

Azerbaijan

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Reform offers the best hope for national stability

Oil has given this former Soviet state great wealth but it still struggles on many fronts, says *Tony Barber*

Waterfront skyscrapers and blustery winds from the Caspian Sea make Baku, Azerbaijan's capital, look and feel a little like Chicago, albeit with fewer bright lights than the great city on Lake Michigan. Baku's spacious, London-style taxis and backstreet pubs inject another kind of western atmosphere into this energy-rich corner of the southern Caucasus.

Yet the luxury fashion stores, jewellery shops and car showrooms of Baku, brought into existence by Azerbaijan's oil and gas wealth, are more suggestive of Dubai. The fact that Russian, after Azeri, is the most widely spoken language in Baku is a reminder that, until it gained independence in 1991, Azerbaijan had spent the best part of two centuries under Russian and Soviet rule –

an experience it has no desire to repeat. Azerbaijan stands at a crossroads of civilisations and markets, old and new, and derives its identity from multiple sources. Azeri is close to Turkish and the Azerbaijani people are kinsmen of the ethnic Azerbaijanis of neighbouring Iran. But Azerbaijan also prides itself on having established the world's first secular Muslim democracy, an experiment that lasted from 1918 to 1920.

In the modern age, the government has sought to anchor national independence in membership of pan-European institutions, such as the Council of Europe and the Organisation for Security and Co-operation in Europe.

Whether the southern Caucasus, which comprises Armenia, Azerbaijan and Georgia, is truly part of Europe is a question over which geographers have scratched their heads since Ancient



Hard hit: Ilham Aliyev, president, has seen growth rates stall — Atila Kisbenedek AFP

Roman times. It did not stop Azerbaijan from hosting the 2012 Eurovision Song Contest, and in June it hosts the inaugural European Games, the biggest international sports event ever staged there.

The games will take place against a backdrop of troubling geopolitical and economic developments for the young state. The Ukrainian uprising that toppled President Viktor Yanukovich in February 2014 disturbed President Ilham Aliyev of Azerbaijan. Not only was it a popular revolution against an authoritarian ruler, but the US and its western allies, regarded as partners in Baku, openly sympathised with the pro-democracy forces on the streets of Kiev.

In what looked like an effort to forestall similar events at home, the Azerbaijani authorities began to crack

A long stretch of low oil prices would test the country's economic model

down on political dissent and independent media even more than in the first decade under Mr Aliyev, who replaced Heydar Aliyev, his father, as president in 2003. Human rights groups estimate that, in the past year, more than 30 activists, lawyers, journalists and bloggers have been detained and, in some cases, convicted on what western governments consider bogus charges such as tax offences.

Even the few Azerbaijani human rights campaigners still at liberty acknowledge that conditions are not as repressive as in some post-Soviet states, notably in central Asia. They entertain faint hopes that the authorities may declare an amnesty for some prisoners in late March to mark Novruz, the Azerbaijani new year.

But Mr Aliyev appears to have drawn

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WE SEE DEVELOPMENT WHERE OTHERS JUST SEE A SKYLINE



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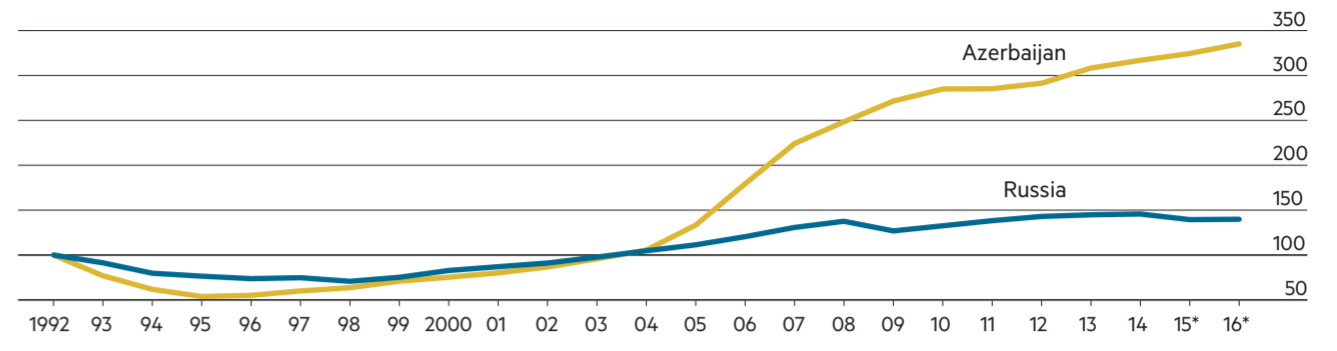
Azerbaijan

State of play



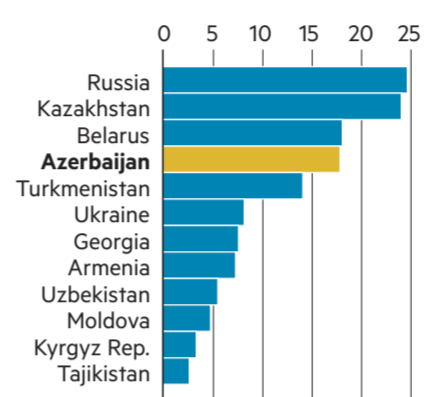
How the increase in Azerbaijan's GDP has outpaced that of Russia since the collapse of the Soviet Union

