

Caspian Oil and Gas

*Mitigating Political Risks
for Private Participation*

A WORLD FREE OF POVERTY

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The paper is an economic analysis of how to mitigate political risk to stimulate private investment in Caspian oil and gas reserves, and explores the macroeconomic implications of risk mitigation. It reviews the principal risks in both producing and transit countries in the region. The paper places emphasis on the need for domestic energy reform, and improved management of public finances, to mitigate risk. It underlines that countries with large reserves of gas, rather than oil, pose particularly high political risks for private investment. The paper surveys several methods for mitigating risk through policy reform and by involving official agencies. An annex to the paper describes how the World Bank Group is helping mitigate transit risk in Georgia.

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Caspian Oil and Gas: Mitigating Political Risks for Private Participation

The Context

1. Since the break-up of the Soviet Union created 15 new states in 1991, all espousing some form of market economy and opening to private investment, the Caspian region has attracted considerable interest in its oil and gas potential. This has inspired acres of newsprint, numerous books and academic papers, talk of a revived “Great Game”, and even a James Bond movie. However, amidst the often-exotic geopolitical speculations, down-to-earth economic analysis of how to mitigate political risk to stimulate private investment has been in somewhat short supply. This paper is intended to help redress the balance.

2. The need for private investment to realize the full potential of the region’s oil and gas reserves is beyond dispute. One estimate puts the total investment requirements at US\$ 140-200 billion (in more or less equal amounts for oil and for gas), of which only a few billion dollars have so far been committed.¹ These requirements are far greater than Caspian governments could mobilize in financing on their own account. Attracting such volumes of private investment into a landlocked, conflict-ridden region of fledgling states, inexperienced in market economics, is a massive policy challenge that has only begun to be faced. However, the economies of the region are likely to be trapped in a low-growth scenario, unless they meet this challenge.

3. There has been a tendency in some quarters to downplay the political risk factors attendant on such investment. It is argued that oil and gas companies are very accustomed to dealing with political risk, by virtue of where the world’s oil and gas reserves are concentrated, and that high levels of political risk are already factored into oil prices. This argument is generally combined with a perception that the hydrocarbon reserves of the Caspian region are so enormous that only the most extreme political risk would deter investment. The consequent prospect of substantially increasing non-OPEC production, from suppliers not dependent on political volatility in the Persian Gulf, has tantalized oil companies and Western policy-makers.

4. However, those reserves have been subject to substantial hyperbole. Total oil reserves of the Caspian Basin have been estimated as high as 200 billion barrels, but *proven* reserves are around 30 billion barrels. This compares to proven reserves in the Middle East more than 20 times larger (at almost 700 billion barrels). Total proven gas reserves in the Caspian region are around 10 trillion cubic meters (almost twice the US reserves), but marketing gas is a much greater challenge than for oil, due to high transport costs (see later). In short, the Caspian is probably not a new Gulf, but more likely a new

¹ “The Future of Caspian Oil: Can a “Great Game” be Averted?”, Cambridge Energy Research Associates, December 1997.

North Sea.² Indeed, its role may be to replace North Sea production as the latter declines, thereby keeping the share of non-OPEC production in world supply more or less constant.

5. It is worth emphasizing that the Caspian Basin's potential is substantially unproven. Each dry hole causes exaggerated pessimism, just as each discovery gives rise to unjustified optimism. These swings make level-headed policy-formulation more difficult, particularly in the midst of a *maelstrom* of geopolitical attention. The balance between oil and gas is also far from determined, which has huge implications for the economic potential of the region's hydrocarbon reserves.

6. Moreover, competition for investment has intensified in the last few years as a number of countries in the Middle East, Africa and Latin America – often with better-known operating environments and lower political risk than the Caspian Region - have become more open to foreign participation in their hydrocarbon sectors. In addition, the Caspian is not a low-cost region for hydrocarbon production; transport costs for export are high, offshore reserves are often in deep water, and most equipment has to be imported from outside the region.³ The low crude oil prices of 1997-99, and the consequent retrenchment of oil exploration in marginal areas, demonstrated how vulnerable Caspian oil and gas investment is to international downswings in a context of growing competition.

