



NATO PARLIAMENTARY ASSEMBLY

ECONOMICS AND SECURITY COMMITTEE (ESC)

Sub-Committee on
Transition and Development (ESCTD)

MISSION REPORT*

Baku, Azerbaijan

12-14 September 2018

233 ESCTD 18 E | Original: English | 14 November 2018

* This Mission Report is presented for information only and does not represent the official view of the Assembly. This report was prepared by Paul Cook, Director of the Economics and Security Committee.

I. EXECUTIVE SUMMARY

1. Azerbaijan has emerged as a key strategic partner for Europe. The much-anticipated completion of the Southern Gas Corridor in 2020 will mark a major step in diversifying the energy supply base of southern Europe. That project will bring significant quantities of gas from Azerbaijan's massive offshore Shah Deniz field to Turkey and Europe, helping the continent diversify its base of energy imports while reducing its dependence on Russian gas. The close economic and strategic partnership between Europe and Azerbaijan was a central theme of meetings NATO PA President Paolo Alli (Italy) and a delegation of the Economics and Security Committee held in Baku on September 12-14.

2. Azerbaijan's foreign and security policy is strongly conditioned by both its geographical position and the ongoing conflict with Armenia over Nagorno-Karabakh. Azerbaijan has tied itself economically to the West, where it sells most of its energy and with which it is forging a range of energy, transportation and trading links. It also enjoys particularly close relations with Turkey.

3. At the same time, the government is strongly mindful of its powerful and economically important neighbours Russia and Iran. Azerbaijan is thus compelled to play a balancing game in an unstable part of the world. While it has an important partnership with both NATO and the EU, it does not harbour ambitions for accession to either organisation, in contrast with its neighbour Georgia.

4. Equally, while Azerbaijan cultivates certain ties with Russia, it does not seek membership in the Russian-dominated Eurasian Economic Union of which Armenia is a member. Its own economic links to Russia and Iran have been rendered all the more complicated by Western sanctions regimes imposed on both countries.

5. Western governments recognise the difficult position in which Azerbaijan finds itself. Several observers told the delegation that the West sees Azerbaijan as an important force for strategic and economic stability in the Caucasus and Caspian regions and beyond. "Our partnership with countries of the South Caucasus is essential because the stability of this region is linked to that of Europe", stressed NATO PA President Alli in his meetings with Azerbaijani President Ilham Aliyev, Foreign Minister Elmar Mammadyarov, and Parliament Speaker Ogtay Asadov. Mr Alli saluted Azerbaijan's role as a balancing point in the region and a driver of economic integration, as well as its active cooperation with NATO and participation in the NATO PA. President Aliyev and Foreign Minister Mammadyarov both reaffirmed their government's commitment to cooperation with NATO, including through increased support for NATO's *Resolute Support Mission* in Afghanistan.

6. Azerbaijan's most compelling challenge is the situation in Nagorno-Karabakh. Araz Azimov, Deputy Minister of Foreign Affairs, expressed frustration with the lack of progress on conflict resolution, and regretted that initial hopes that positive momentum could come from a new government in Yerevan had so far not materialised. He suggested that the international community needs to focus more on the issue and actively uphold principles related to the sanctity of national borders. He told the delegation that there are dozens of ceasefire violations every day and that it is simply misleading to characterise this as a frozen conflict. Other speakers noted that both sides have dug in on their positions. The delegation stressed that any progress towards resolution of the conflict would have to come first and foremost from the two parties.

7. On the economic front, the government of Azerbaijan has made diversification a high priority. Energy price falls exposed the national economy's over-reliance on energy sales. But as Azerbaijan's Minister of Energy, Perviz Sahbazov, told the delegation, when gas and oil prices are too high, the conditions for diversification are undermined. He suggested that the

government would like to see prices at a point where national revenues are adequate to the country's needs but incentives for diversification remain sufficiently compelling. The government priority now is to build up its agricultural, tourism, communication, transportation and information technology sectors, and promoting connectivity and higher educational standards constitutes a common theme in its overall development strategy.

