearly enough attention. The good news is that energy efficiency and decarbonisation offer an opportunity to do just that. The role of natural gas in decarbonisation is still being debated: whether it should serve as a short-term 'bridging' fuel until renewable energy becomes more dominant, or as a long-term 'destination' fuel that would provide back-up during periods of low renewables availability, even beyond 2050. In order to examine this issue, we take the EU's Energy Roadmap 2050 as a reference. In all scenarios, the Roadmap's impact assessment[18] shows that decarbonisation decreases the EU's energy import dependence. This

is crucial because the EU's own production of natural gas is forecast to drastically decrease by 2050."While this could be expected to automatically lead to increasing imports, this is not the case because in all scenarios the EU's overall consumption of gas also decreases, although remaining at a much higher level than production". So in fact in all of the EU's five decarbonisation scenarios there is a decrease – at least to some extent – in natural gas imports by 2050 compared to 2010[19]. The graphs show the Commission's low nuclear scenario, which has the highest need for gas imports to 2050, the high renewables scenario, which has the lowest need for gas imports to 2050.

Yet the EU already has an overall surplus of gas import infrastructure, and it is backing the further expansion of this infrastructure. According to our calculations, as of 2014 the EU already has a total import capacity for natural gas of 537.62 bcm per year or 446 529.5 ktoe, even if Norway is excluded, whose production is expected to steeply decline in the coming decades. Some of this infrastructure, especially for LNG, is already under-used[20].

Juxtaposing existing gas import capacity with gas projections from the Energy Roadmap scenarios shows that, assuming the existing infrastructure stays functional for the next few decades, the infrastructure surplus will only widen, even without any large new infrastructure like the Southern Gas Corridor.

EU ENERGY ROADMAP 2050 HIGH RENEWABLES SCENARIO



Adding the gas PCIs would add around 69 434 ktoe to the EU's import capacity, widening the surplus even further. Even in the scenario with the highest requirements for gas imports, the low nuclear scenario, at the peak of gas imports in 2040 we will need around 311 090 ktoe of imports, and even without the PCI projects we already have 446 529.5 ktoe of import capacity.

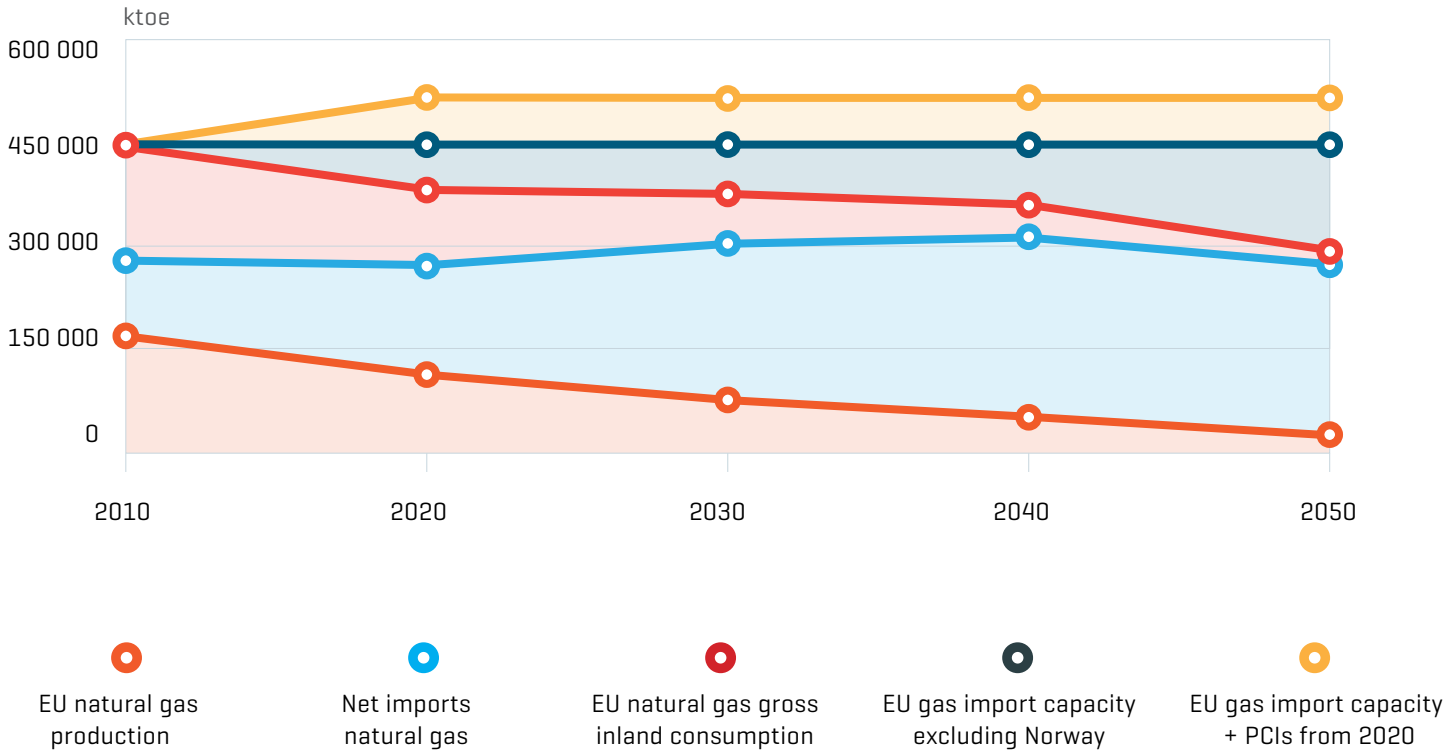
These findings have been bolstered by a September 2014 analysis by the NGO E3G,[21] which among other things finds that:

"Europe's energy security strategy currently lacks coherence. There is a notable disconnect between the economic valuation of energy infrastructure and that of energy efficiency. Gas demand in Europe has fallen by 9% over the last decade, but gas projects are currently evaluated against scenarios that assume 72% higher gas demand in 2030 than would be the case if the proposed 30% energy efficiency target is met. A failure to bridge the consistency gap will lead to public objectives being missed and public money being wasted on expensive but underutilised infrastructure projects".

While only a 27 per cent energy efficiency target was adopted at the European Council in October, the main point still stands. E3G points out that the PCIs have been assessed for a situation in which gas consumption is 30 per cent higher than the Commission's reference scenario for 2030, in which no new policy moves are introduced and gas consumption is expected to remain roughly flat.

