

Structuring Projects:  
The Azerbaijan International Oil Consortium  
Case Study

*“Deal of the Century”*



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**1. Background to the transaction**

a. General history of the area

At one stage Azerbaijan provided for 70% of the oil output of the former Soviet Union. However, by the 1980s this had fallen to just 8%<sup>1</sup>.

When the Soviet Union evolved into the Commonwealth of Independent States, Azerbaijan became an independent state. This new country was made up of a population of 8 million people of whom 90% are ethnically Azeri. It commenced life with high unemployment, a low standard of living and an economy very much dependent upon oil.

The early years of statehood led to a decline in the country's gross domestic product but increase in internal instability.

It has been said that, "...by 2001, Azerbaijan had become a virtual "*monocrop*" economy, with crude oil and oil products comprising 91% of the value of exports.<sup>2</sup> ...".

Notwithstanding attempts to diversify, even by 2007, oil revenues made up more than 40% of Azerbaijan's gross domestic product, and the oil industry accounted for more than 90% of the total of foreign direct investment in the country.<sup>3</sup>

b. Energy History of the Area

Azerbaijan is a small country rich in mineral resources. As far back as 1877 Charles Marvin wrote that more than 2 ½ millennia ago, there was evidence that oil was exported from the Apsheron peninsula, where Baku is located, to Iran, Iraq, India and other countries.

Reports corroborating oil production have been made in the

- 5<sup>th</sup> century by Prisk of Pontus
- 8<sup>th</sup> century by Abu-Istakhri
- 9<sup>th</sup> century by Ahmed Balazuri
- 10<sup>th</sup> century by Masudi (tenth century),
- 13<sup>th</sup> century by Marco Polo, and
- 17<sup>th</sup> century by O'Learius.

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<sup>1</sup> d'Intignano, A.M., "Opening the Caspian Gateway," *Project Finance*, January 2000, p. 18.

<sup>2</sup> [http://www.soros.org/initiatives/cep/articles\\_publications/publications/caspianoilwindfalls\\_20030514](http://www.soros.org/initiatives/cep/articles_publications/publications/caspianoilwindfalls_20030514)

<sup>3</sup> BP in Azerbaijan: A Test Case of the Potential and Limits of the CSR agenda? 2007, Lars H Gulbrandsen, Arild Moe / [Third World Quarterly](http://www.thirdworldquarterly.com/content/document/detail/1789/) <http://commdev.org/content/document/detail/1789/>

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According to Marco Polo,<sup>4</sup> the Apsheron peninsula was dotted with oil wells, which oil was used for lighting and for medicinal purposes.

Azerbaijan currently holds significant oil reserves<sup>5</sup>

Country	Oil Reserves (Billion Barrels)	% of World Total Reserves	Oil Production (1000) bbl p/d	Oil Production % of World
Iran	138,400	10,39%	4,043	4,78%
Russia	60,000	4,51%	9,875	11,67%
Kazakhstan	30,000	2,52%	1,444	1,71%
<b>Azerbaijan</b>	<b>7,000</b>	<b>0,53%</b>	<b>850</b>	<b>1,00%</b>
Turkmenistan	0,600	0,05%	180	0,21%
Caspian Total*	236.594	17,77%	16.494	19,50%
World Total	1.331.698	100%	84.600	

It is said that the world's first commercial oil well was drilled in 1848 in Apsheron; 11 before the first oil well in Pennsylvania.



The above is a picture of an oil well in Azerbaijan from over 100 years ago

By 1899 there were 230km of pipeline, carrying around 1m tons of oil.

By 1910 more than 60% of the oilfields were under the control of three large organisations: Shell, the Oil Production Society of the Nobel Brothers, and the Russian General Oil Society.

<sup>4</sup> [www.sam.gov.tr/.../AZERBAIJANIOILGLIMPSESOFLONGHISTORY.pdf](http://www.sam.gov.tr/.../AZERBAIJANIOILGLIMPSESOFLONGHISTORY.pdf)

<sup>5</sup> [www.iias.nl/epa/.../Job-Staal-Energy-Security-for-the-European-Union.pdf](http://www.iias.nl/epa/.../Job-Staal-Energy-Security-for-the-European-Union.pdf) Source| Based EIA, World Proved Crude Oil Reserves, January 1, 1980 - January 1, 2008 Estimates, Post January 14 2008 May 2008; World Production of Crude Oil, NGPL, and Other Liquids, and Refinery Processing Gain, Most Recent Annual Estimates, 1980-2007, Post April 21 2008, May 2008.

\* The Caspian total includes here Russian and Iranian figures, although these are not found in the Caspian Sea.

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By 1913 there were 3,500 wells in and around Baku.

