

**Applicability of Norway's socio-economic and political strategy
as Oil-State for the Caspian Region
2-3 February, Berlin**

Oil policy and strategy of Azerbaijan

Your Excellencies,
Ladies and Gentlemen,

At the outset, I would like also to welcome all the participants of this seminar and hope that presentations and views to be delivered will not only enrich the knowledge of the audience on the Caspian region energy capacity but also will produce some recommendations for further improvement of socio-economic situation in the region based on Norway's experience.

Today, I am pleased to make a brief presentation on oil policy and strategy of Azerbaijan. Actually my Ambassador has already touched upon the major achievements in this field and, thus, I will just try to elaborate on them.

Azerbaijan is one of the first countries where people learned how to produce oil and use it for medicinal and household needs.

Since the 10th century A.D., the producers of oil started to dig wells at a shallow depth of 10 to 12 meters to be able to collect some oil. By the beginning of the 17th century, there were about 500 wells drilled around the settlements of Baku, the capital of Azerbaijan. Between 1798 and 1830, for the first time in the world, oil was extracted offshore from Bibi Eibat Bay in Baku.

In addition to oil production, Azerbaijan took the lead in oil refining. As early as the 13th century low-density oil fractions, used for indoor and outdoor lighting, were obtained. Industrial refining started in the 1820-1830s. A refining plant was constructed in Baku to obtain kerosene from oil. The first oil-refining plant producing kerosene was built in 1863. In just 10 years, some 50 oil-refining plants were operating in Baku.

Oil-well drilling started in Azerbaijan in 1844, 10 to 11 years earlier than in Pennsylvania, U.S.A. The first wells were not very deep, with depths of not more than 40 to 50 meters. In 1873, the most efficient among them in Balakhany yielded 1,5 thousand tons of oil over a period of three months.

Increase in oil production and entrance into the world market promoted considerably the interests of Azerbaijani oil and oil magnates worldwide. Since 1872, foreign businessmen started to acquire, by tender, oil areas on Absheron. The owners of the newly acquired areas included the Nobel brothers, the

Rothschilds Bank House, among others. In 1874, "The Nobel Brothers Partnership" opened for business. They participated in the construction of an oil-pipeline connecting the oil fields with refineries in Baku.

Production of lubricating oils also started here for the first time anywhere in the world in 1875. Baku luboils exported in 1878 won a firm place in the European and world markets.

Azerbaijan was the first in the world in the total amount of oil produced from 1899 to 1901, extracting more 100 million tons per year, which made up more than 50% of the world's production. Oil production in the U.S.A., at that time amounted to only 9 million tons per year.

World War I, the subsequent revolution and collapse of the economy, coupled with the repeated reshuffling of the government and field owners, all combined to cause the decline of the Azerbaijani oil industry. By 1921, oil production declined to only 2.5 million tons. But by 1925-26, there was an increase in oil production up 6 million tons.

In 1924, for the first time in the world, oil was produced from a marine well erected on timber piled in Bibi Eibat Bay. Thus, offshore oil production was introduced to the world.

Oil production in Azerbaijan achieved its level of 23.5 million tons, which made up 71% of the total output in the USSR in 1941. The years of World War II, however, were characterized by a considerable decrease in oil production - down to 11.1 million tons. Finally, drilling was suspended completely. The industry focused on production of arms and ammunitions.

Drilling and restoration of fields resumed in 1943. Logistic support was improved, new technical and technological innovations were implemented in operations. Discovery and development of the legendary Neft Dashlary (Oil Rocks) oilfield served as a powerful spur to offshore production. For the first time in the world, a unique offshore field was constructed on piles in the open sea. During a short period of time, special assembly sites were created to assemble the blocks for: separate platforms, plants manufacturing metal structures, their anti-corrosive coating, special transport and an oilfield marine fleet. Development of this large deposit in the open sea was a decisive point in the increase of offshore oil production.

One billion tons of oil was produced in Azerbaijan in 1971. The oil industry was being equipped with powerful floating technical means to reach the sea depth of more than 60 meters. In 1968, a self-jackup drilling rig was used for the first time in the world. And in 1977, at the depth of 84 meters, a deep-sea fixed drilling rig was constructed for the first time ever. In 1981, drilling started from

a semi-submersible drilling rig designed for maximum depth of 200 meters.

Ladies and Gentlemen,

Today the role of Azerbaijan and the Caspian basin in oil and oil products delivery to world markets is not so significant, but it increases from year to year. One can argue how big are the oil and gas reserves of the Caspian sea and littoral territories but experts are unanimous that these reserves are comparable with those in North Sea and development of multibillion oil and gas projects in the region will allow Caspian countries in the forthcoming years to be in the list of major oil and gas suppliers at least to European market.

Seriousness of our plans is confirmed by 22 billion US dollars already invested into the projects on exploration, development and extraction of oil and gas as well as the construction of export oil and gas pipelines for the period of 1995-2005.