Also of interest is that E3G has noted that the Commission's estimate of potential energy savings of 174 Mtoe per year by 2030 through energy efficiency measures[22] is around 20 times more than the gas that will be imported through the Southern Gas Corridor. This raises questions about the amount

EU ENERGY ROADMAP 2050 LOW NUCLEAR SCENARIO



of resources being allocated to gas imports versus energy efficiency, as the investment in the Southern Gas Corridor requires as much money as a year and a half of investment potential for energy efficiency and renewable energy in central and eastern Europe, the region most vulnerable to any future gas import disruptions. As demonstrated by the Commission's Security of Supply Stress Test (p.8) some countries are much more vulnerable to potential gas disruptions than others (especially the Baltic States, Hungary, Bulgaria, Croatia and potential EU Member States in the Balkans). Targeted energy measures leveraging USD 45 billion in those countries would deliver short, medium and long-term energy security benefits for the EU faster and cheaper than the Southern Gas Corridor. Moreover, there would be less risk of interrupted gas supplies via the Southern Gas Corridor or supply disruption due to political instability in one of the source countries and all the investments and benefits would stay within the EU. The total investments necessary to utilise the potential for energy efficiency and renewable sources in seven central and eastern European countries amounts to roughly EUR 25 billion annually, totalling EUR 172 billion for the 2014-2020 period.[23]

To be sure, the problem is not the quantity of infrastructure but its location and dependence on Russian gas. And indeed there are some cases like in the Baltic States where some investments may be justified to reduce the vulnerability of the countries' systems and to better distribute gas within the EU. However the problem with adding additional import capacity is that infrastructure operators will do their best to make sure that it is filled with gas. Unless significant amounts of existing gas import infrastructure is decommissioned, which does not seem likely, this represents a direct threat to decarbonisation as well as reducing the EU's overall energy dependence.

3. Impacts on Azerbaijan

In Azerbaijan the Aliyevs have established a family dictatorship. They have held onto power for the past two decades through a combination of holding fraudulent elections, arresting opposition candidates, beating protesters and curtailing media freedom[24]. During the October 2013 presidential elections, the regime conducted a systemic campaign of repression and intimidation, with rival candidates jailed, their children viciously beaten and supporters rallies forbidden. On the day of the vote there were 143 political prisoners in Azerbaijan[25], and videos emerged of ballot boxes being stuffed by the regime, leading to criticisms form the OSCE for failing to meet international standards on free and fair elections.

Protests in fall 2014 outside BP headquarters in London as repression increases against Azeris critical of the Aliyev regime. Photo by Platform

POLITICAL REPRESSION

Since summer 2014 unprecedented levels of arrests and attacks on civil society, even by Azerbaijan's repressive standards, have occurred. Many activists and journalists have been imprisoned on false charges and many more are now in hiding for fear of also being arrested.

Some of those now held are:

LEYLA AND ARIF YUNUS

Leyla Yunus is one of the Azeri regime's fiercest critics. Her work included monitoring political prisoners and promoting dialogue between Azeri and Armenian communities. She was recently nominated for the 2015 Nobel

Peace Prize.[26] Leyla was detained alongside her husband Arif Yunus (a historian and human rights activist), on accusations of treason, spying for Armenia and illegal business activities.[27] These charges carry a life sentence. There is concern for Arif and Leyla Yunus, who both have long-running health problems that require specific medication and foods.[28] These are not being provided in prison. Leyla has also had men enter her cell and sexually threaten her.[29] Before her arrest Leyla was working with Rasul Jafarov to compile a list of political prisoners, and by the time the list was published the names of Leyla and Arif were on it.

RASUL JAFAROV

Rasul was arrested in August and charged with tax evasion, illegal enterprise and abuse of official power.[30] Rasul recently turned 30 in jail. Before his arrest Rasul worked to defend other political prisoners, organising the Sing for Democracy campaign during the 2012 Eurovison Song Contest in Baku and the Sports for Rights campaign in advance of the 2015 European Olympics.[31]

INTIGAM ALIYEV

Intigam was also arrested in August and charged with the same crimes as Rasul: tax evasion, illegal enterprise and abuse of official power.[32] All of the charges are false. He is being held in jail in pretrial detention, where he is expected to receive five years for these charges. Before his arrest Intigam worked as a human rights lawyer defending political prisoners, having submitted more than 22 applications to the European Curt of Human Rights in cases of election rigging, abuses of free speech and the right to a fair trial. Intigam had also helped Rasul and Leyla compile a list of political prisoners in Azerbaijan. Lawyer Khalid Bagirov, who is acting on behalf of all four activists, has said the arrests are politically motivated, and that their acquittal is "impossible".[33]

KHADIJA ISMAYILOVA

On 5 December 2014 Khadija Ismayilova, an award winning investigative journalist, was arrested for 'inciting suicide'.[34] If found guilty she faces up to seven years in prison. Ismayilova has spent years uncovering corruption in Azerbaijan, which she has traced to the Aliyev family.[35] In an article published just before her arrest, Ramiz Mehdiyev, head of the Presidential Administration, accused Ismayilova of treason and espionage.[36] Ismayilova's lawyer Elton Guliyev said there was no evidence against her and that the ruling was "absurd".

This is not the first time Ismayilova has been targeted by the regime. In 2012 she was sent pictures of herself having sex with her boyfriend taken by a hidden camera in her apartment. The pictures were accompanied by a letter telling her to keep quiet or to be "shamed".[37] After going public a tape of her having sex was released online. Khadija Ismayilova has managed to issue a statement from jail, she said "The charges against me are fabricated. The charges are put forward as part of the dirty and black PR. Despite all of this, I remain strong."

The Aliyev regime is almost entirely funded by fossil fuels, and if the Southern Gas Corridor is built the pro-Aliyev elite will make billions of euros while Azeri citizens are left with crumbling infrastructure and unaffordable healthcare. The money from the oil industry was supposed to be controlled by the State Oil Fund for Azerbaijan, which was intended to finance the transition of the Azeri economy away from oil and to ensure that wealth was kept for future generations. Much of the money however has been used for overpriced construction projects. Intentional price inflation enables companies to make large amounts of money from construction projects, and much of Azerbaijan's oil and gas revenues ends up in offshore bank accounts. Investigations by Azeri journalists have linked these companies to the Azeri elite, including the president and his family.[38]

In December 2013, the Italian Undersecretary, the Greek Prime Minister, the British Foreign Secretary and the European Energy Commissioner all travelled to Azerbaijan, less than two months after the heavily criticised elections, to attend the signing of the final investment decision for Shah Deniz stage two[39]. The day before they arrived Anar Mammadli, a key Azeri election monitor, was arrested on false drug charges and has now been in jail for five and a half years[40]. Aliyev is using his country's hydrocarbon wealth to gain political legitimacy from European politicians who are willing to do business with him despite his terrible human rights record.

Fossil fuel wealth has given Aliyev's security forces a secure income base (meaning they do not have to listen to citizens' voices, because they are not reliant on those citizens for a salary) and political legitimacy in the form of support from foreign governments. The 2014 IMF country report on Azerbaijan sets out a devastating analysis of resource dependency. It shows that despite oil profits to the government increasing by about 30 per cent of GDP in mid-2000s, the government has squandered the money, with almost no accountability or oversight. In the last two years oil production has declined, after reaching its peak in 2010, and reserves could be depleted in the next 15 to 20 years. Despite anticipated increases in gas production, gas revenues are unlikely to offset the decline in oil revenues. Oil dependency and fiscal vulnerabilities are rapidly increasing, as the regime's spending remains high. This has meant that transfers from the oil funds to the state budget are increasing and that Azerbaijan is assuming a high oil price to set a budget that will break even. Despite its huge wealth, the country might be running out of money.