After the Russian revolution of 1917, Soviet power was established in Baku. This resulted in the 165 independent oil companies being nationalised by the Bolshevik regime. Between 1918 and 1920, during a brief period of independence for Azerbaijan, these companies were de-nationalised only to be re-nationalised when the Red Army re-imposed soviet control in 1920.

Following the restoration of democracy and independence, a Western Oil Consortium signed a contract with SOCAR in 1994 for the development of the Azeri, Chirag and Guneshli oilfields.

c. The Parties

Following the merger of BP with Amoco, the finance committee approached its task of review of the finance and funding of the Azerbaijan Project cognisant that the two companies had hitherto adopted different strategies to similar issues in relation to the Early Oil Project.

BP had used general corporate funds, whereas Amoco was one of five partners within the Azerbaijan International Operating Company that had raised US\$400m in project finance with assistance from two multilateral agencies, the International Finance Corporation and European Bank for Reconstruction and Development.

The question for the Finance Group to resolve was which funding strategy was to be deployed for the Full Field Development Project on behalf of the merged entity.

## 2. The Transaction

a. Creation of the Azerbaijan International Oil Consortium

Termed the “Deal of the Century”,<sup>6</sup> a Production Sharing Agreement was signed in 1994 for the development of Caspian oil. The parties to this agreement were the

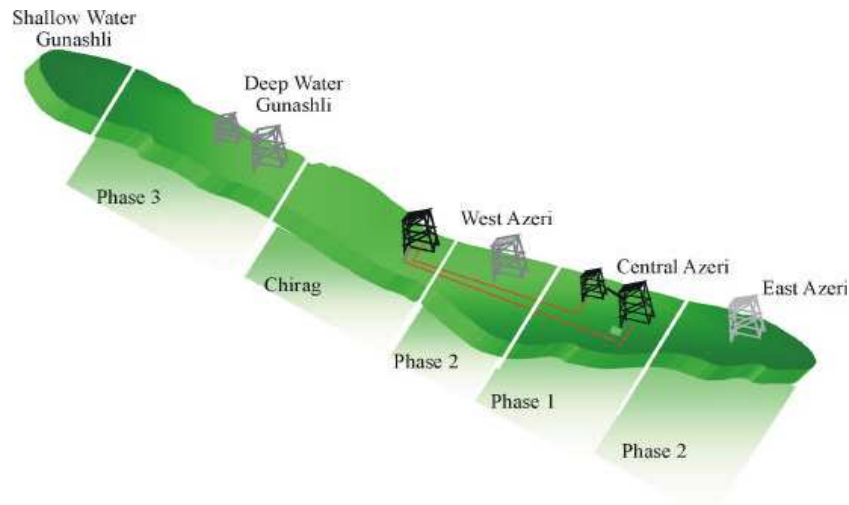
- Azerbaijani government and
- Azerbaijani International Oil Consortium. This is a joint venture of 11 entities which included, the State Oil Company of Azerbaijan, BP, Amoco, Statoil, Turkish Petroleum, Amerada Hess, Unocal, Exxon, Pennzoil, Ramco PLC, LUKoil and Itochu Corp.

The objective of the consortium was to operate a 30-year exclusive concession to develop Azeri, Chirag, and Gunashli. It was believed that between them these fields

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<sup>6</sup> “Azerbaijan-Pipeline Knocked Back,” *Project Finance International*, 3/24/99, p. 45.

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may contain between 4.5b and 5.0b barrels of oil.



b. Possible models that may have fit this transaction

When analysing the various options that could be deployed e.g. incorporated or unincorporated joint venture; or the type of finance to be used corporate or project, significant assistance can be gleaned from the work of Benjamin Esty<sup>7</sup>.

He identified that in adopting project finance as the solution one had resolve both an investment and financing decision.

It was evident; he considered that the use of project finance would serve to mitigate the prospect of under investment in projects carrying a positive net present value, due to the fact that project returns were allocated to fresh capital sources in a manner different to that employed in corporate finance scenarios.

Had the newly merged BP / Amoco proceeded by way of internal funds then there would have been a higher risk that, had the project fallen into difficulties, that potentially “toxic” assets could drag an otherwise healthy BP/ Amoco into distress.

In the event that the Finance Committee adopted the route of internal funds then its risk management would most likely have been managed by way of the use of financial instruments or derivatives. Alternatively risk when project finance is the route adopted is managed more often by reason of changes in organizational form. Considerations relevant to the Azerbaijani scenario include the economic viability of purchasing risk management financial securities.

Under project finance, project equity is concentrated and privately held to ensure that critical deal participants do not act opportunistically. Sponsors use concentrated ownership, unique boards of directors, separate legal incorporation, and high leverage to limit managerial discretion. Concentrated debt and equity ownership provide critical monitoring of managerial actions. By using bank debt instead of public bonds, sponsors gain the benefits of creditor monitoring.