Real GDP, rebased (1992=100)



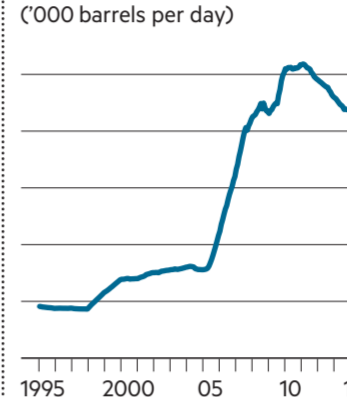
GDP per capita

At purchasing power parity, 2014 (\$ '000)



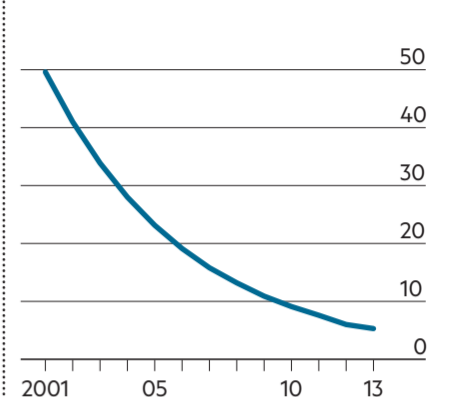
Azerbaijan oil production

Average over previous 12 months ('000 barrels per day)



Azerbaijan poverty rate

% of population



FT research. Sources: IMF; Thomson Reuters Datastream; World Bank. *Forecasts for 2015 and 2016 from Consensus Economics

Threat of ripple effect increases as violence erupts

Nagorno-Karabakh conflict Important pipelines run close to the front line, writes *Tony Barber*

The “frozen conflict” between Azerbaijan and Armenia over the territory of Nagorno-Karabakh is heating up, erupting in regular bursts of violence that threaten regional stability and risk triggering ripple effects beyond the southern Caucasus.

January’s casualty toll of 12 killed and 18 wounded was the highest confirmed number of victims in the first month of a year since a ceasefire halted a 1992-94 war between the two former Soviet republics. That conflict killed at least 20,000 people and turned more than 1m into refugees.

The latest clashes are on a less frightful scale, but international monitors say the 2014 death toll of about 60 people was the worst for 20 years. “The risks are increasing. The nature of the confrontation on the front line is becoming more dangerous. It’s not just snipers any more. It’s attack helicopters, artillery and more,” says one European official.

Serzh Sargsyan and Ilham Aliyev, the Armenian and Azerbaijani presidents, met on three occasions between August and October 2014 for talks brokered by Russia, then the US, then France. But none of these meetings advanced the prospects for a lasting peace settlement.

Instead, military expenditure,

political intransigence and state-fuelled propaganda are intensifying on both sides of a dispute that concerns the EU, Russia, Turkey and the US, not least because oil and gas pipelines important to Europe’s energy security lie close to the Karabakh front line.

Mr Aliyev and his government are displaying more frustration with the lack of diplomatic progress than for many years. At February’s annual Munich security conference, he complained that western powers were guilty of double standards, by imposing sanctions on Russia for its actions in Ukraine, yet taking no meaningful steps to secure Armenia’s compliance with UN resolutions that call for its withdrawal from Azerbaijani land.

Azerbaijan has increased military spending over the past decade so that it is now double the size of Armenia’s entire state budget. Among Baku’s main arms suppliers are Israel and Russia.

In commercial, military and political terms, however, Armenia is more closely aligned with Moscow. Russia’s 102nd Military Base is located at Gyumri, Armenia’s second city. In January Armenia, unlike Azerbaijan, joined Russian president Vladimir Putin’s cherished Eurasian Economic Union, which unites Russia with several other former Soviet republics.

Peaceful protest: people gathered in Baku last month to commemorate those killed during the war with Armenia

Tofik Babayev AFP



Having seized control of Karabakh and seven adjacent districts from Azerbaijan in the 1992-94 war, Armenia now relies heavily on its economic and security relationship with Russia to deter any attempt by Baku to reclaim its lost territories by full-scale war.

What is unclear is how Russia might react if Azerbaijan launched an attack but took care to confine its forces strictly to its side of the internationally recognised border with Armenia.

For Baku, a related consideration is the exposed position of Nakhchivan, an autonomous exclave that is vulnerable to Armenian pressure because Armenian land, next to the occupied territories, cuts it off from the rest of Azerbaijan to the east. Russia and Turkey view themselves as guarantors of Nakhchivan’s status.

With the US and France, Russia leads the Minsk Group, which, under the auspices of the Organisation for Security and Co-operation in Europe (OSCE), has tried without success to broker a Karabakh settlement for 22 years. Moscow’s alliance with Armenia, its arms sales to Azerbaijan and its 2008 military strike in Georgia, which resulted in that republic’s de facto dismemberment at Russia’s hands, raise questions about the Kremlin’s true intentions in the Minsk Group.

‘It’s not just snipers any more. It’s attack helicopters, artillery and more’

However, western officials say acute tensions between Russia and western governments over Moscow’s annexation of Crimea and intervention in eastern Ukraine have not hindered co-operation on Karabakh.