7. The Caspian countries have sometimes overstated their attractiveness to private investors. This is perhaps understandable for marketing (and political) reasons. However, it should not blind policy-makers to the need to be proactive to attract scarce investment to a region where risks are high. Governments can do little about market risk and nothing about geological risk, but political risks are to a considerable extent within their control. The ability of Caspian countries to realize their substantial oil and gas potential will depend critically on improvements in their investment climates through the mitigation of political risk (domestic and regional).

Political Risk in Producer Countries

8. The political economy of oil production gives rise to some specific risks. Oil production tends to employ relatively few people, and in Caspian countries, procures little of its equipment and supply needs locally. The primary linkage to the local economy, therefore, is through state revenues from the oil sector.

9. In the case of Caspian states, the governments' ability to allocate those revenues transparently to high-priority expenditures is often rather weak. Fledgling

² If Kazakhstan's Kashagan prospect and Russia's recent Caspian discoveries live up to expectations, the Caspian Basin may prove to be closer in magnitude to two North Seas, but will likely remain far below Middle East reserve levels.

³ This can impose substantial costs for bulky equipment; there is limited scope for river transport, and several railroads in the region are closed for political reasons (e.g. closure of the Azeri-Armenian and Turkish-Armenian borders means Azerbaijan has no continuous rail access to Turkey, Iran, or the Persian Gulf).

administrations lacking accountability, and with few staff trained in expenditure analysis or auditing, are prone to considerable corruption and waste. Large swings in oil revenues undermine already-rudimentary fiscal discipline.⁴ Weak parliamentary oversight of the executive, and the lack of an impartial and competent judiciary, mean there are few checks and balances against such behavior. Highly personalized and centralized political authority, combined with uncertainty over succession to high office and widespread patronage in public appointments, reinforce these tendencies.

10. This can give rise to a widespread popular perception that most of the benefits of oil are being captured by local elites in collusion with foreign investors, and that there is little impact on increasing the living standards of the majority of the population, who are excluded from participation in oil growth. Even worse, the growth of the oil sector may crowd out investment in the rest of the economy (for example, through exchange rate appreciation), leading to a *decline* in average incomes outside the oil sector. This phenomenon, known as “Dutch Disease”, may already be afflicting some Caspian oil producers, and is almost certain to be manifested once hydrocarbon revenues increase, unless governments take concerted action to prevent this.⁵

11. Even where there is little or no Dutch Disease, non-oil sectors in the oil producing countries of the former Soviet Union seem to be growing only as slowly as the economies of other FSU countries. The oil producers are thus becoming highly dualistic economies, with increasing inequality between those who participate directly in oil growth based primarily on exports, and those who are excluded. Over time, this can be expected to create political tensions.

12. In fact, the governments of the region are channeling very substantial oil and gas resources to their populations indirectly, perhaps partly in recognition of the popular perception of exclusion outlined above. This is being achieved through huge implicit subsidies in the energy sectors of those countries. Consumers pay very little for their electricity and gas (either through low tariffs or tolerance of widespread non-payments), and utilities in turn receive wholesale oil and gas at very low prices or accumulate enormous arrears to state oil companies, which are not likely to ever be paid.

13. This represents a massive subsidy to the population, but is so poorly targeted (i.e. spread so thinly) that it does relatively little to improve living standards (and perhaps not a great deal to improve perceptions of the oil sector). Such subsidies tend to trap resources in low-growth industries, retarding economic restructuring and growth of employment opportunities in the non-oil sector. In addition, the underpricing of energy creates ample opportunity for corruption by those with preferential access to energy supplies.

⁴ Temporary upswings in revenue tend to create permanent expenditure commitments (e.g. higher salaries), which then prove difficult to finance in a downswing. This asymmetry can easily overburden fiscal management and become inflationary.

