

# INTERNATIONAL ALERT

## Oil and the Search for Peace in the South Caucasus: The Baku–Tbilisi–Ceyhan (BTC) oil pipeline

December 2004

## Acknowledgements

The following research document is a result of 18 months intensive work of International Alert's Business & Conflict – BTC Research project team: Adam Barbolet, Davin Bremner, Phil Champain, Rachel Goldwyn, Nick Killick, Diana Klein.

The team would also like to thank many other Alert staff past and present, as well as the following regional experts who significantly contributed to the project.

Burcu Gultekin

Ashot Khurshudyan

Razi Nurullayev

Zviad Shkvitaridze

Arif Yunusov

Staff of Himayadar- Oil Information & Resource Centre in Baku

The project team is grateful to the UK government's Global Conflict Prevention Pool (GCPP) for its generous financial support.

# TABLE OF CONTENTS

<b>Acknowledgements</b> .....	2
<b>Acronyms</b> .....	5
<b>Executive summary</b> .....	7
<b>1. Introduction</b> .....	24
1.1 The contribution of the oil industry to conflict prevention – emerging conflict-sensitive management systems .....	25
1.2 Balancing macro and micro perspectives .....	28
1.3 A peace pipeline? .....	29
1.4 Challenges posed by the political economy of the South .....	30
Caucasus .....	30
1.5 International frameworks influencing TNCs in conflict zones.....	32
<b>2. The BTC project</b> .....	34
2.1 Basic parameters .....	34
2.2 BTC consortium profile .....	34
2.3 Finance .....	35
2.4 Legal framework .....	36
2.5 Security.....	36
2.6 Construction contractors and local content .....	37
2.7 Employment.....	37
2.8 Project-affected communities .....	38
2.9 Community and environmental investment programmes .....	39
2.10 Revenue management .....	40
<b>3. Context</b> .....	42
3.1 International level .....	42
3.1.1 Russia .....	43
3.1.2 Azerbaijani Diaspora in Russia .....	44
3.1.3 The US .....	45
3.1.4 Turkey.....	47
3.1.5 Armenia .....	48
3.1.6 Armenian Diaspora .....	50
3.1.7 Armenians from Nagorno-Karabakh .....	51
3.1.8 Georgia.....	52
3.1.9 Iran.....	54
3.1.10 The UK.....	55
3.1.11 Non-Governmental and Inter-Governmental Organisations.....	55
3.1.12 The EU .....	56
3.1.13 Norway .....	57
3.1.14 OSCE - Minsk Group .....	57
3.2 National level .....	57
3.2.1 Azerbaijani government .....	57
3.2.2 Other governing bodies .....	60

3.2.3 Opposition .....	61
3.2.4 Islamic faith-based groups .....	62
3.3 Local level .....	62
3.3.1 Rural population.....	62
3.3.2 Internally Displaced Persons (IDPs) .....	69
3.3.3. Ethnic minorities.....	70
3.3.4 Baku residents .....	71
<b>4. Links between oil and conflict: some future scenarios .....</b>	<b>72</b>
4.1 Introduction .....	72
4.2 Regional level – what framework? .....	74
4.2.1 Outlook.....	74
4.2.2 Oil industry response .....	76
4.3 National level – the struggle for transition .....	78
4.3.1 Outlook.....	78
4.3.2 Oil industry response .....	83
4.4 Local level – the search for economic security .....	85
4.4.1 Outlook.....	86
4.4.2. Oil industry response .....	86
<b>5. Recommendations .....</b>	<b>89</b>
<b>Annex 1 - Methodology used for analysing oil/conflict impacts.....</b>	<b>93</b>

## Acronyms

AGI	Above Ground Installation
AIOC	Azerbaijan International Operating Company
BDA	Business Development Alliance
BEC	Baku Enterprise Centre
BTC	Baku-Tbilisi-Ceyhan
BTC Co.	Baku-Tbilisi-Ceyhan Pipeline Company
CFSP	Common and Foreign Security Policy
CIP	Community Investment Programme
COFACE	Compagnie Française pour le Commerce Extérieur
CSBP	Conflict Sensitive Business Practice: Guidance for Extractive Industries
CSR	Corporate Social Responsibility
EBRD	European Bank for Reconstruction and Development
ECGD	Export Credit Guarantee Department (UK)
ECRG	Economy and Conflict Research Group
EIP	Environmental Investment Programme
EITI	Extractive Industry Transparency Initiative
ESIA	Environmental and Social Impact Assessment
EU	European Union
EXIM	Export-Import Bank (USA)
FDI	Foreign Direct Investment
HGA	Host Government Agreement
IDP	Internally Displaced Person
IFC	International Finance Corporation (World Bank)
IFI	International Financial Institution
IMF	International Monetary Fund
JBIC	Japan Bank for International Cooperation
LCC	Local Community Co-ordinators
NEXI	Nippon Export and Investment Insurance
NGO	Non-governmental Organisation
NK	Nagorno-Karabakh
OECD	Organisation for Economic Co-operation and Development