If in 1995 export of crude oil from Azerbaijan was equal to 0, then in 2005 it exceeded 12,5 million tons, by 2010-2011 it will reach more than 50 million tons a year.

Since 1994, Azerbaijan has signed 23 Production Sharing Agreements (PSA-s) with major international oil companies, which have established consortia with each PSA. Most of the contracts are offshore. The first project - Azerbaijan International Operating Company (AIOC), which has been signed between SOCAR and 11 international oil companies for development of Azeri, Chirag and the deep-water portion of the Guneshli field, contains recoverable reserves around 500 million tons. Production from the project could reach around 35 million tons per year within 6 years. Due to the projected increase in production in the near future, there is a potential emerging market for oilfield equipment and supplies and related services for transportation solutions either through subcontracting or in cooperation with major suppliers to the various consortia.

The energy strategy of Azerbaijan is multi-dimensional. On the one hand Azerbaijan, for its expanding energy need, pursues policies to ensure diversified, reliable and cost-effective supply sources. On the other hand, the process of liberalizing the Azerbaijani energy market is continuing. The third aspect of its energy strategy is to become a major consumption and transit terminal in the region.

The East-West Energy Corridor concept is mainly based on the construction of trans-Caspian and trans-Caucasian oil and gas pipelines. The East-West Energy Corridor essentially aims at transporting the Caucasian and Central Asian energy resources to the Western markets through safe and alternative routes. The East-West Energy Corridor project mainly comprises the Baku-Novorossisk (Russia)

pipeline, which was commissioned after reconstruction in October 1997 with capacity of about 4,5 million tons a year, then the second pipeline is Baku-Supsa originating at the Sangachaly terminal near Baku and ending at the Port of Supsa on the Georgian Coast. The first crude deliveries via this line occurred in April of 1999. The pipeline has an initial capacity of approximately 6 million tons per year. At the terminus, tanker loading takes place via a single point mooring system. The total distance of this route is approximately 850-kilometers.

The third and most important 1768 km and 3 billion US dollar oil pipeline Baku-Tbilisi-Ceyhan (BTC) with transportation capacity of 50 mln. tons, will be put into operation this year. If necessity arises then the capacity of the pipeline can be increased up to 80 mln. tons of oil per year. The construction stage of the BTC project was launched on 10 September 2002 and the ground-breaking ceremony took place on 18 September 2002 at Sangachal, Azerbaijan with the participation of the Presidents of Turkey, Azerbaijan and Georgia and the US Secretary of Energy. All three countries approved the Environmental and Social Impact Assessments (ESIAs) for the BTC project in October 2002. At the moment the remaining Turkish part is being filled in with oil.

It is natural, that existence of such an export infrastructure allows to provide commercially attractive and safe export on the international markets of crude oil not only from Azerbaijan, but also from other countries of the Caspian basin.

One of the exploration projects in the Azerbaijani sector of the Caspian focused on the Shah Deniz field, which has brought the question of gas to the forefront of the debate about Azerbaijan's hydrocarbon future. A consortium led by BP Amoco and Statoil discovered in the spring of 1999 that Shah Deniz was indeed a supergiant field, but one containing mainly natural gas (along with smaller volumes of liquid gas condensate). According to the first estimates this field contains 1 trl. cub.m. of gas and 300 mln. tons of condensate and requires 4-5 billion US dollars of investments. The relevant activities on development of this field have already started and gas extraction is planned for the end of this year. 16 billion cub. m. of gas extraction per year is expected upon completion of all the works on this field.

The development of gas fields in the Caspian region is commercially even more challenging than oil development. With understanding that upstream gas investments cannot be made until there is a solid sense of who the consumer will be and how much they will commit to pay, not to mention resolution of the transportation questions, Azerbaijan has started negotiations on gas supply with Turkey, the only large market for Azerbaijani gas.

Upon successful negotiations with all the parties involved construction of Baku-Tbilisi-Ersurum (Turkey) gas pipeline started in 2004. According to relevant agreement Turkey will buy 900 billion cub. m. of gas within the period of 15

years. As you might be aware, upon construction of gas pipeline connecting Turkey with Greece Azerbaijani gas will reach not only Turkey but also via this country the European markets.

The initial capacity of Baku-Tbilisi-Ersurum gas pipeline to be commissioned by the end of this year will be 9 billion cub. m. of gas per year, which corresponds to contract volumes of gas delivery to Azerbaijani, Georgian and Turkish markets from Shah-Deniz field. Starting from 2012 the capacity of the pipeline, if necessary, could be increased up to 25 billion cub. m. of gas per year.

Of course, the implementation of the large-scale projects attracting billions of USD with participation of dozens of oil companies, financial-credit institutions from different countries of the world required elaboration and precise realization of a relevant legislative basis that could be attractive for the investors. It was of great importance to provide for a precise implementation of the agreements and contracts signed between the parties, to ensure personal and corporative security of investors and property rights as well as political and social stability in the country and society. We also made lots of efforts to provide for a predictable and sustainable development of democratic institutions and mechanisms, to create competitive market environment and other mechanisms of the market economy.