<sup>7</sup> The Economic Motivations for Using Project Finance by Benjamin C. Esty First Draft: April 19, 2002 Current Draft: February 14, 2003 [www.people.hbs.edu/besty/BCE%20PF%20Motivations%202-14-03.pdf](http://www.people.hbs.edu/besty/BCE%20PF%20Motivations%202-14-03.pdf)

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This combination of structural features effectively control managerial discretion at the project level. Relative to corporate governance systems, project governance systems are much more effective at eliminating wasteful expenditures, discouraging sub-optimal investment, and inducing coordinated, value increasing effort.

The probability that opportunistic behaviour or expropriation will reduce cash flows intended for capital providers is a function of project structure.

Alternatively, corporate financed transactions are more susceptible to expropriation and delay for many reasons. Even as in the Azerbaijan International Operating Company scenario, they are susceptible to cash flow problems unless they raise external debt tied to the project.

Another point of difference between project and corporately financed positions is that expropriation can occur in corporate financed transactions without triggering an event of default because multiple corporate assets and cash flows that cross-collateralize each debt obligation. However, even small acts of creeping expropriation can cause a highly leveraged project company to default. Accordingly an acquisitive sovereign power may be more reticent in upsetting the delicate structure in a transaction funded by project finance because of the greater likelihood that this act of expropriation may jeopardise the project as a whole.

Managers at BP Amoco described the decision to use project finance as equivalent to the decision to buy a “*walk away*” put option on project assets.

Even if the put is priced fairly, the sponsoring firm may be willing to buy it as a way to reduce the incremental distress costs. The cost of the put could easily be less than its value to the sponsoring firm because of these incremental distress costs. The banks, which are selling the put, collectively bear lower incremental distress costs. If the sponsoring firm does not have the ability and the willingness to exercise the put option, then it does not make sense to buy the put i.e., to use project finance.

Having the option to walk away at some point in the future can be valuable even if the sponsoring firm would not or cannot walk away at the present time.

BP Amoco considered that its investments in oil field development to be “strategic assets”. Consequently it was highly unlikely to walk away from them.

The merged BP Amoco resolved rarely to use project finance. It resolved only to use project finance when the assets were very large or subject to significant sovereign or technical risk, in which case a project failure could impose substantial distress costs on the firm.

### **3. Corporate or Project Finance**

When considering the type of finance to be used that is internal funds or project finance, the decision makers need to match the financing to the activity to be financed.

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Downstream activities such as petrochemical plants and power generating facilities which have cash flows inwards and outwards set by long-term contracts are more likely to attract project finance, than upstream activities where the reserves have not yet been proven.

Project finance has disadvantages in terms of costs, time and rigidity however it has advantages in relation to the risk management. It costs more, it takes longer to arrange, has restricted managerial flexibility and requires greater disclosure.

Costs are usually higher in project finance than corporate finance. Upfront fees are usually required to be paid to lenders. Interest rates are usually higher e.g. 400 basis points over LIBOR as opposed to paying slightly less than LIBOR.

An advantage that project finance has over corporate finance is the rigidity it places on the parties by way of 3<sup>rd</sup> party monitoring. In a region where there is alleged to be rampant corruption, this rigidity in requiring engineers reports to be delivered to lenders; whereby sponsors certify the quality of project designs, the feasibility of the project schedule and the existence of hydrocarbon reserves are useful constraints upon in-country parties of all descriptions. These extensive reporting and operating requirements placed on borrowers restricted the in-country parties ability to change design or dispose of assets.

However, the structuring of a multi-party project finance deal will take much longer than a corporate finance deal. This time scale is further extended when it is not merely the sponsors who are multi-party, but also the lenders.

The BP Amoco business unit was required to determine whether a project had a positive net present value using the pre-determined corporate weighted average cost of capital formula. In doing so it assumed a debt to capitalisation ratio of 30%. The finance group made recommendations upon the project to the specialised finance team who then assessed the various financing structures using an incremental cost analysis.

#### **4. Pre-1998 and the Merger between BP and Amoco**

The Azerbaijan International Operating Company was granted an exclusive concession<sup>8</sup> to develop the Azeri, Chirag, and deepwater Gunashli subject to satisfactory results from a

1. Seismic survey
2. Environmental impact study, and
3. Series of test wells.

Following the above the Azerbaijan International Operating Company was required to submit a detailed development proposal, which in the event consisted of 4 incremental stages

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<sup>8</sup> Ramco Energy p.l.c. Prospectus dated 3/10/97, pp. 41, 47.