8. The delegation also visited BP's Sangachal Terminal and spoke with Bakhtiyar Aslanbayli, BP's Vice-president for Communication, External Affairs and Strategy for Azerbaijan, Georgia and Turkey. While there has been great progress toward completing the Southern Gas Corridor including the finalisation of the Trans-Anatolia Natural Gas Pipeline (TANAP), the final leg of the Trans Adriatic Pipeline (TAP) from Albania to Italy is awaiting final approval by the Italian government. If approved, the project is due to be completed by 2020, bringing Azerbaijani gas to the heart of Europe.

9. In the longer term, there is a potential for some Central Asian gas to move through this vital infrastructure if and when a trans-Caspian pipeline is constructed. Moreover, BP officials suggested that Iran could eventually move gas through this system, but this would be hard to imagine given the current sanctions on that country. Moving gas under the Caspian is now legally feasible as the Caspian littoral countries have recently agreed on a legal status governing that body of water. That agreement ends the legal limbo over the Caspian's status. However, any littoral state could theoretically block a bilaterally agreed pipeline project by invoking an environmental clause in the new agreement.

10. The delegation of the NATO PA's Sub-Committee on Transition and Development consisted of 16 parliamentarians from 11 NATO member states, and alongside NATO PA President Paolo Alli (Italy) and Vice President Vitalino Canas (Portugal), it was led by Economics and Security Committee Chairman Ivans Klementjevs (Latvia). The delegation's programme included meetings with members of the Azerbaijani parliament's delegation to the NATO PA, researchers from the Centre for Strategic Studies (SAM), Baku-based ambassadors of NATO countries, and officials from the EU, the United Nations and the World Bank. The sub-committee's rapporteur, Ausrine Armonaitė (Lithuania), has produced a report on *The Energy Security Challenge in Central and Eastern Europe*, (<https://www.nato-pa.int/document/2018-energy-security-challenge-central-and-eastern-europe-175-esctd-18-e>) and the visit generated information for the second iteration of that report to be presented at the Assembly's Annual Session in Halifax, Canada.

II. INTRODUCTION

11. The conflict with Armenia has shaped domestic politics in Azerbaijan in important ways. Roughly 1 million people are currently internally displaced. The restoration of Nagorno-Karabakh remains the state's highest priority, and this ambition strongly conditions its foreign policy. Azerbaijan will assume the chair of the Non-Aligned movement in 2019 and will use that position to advance its views on the stand-off with Armenia.

12. Azerbaijan has to cope with many other challenges in the region. Its relations with Iran are not easy. There are an estimated 25 million ethnic Azeris living in Iran and the treatment of this minority is a concern to Baku. Azerbaijan also worries about growing tensions between Iran and Israel escalating as the Azerbaijani have important relations with both countries. Azerbaijan is concerned about the potential impact of US sanctions on Iran as it could weaken the regional economy, generate instability and reinforce the hardliners in Iran.

13. Azerbaijan has moved quickly to develop its energy sector. Azeri-Chirag-Deepwater Gunashli (ACG)-International Contract No. 1 was signed by President Heydar Aliyev and participating international companies on September 20, 1994, ratified by the parliament on

December 2, and went into effect on December 12 that year. Because potential reserves are estimated at 6 billion barrels of oil, this project was called the "Contract of the Century". The projected investment for the plan is USD 13 billion. As a result of this contract, Azerbaijan began moving oil westward through the Baku-Tbilisi-Ceyhan pipeline which, in turn, made it possible to sell its oil on global markets.

14. Azerbaijan is now entering the global gas market. The Southern Gas Corridor project has been an important European Commission initiative to build a natural gas supply route from the Caspian to Europe. The goal of the Southern Gas Corridor is to reduce Europe's dependency on Russian gas and diversify Europe's energy supply. The route from Azerbaijan to Europe consist of the South Caucasus Pipeline, the Trans-Anatolian Pipeline, and the Trans Adriatic Pipeline which has not yet been completed. The gas filling these pipelines will initially come from the Shah Deniz gas field, located in the Caspian Sea off the coast of Baku.