Nagorno-Karabakh (which means “mountainous black garden”), a mainly Armenian-populated enclave of Azerbaijan in Soviet times, is today, for most practical purposes, an appendage of Armenia. However, like the Turkish Cypriot breakaway state in northern Cyprus, Karabakh is isolated in the international community. Its officials are excluded from the peace process, being represented by Armenia — a shut door at which they chafe.

Since 2007, mediators have tried to build an agreement on the so-called Madrid Principles, which foresee a phased Armenian withdrawal from most of the occupied lands around Karabakh and an eventual popular vote on the region’s status. At bottom, it may be that neither Armenian nor Azerbaijani society is psychologically ready for the concessions necessary to achieve a non-military solution.

“Given the breadth and depth of the propaganda on both sides, the younger generations may not be receptive to compromise,” says an official from an OSCE nation.

Reform offers the best hope for national stability

Continued from page 1

the conclusion that the energy partnership forged with the west since the 1990s will not stop western governments from criticising Azerbaijan on domestic matters — a stance Baku objects to as brazen interference.

From the government’s perspective, events in the post-Soviet space took a more alarming turn after Russia exacted revenge for Mr Yanukovich’s downfall by carving up Ukraine.

Azerbaijan’s leaders are also concerned about the implications for domestic stability of Syria’s civil war and the rise of the Islamic State of Iraq and the Levant, known as Isis. Several hundred Azerbaijani citizens have gone to take part in the Syrian war, causing the government to tighten its antiterrorism laws last year and arrest dozens of suspected fighters.

Azerbaijan is a predominantly secular society — a legacy, in large part, of 70 years of official Soviet atheism — and only 15 per cent of the population are religiously observant, according to government estimates. Nevertheless, the state’s extensive security apparatus keeps a close eye on sermons, speeches and other activities at mosques in order to snuff out Islamist militancy.

On the economic front, a sharp drop in oil prices over the past 12 months has slammed the brakes on Azerbaijan’s once spectacular growth rates and slashed its state revenues, which depend largely on hydrocarbon production and exports. It forced the government on February 21 to devalue the manat by roughly a third against the dollar and euro.

A long period of low oil prices would test the country’s economic model and perhaps also the patience of its people, millions of whom have been lifted out of poverty thanks to exploitation of the country’s oil and gas reserves. For all the progress of the past 20 years, Azerbaijan remains a society with enormous differences in wealth separating the political, bureaucratic and economic elites from the masses.

For now, the government hopes time

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Private business Diversification has become the buzzword of choice in government circles

Fuad Mekhtiyev gazes lovingly as an enormous machine whirrs, spinning bottles and cleaning them at a dizzying pace before filling them with a fizzy brown liquid.

“I can stand here for an hour, two hours, watching,” says the founder and owner of Aquavita, one of Azerbaijan’s leading drinks manufacturers.

He counts off the names of western manufacturers whose equipment he is using — the bottling line he bought in 2011 made by Krones, a German company; the machine that makes “preforms” to produce plastic bottles, he bought from Husky, a Canadian group.

“Crazy expensive,” he grins, but “absolutely in line with the best in the world”.

Starting in 1996 with just a small patch of land and a plan

to bottle spring water from the mountains, Mr Mekhtiyev built his company into one of the country’s largest water suppliers. More recently, he has been branching out into soft drinks, including Gulustan, the brown fizzy liquid he enjoys watching being bottled on the outskirts of Baku.

As oil earnings slide, private sector businesses such as Aquavita have become a critical part of government strategy for the economy.

“These guys are a beacon not just in food and soft drinks but for the whole of the rest of the private sector,” says Neil McKain, head of the Baku office of the European Bank for Reconstruction and Development, which is a lender to Aquavita.

As in much of the oil-producing world, “diversification” has become the buzzword of choice. “We are working to ensure Azerbaijan can be successful without oil revenues,” says Ali Hasanov, the spokesman for president Ilham Aliyev.

Official data show the non-oil sector accounts for some 60 per cent of GDP, and registered an impressive growth rate of 6.9 per cent last year. But much of the sector is driven by the government’s reinvestment of its oil earnings in construction and

Aquavita is one of the country’s largest water suppliers



infrastructure. Azerbaijan, like many former Soviet countries, suffers from a legacy of bureaucratic corruption. It has taken steps to improve the business environment, such as setting up a “one-stop shop” for company registration.

But structural problems remain. Much of the country’s economic activity is controlled by a few large family holding companies with links to powerful people.

But Mr McKain argues that the current oil slump will loosen the grip of the elites on the Azerbaijani economy. “Mid-sized corporates are growing much more quickly than any other segment of the economy. As the influence of those companies grows, they’re able to press for reform,” he says.

Jack Farchy

1/3

The amount the manat has been devalued against the dollar

\$37bn

Value of assets in Azerbaijan’s state oil fund, Sofaz

will be on its side. Sofaz, the state oil fund, sits on about \$37bn in assets, on some of which Baku can draw in the event that unemployment goes up and living standards come under pressure.

The central bank has reserves of about \$11bn, and public debt is very low. Above all, the government knows it will soon start earning billions of dollars in annual revenues from the Southern Gas Corridor project, which is scheduled to deliver Caspian Sea gas to Turkey from 2018 and to EU markets from 2020. The question is whether the government, with these revenues on the horizon, will shrink from reforms needed to loosen the grip of oligarchs on the economy, promote the private sector, root out corruption and allow more space for public debate.