⁵ Just as the fiscal effects of oil revenues are asymmetric between upswings and downswings, so are the exchange rate effects. Non-oil sectors wiped out during an exchange rate appreciation induced by an oil boom, are not easily restored when a downswing in the oil cycle causes a depreciation of the exchange rate.

14. This subsidy policy is not likely to be sustainable as utility infrastructure becomes highly unreliable through lack of funds for maintenance, and energy sectors become very short of working capital. Azerbaijan's 12-hour daily electricity blackouts in the winter of 1999/2000 are striking testimony to these trends (Azerbaijan devotes as much as 10 percent of GDP to such subsidies). The expansion of oil exports from Azerbaijan at a time when much of the population was in the cold and dark can have done little to enhance the popular image of the oil sector.

15. The same weaknesses in political institutions, which give rise to poor allocation of oil revenues, create uncertainty about the very property rights on which those revenues are based. Property right enforcement is notoriously difficult in Caspian countries, given the personalized nature of political authority, weak legal/judicial frameworks, and widespread corruption. In the case of foreign investment in the oil sector, there has been a strong tendency to overcome this through production sharing agreements (PSAs) which provide for extensive resort to international legal and judicial systems, and for immunity from changes in host country law. These PSAs tend to be ratified by parliament to give them the force of law (once presidential assent is given). However, such protection is obviously only as good as presidential/parliamentary authority and the rule of law are valid. To date attempted encroachments on the integrity of PSAs in the region have been fairly minor, but they may increase in significance when foreign investment is more entrenched, or as a result of political instability.

Political Risk in Transit Countries

16. Caspian geography dictates a high degree of dependence by producer countries on transit countries for export of oil and gas. This dependence is intensified by geopolitical forces and environmental concerns about oil shipping routes, which create pressures for pipelines that are not always by the shortest route to market.⁶ Some of the pipelines proposed involve a number of transit countries, which is exceptionally high, or even unprecedented, by comparison to elsewhere in the world.⁷ Transit is always risky, and Caspian transit countries are riskier than most.

17. Transit risk derives to a considerable extent from fundamental pipeline economics.⁸ Pipelines have (i) high fixed capital costs (construction, line pipe, terminals, acquisition of rights of way); (ii) low salvage values (pipelines have few alternative uses

⁶ Three of the five Caspian littoral states are landlocked (Azerbaijan, Kazakhstan, Turkmenistan). Russia and Iran have terminals (existing or potential) with direct access to the open seas, but much oil shipment from those terminals requires eventual passage through environmentally- or politically-sensitive straits (Bosphorus, Danish Straits, Straits of Hormuz)

⁷ Perhaps the most extreme example is the proposed Trans-Caspian Gas Pipeline, which involves four countries (Turkmenistan, Azerbaijan, Georgia, and Turkey) and transit across a territory with controversial property or use rights (the Caspian Sea itself). There are few, if any, examples of such transit complexity elsewhere in the world.

⁸ This analysis draws on the work of Professor Paul Stevens (University of Dundee). See for example, "A History of Transit Oil and Gas Pipelines in the Arab World: Lessons to be Learnt", Middle East Journal (Spring 2000). This article cites numerous examples of Middle Eastern pipeline disputes over transit issues, which should give pause for thought to Caspian pipeline analysts.

and limited scrap value); and (iii) low variable costs (costs of pumping, maintenance etc. are low in relation to capital costs). However, profit-maximizing behavior implies that operations will continue as long as variable costs are covered, and some contribution is therefore being made to otherwise unrecoverable fixed costs. Once pipeline operations have commenced, therefore, large unilateral increases in transit fees⁹ can often be imposed by the host country without making continued operation uneconomic. Since oil and gas production usually involves high rents, the potential for forced capture of part of those rents by transit countries is thus very high.¹⁰

18. A number of economic factors affect the degree of transit risk. If the transit fees from a pipeline represent a high proportion of government revenues (particularly of scarce foreign exchange revenues), the temptation for the host government to take unilateral action is obviously high.¹¹ On the other hand, governments would need to take into account that such unilateral action could deter other foreign investment. However, most Caspian governments are in a weak fiscal position, are not experienced in making such trade-offs between revenue and investment (therefore the risk of a “mistake” is high), and tend to operate with short political horizons (thus greater revenue now is worth much more than greater investment later). In addition, foreign investment is occurring largely in the high-rent oil sector, in which the deterrent effect may be relatively low.