SOFAZ receives much of Azerbaijan's hydrocarbon income. It was established to save wealth for future generations and to diversify the economy. This has not happened. In 2010 SOFAZ income totalled USD 7.2 billion, with predicted expenditures at USD 6.6 billion, leaving less than 10 percent for future generations. Of that planned expenditure, 80 percent is allocated for government spending, covering items such as the military, the police (enforcers for Aliyev's regime) and construction projects. For the first time since its creation, SOFAZ had to draw down resources to finance spending in 2013. The Azeri think-tank Centre for Economic and Social Development calculated that USD 45 billion was channelled from SOFAZ into the national budget in the last few years. The Centre warned that SOFAZ's assets will be spent by 2017 if the current high levels of transfer are continued.[41]

President Ilham Aliyev has been warmly welcomed by political figures across Europe, most recently in June at the Council of Europe where he attended a session as Azerbaijan headed the Council. Azeri activists have continuously lobbied the Council to draw attention to the huge number of human rights abuses, political prisoners and violations of freedom of expression in the country. The regime's lobbyists are also frequently in attendance at such events, engaging a successful brand of 'caviar diplomacy'. Many members of parliament in the Council of Europe enjoy a cosy relationship with the regime and a warm welcome to their 'club'.

Last year Aliyev went to Brussels to promise Europe a total of two trillion cubic metres of gas from Azerbaijan. At the same meeting then-Commission President Barroso spoke about the 'very good exchange he had with Aliyev' and spoke in a positive tone about democracy and human rights in Azerbaijan,[42] words that gave Aliyev support prior to the repressive pre-election period.

However support from the EU and European companies for the Azerbaijan regime is far from new. Thirteen companies were brought in to extract Azeri oil in the 1994 'Contact of the Century', which saw BP lead the consortium responsible for the BTC pipeline. This project provided Aliyev with the finance that has underpinned his dictatorship.

Mirvari Gahramanli works at the Public union for oil worker's rights. She blames BP for Aliyev's survival:
"BP is where the President got his power from. What is he without the money? Where is his wealth, where are his police without BP's money? They [the Aliyevs] have grown rich from BP and now as a result they have much more power."

By setting the rules of the game for oil contracts, the Azeri elite – much of which ruled during the Soviet era – has captured the active support of foreign investors in concentrating their power. Each contract signed has helped entrench Aliyev further. Arzu Abdullayeva, a campaigner for human rights and co-chair of the International Helsinki Citizens' Assembly said told Platform during a visit to Azerbaijan,
"From my side, I can say that BP doesn't do anything for human rights. Especially as BP is a great cooperator with our regime, I am dissatisfied; they are not helping us build our democracy. It's great that they train some journalists to write articles professionally – but this is minor compared to their support for the repression."

Repression and the centralisation of authority under both Heydar and Ilham Aliyev have allowed the oil companies to operate in a highly profitable environment. The lack of autonomous state institutions asserting a different perspective from that of the President is seen as a blessing. The concentration of power has meant that corporations have felt little need to be held accountable to government departments, nor to consider that there is any opposition to the Aliyevs. In an extraordinary twist of language, a business think tank described how, in Azerbaijan, 'oil projects sidestep many potential administrative pitfalls and delays … environmental and labour laws, for example, can prove elastic.'[43] BP and other corporations have played a crucial role in enabling Aliyev's regime to strengthen its grip over Azeri society, achieving what the companies describe as 'stability'.

Shortly before his arrest in August 2014, Rasul Jafarov said:
"Before the oil and gas incomes came to Azerbaijan we had more democracy and freedom. The main income from oil came in 2006 when the Baku-Tbilisi-Ceyhan pipeline started to operate. And from that time the situation started to deteriorate. We have problems with journalists and religious believers being arrested – if you criticise the government you can be easily interrogated and prosecuted under fabricated charges."

3.1 SHAH DENIZ – WHAT BENEFITS FOR ORDINARY PEOPLE?

In its brochure on Shah Deniz stage two and the Southern Gas Corridor, BP claims the projects will create around 10 000 construction jobs in Azerbaijan. Without further details eg. whether the amount contains indirect jobs, the number seems inflated when compared with figures provided in the project's environmental and social impact assessment (ESIA).

The Shah Deniz stage two ESIA claims that between 81 and 3 600 people will be employed during the onshore construction and installation and that an additional 2 000 jobs will be created on the marine subsea works. However, as the employment spans over the course of the works, most workers will be hired for the peak phase of construction and installation and be awarded with only temporary contracts. After the construction and subsea works will have been completed towards the end of 2015 and 2016, respectively, de-manning will occur. The layoffs are expected to have serious impacts on the household income of workers who do not find alternative employment.

On local employment, the ESIA commits to maximise employment from local communities that meet or exceed the percentage targets at the first Shah Deniz field. For

A city councilor in Sangachal, where the terminal for the BTC pipeline is located.

the construction and installation periods, these targets are set at at 30 per cent to 50 per cent for professionals and 70 per cent for non-professionals. Experience has shown that contractors hire foreign-born labourers for construction works on oil and gas projects in Azerbaijan. Asian workers from the Philippines and India were brought in to work on the construction of the BTC pipeline and comprised one quarter of the total workforce at the contracting company.

Unofficial sources of information claim that both SOCAR and the contractor companies prioritise the foreign workforce irrespective of the targets mentioned above, in order to avoid massive layoffs of Azeri workers that could risk the discontent of the newly unemployed. Even when the local workforce employment targets increase significantly over the development and five-year post production phases, the number of employment opportunities dramatically decreases. Without providing a long-term outlook, the ESIA states that 100 permanent jobs will be created during the operational phase.

There are other ways in which Western oil and gas contractors perpetuate disparities in working conditions among the local and foreign workforce. Over the years, human and labour rights groups like the Committee for the protection of oil industry workers' rights have pointed out that local workers in contractor companies are likely to receive lower wages and work without healthcare coverage and contracts. In 2004 and 2005, Azeri workers employed by the BTC pipeline consortium organised a series of strikes to complain about poor working conditions, low wages and unequal treatment of foreign workers.

Azeri workers may also suffer from political pressure due to SOCAR's influence during the hiring process. The production-sharing agreement grants SOCAR influence over the selection of candidates for new positions throughout the supply chain. The operating company and the sub-contractors are obliged to present SOCAR with a list of employees they intend to hire. SOCAR can make recommendations on the candidates and persons recommended by SOCAR are given priority in the hiring process. SOCAR can also exercise influence over the remuneration levels as it revises together with the contractors the annual budgets. This discriminatory contractual obligation can present grounds for politically influenced decisions.