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- a. Early Oil Project
  
- b. Full Field Development Project

I / Part I

Scheduled to commence in 2000 this was budgeted to cost, possibly as much as US\$ 3.1b and raise production to 0.3b bpd by 2003<sup>9</sup>

II / Part II

The development of the Gunashli field was timetabled to commence in 2002 and cost around US\$ 3.0b, and would raise production to a total of 0.6b bpd.

III /Part III

The development of the Azeri field was timetabled to commence in 2003 / 2004 and cost US\$ 2.0b raising total production to 0.8b bpd by 2005.

The additional production to raise capacity from 0.3b bpd –to- 0.8b bpd would require additional investment<sup>10</sup>.

Additionally the Production Sharing Agreement

- created a revenue sharing agreement for output and
- a special tax regime for Azerbaijan International Operating Company in lieu of other local taxes.

- a. Early Oil Project

Apart from the component of a pipeline through Georgia, this was, completed by March 1999. It related to the development of the Chirag Field and included: -

- restoring an offshore production platform,
  - drilling fresh wells,
  - constructing a 105-mile sub-sea pipeline to an onshore terminal.
  - rebuilding two export pipelines to the Black Sea
    - 750-mile northern route to the Russian port of Novorossiysk and
    - 550-mile western route to the Georgian port of Supsa
- They produced as planned 0.1m bpd but had cost 90% more than budgeted for at US\$ 1.9b<sup>11</sup>.
- constructing an export terminal at Supsa.

<sup>9</sup> Dorsey, James M. "Pipeline Flap May Clog Expansion in the Caspian Sea," *The Wall Street Journal*, 8/11/99, p. A14.

<sup>10</sup> "Azerbaijan-Pipeline Knocked Back," *Project Finance International*, 3/24/99, p. 45

<sup>11</sup> The \$1 billion estimate is from the Ramco Energy p.l.c. *Prospectus* dated 3/10/97, p. 37; the final cost of \$1.9 billion is from the EBRD's web site at: <http://www.ebrd.com/english/opera/PSD/PSD1998/238chirag.htm>.

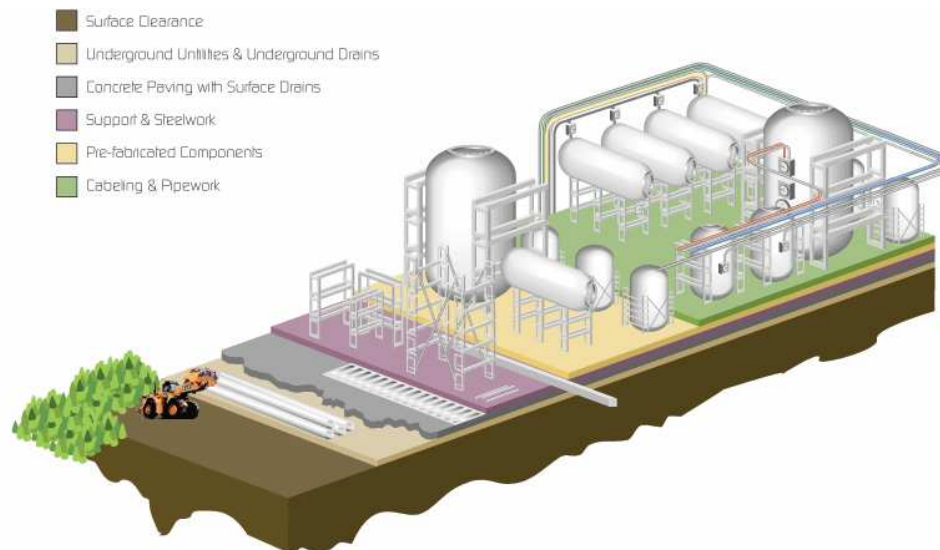
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b. Full Field Development Project - Part I

The Azerbaijan International Operating Company adopted an unincorporated joint venture structure<sup>12</sup>. Each party had a fixed percentage share obligation to contribute towards funding the US 1.9b cost of the Early Oil Project, and an equivalent relative percentage share to receive off take.

Limited recourse was achieved by each party creating its own Special Purpose Vehicle. Co-ordination was achieved by the parties creating a further, joint Special Purpose Vehicle to conduct the Operation and Management of the project

In this stage there objective was to build the Shah Deniz gas Export facility



The manner adopted for funding was 48% Corporate Finance with BP investing US 325m.

The remaining 52% was invested by way of Project Finance. Amoco plus 4 other members of the Azerbaijan International Operating Company created a Mutual Interest Group<sup>13</sup> to seek loans in the sum of US\$ 400m via the International Finance Corporation and European Bank for Reconstruction and Development.