19. Transit country behavior is also affected by whether the country has offtake from the pipeline. Potential loss of supplies for offtake may inhibit unilateral action. This tends to be more a factor for gas than for oil, because alternative oil supplies are more often available (for the transport cost reasons outlined below). In addition, resumption of gas supply after temporary disconnection is expensive for safety reasons, which could deter actions that may invoke a cut-off. However, most gas pipeline proposals in the Caspian region involve transit countries that already have alternative gas suppliers. Moreover, transit countries cannot be cut off without simultaneously cutting off countries further along the pipeline. The threat of loss of domestic offtake is therefore unlikely to be a strong disincentive to unilateral action by gas transit countries in the Caspian region.¹²

20. Perhaps the strongest incentive for “good behavior” on the part of transit countries is the availability of alternative pipelines for producers. This point is well-captured by the Baku bumper sticker, “Happiness is Multiple Pipelines”. In several cases of proposed pipelines in the Caspian region, alternatives either already exist or could be created at relatively low cost by connecting to existing systems.¹³ The propensity of some

⁹ Pipeline terminology is not used with absolute consistency. However, in general, a “transit fee” is a tax paid to a host government for use of a pipeline right-of-way. A “tariff” is a user charge paid to the operator of a pipeline by a shipper of oil or gas through that pipeline. The analysis presented here for transit fees could be applied equally to tariffs charged by pipeline operators owned or controlled by the transit country government.

¹⁰ This potential is greater for oil than for gas since the rents tend to be higher for oil.

¹² “Losses” of Russian gas transited through Ukraine and Georgia, and arrears for Russian gas supplies to those countries, are good examples of the weakness of this disincentive.

¹³ For example, the Russian and Iranian pipeline networks (both oil and gas).

governments in the region to subsidize pipeline construction heavily, although wasteful on the whole, does serve to enhance discipline on competing transit countries.¹⁴ In general, the high degree of transit competition in the Caspian region should help to induce good behavior. On the other hand, some of the alternative transit options involve crossing competing producer countries.¹⁵ This competition reduces the attractiveness of such transit, since a competing producer may disrupt transit to enhance its own market prospects.

Gas-Specific Risks

21. Gas costs about seven times as much to transport as oil, due to its lower energy density. This means that, while oil just needs to be transported to the nearest terminal and then shipped for sale in international markets, gas tends to be restricted to regional markets.¹⁶ As a result, gas producers are much more likely to be captive suppliers than oil producers, and will enjoy correspondingly lower rents.

22. If Caspian hydrocarbon reserves turn out to be much richer in gas than expected a few years ago when the region opened up to foreign investment, this has enormous macroeconomic implications. The recent Shah Deniz gas discovery suggests that the adjacent portion of the Caspian may be much richer in gas than oil. The whole region may be very rich in gas with Turkmenistan, Russia, Azerbaijan, Kazakhstan, Iran, and perhaps eventually Uzbekistan, all competing to offload large volumes. Unfortunately, most of the gas-deficient markets in the region, except for Turkey, suffer from very high non-payments due to lack of economic restructuring and weak enforceability of contracts.¹⁷

23. The non-payments issue poses both commercial and political risks. The commercial risk is straightforward: companies cannot sell much gas in the host country, and are therefore restricted largely to the highly-competitive Turkish market, in which they are very much a price-taker (or may even be crowded out by competition).¹⁸ The

¹⁴ There appears to be a growing tendency for governments in the region to build or plan to build pipelines with subsidized financing, substantial tax breaks, or government guarantees. Examples include Yuzhne-Brody (Ukraine), Chechnya bypass through Dagestan, Blue Stream, Baku-Tbilisi-Ceyhan, and the pipeline from Neka on Iran's Caspian coast.