15. Currently there is no oil or gas moving from Central Asia through Azerbaijan, but there is clearly an aspiration to eventually construct a trans-Caspian pipeline that would make this possible. Laying pipelines across the Caspian is now possible as the littoral states have finally established a legal framework governing the use of that sea. The one hitch is that there is an environmental clause which theoretically gives Russia or any littoral state an opportunity to block any such project.

16. The economy of Azerbaijan remains highly reliant on the energy sector. Oil and gas constitute 88% of Azerbaijan's exports, although efforts are needed to diversify the economy. Between 2004 and 2014, GDP tripled, but when energy prices dramatically fell in 2015, GDP fell by 50%. Azerbaijan has a potentially dynamic agricultural sector which played a particularly important role during in Soviet times and which could become another engine of economic development. Indeed, 40% of the Azerbaijani population works in agriculture. Education has emerged as a central national development priority and one goal is to raise skill levels and introduce modern farming methods in the countryside. Tourism is seen as another potential source of foreign exchange earnings, but this will require significantly greater investment in infrastructure. The country's leaders have also identified communication and information technology as representing a potential third leg of the national economy in the future.

17. Many economists argue that high oil prices make it more difficult for Azerbaijan to diversify its economy. The terms of trade move against the current in such circumstances and there is less incentive to tie up investment resources in sectors which are penalised by currency appreciation. That said, reform and diversification are essential to building a more open, dynamic and prosperous society. This kind of change will be essential to overcome a very significant gap both between rich and poor and between rural and urban regions of the country.

III. SECURITY AND THE REGIONAL DIPLOMATIC MAP

18. Azerbaijan is compelled to play a delicate balancing game between East and West given the tensions in the region and the presence of powerful neighbours like Russia. Strong relations with the West are a factor in Azerbaijan's relations with Russia. In effect, Azerbaijan conducts a multi-vectoral foreign policy based on balancing relations – between the West and Russia, Israel and Iran, etc.

19. Although a young generation of Azerbaijanis is not focused on Russia, ties with that country remain important. There are, for example, over a million Azerbaijani workers in Russia. Russian foreign policy invariably conditions the strategic landscape in which Azerbaijan operates, sometimes in unexpected ways. Azerbaijan, for example, must closely monitor Russian policy in Syria as it is particularly concerned about the return of foreign fighters from

that country and the movement of refugees from that country across the region. Azerbaijan is also an energy competitor with Russia, even if the scale of its production is smaller. It cannot replace Russian energy for Russia's customers, but it can be a factor in Europe's reducing its over dependence on Russian oil and gas. It remains to be seen how much competition Russia will tolerate. Azerbaijan must therefore play a balancing game in this respect as well.

20. Azerbaijan is also concerned about the return of fighters from Afghanistan and Syria and its apprehensions are heightened by the fact that it is a country of transit. The country is very focused on military to military cooperation and has long sought to take full advantage of its ties with NATO to modernise the military.

21. Azerbaijan has not played a prominent role in China's One Belt, One Road Initiative. China has adopted an approach to the South Caucasus as a whole, and Georgia has so far been the local player most interested in partnering with China. Azerbaijan does not want to be economically captured by the Chinese, but it is nonetheless very interested in deepening its ties to the East, especially with states across the Caspian. It does have some apprehensions about rising Chinese influence there.

IV. MEETING WITH H.E. OGTAY ASADOV, SPEAKER OF THE NATIONAL ASSEMBLY, AND MEMBERS OF THE NATIONAL ASSEMBLY

22. Mr Asadov noted that the countries of the South Caucasus have each adopted very distinct foreign and security policies. Azerbaijan remains a neutral player in international politics while Georgia has opted to link itself to the Euro-Atlantic, and Armenia has joined the customs union with Russia and relies on its military support. Azerbaijan's geopolitical identity is characterised by non-alignment. The Azerbaijanis have four separate identities and have been shaped by these European, Soviet, Islamic, and Turkic legacies.