OPEC	Organization of the Petroleum Exporting Countries
OPIC	Overseas Private Investment Corporation
OSCE	Organization for Security and Co-operation in Europe
PLR	Prevailing Legal Regime
RDI	Regional Development Initiative
SACE	Servizi Assicurativi del Commercio Estero
SCP	South Caucasus Pipeline
SME	Small or Medium-sized Enterprise
SOFAR	State Oil Fund of Azerbaijan
TNC	Transnational corporation
UNDP	United Nations Development Programme
VPs	Voluntary Principles on Security and Human Rights

## Executive summary

This report sheds light on the nature of the relationship between the oil industry and conflict in a region that has been unstable since the collapse of the Soviet Union in the early 1990s – with a particular focus on the Baku-Tbilisi-Ceyhan (BTC) pipeline (currently being built to transport oil from the Caspian to the Mediterranean). The report recognises that construction of the pipeline is largely the responsibility of BTC Co. set up for this purpose, but directs its recommendations and analysis to BP, the operator of the BTC pipeline, as well as the largest stakeholder in the project and region, and therefore perceived as the company with highest responsibility for addressing conflict-related issues. The report is most comprehensive in its analysis and recommendations relating to Azerbaijan. Resource constraints prevented similarly in-depth analysis of Georgia and Turkey, although the report does address these regions within its handling of international and regional conflict dynamics.

It has been written by the UK-based conflict transformation non-governmental organisation (NGO), International Alert, as part of its Business and Conflict programme.<sup>1</sup> The report recognises that BP has taken important steps towards addressing some of the complexities associated with its presence in the South Caucasus, seeking to maintain good relations with all actors – local and international NGOs, and local and national governments, as well as its backers in the International Finance Institutions (IFIs). Nevertheless, it is our assertion that further studies such as this one into the links between major foreign investment projects and conflict will bring added value to companies such as BP in their efforts to maximise the benefits of their investments to both shareholders and local communities where they operate. Based on a process of research and analysis of the potential interactions between oil and conflict that is described in more detail in Annex 1, as well as findings from a broader programme of activities that are geared towards promoting a positive role for companies operating in conflict-affected countries, the report is designed to complement companies' own analyses of these issues and efforts to address them. The report makes recommendations

---

<sup>1</sup> For more information see <http://www.international-alert.org/policy/business.htm>. In particular this research grew out of the programme's field project in the South Caucasus, and the early stages of its policy project

to BP on what steps it could take to mitigate these potentially negative impacts, at a time when the company is about to launch a new Regional Development Initiative (RDI).<sup>2</sup> The RDI will support economic development in Azerbaijan, Georgia and Turkey, reaching beyond the 4km pipeline corridor to areas that are usually outside the scope of community investment programmes implemented by oil and gas companies. However, the RDI does not envisage linking the three target countries via economic cooperation, nor does it include Armenia or any of the non-recognised entities. This may potentially reinforce conflict fault lines and increase development disparities in the South Caucasus. If the BTC, as a manifestation of the international role of the oil industry in the conflict dynamics of the region, is to become part of the solution rather than part of the problem, ways must be found to frame the benefits of oil more inclusively. This will require greater regional co-operation between oil companies and the international community, and a regional approach to the issue of security.<sup>3</sup>

## Background

The collapse of the centralised, planned Soviet economy ushered the region's newly independent states towards the free market that now dominates the global economy. In the South Caucasus it also opened up new market opportunities for Western oil companies and their financiers, and raised expectations of improved economic conditions locally. It also threw the countries of the South Caucasus into turmoil, as sub-regions such as Abkhazia, Nagorno-Karabakh (NK) and South Ossetia became the focus of disputes over the legitimacy of the 'born-again' nation states of Armenia, Azerbaijan and Georgia. After the euphoria of the initial collapse of the USSR, the former Soviet leaders' continued hold on power, and the

---

development of Conflict Sensitive Business Practice: Guidance to Extractive Industries (CSBP), which will be explored more fully in the report.

<sup>2</sup> 'The EBRD and BP have each earmarked up to \$25 million in grants and loans for the initiative; other members of the BTC consortium are expected to join with target funding overall of around \$100 million. The first investments are anticipated for mid-2005.' (<http://www.ebrd.com>)

<sup>3</sup> International Alert's Business and Conflict programme also researches policy options for the international community in terms of promoting a more positive role for business in conflict zones, see Banfield, J., V. Haufler and D. Lilly, *Transnational Corporations in Conflict Prone Zones: Public Policy Responses and a Framework for Action* (International Alert, 2003) and *Multilateral Development Banks and Export Credit Agencies: The Case for Conflict-Sensitivity* (International Alert, forthcoming 2005).



effects of their regimes, combined with ensuing violent conflict to worsen the economic security of most people living in the South Caucasus. Today, the ability of communities to trade is often blockaded as a result of conflict, and shadow economies have evolved where trade is unregulated, and 'taxes' unseen, channelled towards individuals rather than government institutions. Government coffers are empty and the potential for socio-economic investments to improve the livelihoods of the South Caucasus people is low.<sup>4</sup>