For the moment, it is unclear whether Azerbaijan’s leaders take the view that such reforms will be, in the long run, the best guarantee of the internal stability they cherish so dearly.

Azerbaijan

Devaluation and job losses as oil price slide hits hard

Economic downturn Falling revenues upend government plans, reports *Jack Farchy*

On a Friday afternoon in mid-February Elman Rustamov told the FT: "You have come to a hot kitchen. Everything is burning."

That weekend, Azerbaijan's central bank governor put an end to the dollar peg for the manat that had held since mid-2011. A week later, after an abortive attempt to manage a gradual weakening of the currency, the central bank shocked the nation by announcing a new manat-dollar exchange rate 34 per cent weaker than before.

Vahid Ahmadov, an MP and member of the parliamentary economic policy committee, railed that the central bank had "deceived us, the deputies, and the whole people of Azerbaijan".

The pressure had been building on Mr Rustamov for months, as oil prices tumbled by more than 50 per cent from their summer 2014 peak, and the currencies of neighbouring countries, such as the Russian rouble, Georgian lari and Turkish lira, suffered sharp falls.

Right up until the new exchange rate was announced on February 21, Azerbaijani politicians insisted that Baku would not undertake a big devaluation, with President Ilham Aliyev telling parliament in January that the stability of the manat "demonstrates the success of our economic policy".

Indeed, a stunned Azerbaijani population queued for hours at exchange points in the wake of the devaluation, while Moody's warned that the move

would "pressure banks' asset quality".

That the Azerbaijani central bank could no longer maintain the stability of the currency underlines the extent to which the slide in oil prices has upended the government's economic plans.

The cause for the move was a large-scale flight from the manat by local depositors. Mr Rustamov said ahead of the devaluation that the central bank had spent about \$1bn in a month defending the peg, as savers shifted money into dollars. The proportion of deposits held in dollars had risen 4-5 percentage points in the first six weeks of the year to 40 per cent, he said.

In the week ahead of the devaluation, depositors were buying \$500m a day, according to president Aliyev.

More broadly, the fall in oil prices has put a heavy strain on government finances. Oil and gas account for 95 per cent of Azerbaijan's exports, 75 per cent of its government revenues, and 40 per cent of its GDP.

Mr Rustamov said that if oil prices averaged \$50 a barrel, the balance of payments surplus would be five times smaller than last year's level of \$10bn-\$11bn. Moreover, at an oil price of \$50 a barrel, the revenues of Sofaz, the state oil fund which receives the earnings from the government's energy sector stakes, would fall from last year's \$16.3bn to just \$4.7bn, according to Gubad Ibadoglu, an independent economist who heads Baku's Economic Research Centre, a think-tank.

Those falling revenues have created a



Digging deep: falling revenues have led to job cuts

Jejhum Abdulla Bloomberg

'The economic and social situation is getting worse by the day'

problem for the government, whose 2015 budget, drawn up under an assumption of \$90-a-barrel, envisaged Sofaz would this year fund just over half the budget revenues, spending a total of 11.8bn manat — worth \$15.1bn before the devaluation and \$11.2bn after it.

In theory, this kind of countercyclical spending was just what the state oil fund was set up to do.

"During the good times, we've accumulated quite significant reserves," says Shahmar Movsumov, chief executive of Sofaz. "This is the first year we will probably see some drawdowns from the fund. This is exactly the role of the fund. We're testing the concept."

However, he added that the oil fund will most probably spend less than 10 per cent of its \$37bn reserves.

Even before the devaluation, the government was taking steps to shore up its

revenues, implementing a highly unpopular tax on deposit income from January, as well as other levies on imports of luxury goods such as cars and yachts. Executives say it is also taking informal steps, such as delaying tax refunds, to boost its resources.

Mr Ibadoglu says that falling oil revenues have prompted state-owned companies to cut jobs. "The economic and social situation is getting worse by the day. The government didn't have any alternative" but to devalue.

International agencies, such as the European Bank for Reconstruction and Development, are predicting a slowdown in growth to 1.5 per cent, from 2.8 per cent in 2014. But even that may be optimistic. "If we get to the end of the year in positive growth for GDP, I would classify that as a success," says Neil McKain, head of the EBRD's Baku office.

Fund drawdown Baku turns to the state oil fund to save the economy

When Shahmar Movsumov joined Azerbaijan's state oil fund, Sofaz, in 2006, it had \$1.2bn in assets under management, 30 staff, and only invested in one asset class — fixed income.

Now, Mr Movsumov is chief executive of the world's 29th-largest sovereign wealth fund, with a \$37bn pool of assets, including real estate in London, Paris, Moscow and Seoul, equities and gold.

"We have a map with flags in countries where we have investments — it's almost covered with flags. That has happened in the past 10 years," he says.

Speaking in Sofaz's gleaming new €107m office building, which boasts since its own gold vault, Mr Movsumov is conscious of the weight of expectations on his fund.

As Azerbaijan faces up to its toughest year since the oil boom began more than a decade ago, the country is looking to Sofaz to save the economy. For the first time since the oil fund was founded in 1999, the government will draw down some of its money.