¹⁵ For example, Russia, Iran, and Azerbaijan (for Turkmen gas).

¹⁶ In some cases, the option exists of liquefaction at a terminal near the wellhead and shipment to a regasification plant near the market. However, there is very limited economic scope for liquid gas exports in the Caspian region due primarily to the distance of wellheads from terminals.

¹⁷ For Azerbaijan, the worst-case scenario is to be very rich in gas and outcompeted in the Turkish market. In this scenario, Azerbaijan's macroeconomic prospects might not be substantially better than an average non-hydrocarbon producer in the former Soviet Union, because other paying markets may simply not be available.

¹⁸ Indeed, in some cases in the Caspian region, the foreign investors' commercial rights to any gas discovered are unclear. For example, production sharing agreements in Azerbaijan give all rights in associated gas to the State Oil Company of the Azerbaijan Republic (SOCAR), and "associated" tends to be defined in very broad terms (so that many gas discoveries could fall within this definition by virtue of even quite low liquid content).

political risk is at least two-fold. First, companies may be forced to dump gas effectively free-of-charge in the host country market to assuage popular opposition to the export of gas while supplies are restricted domestically. Second, where gas is associated with oil, recovery of the oil may require flaring or venting of gas for lack of paying markets (or lack of financing for infrastructure to process and transport that gas, due to lack of paying markets). The resultant pollution imposes an international reputational risk for the companies concerned. This is of increasing concern to major oil companies considering investment.

24. In short, gas-based development will require a paradigm shift for Caspian governments and for companies investing in the region. The current approach, in which the oil sector operates largely in isolation from the domestic economy, will not work for gas. Macroeconomic optimism based on the prospect of massive oil exports to international markets, may need to be moderated substantially for a scenario in which reserves are predominantly gas.

**Box 1:
Demand Prospects in the Turkish Gas Market**

Proven gas reserves in the Caspian region already represent a significant resource. Exploitation of these reserves, however, will be dependent on securing assured market outlets for the gas. The market that offers the greatest near term prospects for additional gas sales is Turkey. In pursuing this market, however, the Caspian producers face both significant uncertainty with regard to the demand outlook and intense competition on the supply side.

Turkey is experiencing rapid growth in its energy demand. Over the past ten years, electricity demand has grown at a rate of about 9% per year and this rate of demand growth is expected to decrease only slowly. Much of the future electricity supply is projected to be based on gas. Gas demand is currently supply constrained and Turkey has pursued a policy of securing access to future imported gas supplies from a variety of producers. As part of this process, Turkey has entered into take or pay agreements that have been ratified by parliament that will involve the supply (at a plateau level) of 45 billion cubic meters (BCM) of gas per year. In addition Turkey has entered into an agreement to purchase 16 BCM delivered via the proposed trans-Caspian pipeline and has had other discussions involving possible supplies from Kazakhstan, Azerbaijan, Iraq and Egypt.

While gas demand in Turkey is expected to grow rapidly, provided the necessary investments are made to transport and utilize the gas, there is a rather wide range in the estimates of the pace of demand growth. Demand projections for 2010, for example, range from 27 BCM up to the BOTAS forecast of 53 BCM. There is a distinct possibility, therefore, that Turkey will be unable to consume all the gas it has contracted for and that access to the Turkish gas market in the near term will be limited to volumes associated with the first projects to deliver gas to Turkey. It remains to be seen whether Caspian supplies can be competitive in this race.

Risk Mitigation through Institutional, Policy and Legal Reform

25. Caspian states can provide substantial risk mitigation to private investors in the hydrocarbons sector through more prudent fiscal management. Building institutions, which will allocate large hydrocarbon revenues wisely, will do much to improve the popular image of the sector. This will require a range of reforms of budgetary management, accounting and auditing, which would be needed even if existing systems were not to be overwhelmed by such revenues.