Although the Azeri constitution and the contractor companies formally respect freedom of association, including the right to form trade unions, the practice has been different. In November 2005, workers at the McDermott oil service company contracted for the construction of the BTC pipeline held a two-day strike demanding higher salaries, health coverage, better treatment and unionisation. The 2007 annual survey of violations of trade union rights published by International Trade Union Confederation (ITUC) expressed concern over the fact that many joint ventures and foreign enterprises working in Azerbaijan, especially BP and its subcontractors, continued to create obstacles to establishing trade unions and exercising trade union activities.

Three years later, the ITUC confirmed that labour rights are often violated in transnational companies, noting that "the most common violations include conclusion of fixed-term contracts for one to three months, deprivation of annual leave days granted by law, overtime without extra payment, and failure to transfer social insurance taxes." The ITUC added that the international companies operating in Azerbaijan also prevent the creation of trade unions, threatening employees with dismissals. With all its 448 employees in Azerbaijan members of the trade union registered with the Ministry of Justice since 1997, Lukoil is quite another extreme, raising suspicions about the effectiveness of unionising.

4. Impacts on transit countries – Turkey and Italy

The Trans Anatolian Pipeline (TANAP) will create a high security, militarised corridor across the whole of Turkey, with costs estimated at USD 11.7 billion[44]. Much can be learnt from the BTC pipeline in terms of the likely impacts of TANAP. People living along the route would face major disruptions to their lives. During the construction of the BTC pipeline, people lost land that they relied on. A flawed compensation process meant that people were not properly recompensed and when they publicly questioned this, they were sometimes silenced with beatings or arrests.

For example, Ferhat Kaya, an activist from Calabas in the Ardahan province of Turkey was arrested and tortured by the Jandarma paramilitary police. Ferhat recalled during an April 2013 interview with Platform: "Living along the route of BTC pipeline I saw what the free movement of oil and gas meant for the people of Turkey: environmental destruction, loss of livelihood and heavy repression along the militarised route. I was arrested and tortured for speaking out against the BTC pipeline. If the Euro-Caspian Mega Pipeline goes ahead, people living along it will experience the same repression."

Already security firms are being consulted on how to militarise the Southern Gas Corridor route.

TANAP is currently owned entirely by Azeri and Turkish entities, with SOCAR owning 80 per cent, Botas 15 per cent and TPAO 5 per cent. BP has agreed to acquire a 12 per cent share. SOCAR's pivotal role in the delivery of TANAP is concerning because of its own paramilitary force which it has used in the past to violently silence critical journalists.[45]

Aliyev and former Italian prime minister Enrico Letta, August 2013. Photo by flickr user palazzochigi.

TRANS ADRIATIC PIPELINE IN TROUBLE IN ITALY

The Trans-Adriatic Pipeline is one of the components of the Southern Gas Corridor. TAP would start near Kipoi on the Greece-Turkey border, cross the north of Greece, then southern Albania and near Fier it would enter the Adriatic Sea, re-emerging in the Apulia region of Italy. The overall cost of TAP is unknown, but according to media reports, the Greek section alone may cost about EUR 1.5 billion[46].

The project has faced fierce opposition by residents and public authorities in the province of Lecce where the project is expected to surface and where large infrastructure (including a decompression station) should be sited. "Look at this bay, it is one of the most beautiful beaches of southern Italy. This is what the pipeline will destroy", said one resident during a visit in January 2014. "It will destroy our sea and our coast, it may put at risk our fresh water reserves, it will destroy hundreds of olive trees which are up to a thousand years old" said another resident of Melendugno, the municipality where the pipeline would come ashore. A local fisherman and manager of a fish restaurant said, "They will never do the TAP. It is too much of a crazy project, they can't be serious in moving forward with construction".

The project environmental impact assessment presented by the TAP consortium to the Italian Ministry for Environment in September 2013 has a number of issues that need to be resolved. The EIA received negative comments from a technical commission in Melendugno, the region of Apulia, and from independent experts in residential associations and large environmental groups like WWF. In November 2013, hearings were organised at the Italian Parliament on the ratification of the international treaty among Italy, Albania and Greece, where additional concerns were raised about the economic and financial aspects of the project[47]. So far 38 municipalities have voted on motions to reject the project. In spring 2014, the EIA commission at the Italian Ministry of Environment asked for a list of additions to the TAP study, many of which were fundamental aspects of the project. Melendugno and civil society organisations part of the 'No TAP' committee flagged to the media in June 2014 that the project most of the issues raised by the ministry remain unaddressed.

The Ministry of Culture also expressed a negative opinion on the project. On 12 September 2014, the government called an urgent Council of Ministers meeting to give a green light for the EIA in spite of the negative opinion issued by the Ministry of Culture, which had co-decision power in approving the project. One pending issue is that the project apparently did not go through an industrial risk assessment, which is compulsory for industrial plans like TAP. The responsible authority is the Apulia region, which in November flagged to the administrative court that the entire EIA should be considered invalid for this reason[48].

More problems appeared as the project moved towards the final authorisation procedure. At a first meeting between the government, the Apulia region and local authorities on 3 December 2014, the region rejected the authorisation, while Melendugno and the Province of Lecce expressed a negative opinion. The Ministry of Culture expressed again a negative opinion, which leaves the project in a conflicting situation with respect to the government's position. According to local and national media, magistrates and the tax authorities are investigating the project[49].

The promoter of TAP is a consortium registered in Baar, a city in the Swiss canton of Zug, a well-known tax haven. TAP's shareholding is comprised of BP (20 per cent), SOCAR (20 per cent), Statoil (20 per cent), Fluxys (19 per cent), Enagás (16 per cent) and Axpo (5 per cent), some of who also plan to develop the Shah Deniz stage two field. Total and E.ON were previously shareholders but in late September 2014 left the consortium[50]. TAP is expected to transport 10 billion m3 of gas per year, and expanded to 20 billion m3 in a second phase.

Since its feasibility stage, TAP has received the backing of the Commission and the EBRD, who have also supported other components of the Southern Gas Corridor. TAP acknowledged two grants in 2005 and 2006 and used EBRD standards as a reference for the EIA[51]. While the EBRD has made no secret of its interest in financing the project[52], TAP presents itself as a "private finance" project[53].

TAP is included in the list of Projects of Common Interest, and in the May 28th 2014 Communication from the Commission on a European Energy Security Strategy[54] where it is referred to as a key security of supply infrastructure project.[55] This means that the project could benefit in the future from the Project Bond Initiative and Project Bond Credit Enhancement instruments that the Commission and the EIB are testing.

5. How does financing Lukoil help lessen dependence on Russia?

The irony of the situation is clear: the EU spends years trying to diversify away from dependence on Russia for its gas supplies, only to end up supporting Lukoil in Azerbaijan.

The irony is even greater considering that Lukoil is one of the companies targeted by EU[56] and US sanctions against Russian firms[57]. In September 2014 both the US and EU imposed sanctions preventing the provision of equipment and services for deepwater oil exploration and production, Arctic oil exploration and production, and shale oil projects in Russia. Lukoil is not named individually on the EU list but would be affected as one of the companies involved in these activities, as it has requested a licence from the Russian government to develop the Arctic shelf.