<sup>12</sup> Summary of Project Information, International Finance Corporation (IFC), 3/25/98, available at: <http://wbln0018.worldbank.org/IFCExt/spiwebsite1.nsf/9456cd2430750aa9852568890061df/d0/854c52d6e0f6d2858525688e0070d9ac?OpenDocument>

<sup>13</sup> "Azerbaijan Oilfield to Get International Finance," BBC Worldwide Monitoring, Interfax News Agency, Moscow, 2/18/99.

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This route, of seeking loans from development banks was chosen to mitigate political risk.

The loans were structured

- A - Direct Loans in the total value of US\$ 200; with US\$ 150m coming from the International Finance Corporation and European Bank of Reconstruction and Development and the remainder to be sought from commercial banks.
- B - Indirect Loans, as agent for syndicated banks in the value of US\$ 200m, comprised of US\$ 75m from commercial banks

## **6. Post the Merger between BP and Amoco**

Since the formation of the BP-led Azerbaijan International Operating Company in 1994, although by 2007, Azerbaijan had signed 24 Power Sharing Agreements with over 30 companies, it was accepted that the increase in the country's rate of oil production since 1997 came almost entirely from the BP operated Azerbaijan International Operating Company consortium. It was said that, "...*Among the multinational oil companies in Azerbaijan, BP have remained firmly in the driver's seat ever since the establishment of the Azerbaijan International Operating Company* ..."<sup>14</sup>

Following the merger of BP and Amoco the new policy statement of the finance committee for the merged company concluded that it shared a common preference for using internal funds to finance capital expenditures. Project finance was to be used to harm

1. Megaprojects;  
These were projects that were large enough to cause material harm to the company's earnings, debt rating and in the extreme, its very survival.
2. Projects in the politically volatile areas; i.e.  
Where there was a high degree of political risk, such as war, strikes, sabotage, and lack of property rights, direct or creeping expropriation or currency inconvertibility, where sovereign interference had to be deterred.
3. Joint ventures with heterogeneous partners, e.g. where partners had a weaker credit capabilities or where partners included host governments.

Guidance has been given as to why a party may seek to finance a project by means of Project Finance as opposed to Corporate Finance, however before reviewing this guidance one must first examine what is project finance. This has been defined by Benjamin Esty in his book *Modern Corporate Finance – A Casebook* as, "...*the development or exploitation of a right, natural resource, or other asset where the bulk*

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<sup>14</sup> BP in Azerbaijan: A Test Case of the Potential and Limits of the CSR agenda? 2007, Lars H Gulbrandsen, Arild Moe / [Third World Quarterly](http://commdev.org/content/document/detail/1789/) <http://commdev.org/content/document/detail/1789/>

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*of the financing is not to be provided by any form of share capital and is to be repaid principally out of revenues produced by the project in question....”*

Assistance is available as to which form of finance is best suited. It is said that one should examine, what it is that each party is seeking to obtain from the transaction. In the Azerbaijani context, the Writer believes that significant relevant factors included:-

A Host government

- 1) To satisfy the national interest and have the project completed (to the government's specifications) as soon as possible.
- 2) To reduce or eliminate the need to use the government's own funds or borrowings.
- 3) Generally to transfer the risk from the public sector to the private sector.

B Azerbaijan International Oil Consortium

- 1) To make profit.
- 2) Secure upstream or downstream integration
- 3) To share the risk in carrying out the project
- 4) To retain control of the project for as long as possible in times of hardship.

a. Risk

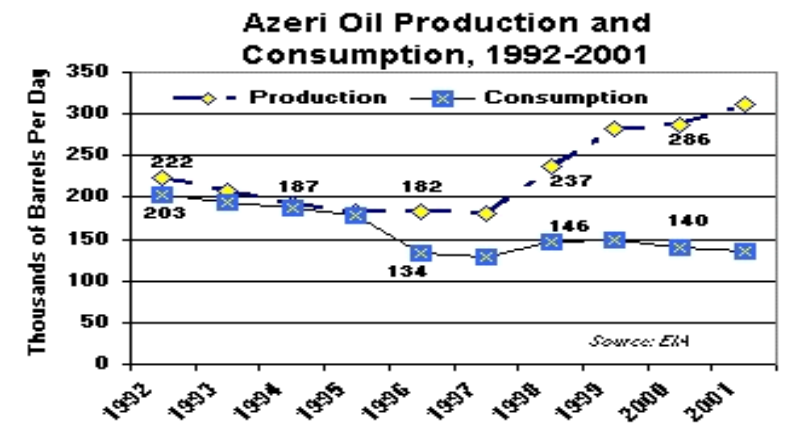
Under corporate finance, risk sharing is allocated by reference to the pricing structure, whereas in project finance the risk is placed upon the party most appropriate to bear that risk.