26. It may also require special mechanisms such as an “oil fund”. In essence, an oil fund is an institution which receives oil revenues by law, and decides how much to save and how much to spend. Careful saving of oil revenues in boom years, and subsequent expenditure in lean years, can mitigate the inflationary bias and exchange rate instability described above. Expenditures from the oil fund should be subject to the prioritization process of the overall government budget, but can be labeled as having been oil-financed. This can help the population see the linkages between oil production and wider socioeconomic development.

27. Better fiscal management should also reduce the importance of oil-related revenues, as other tax bases are developed and expenditures are rationalized. This will help to protect the sector from government temptation to increase unilaterally the tax obligations of the sector. This is of particular importance in transit countries for the reasons noted above.

28. In parallel to fiscal reform, Caspian governments need to reduce the wasteful, poorly-targeted subsidies currently being channeled from upstream oil and gas through the rest of the energy sector. This quasi-fiscal resource flow tends to be very large, and could achieve much greater poverty alleviation impact if allocated more deliberately and transparently. This would also help create a more reliable energy supply, and reduce opportunities for rent-seeking. As such, oil wealth could be associated with economic prosperity, honesty, and efficiency rather than the converse. This could do much to reduce political risk.

29. Policy reforms which could achieve these objectives include strategic investor privatization of energy utilities (to overcome non-payments), creation of competitive energy markets and regulation of natural monopolies (to avoid excessive tariffs), and better-targeted social assistance (to offset increased cost-recovery by utilities). In gas-consuming utilities (gas distribution, gas-fired electricity generation), such reforms would increase the paying market for gas, thereby mitigating some of the gas-specific risks described above.¹⁹

¹⁹ Of the Caspian oil and gas producers, only Kazakhstan has made significant progress on such reforms (albeit with regulatory deficiencies, which have given rise to investment disputes). Given that implementing a comprehensive energy reform program can easily take 4-5 years, the lack of reform programs in the other Caspian states could seriously hamper upstream gas development.

30. Legal reforms, which enhance property rights, environmental management, and labor protection, as well as judicial reforms to improve enforceability, would help mitigate investor risk and increase the host country benefits from investment. Over time, host countries could move away from the ratified PSAs, which provide apparently strong political risk mitigation, but do so only through a perceived loss of sovereignty (which imposes its own political risk). This will require *inter alia* sound investment and tax legislation (including probably a specific petroleum law reflecting best international practice), strong civil codes and other legislation underpinning contractual rights, enhanced labor law, and improved legislation on environmental standards and liabilities. For pipelines, it may also require improvements in land legislation.

31. Building the capacity of institutions that interface with the hydrocarbons sector can mitigate political risk. Most Caspian states have succeeded in establishing small expert teams with a good understanding of the international oil business, but their understanding has not always been well-disseminated to the myriad other government institutions which come into contact with the sector. In addition, the dearth of experienced officials has meant that those with experience tend to combine regulatory and commercial functions, which should ideally be divided to prevent conflicts of interest.

32. Perhaps the most important way to mitigate political risk is to negotiate balanced agreements at the outset, which allocate risk and reward appropriately between host governments and foreign investors. In the midst of geopolitical pressures and uncertainty about competing projects, this is often difficult to achieve in the Caspian hydrocarbon sector. It is made no easier by the often short-term horizons of political decision-makers within the region and outside, and by the sometimes similar horizons of oil company executives, all endeavoring to bring complex projects to closure. Those short-term factors can overshadow the fact that hydrocarbon projects often have a potential life of several decades. Agreements which are not designed to have a good chance of enduring changes of government and major economic fluctuations can prove very disruptive to a host country's political life and investment climate, as well as to the fortunes of the investor. The history of the oil industry is replete with examples.

Risk Mitigation Through Official Agencies

33. In some cases of Caspian hydrocarbon investments, the investment framework will mitigate risk sufficiently to permit the investment to go forward. In other cases, particularly those involving transit pipelines, risk mitigation instruments from official agencies may be needed for the investments to be able to mobilize sufficient private equity, commercial financing or private political risk insurance. Such official agencies include multilateral and bilateral development banks, as well as export credit agencies.