"This is exactly the role of the fund and the framework that was foreseen since the beginning. We are testing the concept of the volatility reducer, or buffer," says Mr Movsumov.

The heightened importance of its role will throw the spotlight on Sofaz, which is in the process of transforming itself from a conservative savings pot for excess oil revenue to a sophisticated global investor.

In recent years, it has moved beyond the staid world of bonds, adding equities, gold and real estate to its portfolio. It expects to start investing in China imminently, having just received approval for a 3bn renminbi quota from



Tough times: Shahmar Movsumov, Sofaz chief

Beijing, Mr Movsumov says. And it is looking to expand in private equity by making an investment in a large western fund.

"This industry is completely new for Azerbaijan. We have built a world class asset management company in a country without any legacy of asset management," says Mr Movsumov.

The next step will be to open an office abroad, most likely in London, he says, although he will not say when.

In the meantime, he has a domestic economic crisis to help avert. Mr Movsumov says the fund will probably be able to draw down several billion dollars without making any asset sales, thanks to the short-dated maturities of its fixed income portfolio, still 80 per cent of assets.

"I think we are in better shape than any other big reserve-accumulating country.

"Look what is happening in Venezuela or Iran which don't have reserves — the fiscal impact is enormous," he says.

"The vision that was put in place is resilient, and we can go two to three years with this situation."

Jack Farchy

Delicate balancing act amid regional and global powers

Politics

The country is determined to defend national independence and strengthen its internal stability, says *Tony Barber*

One side of every Azerbaijani banknote bears a national map, in the bottom left corner of which is another map that depicts Azerbaijan as an integral part of Europe.

The political message seems clear. Azerbaijan is no longer some docile, Moscow-controlled province, as it was under the 19th-century tsars and the 20th-century Soviet commissars. It is an independent nation whose identity, prosperity and security are intertwined, to varying degrees, with that of Europe as a whole.

Yet in some respects, the message of the banknotes is misleading. Azerbaijan is not, and does not want to be, fully aligned with Europe or, for that matter, with the US. Under Heydar Aliyev, the late president, and Ilham Aliyev, his son and successor, the essence of Azerbaijani foreign policy for more than 20 years has been to strike a delicate balance between various regional and global actors, stretching the nation's freedom of manoeuvre.

The overriding objectives are to defend national independence and strengthen internal stability. But the domestic dimensions of this stance are attracting western criticism, because they appear increasingly to involve an intolerant approach towards free speech and political dissent.

Azerbaijan has developed a strong partnership with the US and EU on energy, trade and some international security matters such as Afghanistan and Iraq. But it also appreciates the value, even the necessity, of constructive relations with Russia, its huge northern neighbour.

At the same time, Azerbaijan enjoys warm ties with Turkey. It maintains an

Ramiz Mehdiyev, chief of staff

important, below-the-radar relationship with Israel, mainly on defence and security. It has correct, but not particularly vibrant ties with Iran, its southern neighbour — and is acutely aware that Tehran might seek to capitalise on any nuclear deal with the US to reassert its historic influence in the southern Caucasus.

Over the past 12 months, the west's confrontation with Russia over Ukraine, tensions over the disputed enclave of Nagorno-Karabakh and frictions with the US over Azerbaijan's human rights clampdown have raised questions about whether Mr Aliyev and his advisers are recalibrating their foreign policy.

Unlike Armenia, Azerbaijan voted last March in support of a UN resolution that rejected Russia's annexation of Crimea and upheld Ukraine's territorial integrity. Unlike Armenia, it has stayed out of the Russian-led Eurasian Economic Union.

But, in contrast to these positions, Ramiz Mehdiyev, Mr Aliyev's long-time chief of staff, caused a stir in December with a polemical article, entitled "World Order of Double Standards and Modern Azerbaijan", that amounted to the most sustained, high-level attack on US policy published in the era of the Aliyevs.

Its thrust was that Washington was plotting with opposition elements in Azerbaijan to promote a "colour revolution", akin to those which overthrew the governments of Georgia and Ukraine in 2003-2005. The article's publication

coincided with a crackdown on non-governmental organisations and the closure of the Baku office of RFE/RL, a US-funded news service.

Moreover, Azerbaijan has welcomed a stream of prominent Russians over the past year, signalling to Moscow that it does not wish its UN vote on Crimea to damage relations. Perhaps the most unusual guest in Baku was Vladimir Zhirinovskiy, the Russian ultranationalist. Notorious in years past for having hurled insults at the Azerbaijani people — the nation's speaker of parliament once labelled him a "sick clown" — Mr Zhirinovskiy was even granted an audience with Mr Aliyev.

Yet Azerbaijan has no desire to slip into Moscow's political orbit. Hikmet Hadji-Zadeh, a former Azerbaijani ambassador to Moscow and critic of Mr Aliyev's crackdown on the opposition, comments: "The government is getting spiritually closer to Moscow, but the money is with the west. It's a kind of dualism."

There are limits to Azerbaijan's sense of a European destiny. Winning the Eurovision Song Contest, as it did in 2011, and hosting the inaugural European Games, as it will in June, are one thing. Applying to join the 28-nation EU, let alone Nato, are quite another. Even an association agreement and a comprehensive free trade accord with the EU — steps that fall well short of formal membership — are not on the horizon.