Even before this, Lukoil President Vagit Alekperov conceded that the US and EU sanctions were having an effect on Russian energy companies.[58] Since September, it has been reported that Lukoil has sought access to unallocated oil fields in Russia to ease the impact of sanctions[59], that a joint venture between Total and Lukoil will be affected by the sanctions[60], and that Lukoil has sought various loans due to the credit squeeze caused by the sanctions on certain Russian banks.[61] While the September sanctions do not restrict Lukoil's access to financial services, some observers say that they make international borrowing difficult for Russian energy companies to develop projects abroad. They predict that Lukoil will have to conquer Asian markets and possibly overcome interest rate risks.[62] If this is the case, the EBRD's proposed loan will certainly help alleviate these impacts, and therefore undermine the sanctions.

6. Lukoil and its past record in Russia

In the project summary document for its share in Lukoil's participation in Shah Deniz stage two, the EBRD says *'this project has a high level of transparency and is adhering to strict international and national standards'*.[63]

But given Lukoil's track record of adhering to international standards when the EBRD is footing the bill, such a claim as the one in the case of Shah Deniz seems far from justified. In 2007 the bank invested USD 300 million in Lukoil's strategic environmental programme in Russia that included, among other environmental remediation investments, pollution clean-up, pipeline replacement and gas flaring reduction[64].

At the end of 2013, shortly before the latest EBRD loan to Lukoil was approved, Lukoil was fined 614 million rubles (USD 18.5 million) for nine oil spills since 2011 in Russia's northern republic of Komi, which covered an area estimated between 20.5 and 21 hectares. Reportedly Lukoil-Komi spent 15 million rubles on recultivating the polluted land, but a court ruled it to be an insufficient measure.[65]

Greenpeace Russia produced a shocking video[66] and reported accounts of indigenous Komi people who failed to note the *'environmental benefits'* that the EBRD financed, but instead complained about a lack of consultation regarding well construction and an attempted cover-up of a leaking oil pipeline. At a public meeting in March 2014, 150 residents from 13 different villages in the Izhma district of Komi unanimously voted for a resolution addressed to the district's parliament, asking for the suspension of all industrial activities of Lukoil in Komi until the problems were resolved.[67] In April 2014 the municipal council of Izhma supported the claims of the local community and voted to stop Lukoil operations in the area.[68]

The local indigenous community's health and livelihoods are heavily affected by air, water and food pollution caused by the flaring of gas and leaking pipelines that pollute surface and underground water. A Greenpeace oil spill patrol[69] detected this summer over 100 fresh and existing oil spills in the forests, swamps, grasslands and along river banks: corroded and ruptured pipelines, leaking pipeline connections and regulation gear, illegal sludge leftovers and dumping are just some examples of unacceptable practices.

Komi villagers told the Greenpeace patrol about their concerns about an increased death toll due to cancer, the fact that only around 10 per cent of people in the villages have jobs in the oil industry and the absurd situation that while having an unhealthy amount of gas in the air, the villages do not get any gas supplies for heating but rely instead on firewood.

On 18 November 2014 the indigenous people of Komi protested in Saint Petersburg against the damage caused by Lukoil's operations.[70]

At a meeting with civil society organisations in May 2014, EBRD representatives said that the USD 300 million loan was *'a drop in the ocean'*. While it is true that Lukoil is one of several companies extracting oil in the Komi region, it is clear that the intended transition impact of the EBRD strategic environmental programme – *'the demonstration of a replicable large scale environmental clean-up programme creating a benchmark for other Russian corporates in the natural resource sector'* – has not been achieved.

7. BP, SOCAR and past records

BP presents itself as a responsible company with a good record on environmental protection and health and safety. The reality is starkly different. BP's history speaks for itself: the company has been responsible for a catalogue of spills, explosions, deaths and leaks. Such a record does not paint a portrait of a responsible company but rather one that is failing to adequately protect the environment and its workers.

BP'S ENVIRONMENTAL AND SOCIAL RECORD

Some examples of environmental and social disasters BP has been responsible for include the following:.

- 1990 - BP was forced to settle in court for dumping waste into US rivers, paying USD 2.3 million for discharging waste from its Marcus Hook refinery into the Delaware River. Authorities said BP was discharging excess oil and grease, ammonia, solids, sulphides and various chemicals that reduced the amount of oxygen in the water, changed its acidity and sickened and killed fish. The Environmental Protection Agency said from 1979 to 1990, BP had violated its wastewater discharge permit 6 500 times.[71]

- 1991 - An explosion at the company's Ferndale refinery in the US killed one person and injured six others. Following a six-month investigation, BP was charged with 20 violations of the Washington Industrial Safety and Health Act and fined USD 135,710.[72]

- 1994 - Over a three-year period, BP was responsible for the illegal disposal of hazardous waste on Alaska's North Slope. BP's contractor Doyon Drilling illegally discharged waste oil, paint thinner and other toxic and hazardous substances by injecting them down the outer rim of the oil wells. BP Exploration Alaska failed to report the illegal injections when it learned of the conduct and in 1999 agreed to resolve charges related to the illegal dumping for USD 22 million.[73]

- 1997 - BP's 800-kilometre Ocensa pipeline in Colombia came into operation after destroying crops, fishponds and local livelihoods. Hundreds of residents were forced into destitution and displaced to cities. Rural Colombian farmers stood up to intense repression and death threats to eventually take BP to court. In 2006, BP accepted responsibility and agreed to a multi-million dollar settlement.[74]

- 1999 - Whistle-blowers criticised the management of an Alaskan pipeline operated by a company Alyeska of which BP owned 50 per cent. A group of senior employees spoke to the Guardian about "impending disaster and prepared evidence of falsified inspection reports, a culture of intimidation, and 'lip service' to safety... Collectively, the whistle-blowers describe a life-threatening 'gamble' by Alyeska with the people of Alaska and its fragile environment. A battle between safety and the bottom line – one where executives and their contractors, concerned about budgets and bonuses, actively undermine and intimidate technicians and inspectors given the task of upholding safety."[75]

- 2005 - In March an explosion at BP's Texas City refinery in the US killed 15 workers and injured more than 170 others. BP admitted that 'deeply disturbing' internal mistakes were responsible for the explosion. BP pleaded guilty to a felony charge for violating the federal Clean Air Act, agreed to serve a three-year probationary period and to pay a USD 50 million fine.[76]

- 2006 – 267 000 gallons of spilled oil was discovered in March at the Prudhoe Bay field, the largest ever spill on Alaska's North Slope region. In the court case brought against BP, prosecutors said BP managers failed to heed 'many red flags and warning signs' that key pipelines were being eroded. In 2011 federal officials announced that BP would pay USD 25 million in civil fines to settle charges arising from two spills within its network of pipelines in Alaska in 2006 and from a wilful failure to comply with a government order to properly maintain the pipelines to prevent corrosion.[77]