I think all these promoted the cooperation of the Government of Azerbaijan with foreign investments in the oil and gas sector.

It is clear that the major goal of such a large-scale development of the oil and gas resources of Azerbaijan is to maximize revenues of the country from exploitation of its natural resources and implementation of the projects in this sphere. Rational use of these revenues for increasing of welfare of the people are of utmost importance for the development of social sector as well as of the non-oil sector of the economy in order to provide for prosperity of the future generations. Actually that was the main idea of establishment on the base of the Norwegian model of a State Oil Fund in 1999. The cornerstone of the philosophy behind the Oil Fund is to ensure intergenerational equality of benefit with regard to the country's oil wealth, whilst improving the economic well-being of the population today and safeguarding economic security for future generations. It is a mechanism whereby energy-related windfalls will be accumulated and efficiently managed. In so doing, the government is demonstrating its overriding desire and determination to avoid the inherent risks for any nation in the midst of an oil and gas boom to spend excessively and create macroeconomic distortions. Oil Fund is a state extra-budgetary fund, functioning as a separate legal entity, with its own expert management team and government supervisory hierarchy. Nowadays above USD ca. 1,5 billion are accumulated in the Oil Fund. Till now approximately USD 480 million or 33%

of incomes were used for financing different investment or social projects. A key measure to promote transparency within the Oil Fund's reporting system and operation is a regular audit of the Fund's financial activities by a reputable firm of international auditors. Ernst&Young was appointed as auditor for the Oil Fund's financial statements during the three years of its activity. At the same time, the Fund's activity may be examined by the Chamber of Accounts, established by the Azerbaijani Parliament. Oil Fund is also closely involved in the Extractive Industries Transparency Initiative (EITI) of the British government.

Ladies and Gentlemen,

Obviously further development of the above-mentioned and other oil and gas projects will allow in the nearest future to fully provide internal needs of the country for natural gas both for household sector, and for electric energy production sector. At the same time, intensive development of agricultural and industrial production in regions of Azerbaijan force the Government to pay special attention to growing needs of the country on reconstruction and development of gas-distributing networks, underground gas storehouses, introduction of effective methods of gas account and management of a gas facilities.

The government of the country is active in this direction in conformity with a special "State Program on development of a fuel and energy complex for the period of 2005-2015 " and is ready for mutually advantageous cooperation in this area with all the interested investors and financial institutions.

Taking into account the necessity of creation of an internal gas market the Government has taken some measures in the electric energy sector. Up to 2002 the State Company „Azerenerji“ functioned as a vertically integrated monopoly of generation, transmission, distribution and sale of electricity. In 2002 two distribution companies were established – one for Absheron-Baku and northern regions, the second one for the other regions of the country. Later on operational management of these companies was transferred to private investors Barmek (Turkey) and Bayva (Azerbaijan).

Since 1994 on the basis of the allocated means under credits construction of power objects is carried out as well as reconstruction and replacement of morally and physically worn out equipment is conducted. Upon this a number of hydroelectric and steam and gas power stations commissioned.

In October 2004 the State Programme on use of alternative and renewable energy sources has been endorsed.

Limits of hydrocarbon resources as traditional energy sources, and environmental concerns made it necessary to increase energy production by application of alternative or renewable sources. By virtue of a natural conditions, Azerbaijan has quite attractive renewable energy potential. Therefore, with the purpose of creation of new power capacities due to alternative sources available in the country and adopting experience of the advanced countries in this area, it was offered to carry out a number of actions to involve the private investment capital in this new segment of electric energy generation. The researches conducted in Azerbaijan, have shown, that there is a potential of production of electric energy in amount of 2.4 billion kilowatts per year using only a wind power. We are confident, that ongoing intensive consultations with foreign investors will be successful soon.

All aspects on development of a fuel and energy complex in Azerbaijan are reflected in the State Program, including all the actions to be taken. With a view of the further development of the internal electric power market, the Government takes into account the market requirements connected with realization of the subsequent stages of privatization of some electric power objects.

The further liberalization of the market requires both investment and technical, and legislative innovations. Recently accepted Law on investment activity and being developed Competition Code could be regarded as steps in this direction. The government undertakes also necessary steps to allow manufacturers and consumers, i.e. the market as a whole, to be sensitive, but also ready to risks on management of generating and distributing networks.

Ladies and Gentlemen,

Before I conclude my presentation, I would like to repeat again that the Caspian region is one of the largest remaining potential resources of undeveloped oil and gas in the world. Recent levels of interest by the major international oil and gas producers, the international contractor community and by governments and academic institutions are a good testament to the region's potential. Having this in mind, the main avenue of our oil strategy is use this potential to provide economic and social prosperity and stability for future generations. We hope this seminar will be not the last forum of its kind to study the Norwegian model of prosperity with the purpose of its further application in the Caspian region.

Thank you for your attention.