Unlike Georgia, Azerbaijan has no such far-reaching European aspirations. It is even critical of the way the EU tried, from 2009, to shoehorn six former Soviet republics, including itself, into a so-called Eastern Partnership — a framework implying a degree of convergence among the six that Azerbaijan regarded as exaggerated and unhelpful.

"We think it would have been more effective if the EU had signed a bilateral partnership with each country individually," says Ali Hasanov, Mr Aliyev's spokesman.

He adds: "These countries have different economic resources, different security interests, different regional concerns."

For the moment, Azerbaijan's foreign policy balancing act is set to continue. Arguably, it is the most realistic choice for a newly independent nation in a dangerous neighbourhood.

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Azerbaijan

Baku seeks alternatives as production declines

Energy

Plans are in train to develop the state as a hub for natural gas, writes *Jack Farchy*

Baku has a long history as an oil town. From “Black City”, the 19th century suburb known for its oily grime, to modern architectural extravaganzas such as the three flame-shaped towers that dominate the city’s skyline, oil has for more than a century been a central part of the identity of Azerbaijan and its capital.

But now Azeri-Chirag-Guneshli, the enormous field offshore in the Caspian Sea whose development since 1994 has spurred Baku’s most recent oil boom, is moving into terminal decline. And Azerbaijan is trying to reinvent itself as a leading producer and transit hub for natural gas.

Eshad Nassirov, vice-president for marketing and investments at Socar, the

state oil company, says: “We are going to compensate for the decline in the production of crude oil with an increase in the production of gas and condensate from other fields.”

At the centre of this ambitious plan is the \$45bn Southern Corridor project, signed with great fanfare at the end of 2013, which would deliver Caspian gas directly to Europe, starting in 2020.

Little more than a year later, however, the project’s economics are under scrutiny amid a tumble in oil prices that is also dragging down natural gas prices in Europe.

Two of the partners in the project, Total and Statoil, have sold their stakes since the final investment decision was signed, amid grumblings about its expected profitability.

Mr Nassirov concedes that the project will be less attractive in a lower oil price environment – it would break even at an oil price of about \$60 a barrel, he says, compared with recent prices of below \$50.

But he says there is no talk of scrapping the flagship investment: “Of course, we will be affected [by the fall in

oil prices], but not to the extent that we will cancel or postpone our big projects such as the Southern Gas Corridor.”

In its efforts to keep the project on track, Socar is delaying and cancelling other projects, he says, scaling back plans for an enormous petrochemical plant and reducing spending on construction in Baku.

BP, which is leading the development of the Shah Deniz II gasfield as part of the project, has already committed \$10bn in contracts, says Gordon Birrell, the oil company’s regional head, making a reversal highly unlikely.

The fall in oil prices has complicated things, however.

Of the overall \$45bn cost of developing the field and building 3,500km of pipelines from Azerbaijan to Italy, some \$10bn-\$12bn is scheduled to be funded by Socar and the Azerbaijani government, according to Shahmar Movsumov, chief executive of Sofaz, the state oil fund.

With oil prices falling, Baku is rethinking how it will fund its share of the project, Mr Nassirov says. “We are changing our views, first of all because

Contract Talks continue

When Azerbaijan signed a deal with BP and other international oil companies to develop the Azeri-Chirag-Guneshli field in 1994, it was dubbed the “contract of the century”.

The deal has delivered spectacular wealth, with the field accounting for three-quarters of national oil production.

Now the field’s future is uncertain: the 1994 production sharing agreement expires in 2024, and negotiations are continuing.

Gordon Birrell, regional president for BP, says the company will continue to invest even without a new production sharing agreement, but that “it’s probably a different shape of investment profile”.

there is a new need for money with the falling prices for crude oil,” he says. “We will be using our own funds, money from the oil fund, and we will be trying to attract money from project finance.”

Another problem has been thrown up by the new Greek government, which has suggested it might seek to renegotiate the terms of its involvement as a transit country for the project, creating a ripple of concern in Azerbaijan.

Nonetheless, analysts expect Azerbaijan to resolve these issues.

“The government views the Southern Gas Corridor as a major strategic investment for the country,” says Livia Paggi, a Central Asia and Caucasus analyst at risk consultancy GPW, adding that Sofaz may seek to issue a eurobond to help fund its commitments to finance the project.

With plans to deliver 10bn cubic metres to Europe a year, the size of the Shah Deniz II project is relatively modest. Gazprom managers, who sell about 150bcm to the continent annually, have joked that it is “just about enough for a barbecue”.

But Azerbaijan’s ambitions in gas

stretch well beyond Shah Deniz. Baku hopes that the construction of a pipeline to Europe will stimulate a cluster of smaller fields, such as Absheron, Umid-Babek, and ACG deep, which together could double the flow of gas to Europe.

In the longer term, the pipeline could also become a conduit for Iranian or Turkmen gas, making Azerbaijan a key part of Europe’s strategy to diversify its energy supplies away from Russia.

But these grand plans are increasingly under threat amid falling oil prices and lower appetite for big investments among the world’s oil majors.

In December, Russia threw another spanner in the works, announcing it would abandon the 63bcm a year South Stream pipeline project across the Black Sea and redirect it via Turkey instead, where, if realised, it would be in direct competition with Azerbaijani gas.