23. Mr Asadov noted that the Trans-Adriatic Pipeline (TAP) is now 70% completed and should be finished by 2021, despite a degree of political opposition in Italy. This last leg of the pipeline will move gas to Italy, which will purchase 10 billion m³ (barrels per day). Of course, a number of countries along the route will also purchase Azerbaijani gas. The Shah Deniz I field, which has been pumping gas since 2006, has a production capacity of 8 billion m³, while output from Shah Deniz II is expected to reach 16 billion m³ of natural gas per year, with 10 billion m³ earmarked for Europe and 6 billion m³ for Turkey. Some have questioned how long Azerbaijani production alone can fill these pipelines. Gas production is projected to peak at 50 billion m³ between 2022 and 2029 and will then begin to decline. European demand is expected to grow at a slower pace. Turkey will be using more renewables over the coming decade and, to some extent, this will curtail its own demand for gas from Azerbaijan, although Turkey will remain a dynamic gas market.

24. Azerbaijan is also playing a key role in regional transportation networks. Azerbaijan joined Traseca, an international transport programme involving the European Union and 14 Eastern European, Caucasian and Central Asian countries which seeks to strengthen economic relations, trade and transport in the regions of the Black Sea basin, the South Caucasus and Central Asia. Azerbaijan is also participating in projects that aim to directly link that country to Europe and the Black Sea. Although it is not a key protagonist in China's Road and Belt Initiative, it does recognise that enormous project's potential benefits.

25. Mr Asadov also discussed the situation in Nagorno-Karabakh and mentioned the high number of internally displaced persons (IDPs) and refugees that conflict has generated. He noted that Armenia has benefited from a strong network of expatriates in the West, which has helped it communicate its own narrative of events to the international community. The government of Azerbaijan has worked to build and strengthen its own ties to the West. He

noted as well that this has been a war of attrition which has caused both sides to spend vast resources, but added that Armenia has been drained by the conflict while Azerbaijan has begun to prosper.

V. VISIT TO BP SANGACHAL TERMINAL AND CASPIAN ENERGY CENTRE AND TOUR OF THE TERMINAL OPERATIONS SITE, HOSTED BY BAKHTIYAR ASLANBAYLI, VICE-PRESIDENT, COMMUNICATION, EXTERNAL AFFAIRS, STRATEGY AND REGION, AZERBAIJAN, GEORGIA AND TURKEY, BP

26. The delegation visited the BP Sangachal Terminal and Caspian Energy Centre to learn about the energy pipeline networks linking Azerbaijani oil and gas fields to Europe. Azerbaijan's oil fields are the world's oldest and began pumping oil in 1846. The pipeline from Baku to Batumi was built in 1847. During WWII, Azerbaijan played a key role in the Soviet war effort and produced 80% of the oil used by the Soviets in the war. Currently, Azerbaijan contributes 1% of global oil production. BP itself operates eight platforms and three pipelines. The energy Azerbaijan produces meets all domestic needs, with the remainder moving to international markets.

27. BP has introduced a number of innovative developments to the region, including a subsea construction vessel operating in the Caspian and simultaneous water and gas injection to facilitate the extraction of hydrocarbons. BP has so far invested USD 71 billion in Azerbaijan and produced 3.3 billion barrels of oil. The current workforce is 90% Azerbaijani, and the company is helping to underwrite education in order to increase the skillset for workers.

28. As for pipeline security, the host government is responsible for providing both physical and cyber protection. The state has devoted special forces to protecting these pipelines. The regional market has been shaped by sanctions on Iran, which has impeded that country's energy development and its integration in world markets. In a sense, this has created an opening for Azerbaijan. Iran currently does not have the capacity to export gas and needs significant investment to modernise capital equipment in order to make its energy sector more efficient. Pipelines could eventually link Iran to regions where energy demand is dynamic, but this is not possible in the current diplomatic environment.

29. For the EU, Azerbaijan is one of the six Eastern partners. The EU recognises Azerbaijan as a particularly important country in the South Caucasus, a source of stability in the region and a contributor to European security. Unlike Georgia, Azerbaijan has not expressed an interest in EU membership. It is focused on building a strategic partnership covering a range of sectors including:

- Institution building;
- Governance;
- Economic growth and market development;
- Connectivity and energy; and
- People to people contacts and mobility.