- 2010 - In April the Deepwater Horizon drilling rig exploded in the Gulf of Mexico, killing 11 workers. Oil gushed into the ocean until 15 July when the well was capped. The US government claims that 4.9 million barrels of oil were spilled in the offshore disaster, while BP estimates a leakage of 3.26 million barrels during the three-month period it took to cap the blowout.[78]

- 2014 - In March BP's Whiting refinery in Indiana spilled between 470 and 1228 gallons of crude oil into Lake Michigan, a drinking water source for some seven million Chicago residents. The refinery has also been criticised for being responsible for huge black mountains of 'high-sulfur, high-carbon risk petcoke' along the Calumet River, a by-product of tar sands production.[79]

In addition to being responsible for many environmental catastrophes, BP has a unique responsibility for the largest environmental tragedy the modern day world has ever known – climate change. In 2013, peer-reviewed research revealed that BP was the fourth most responsible entity for the entirety of greenhouse gas emissions generated since the dawn of the industrial revolution. The research shows that BP had been responsible for 38.84 giga-tonnes of CO2e – which is 2.47 per cent of all anthropogenic greenhouse gas emissions since 1750.[80]

Although the proposed EBRD loan is not directly to SOCAR, the company is one of the major Shah Deniz shareholders and the largest shareholder in TANAP with 80 per cent of the shares, meaning that its record also needs scrutinising. Risks associated with the company mean that the Shah Deniz project and other elements of the Southern Gas Corridor may not be in line with the financiers' environmental and social policies as well as their integrity policies.

One of the most alarming elements has been noted above: SOCAR's security force which is employed against anyone causing the company trouble.

In addition, cases of corruption at SOCAR have been documented, including traders selling Azeri oil below price for personal profit, at least partly through a subsidiary called Socar Trading, which is registered in Switzerland and half-owned by private investors whose acquisition of the shares remains shrouded in mystery.[81] Potential financiers of projects involving SOCAR would do well to look into the company's transparency more carefully.

8. Financial risks

Oil and gas projects are inherently risky, which companies and governments need to take into account. A key consideration is how those risks are shared. Although the Shah Deniz gas field and the Southern Gas Corridor are mostly private sector projects (though SOCAR is state-owned), the indications so far are that public financing institutions will most likely take some of the risk while the gas companies take any profits.

Scarce information is available on the financial aspects of the Shah Deniz stage two agreement. When the final investment decision on the Shah Deniz stage two and South Caucasus Pipeline Expansion was publicly announced in December 2013, the overall cost of both projects was estimated at USD 28 billion[82]. However no substantial information about the economic and financial structure (and sustainability) of the project has been published, with a number of Azeri and international corporations continually referring to the project as a 'private' endeavour.

As mentioned in the introduction, several companies have already withdrawn from Shah Deniz stage two. Statoil announced in the same communique as the final investment decision that it was selling its 10 per cent in the project[83], followed in October 2014 by its total divestment from Shah Deniz stage two and SCPX[84]. The initial divestment of the Nordic oil major was minimised in a press statement by BP[85]. In October 2014, Statoil said that the company "remains committed to its business in Azerbaijan.[86]

The lack of information on the economic and financial aspects of the project is problematic given the interest of the EBRD and other public financial institutions in the project. Experience within the oil and gas industries and with some Lukoil operations outside of Russia allow further observations on the financial risks and public subsidies to the project.

VOLATILE OIL AND GAS PRICES

Hydrocarbon price fluctuations - an inherent risk to the industry - have intensified in recent months, with oil prices reaching all-time lows. In its 'Overview of Lukoil's Basic Business Risks and Uncertainties,' the company foresees that energy prices will become more volatile due to the unstable supply and demand at the global market.[86]

Photo by flickr user ahmadnawawi

In August 2014, the International Energy Agency reported the saturation of demand on the Atlantic market and downward price pressures on surplus production from Libya. In December 2014 oil prices, to which gas prices are generally linked, fell to below USD 70 per barrel for Brent Crude.[87] This situation might change swiftly with fighting over the control of oil resources in Iraq, Libya and because of the Russia-Ukraine conflict. Experts are predicting that reducing demand for gas in Europe coupled with low gas prices may lead to economic problems for the Southern Gas Corridor. The Oxford Institute for Energy Studies (OIES) predict that European gas demand may not recover its 2010 level until about 2025.[88]

At an event held in BP's London offices in June 2014, Jonathan Stern, Chairman of the Natural Gas Research Programme at OIES, argued that low gas demand in Italy undermined the economic case for TAP and predicted that most of the gas would be sold in Turkey instead of Europe.[89]

UNCERTAIN RESERVE ESTIMATES

Reserve estimates involve uncertainty because they depend on the reliability of geological and engineering data and the interpretation of the figures. The declining output in the Azeri Chirag and Guneshli (ACG) oil fields has led to a deteriorating relationship between Azerbaijan and BP.[90] Lukoil, originally a member of the consortium operating the ACG fields, sold its shares to a Japanese company, Inpex, literally days before the crisis. One theory explaining the withdrawal says that Lukoil pulled out due to economic reasons i.e. a lack of profitability of the investment and expectations for bigger gains at Shah Deniz.[91]

GEOLOGICAL RISKS

With untapped oil and gas reserves diminishing, exploration has embraced unconventional extraction techniques and geologically-challenging environments. Oil and gas companies have faced financial risks connected with more difficult extraction techniques and the possibility that reserves will be smaller than estimated. For example, technological complications have halted Lukoil's drilling at the oil field in waters shared by Azerbaijan and the Russian republic of Dagestan. In November 2004, Lukoil had to close the first exploration well at the Yalama field because of water problems.[92]

OPERATIONAL HAZARDS

Operational hazards including oil spills and blowouts are omnipresent in the oil and gas industry. The costs of mitigation, fines and investment in precautionary measures can increase project costs. For example in January 2014, Lukoil's subsidiary operating oil fields in the Russian republic of Komi was fined EUR 14.7 million for nine oil spills that occurred 2011.[93]

INSUFFICIENT LIQUIDITY RISKS

As with any other corporations, oil and gas companies need cash to pay for equipment and services. Of the private oil and gas companies, Lukoil had the 15th largest global capital expenditure for exploration, USD 1 billion in 2013.[94] Although the situation may change as sanctions by the EU and US tighten, the company has so far been successful in raising funds on capital markets. In August 2014, Lukoil agreed on a loan for USD 1.5 billion with Citi and JPMorgan,[95] which raises questions about the additionality of an EBRD loan.