While the supplies from Shah Deniz are already contracted, Russian gas could displace other Azerbaijani projects, given limited pipeline capacity, says Gulmira Rzaeva, research associate at the Oxford Institute for Energy Studies.

Grandiose project to put the country on the sporting world map

Baku Games Construction and upgrade costs are in the range of \$3bn-\$7bn, reports *Jack Farchy*

Baku’s national stadium is a hive of activity. In every direction, teams of workers are rushing to put the finishing touches to the 68,000-seat arena in time for the opening ceremony of the inaugural European Games in June.

One group is laying the running track; another is painting the stands; yet another team is laying kerbs and planting trees in the little patches of grass outside the stadium.

The mad dash to finish everything in time for the opening ceremony – a common theme of big sporting events – has acquired greater urgency in Baku’s case as the city has had less than three years to prepare, compared to the usual seven-year lead time.

“It’s a remarkably short window for a project this size,” says Ron Cameron, the venue manager for the stadium. “I had my doubts when I got here, but they’ve got it all done.”

Azerbaijan is no stranger to mega projects. But the Baku Games, which will run for just over two weeks from June 12, are perhaps its most grandiose project yet.

The government sees the Games as the first step in a broader strategy to use sport to promote Azerbaijan’s “soft power” on the world stage. They are the first big instalment in a series of flagship sporting events that the country plans to host, from a Formula 1 Grand Prix next year, to the Islamic Solidarity Games in 2017, to several matches in the Euro 2020 football championship. There is also speculation of a bid for the 2024 Olympics.

“This is the great coming-out party of Azerbaijan,” says Simon Clegg, chief operating officer of the Games.

It is an expensive party, though, at a time when Azerbaijan’s government revenues are being squeezed by the slide in oil prices. The official budget of the

Games this year is 950m manat, according to a statement by the sports minister ahead of February’s devaluation, but economists estimate that the cost, including the construction of stadiums and upgrading of infrastructure, to be in the range of \$3bn-\$7bn. This year alone, spending linked to the Games is budgeted to account for a quarter of the government’s entire capital expenditures.

“Everyone is feeling it here in terms of funding that’s available. But the government has been very supportive in terms of ringfencing funding for the Games,” says Mr Clegg, noting that the Games’s organising committee has made a “modest” budget reduction in response to the tougher economic climate.

Even with reductions, the Games are still a huge logistical undertaking, featuring 20 sports, 6,076 athletes, and 759 medals.

A brainchild of the International Olympic Committee, they were designed as a counterpart – the “fifth Olympic ring” – to other continental Olympic competitions held in the Americas, Asia, Africa and the Pacific.

But, as the first European Games, success is not a given. “We’ve had to go to the commercial marketplace, be it sponsors or broadcasters with a blank piece of paper and a bunch of promises. There’s no track record,” says Mr Clegg. “Revenues from those sources are not what we might aspire for them to be.”

Another challenge has been to attract the continent’s best athletes. Here, the organisers were stymied by the relatively late decision to hold the games in 2015 – the European Athletics Future Championships, an established fixture in the calendar, were already scheduled to be held in Moscow this June.

While the Baku Games will have an athletics competition, it will not feature Europe’s best teams but instead the



Finishing line: the vast national stadium in Baku nears completion

third division, including the national team of Azerbaijan.

Beyond athletics, though, the organisers are confident that the continent’s top athletes will make the trip to Baku.

“There’s only ever one first European Games champion,” says Pierce O’Callaghan, director of sport at the Baku Games. As important, the organisers have succeeded in making 11 of the events qualifying competitions for the 2016 Olympics in Rio.

“That means athletes will be very motivated to come,” says Mr O’Callaghan.

A more difficult question is whether the Games will achieve the desired promotional boost for Azerbaijan in the world. They are likely to become a lightning rod for critics of the country’s deteriorating human rights record, with several of the country’s most prominent activists languishing in jail.

In a letter to the FT from prison, Leyla Yunus, one of the country’s leading activists, said that holding the Games in

Baku would “contradict the very spirit of the Olympics”.

Mr Clegg concedes that the European Games do not yet have a sufficiently high profile to attract large numbers of foreign tourists.

“Realistically, many of the ticket sales will come from [the] domestic public,” he says.

Among that public, though, some have already caught the Olympic bug. The organising committee has had 29,000 applications to volunteer during the Games, and has a thriving graduate scheme.

The enthusiasm of the graduate trainees is contagious. “When Baku was chosen to host the Games in 2012, I was really proud,” says Turgut Qambarov, a 21-year-old member of the Games’s graduate scheme, who says with pride that he is one of only two local staff working on the timekeeping and results team.

When I wake up in the morning I think: I am doing results,” he beams.

OPINION

Shawn Donnan



Economic promise is tied to Silk Road

Azerbaijan’s trade statistics tell a pretty clear story about the oil-rich country’s recent economic history.

Since the collapse of the Soviet Union, the government in Baku has looked west and to Europe in particular in pursuit of its commercial ambitions.

The EU is the destination for almost half of Azerbaijan’s exports (about 95 per cent of which are oil and gas) and the source of more than a third of its imports. Although China is almost inescapably everyone’s biggest trading partner, it accounted for just 5.3 per cent of Azerbaijan’s imports in 2013 and did not even make the top five export destinations, according to the World Trade Organisation.