34. The agencies offer a range of risk mitigation instruments: direct loans, loan syndications, guarantees, equity, and insurance. The principal agencies active in the

region, and offering private sector risk mitigation, include the World Bank Group²⁰, European Bank for Reconstruction and Development (EBRD), Asian Development Bank (ADB), European Investment Bank (EIB), Overseas Private Investment Corporation (OPIC), and export credit agencies (such as ECGD, JBIC, US Exim, Coface, Hermes, EDC, and SACE).²¹

35. Although the risk mitigation instruments differ substantially in scope, they are similar in one key respect: the involvement of public sector agencies can give a unique degree of protection to private investors – a so-called “halo effect”. In essence, a government’s breach of its obligations to foreign investors becomes *de facto* or *de jure* a breach of its obligations to foreign governments (either individually or collectively), and can have broad implications for that country’s access to official financing and to capital markets. In the Caspian region, where capital market access is fragile and relations with foreign governments highly important for geo-strategic reasons, the halo effect could have particular value. However, it should not be seen as a substitute for reducing risk through institutional, policy and legal reform.

²⁰ The World Bank Group consists of (i) the World Bank, which finances governments or provides guarantees to commercial lenders against government counter-guarantees (the Bank is divided into the International Development Association lending to or providing guarantees for the poorest countries, and the International Bank for Reconstruction and Development doing this for all other member countries below a certain income threshold, or for the poorest countries on an “enclave” basis); (ii) the International Finance Corporation lending to the private sector or taking equity; and (iii) the Multilateral Investment Guarantee Agency insuring the private sector against political risk.

²¹ The official agencies, and the instruments which they can provide, are comprehensively described in, “Project Financing and Risk Mitigation for Caspian Pipelines: A Guide to International Financial Institutions, Export Credit Agencies, and Political Risk Insurers”, Management Strategies Inc. (report for the US Trade Development Agency and the World Bank).

Annex: The World Bank Group and Transit Risk Mitigation: The Case of Georgian Pipelines

36. Georgian cooperation with the World Bank Group over pipeline transit began in 1995. At that time, the Government of Georgia and the Georgian International Oil Corporation (GIOC, the state agency responsible for oil pipeline transit) requested financing on an urgent basis for short-term advice in their “Early Oil” negotiations with the Azerbaijan International Operating Company over the Baku-Supsa pipeline.²² GIOC was newly-established, and Georgia was undertaking its first involvement in a privately-financed large infrastructure project. This collaborative effort with the Bank later developed into a range of cooperation with the Bank Group to build institutions, enhance the policy framework, and to finance investment in infrastructure.

37. In 1997, Georgia and the World Bank agreed on an Oil Institution Building Project. The Bank credit financed a feasibility study of a potential Baku-Supsa major export pipeline (MEP), as well as financial and legal advisors for MEP negotiations.²³ The feasibility study covered economic, financial, legal, engineering and environmental issues, and provided GIOC with substantial training in those disciplines. It also involved the extensive use of Georgian consultants (particularly environmental scientists) alongside international experts, ensuring that local knowledge was incorporated and that technology was effectively transferred. In addition, a National Oil Spill Contingency Plan is being prepared under the Integrated Coastal Zone Management Project financed by the Bank.

38. The training provided by the Baku-Supsa feasibility study helped to prepare GIOC for the negotiations of the Baku-Tbilisi-Ceyhan Intergovernmental and Host Government Agreements (IGA and HGA respectively). This was complemented by internationally-experienced negotiations advisors. The Georgian Government and GIOC were thus able to formulate negotiating positions in a much better-informed manner than had been the case for Early Oil. It could be argued that mutually-acceptable and sustainable compromises could be more easily reached in this way. In short, institution-building at GIOC has mitigated Georgian transit risk.