The elements that the BP / Amoco finance team will have considered will have included direct risk reduction, hedging, insurance, e.g. political risk insurance, financial execution and business insurance.

b. Financial Engineering.

The team will have reviewed the gearing advantages that accrue to project finance above corporate finance in that typically; on a corporate basis this was 30% debt-to-value, whereas with project finance it was as high as 70%.

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Azeri Oil Production and Consumption between 1992 and 2001<sup>15</sup>



c. Financing of the Early Oil Project following the BP / Amoco merger

The decision to be resolved was whether to and if so, by what manner to re-finance the Early Oil Project.

If the outstanding US\$ 73.8m was pre-paid by a combination of the issue medium and long term bonds and commercial bank loans this would it was felt produce significant cost savings in terms of money spent. However the requirement to comply with reporting requirements would not be removed and the loss of goodwill for the Azerbaijan International Operating Company generally with the International Finance Corporation and European Bank of Reconstruction and Development may not be in the overall interest of the project.

d. Positive attributes

In the event, the involvement of the European Bank for Reconstruction and Development considered its impact to be very significant.<sup>16</sup> The bank accepted its limited leverage in relation to reforming the overall economic climate in Azerbaijan, however it provided significant support to the Azerbaijan International Operating Company for the development of the Chirag and Guneshli production areas, offshore.

The bank felt that its involvement acted as a reassurance to other investors. It believed it had deployed an innovative financing and security structure that involved a major lending syndicate, which had strong upstream and downstream linkages.

<sup>15</sup> <http://www.azerb.com/az-oil.html>

<sup>16</sup> [www.ebrd.com/pubs/finance/retroa.pdf](http://www.ebrd.com/pubs/finance/retroa.pdf)

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e. Financing of Full Field Development Project - Part I

The contribution required from BP Amoco was US\$ 1.0b. Various funding strategies could be deployed

e.g. 50% from internal funds : 50% from project finance

This would give the company, the best and worst attributes of both avenues of funding.

Alternatively 100% project finance could be sought by BP Amoco, in conjunction with other members of the Azerbaijan International Oil Consortium. This would produce the best leveraged result for its investment. It would retain political risk protection but may be costly and extend the time before which the finance was closed and in place.

A 3<sup>rd</sup> possible route forward would have been 100% internal funds could be applied by BP Amoco. However BP would have to in adopting such a position be cognisant its position in Azerbaijan. It has been said that, "...BP is the leading foreign company in the country..."<sup>17</sup>

This option may reduce the goodwill between the other members of the Azerbaijan International Operating Company and the development banks. The remaining funds arranged by project finance may come with more stringent conditions which may increase the burden of operation and management generally. It may additionally aggravate the application for funding of Parts II and III. The dual financing strategy may give rise to separate or conflicts of interest between those who have funded internally and those who have funded via corporate finance. Tensions may arise between the various parties who may perceive BP Amoco to have benefitted from the enhanced political risk protection that is a by product of the project finance without having contributed financially to that level of protection.

f. Main Export Pipeline

The Concession was thought to contain between 4.5b –to- 5.0b of oil, however notwithstanding the necessity for a new pipeline to transport the oil recovered, it was initially considered that construction of an Main Export Pipeline would only be cost effective if there were proven reserves amounting to 6.0b barrels of oil.

Political considerations as well as timing, cost and financial responsibility were important issues in locating the route for the Main Export Pipeline. At a cost of possibly as much as US\$ 4b, the 1,080 mile route from Baku to Ceyhan on the Mediterranean via Georgia and Turkey, favoured by the US, Turkey, and Azerbaijan appeared potentially un-commercial.

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<sup>17</sup> BP in Azerbaijan: A Test Case of the Potential and Limits of the CSR agenda? 2007, Lars H Gulbrandsen, Arild Moe / [Third World Quarterly](http://commdev.org/content/document/detail/1789/) <http://commdev.org/content/document/detail/1789/>

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## 7. Project Risks

Risk diversification reduces a parties risk in a specific engineering and procurement project; however, the aggregate level of uncertainty for the consortium remains constant. The objective is by way of business and political risk assessments to achieve better investment decisions whereby uncertainty is reduced so that the operating results will improve.

Major risks that are particularly relevant to the oil industry include oil reserves and oil price. Specifically related to this project in Azerbaijan the risks also included transportation plus volatility in terms of its evolving economy and political model

### a. Political Risks

The nexus between the investment decision and political risk in the BP/Amoco project re-financing analysis would compare the level of political support provided the 2 alternatives of project finance set against corporate finance. These would be referenced against the standards applied in Azerbaijan for transparency, commitment and institutional maturity and thereby model their likely impact upon project revenues.