ENVIRONMENTAL REGULATIONS

Environmental requirements linked to operational performance may cause further costs for the oil and gas industry. In 2005, Lukoil withdrew officially from the development of the Zykh-Govsany oil field in Azerbaijan, saying that "the economic performance of the project does not meet the Company's efficiency requirements due to considerable expenses for the environmental reinstatement of the contractual area and heavily exploited deposits"[96]. The head of Lukoil in Azerbaijan explained two years prior to the formal withdrawal that the company would need to spend around USD 100 million out of a total investment cost of USD 300 million to rehabilitate the heavily polluted territory around the field.[97] Lukoil's annual contribution into the State Environmental Protection Fund for air and water pollution has been minimal, as have its fines. In 2011, the Azeri Ministry of Environment fined Lukoil with a negligible USD 1 116 for its polluting practices.[98]

TAX REGULATIONS

Changes and loopholes in the national tax code can impose unexpected financial requirements on oil and gas companies. In 2003 Azerbaijan and Lukoil entered a dispute over USD 250 million in profit tax on the sale of Lukoil's share in the ACG field. Lukoil gained USD 1 130 million from the sale.[99] Recently Lukoil's refinery in Romania was investigated under a probe for EUR 112 million in tax evasion and EUR 118 million in money laundering.[100]

9. Public financing for Shah Deniz and the Southern Gas Corridor

Oil and gas companies make huge profits at the expense of the public. Not only are the companies linked with environmental degradation and human rights controversies, they also take away money from national budgets that could be spent on public services and infrastructure. As outlined in the following section, national governments and state-backed financial institutions have already provided Lukoil with generous long-term financing, guarantees and other incentives, and are likely to do so for the Southern Gas Corridor as well.

RUSSIAN GOVERNMENT LOANS AND GUARANTEES

Governments extend loans and guarantees to the national oil and gas companies at favourable interest rates in order to enable them refinance overseas debts. The Russian government uses federal subsidies also to exercise its political influence. In October 2008, Lukoil featured among four oil and gas companies that received up to USD 9 billion in government loans to restructure their foreign loans.[101] After the US and EU sanctions restricted Lukoil's access to capital markets, posing difficulties for its ability to repay debt and invest, Lukoil requested licenses for undistributed natural resources reserves in Russia.[102] It might be expected that the shortage of liquidity might open the door to further government financial support.

EXPORT CREDIT AGENCIES

Government-sponsored export credit agencies (ECAs) provide public financial support for exporters and importers. Depending on their mandate, ECAs offer short to long-term credit, insurance or a combination of both. ECAs can thus extend services similar to banks and finance foreign corporations to undertake large-scale projects in developing countries. In terms of loan volumes, ECAs are estimated to support twice as much oil, gas and mining as the multilateral development banks.[103] It is debated whether state-sponsored export credits are regarded as export subsidies but we argue that they are. They act as another vehicle for channelling public money into natural resource extraction companies. As illustrated by the cases below, the decisions of ECAs are influenced to a large extent by political and economic realities.

In September 2002, the US ECA, the Export-Import Bank extended up to USD 26.4 million credit to Lukoil for the purchase of oil drilling equipment.[104] A month later, Ex-Im Bank was to sign a Memorandum of Understanding with Lukoil, Yukos and Sibneft for guarantees of up to USD 100 million each that would enable the companies to purchase US equipment and services.[105] It is unclear whether this agreement ever materialised.

In January 2014 the Italian export credit agency SACE along with five commercial banks provided a EUR 420 million export credit facility to Lukoil's subsidiary for the modernisation of a Bulgarian refinery.[106] SACE covered 95 per cent of the credit, due to the involvement of an Italian engineering and construction company.

MULTILATERAL DEVELOPMENT BANKS

Multilateral development banks (MDBs) are likewise public actors that have played an important role in the provision of state-backed debt and guarantees for oil and gas companies. Apart from providing capital, MDBs act as catalysts for mobilising other sources of financing, in particular from commercial banks. Since 1998, Lukoil and its subsidiaries have received nearly EUR 1 billion in 12 loans and guarantees from the World Bank's International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA), the Asian Development Bank (ADB), the EBRD and the Islamic Development Bank.

MDB FINANCING FOR LUKOIL 1998-2014 (APPROVED)[107]

Country	Project Name	Client	MDB financier	Year	Total cost (EUR)
Azerbaijan	Lukoil Overseas: Shah Deniz Gas Condensate Field Development II	Lukoil Overseas Shah Deniz Ltd	EBRD	2014	145 m (USD 200 m)
Azerbaijan	Lukoil Overseas: Shah Deniz Gas Condensate Field Development	Lukoil Overseas Shah Deniz Ltd	EBRD	2005	79.8 m
Azerbaijan	Chirag Early Oil – Lukoil Overseas	Special-purpose companies owned by Amoco, Exxon, LUKoil JSC, Türkiye Petrolleri AO and Unocal	EBRD	1998	14 m
Kazakhstan	Lukoil Overseas	Lukoil Overseas Karachaganak B.V.	IFC	2002	69 m (USD 75 m)
Regional	Lukoil Overseas: South Caucasus Gas Pipeline	Lukoil Overseas Shah Deniz Midstream Ltd	EBRD	2005	29.4 m
Romania	Lukoil Petrotel	S.C. Petrotel-Lukoil S.A.	IFC	2005	60 m (USD 82 m)
Russia	LUKoil Environmental Loan	Lukoil JSC	EBRD	2007	108.8 m
Russia	Lukoil-Perm	ZAO Lukoil-Perm	EBRD	2003	16.6 m
Russia	Lukoil Medium Term Working Capital Facility	Lukoil JSC	EBRD	2000	54.4 m
Uzbekistan	LUKOIL Overseas Uzbekistan Ltd - guarantee to Swiss BNP Paribas to cover a non-shareholder loan to LUKOIL Overseas Uzbekistan Ltd. for the Kandym-Khausak-Shady-Kungrad gas development project.	LUKOIL Overseas Uzbekistan Ltd.	MIGA	2012	82.8 m (USD 119.5)
Uzbekistan	Unknown - According to media reports, the IDB contributed with USD 100 million in loan financing to a total USD 500 million loan that Lukoil Overseas Lukoil received from a consortium of banks.	LUKOIL Overseas Uzbekistan Ltd.	Islamic Development Bank	2012	69.4 m
Uzbekistan	Uzb: Kandym Gas Field Development.	LUKOIL Overseas Uzbekistan Ltd.	ADB	2011	208.3 m (USD 200 m) political risk guarantee, and USD 100 m in loan financing
				TOTAL	**937.5 m**

MDB FINANCING FOR LUKOIL (UNDER CONSIDERATION)[108]

Country	Project Name	Client	MDB financier	Year	Total cost (EUR)
Azerbaijan	Lukoil Shah Deniz Stage II	Lukoil Overseas Shah Deniz Ltd.	EBRD	2015	393.6 m (up to USD 500 m)
Azerbaijan	Shah Deniz Stage II Gas Condensate Field Project	Lukoil Overseas Shah Deniz Ltd.	ADB	2015	354.3 m (USD 450 loan and equity)
Uzbekistan	Kandym new PRG and amendment of existing loan/PRG	LUKOIL Overseas Uzbekistan Ltd.	ADB	2014-2015	111.9 m (USD 150 loan and equity)
				TOTAL	**859.8 m**

THE COMMISSION AND THE EIB

Lukoil may benefit from EU development money via the Union's financial instruments aimed at bringing energy independence and market integration. The Projects of Common Interest published in October 2013[109] include EUR 5.85 billion for trans-European energy infrastructure under the Connecting Europe Facility (CEF). Project promoters can benefit from grants and financial instruments made available by institutions such as the EIB, including the Project Bond Initiative and the Project Bond Credit Enhancement.