39. Prior to the commencement of negotiations, GIOC coordinated policy reforms that laid the foundations for a more effective and advantageous set of transit arrangements. This was supported in 1999 by the Energy Sector Adjustment Credit (ESAC) from the Bank, which underpinned key legal reforms (identified, in part, by the Baku-Supsa MEP feasibility study). In particular, laws were adopted providing for eminent domain procedures (compulsory purchase or easements in the public interest)

²² The Azerbaijan International Operating Company (AIOC) is a consortium of SOCAR and 11 foreign oil companies.

²³ The Bank credit to Georgia for the Baku-Supsa MEP feasibility study was in parallel to a Bank loan to Turkey for a Baku-Ceyhan MEP feasibility study.

and for environmental liability in case of transportation of hazardous substances (including oil). In addition, Georgia ratified a number of important international treaties related to oil spills.

40. The law on eminent domain allowed Georgia to negotiate provisions in the Baku-Tbilisi-Ceyhan HGA that avoided exposing the Government to any significant costs in acquisition of land or access rights for the pipeline corridor. Those provisions in the HGA, and the law on eminent domain, should ensure that private landowners whose land is needed for that corridor will be adequately compensated by the pipeline investors. The law on transportation of hazardous substances ensures that polluters pay for any pollution. It imposes “strict” liability on a pipeline operator, such that the operator is obliged to clean up oil spills and compensate for damage, even if that damage were caused by a third party (the operator can then seek restitution from the third party). The law should ensure that any pollution is cleaned up quickly, and that parties suffering loss can claim compensation. The law’s provisions were incorporated in the HGA.

41. Overall, the legal reforms supported by the ESAC ensured that negotiations resulted in a more balanced agreement, and that difficult land acquisition and environmental issues could be handled in a less contentious manner in the project implementation stage. More fundamentally, this process moved Georgia away from negotiating the conditions of private infrastructure investment on a case-by-case basis towards establishing an overall incentive framework based on the generally-applicable rule of law.

42. In parallel, IFC provided financing for Early Oil development in Georgia (and Azerbaijan) with a US\$ 100 million “A” loan on its own account, and catalyzed a US\$ 100 million syndicated “B” loan (for which IFC was the lender of record). The loans were made in 1998 to five of the members of AIOC.²⁴ This established that the Bank Group could participate in the financing of a complex Caspian oil development, thereby reducing investment risk in the region and creating a precedent for possible future Bank Group involvement.

43. At the same time, preliminary discussions have been underway concerning Bank Group financing and guarantees for the MEP in Georgia. Although no commitments have been made, these discussions have created an understanding between Georgia, potential investors, and the Bank Group about what features of the MEP project would facilitate Bank Group involvement (likewise for Azerbaijan and Turkey). This has focused on the need for the project to be in the host country’s economic development interests, to observe high standards of environmental management and social impact mitigation, and for commercial agreements to be balanced enough to promote sustainability.

²⁴ Amoco (now BP Amoco), Exxon (now ExxonMobil), Lukoil (second largest oil company in Russia), TPAO (state oil and gas company of Turkey, which was treated by IFC as a private enterprise when operating outside its own country), and Unocal.

44. Georgia and the Bank have also cooperated in gas pipeline transit. The Structural Reform Support Project has provided funding for financial and legal advisors for the Georgian Gas International Corporation (GGIC, the state agency responsible for gas pipeline transit) to better assist the Government in transit negotiations. The ESAC catalyzed creation of a regulatory framework for the domestic gas sector to prepare the way for strategic investor privatization of gas distribution. Similarly, the ESAC supported privatization of a 600 MW gas-fired electricity generation plant. The expected improvement in payment for gas consequent on these privatizations should help Georgia negotiate better offtake and transit terms. The ESAC-supported legislation on eminent domain and environmental liability outlined above should also improve gas transit arrangements.

45. In these various ways, the Bank Group has developed effective relationships with both public agencies and private investors involved in pipeline transit across Georgia. This has formed part of very extensive lending and advisory services provided by the Bank Group to Georgia across a wide range of sectors. The Bank Group has thus been well-placed to play an “honest broker” role in facilitating pipeline development in Georgia, thereby mitigating risk for investors, the host government, and other pipeline participants.



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