The legal system was emerging from Communist control and was as yet relatively untested in terms of corporate, insolvency and financial law generally.

The head of government of Azerbaijan, President Aliyev was firmly in control, but at aged 76, was unlikely to survive the life of the project. The identity of those who would follow him and the manner by which they would achieve and maintain power was uncertain. Consequently the effect that this transition would have upon the domestic economy generally, and the involvement of foreign oil companies in this project in particular, was uncertain.

Azerbaijan has been characterized as a “polyarchy”<sup>18</sup>, with immature bureaucratic institutions, unclear “rules of the game,” and uncertain lines of political succession. BP is well aware of the dangers having experienced creeping expropriation when it lost a US\$ 500m investment in the Tyuman oil fields of the Russian Federation. BP still in 2007 held the view that in Azerbaijan, the level “...of transparency on the government’s spending of oil revenues remains a major barrier to reliable oversight...”<sup>19</sup>

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<sup>18</sup> Michaud, Dennis Wright, Multinational Energy Firms in the Caspian Basin: A Bayesian Approach to Incorporate Political Risk in Corporate Strategy (February 1, 2005). Available at SSRN: <http://ssrn.com/abstract=555401>

<sup>19</sup> BP in Azerbaijan: A Test Case of the Potential and Limits of the CSR agenda? 2007, Lars H Gulbrandsen, Arild Moe / [Third World Quarterly](http://www.thirdworldquarterly.com/content/document/detail/1789/) <http://commdev.org/content/document/detail/1789/>

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There were simmering regional tensions, with

- Armenia generally,
- Russia and Iran, as to the beneficial ownership of natural resources.

Countries such as Iran, Turkey and Russia compete to secure the greatest share that they can of the Caucasian Energy Basin. To the countries that succeed will accrue strategic rewards. “The victor in the struggle will receive not only billions of dollars in the form of transit fees. The real gain will be control of over the pipeline which will be the most important factor of geopolitical influence in the trans-Caucasus and Central Asia.”<sup>20</sup>

b. Financial Risks

The Far East Financial Crisis that began in 1997 reached the Caucasus by the autumn of 1998. It had significantly affected the availability and cost of credit in Russia. LUKoil was owned by the Russian government and a 10% participant of the Azerbaijan International Oil Consortium

BP was cognizant of the risks involved in this project. Accordingly they proceeded by way of a syndicate and engaged in an incremental investment policy.

c. Transportation Risks

Transneft, a state-owned Russian company was a part owner of the northern and western pipelines. They could determine pricing and service and therefore could disproportionately influence operation and economic viability.

The Economist wrote: “*Azerbaijan is worried that the Russians will have a stranglehold, and the oil companies fret about security: even with a bypass (around Chechnya), the pipeline will still be within shooting distance of the unpredictable Chechens.*”

Although less capricious there would still be a measure of uncertainty if the oil passed through Turkey.

d. Industry Risks

In common with any upstream project this development carried risks in relation to

- Reserves, in terms of their actual presence and also in terms of the difficulty of extraction
- Price. When initially approaching this re-financing exercise BP Amoco had modelled on oil achieving a price of US\$ 14.00. In 1999, the price of oil

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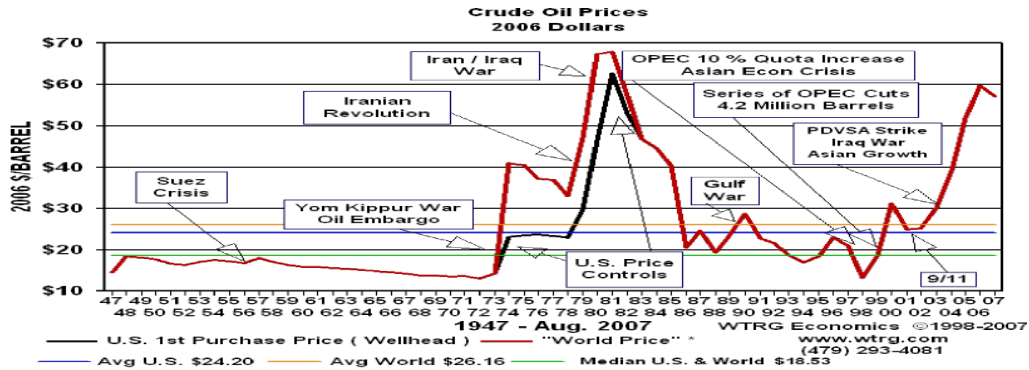
<sup>20</sup> Robert E. Ebel. Energy Choices in Near Abroad: the haves and have-nots face the future. 1997 CSIS Washington DC p37-38



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collapsed to a 25-year low of US\$ 10.00 per barrel. It was estimated that the cost of extraction of Caspian Oil amounted to US\$ 7.00 per barrel.