Although Azerbaijan cannot replace Russia as a supplier of energy to Europe, it can play an important role in diversifying Europe's energy supply. This is particularly the case for the south of Europe, including the Western Balkans.

30. There are currently 12 ongoing EU projects with Azerbaijan that both support Azerbaijan's development and contribute to Europe's energy diversification. As the southern corridor gas pipeline nears completion, there has been more discussion about follow on projects, including the idea of tapping into gas east of the Caspian and moving it towards Europe. This would require the construction of a trans-Caspian pipeline. According to the recently signed treaty setting borders in the Caspian Sea for the littoral countries, these countries can now agree to build pipelines through their territorial waters, although there is an

environmental clause that confers other states the right to stop such projects if they pose environmental threats. This clause could directly impinge on future investment, although the general thrust of the agreement will be to encourage investment and commercial activity. In any case, a trans-Caspian pipeline would require huge investments and it is not clear that the economics would work, at least in the current market context.

VI. CONFLICT AND DEVELOPMENT IN AZERBAIJAN

31. Because of the war between Armenia and Azerbaijan, there has been a significant number of IDPs resettled in Azerbaijan. It is sometimes difficult to discern who is and who is not an IDP as lines of poverty and displacement have blurred somewhat over the years. The UN itself does not have a large presence in Azerbaijan because Azerbaijan has the means to finance critical programmes and support systems. The UN's support thus tends to be technical and targeted. With a yearly budget of USD 20 million, it works primarily on environmental challenges, climate change, and natural disasters. The key challenge is funding – while the EU is one of the largest donors, Azerbaijan does not qualify for a lot of funding available. Consequently, the UN must rely on external sources and the Azerbaijani government for key project financing. Accordingly, the government of Azerbaijan provides a substantial amount of resources to IDPs including cash assistance, emergency shelter, long-term accommodation (specifically a large number of apartments housing a third of IDPs), and healthcare and education.

32. The UN also supports the efforts of the Minsk Group, which has long sought to help establish a foundation for peace. But as there has not been substantive progress on a settlement, the UN is compelled to prepare contingency plans should the conflict escalate and produce further displacement in the region. That said, a number of analysts believe that neither side wants war as this risks drawing in external powers including Russia and Turkey and would spell disaster for all sides. Both sides are thus engaged in posturing and do not now seem to be pushing towards a wider conflict. Any final settlement of the conflict would need to have the endorsement of the UN Security Council in order to pave the way for UN peacekeeping.

33. The World Bank has played an important role in financing key development projects in Azerbaijan and has helped underwrite programmes supporting pipeline development, vaccination programmes and efforts to improve conditions for IDPs. In the Bank's estimation, Azerbaijan has made significant progress on the development front and the relationship between the Bank and the government of Azerbaijan should be understood in the framework of a partnership. Azerbaijan does not require financial assistance as such because of its significant energy earnings. But it does require support to acquire knowledge and best practices to ensure that the country is developing in an efficient and sustainable manner.

34. With energy prices back on the rise, economic growth in Azerbaijan is once again accelerating. The country is generating significant foreign exchange earnings and needs to manage these funds with an eye on long-term development. The government has recently reduced spending to put the budget on a long-term sustainable basis. It must be careful not to vastly increase spending when energy prices rise, or it will render the fiscal system unstable. Creating a more diverse and broad-based economy poses a real challenge to the country. Stabilising the budget should help encourage the emergence of new industries less beholden to energy prices. High energy prices, in this sense, can be a curse as they reduce the incentive to diversify into non-energy sectors.

35. Azerbaijan confronts a range of structural economic challenges. The transport sector must be modernised, logistics need to be upgraded and connections to regions like Central Asia must be enhanced. Improvements in water supply, sanitation services and agriculture remain essential development priorities. Health care, social security and pension reforms are

also needed. The World Bank is assisting IDPs and working on environmental challenges, health reforms, social security, poverty reduction and pensions. The World Bank is also helping Azerbaijan to develop a legitimate and efficient courts system. The World Bank is not funding transportation or renewable energy programmes and the government intends to support these projects with its own resources. The government is also currently assessing the possibilities of deploying significantly more solar panels and wind turbines as Azerbaijan has both significant wind and sun. Investment has thus far been limited, but there is significant potential.