But the tides of history are shifting again. Power politics are on the ascendancy in the world and Azerbaijan may just find itself a beneficiary, if only because it sits firmly in the path of China’s latest ambitions.

Xi Jinping, China’s president, has made restoring the ancient Silk Road between China and Europe one of Beijing’s biggest priorities, most recently allocating \$40bn to a fund to rebuild and improve infrastructure on the overland route through Central Asia and the Caucasus.

The move is seen by many as Beijing’s response to a push by the US and Japan to set up their own Pacific trade bloc, the Trans-Pacific Partnership. And with good reason: Washington has unashamedly been selling that Pacific pact as its response to China’s rise and its opportunity to make sure it can beat Beijing to the punch in setting the rules of the road for the global economy. Moreover, the sales pitch in the US is much the same for an even larger transatlantic trade agreement with the EU.

Why should that competition between the world’s economic megaliths matter in Baku?

There are the small matters of geography and history. Azerbaijan once sat on the Silk Road, a strategically placed pit-stop for traders travelling between China and Europe or heading north into Russia and south into what is now Iran.

And then there is the consensus on where the future of the global economy lies. As any chief executive of a multinational consumer products company will tell you, when it comes to expanding your business, Asia and its emerging middle class represent both the present and the future.

There are definitely signs that Azerbaijan’s president, Ilham Aliyev, who inherited the post from his father in 2005, understands that.

During a visit to Beijing in May, he endorsed Xi Jinping’s plans for a Silk Road revival as he signed a series of deals.

Later this year, Baku will host the annual meeting of the Asian Development Bank, which Azerbaijan joined in 1999.

It has also spent heavily in recent years on ports and roads, all in the name of improving its role as a trading link between Asia and Europe.

What might stand in the way of those ambitious plans? Quite possibly those existing patterns of trade: its position on the Caspian has given it an important role in recent years as an alternative energy supplier for a Europe concerned about its dependence on Russian gas. European demand for Azerbaijan’s oil riches is unlikely to end soon.

Though it may boast vast energy reserves, Azerbaijan is a relatively small pit-stop on the Silk Road. It may even be at risk of China’s grand ambitions passing it by. Maps put out by China’s state media of Mr Xi’s mooted overland Silk Road appear to circumvent the Caspian and Azerbaijan.

Still, that seems unlikely. It also may represent a misunderstanding of Beijing’s grand vision. Mr Xi’s stated goal is to create an “economic belt” across central Asia and the Caucasus to Europe. His overland plans are matched by a wending maritime version that seems designed to bring as many other Asian countries into the fold as possible.

For hundreds of years, Azerbaijan’s economic promise was tied to its place on the Silk Road, as that bridge between Europe and Asia. These days, it is hard to see how its plans – or promise – could lie anywhere else.

Tourism

Jack Farchy pays a visit to the slopes of Shahdag

Standing at the top of a chairlift with a group of girlfriends, Aynur looks wistfully at the skiers zooming past.

“I’m a bit sad that everyone else is skiing and I’m here watching, but I didn’t want to risk it,” says the 20-something Baku resident, before returning to take some more photos of herself against the spectacular backdrop of the snowy Caucasus Mountains.

Skiing is Azerbaijan’s newest sport, and the recently opened resort of Shahdag is full of locals who, like Aynur, are not quite ready to try it.

With state-of-the-art lifts and a

luxury hotel, Shahdag is Azerbaijan’s answer to Russia’s Sochi – or Courchevel in France or Verbier in Switzerland. The resort is a key part of Azerbaijan’s efforts to boost tourism and reduce its dependence on oil.

Under the slogan “land of fire”, Azerbaijan has embarked on an ambitious campaign to market itself to the world, hoping that the Eurovision Song Contest in 2012 and the European Games this year will encourage visitors.

The tourism ministry has announced plans to boost the number of foreign visitors to 5m by 2020 from just over 2m last year, most of them from Azerbaijan’s neighbours: Russia, Georgia, Turkey and Iran.

On a sunny weekend in February, there was no shortage of locals and expats. But genuine tourists were rare, as almost all the visitors were weekend-



Smooth running: Shahdag is currently a weekend retreat

ers from Baku, a three-hour drive away.

Stuart de San Nicolas, manager of Shahdag’s upmarket hotels the Pik Palace and Park Chalet, says the occupancy rate is 12 per cent. The town is busy at weekends but empty in the week.

One problem is the resort’s size. “To be competitive with European markets,

we must have about 45km of slopes,” says Mr de San Nicolas. But Shahdag currently has 17km of half a dozen cruisy red and blue runs.

There are other barriers to Azerbaijan’s tourist ambitions. For example, travelling to the country means a cumbersome visa application for most visitors. And, until February’s devaluation, the manat was relatively high as other regional currencies had devalued.

There is no shortage of plans to attract foreign tourists. Mr de San Nicolas aims to launch package trips combining a few days shopping in Baku with a visit to the mountains. There are also plans to build a golf course.

In the meantime, the residents of Baku are enjoying their new weekend playground. As Mr de San Nicolas says: “If you’re not in a selfie with Shahdag in the background, you’re not in.”