According to the Commission, for a project to be considered of 'common interest', it should demonstrate significant benefits for at least two EU Member States, contribute to market integration, enhance security of supply, and reduce CO2 emissions. The PCI list has been criticised because of the non-transparent project selection process and vague selection criteria, resulting in a number of the projects with negative environmental and economic impacts, as well as human rights violations and corruption scandals. Finally, as mentioned above, while the EU Energy Roadmap 2050 stresses the need for more support for energy efficiency and renewables, the commissioning of more gas import infrastructure represents a direct threat to the EU's decarbonisation goals.

STABILITY GUARANTEES AND TAX INCENTIVES IN AZERBAIJAN

To attract foreign investors to oil and gas exploration projects, Azerbaijan - like other resource-rich developing countries - puts in place stability guarantees and tax incentives. These may take away money from the state budget and place burdens on the country's fiscal and taxation policies. Moreover, foreign investment in Azerbaijan is protected by a 10-year moratorium for legislative changes adversely affecting operations.[110]

A stabilisation clause included in petroleum and gas agreements addresses how law amendments adopted after the execution of the agreement impacts the investor. Stabilisation clauses have been criticised because they limit the governments' sovereign right to change laws, while placing a price tag on the environment and human rights, because they exempt investors from complying with safeguards. The Production Sharing Agreement (PSA) for the exploration of the first Shah Deniz phase, ratified in 1996 by SOCAR and six companies including Lukoil and BP, is emblematic of this controversy. The Shah Deniz PSA contains an economic stabilisation clause which states that if changes in the national laws occur, the terms of the agreement will be "adjusted to re-establish the economic equilibrium of the parties"[111]. In addition, the clause commits SOCAR to indemnify the investors for losses and costs incurred when complying with the new laws. The clause intended to maintain the economic status-quo of the project effectively increases the costs of governments being able to influence the investor and domestic fiscal and tax policies.

TAX EXEMPTIONS IN AZERBAIJAN

Under the existing Shah Deniz PSA, the contractor's tax obligation is to pay a profit tax of 25 per cent. The profit tax is at the lower end of the spectrum, as most PSAs signed by Azerbaijan stipulate a profit tax above 25 per cent.[112] In addition to the profit tax, companies also pay social insurance. The Shah Deniz PSA granted contractors and subcontractors an exemption from paying customs fees and VAT on equipment and services imported into Azerbaijan for the purpose of the field exploration.[113] The companies are entitled to full exemption from other taxes, such as land and property taxes and royalties. Personal income tax is paid by employees. For Shah Deniz stage two, Azerbaijan and the consortium partners extended the PSA to 2048. The terms of the agreement are not known.

10. Conclusions

With the ongoing crisis between Ukraine and Russia, it may appear natural for the EU to look further afield for other sources of gas and to hurry the construction of infrastructure to bring gas into the EU. However, a closer look at the situation reveals a number of weaknesses in the approach currently being taken.

The first set of problems relates to the actual need for and prioritisation of the Shah Deniz and Southern Gas Corridor projects. Gas demand in the EU has been on the decline for the last decade and is expected to remain roughly flat in the coming decades, with a decline by 2050 in all of the EU's Roadmap scenarios. Existing infrastructure is currently under-utilised, especially LNG terminals. So while there may be a case for better interconnectors between certain EU countries, projects of the scale of the Southern Gas Corridor are not necessary. They may either end up being under-utilised and a waste of money or may threaten the EU's decarbonisation agenda and divert attention away from the need for more ambitious moves on energy savings.

The second set of problems relate to the Shah Deniz and Southern Gas Corridor projects strengthening the repressive Azeri regime (and potentially also the Turkmen one) as well as creating a militarised corridor across Turkey and other transit countries.

Projects such as Shah Deniz and the Southern Gas Corridor are not likely to move forward without public money in the forms of loans from the EBRD and EIB, guarantee instruments such as Project Bonds, tax incentives and guarantees from export credit agencies. One such loan for Shah Deniz stage two is due to be approved by the EBRD in late January 2015. It is questionable whether companies such as BP, Lukoil and SOCAR are deserving of public money at all considering their size, wealth and previous environmental and social records.

The good news is that the potential involvement of EU financing means that decision-makers in the EU have various opportunities to prevent public money being wasted on projects that are unnecessary, may endanger the EU's climate goals, promote human rights violations and divert attention from urgently needed energy saving measures.

11. Recommendations

TO THE EUROPEAN COMMISSION:

- Undertake an analysis of what network infrastructure the EU does and does not need in order to achieve decarbonisation. The approach of defining EU priorities through a shopping list of its Member States will not bring the desired results. A thorough analysis of the impact of oil and gas projects from the PCI list on the EU 2030 and 2050 greenhouse gas reduction targets needs to be analysed and discussed with all interested stakeholders.

- Prevent support by the CEF, the EIB and the EBRD for large new gas import projects. The CEF must finance projects that bring benefits for the use of renewable energy and increased energy efficiency, instead of controversial gas mega-pipeline and oil projects.

- Rather than courting the repressive regimes in Azerbaijan and Turkmenistan in for their gas resources, the EU should criticise them for their human rights violations while supporting the victims of these repressive regimes.

- Prioritise financial support for energy efficiency – especially in the residential sector – and sustainable, renewable energy sources over gas and other fossil fuels

- Monitor the approval procedures on the national level for the PCI projects and ensure that fast-tracking does not lead to a watering down of environmental standards and public participation.

- So far the Projects of Common Interest list has been put together with very limited public participation. Given that projects on the list can expect the support of public money, there is an urgent need to broaden the possibilities to discuss the projects and the rationale behind the list publicly before any new list is produced.

- The legislative basis for the mandate of the Commission to negotiate with Turkmenistan must be disclosed to the public.

FOR MEPS:

- Prepare an own-initiative report on the current PCI list with recommendations on energy infrastructure needs to support decarbonisation.

- Where projects are in conflict with EU law, climate goals or human rights, insist that the Commission removes them from the PCI list, most notably the projects that make up the Southern Gas Corridor. In any case the list will be renewed every two years, providing opportunities to oppose particularly problematic projects.

TO THE EBRD AND EIB:

- Phase out financing for fossil fuels, especially projects like Shah Deniz stage two, TAP and TANAP, which are of such a scale that they endanger the EU's decarbonisation targets. Such goals may be part of the EIB's planned climate policy.

- The EBRD is encouraged to maintain its restrictions on financing in Turkmenistan (as well as Uzbekistan, Belarus and Russia). However it should also restrict financing in Azerbaijan considering the country's worsening human rights situation.

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