VII. MEETING WITH H.E. ARAZ AZIMOV, DEPUTY MINISTER OF FOREIGN AFFAIRS

36. The Delegation met with Araz Azimov, the Deputy Minister of Foreign Affairs, who in his remarks recalled the many years of contacts between the parliament of Azerbaijan and the North Atlantic Assembly. He characterised Azerbaijan as ‘strong, stable and consistently progressing’ and added that his country’s relationship with Turkey stands at the core of that stability. Most of his remarks focused on the conflict in Nagorno-Karabakh, and he suggested that the longer this conflict remains unresolved, the less chance there is of achieving a political settlement.

37. He argued that the occupied territories are characterised by a kind of lawlessness and are being used for narcotrafficking, with war lords exploiting the frozen conflict to engage in illicit trade. He suggested that the chance for a breakthrough is currently low and tensions will rise as a result. The Deputy Minister also expressed concerns about Armenian attacks on civilian infrastructure, as well as illegal settling of territories. He said that it seems the EU is prepared to identify its partnership with Azerbaijan as strategic which, he said, was not helpful.

38. Although a ceasefire was announced in 1994, the Deputy Minister noted, the past two decades have been riddled with *daily* violations of the settlement and negotiations are not moving forward. There is disappointment in Baku that, over the last decade, the United States has not chosen to play a bigger role in the effort to settle the conflict. Azerbaijan will not accept Russia as the sole peacekeeping force in the Caucasus, and for this reason, it is important that other external powers be prepared to play such a role. He added that NATO does not have and has never had a clear strategy for the Caucasus. Finally, he identified areas of shared concern for Azerbaijan and NATO: counterterrorism, infrastructure, and pipeline security.

VIII. MEETING WITH H.E. PERVIZ SAHBAZOV, MINISTER OF ENERGY

39. Mr Sahbazov opened his remarks by noting that, in 2017, Azerbaijan celebrated the milestone of having extracted a total of 2 billion tonnes of oil. He said the settlement of borders in the Caspian Sea will galvanise energy-related foreign investment in the region. Opening the Caspian Sea to oil and gas development and to the construction of infrastructure to move this energy to market has transformed Azerbaijan’s economy. The country has signed more than 30 agreements and contracts with over 40 companies from 19 countries. It has also managed to diversify transportation routes. This has been critical for a land-locked country. Today, Azerbaijan supplies Europeans with oil through the Baku-Tbilisi-Ceyhan (BTC) pipeline line. It has become an important oil supplier to Germany and supplies roughly 32% of crude oil for the Czechs, to name a few examples.

40. Azerbaijan is also extracting gas and transporting it through the Southern Gas Corridor. This is a major project for Azerbaijan, which is set to provide a huge economic boost while creating opportunities for its neighbours, other suppliers, transit countries, and consumer countries.

41. Some economists now worry that the price of oil has become too high and that this will discourage economic diversification. Energy price stability is preferred to high prices, as this will help Azerbaijan develop its non-energy sector, which will be essential to placing economic development on a sustainable footing. Energy prices have recently risen substantially, in part due to the prospect of renewed sanctions on Iran, conflict in the Middle East, and the dramatic reduction of the oil production in Venezuela. Azerbaijan will have to take measures to exercise fiscal discipline in this economic environment.

42. Azerbaijan has drafted a strategic road map to develop the non-oil and gas sectors. The government has developed a new law on electricity to reduce the domestic consumption of carbon fuels. The government has also drafted a new law on energy efficiency to reduce energy waste. State support will remain essential to develop the renewable energy sector. The state will provide compensatory subsidies to encourage renewable energy companies and to make their products competitive in the domestic market. The minister noted that increasing the security of the country's energy infrastructure is essential and has been a topic of discussion with NATO.