**World Crude Oil Price 1947-2007<sup>21</sup>**



e. Risk Management

Often many projects are structured deliberately to insulate the project company from as many risks as possible. E.g.

- Foreign-exchange risk, possibly by way of currency hedging
- Legal liability. If the Special Purpose Vehicle is merely a financial shell and gives a warranty to a 3<sup>rd</sup> party then the lender may require the substantive contractor to the Special Purpose Vehicle to also give an identical warranty to the Special Purpose Vehicle, a process known as 'back to back'
- Where possible the project company will seek to pass through any costs to the end user.

Having regard to the particular factual circumstances that applied to the Azerbaijan International Operating Company scenario, the merged finance team at BP Amoco will have considered many of the following factors and in the end, recommended that taking part in the Azerbaijan International Operating Company application for project finance, rather than applying internal funds was the most appropriate for those circumstances. Such factors included

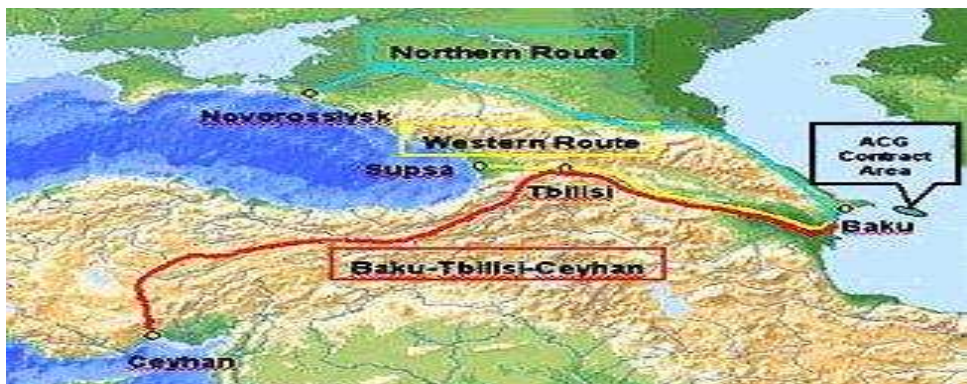
- (i) Provision for the concessionaire to vary the specification, with consequential provisions dealing with time and money.
- (ii) Provisions enabling the concessionaire to visit and inspect
- (iii) For the concessionaire or/host government to use its necessary compulsory purchase powers to transfer to the project company any real estate need of the project.
- (iv) An obligation on the concessionaire to carry out necessary parallel worlds e.g. if we're building a bridge then they need to build the connecting roads
- (v) Provision requiring the project company to commit access to the concessionaire to upgrade facilities, e.g. allow the telephone company to upgrade its line, along our motorway.

<sup>21</sup> WTRG Economics, Oil Price History & Analysis, <http://www.wtrg.com/prices.htm> - April 27 2008.

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- (vi) Provision for the payment by the project company of a concession fee.
- (vii) Provisions of the concessionaire to charge relevant fees in return for the project company delivering its service under the concession agreement.
- (viii) Provision for the concessionaire to have some control over the fees/fares charged by the project company, under its concession.
- (ix) A financial balance clause. This is a clause which they seek support the concession holder back in the same financial position he would have been in but the carers of certain risks which have been assumed by the person granting the concession. This financial balance clause has to address, the extent of the financial damage to be paid and how it is calculated, together with how the damage should be put right.  
In calculating the amount to be paid either a financial model can be used or one can determine the method by which it will be resolved i.e. litigation, arbitration or some other form of dispute resolution.  
As to how the damages to write this can be by way of a cash payment, extending the concession period, or increasing the tariff to be paid
- (x) Provision that allows the concessionaire to terminate, or, enter in and take control of the project if it runs into difficulties.
- (xi) Restrictions upon the transfer of shares by the shareholders.
- (xii) The concessionaire to agree and give assurances that the correct subsidy and taxation structure will be in place to ensure the project economically viable.
- (xiii) The amount payable to the project company if the project is terminated by reason of the default of the concession holder. Sometimes the concessionaire will limit the amount payable on a project company's default as being only that payable for the benefit of the banks. If so, one formula adopted is to pay compensation equal to the lesser of the amount due and owing to the banks (and any hedging counterparties) and the net present value of the project revenues.

In the end, the decisions taken were the correct ones. The pipeline was constructed<sup>22</sup> and carried its first shipment in June 2006. The pipeline stretches 1,768km from Baku in Azerbaijan to Ceyhan in Turkey, via Tbilisi in Georgia and can handle 1m bpd million barrels of oil per day.



<sup>22</sup> <http://www.itochu.co.jp/en/business/metal/project/03/>