At face value, oil revenues promise much in such circumstances. For Azerbaijan, the balance of funds in the account of the State Oil Fund of Azerbaijan (SOFAR) stood at \$806 million by end 2003. Depending on the price of oil, Azerbaijan's total earnings from oil up to 2010 will be between \$10-20 billion. With a population of approximately 10 million (including the Diaspora in Russia<sup>5</sup>), this represents a significant sum that could be channelled towards improving standards of living and a more robust economy. There are also some potential benefits to Georgia, with transit fees from the BTC pipeline representing an important contribution to Georgia's relatively modest budget, and the promise of closer ties with the West.<sup>6</sup> Turkey's increasing energy needs will be eased by oil from the BTC, and later from gas to be transported by a parallel pipeline running from Baku to Erzurum<sup>7</sup>.

## **Conflict risks and oil**

However, for each of these countries, and indeed for the region as a whole, the picture is more complicated than one of straightforward reward. It is now commonly recognised that oil can just as easily contribute to instability as it can to stability and sustainable development in certain countries.

---

<sup>4</sup> Although figures vary, some commentators estimate that those of the Georgian government increased by 40% following the recent fall of Abashidze in Adjara.

<sup>5</sup> See section 3.1.2 on the Azeri Diaspora for further information

<sup>6</sup> Although the benefits of oil will be felt more in Azerbaijan, the importance of Georgia as a transit corridor for the BTC pipeline should not be underestimated, as highlighted by the Georgian government's temporary suspension of the pipe's construction due to the government's concerns about environmental impact in Borjomi.

<sup>7</sup> The gas pipeline constructed and operated by the BTC consortium only runs to the Georgian- Turkish border. Its extension to Erzurum is constructed and operated by the Turkish gas company BOTAS

The three states of the South Caucasus region remain in transition from the Soviet system of the 1980s to a new, yet to be defined, common political and economic framework. While the European Union's (EU's) Neighbourhood Policy offers a framework within which Armenia, Azerbaijan and Georgia may jointly operate, there remain major rifts in the relations between two of these three countries that may prevent or delay it from taking root. The alliances forged to exploit Caspian oil between Azerbaijan, Georgia, Turkey and Western governments and financial institutions, also threaten to make the realisation of a common political and economic framework for co-operation in the region less likely. These alliances negate Turkey's potential mediating role between Armenia and Azerbaijan, alienate Armenia, Iran and Russia, and consequently contribute to the freezing of conflict in the region. This is unlikely to ease relations between Georgia and Russia over South Ossetia, where the recent closure of the Ergneti market has arguably pushed this internationally non-recognised entity closer to its Russian neighbour and heightened the likelihood of conflict escalation. If violence breaks out again, the BTC pipeline could well become a target for sabotage or even a direct military target, if perceived as vital for war efforts for the Georgian state.

Currently, relations between Russia and Azerbaijan are stable. However, some commentators speculate that Russia may react to growing geopolitical divisions by, for example, deporting Azerbaijani economic migrants, thereby putting more pressure on a local Azerbaijani labour market where high unemployment, caused by the closure of Soviet factories, has been a factor pushing young men abroad in search of jobs. Economic security may not improve if structural governance issues are not addressed, and/or the non-oil sector continues to be neglected in Azerbaijan. Growing discontent may lead to stronger alliances between the Talish and Iran in the South of Azerbaijan, and between the Avars and Russia in the North.

The report's authors focused their conflict analysis on the NK conflict, and Table 1 shows a summary of the key needs and interests that sustain it. With little improvement in economic security, the conflict over NK will remain as a target of blame, and images of Armenians as 'the enemy' will likely be strengthened, decreasing the likelihood of a peaceful resolution to the conflict between Armenia and Azerbaijan over NK, and piling expectations onto the oil

industry as the main engine for future economic prosperity, and the regaining of NK and national pride.

### **Challenges to oil companies**

The risks to stability at both local, national and broader regional levels that are associated with oil exploitation in the South Caucasus clearly therefore in turn pose a complex of interrelated challenges to BP – ranging from micro-logistical and security challenges, to broader and more indirect challenges that will arise as a result of regional impacts. Ongoing campaigns against the BTC project at both the local level, particularly in Georgia and Turkey, and internationally illustrate the potential damage to company reputation that these challenges pose.

Across Azerbaijan, there are high expectations that oil will improve economic security and assist the return of NK. If these expectations are not met, however, there may be a backlash against the government and hence oil companies which are increasingly regarded as partners of host and Western administrations. This backlash may fuel internal divisions, and the needs and aspirations of different ethnic and religious groups. The pipeline could soon become a target for such groups, in the same way that it could become a target for those seeking independence and political recognition from Georgia. Similarly, a predatory developmental trajectory related to oil revenue in Azerbaijan would reflect badly on BP's reputation both locally and internationally. It would likely cause frustration amongst communities that are currently expectant of economic and political change, antagonise the political opposition, harden national Azerbaijani positions against Armenia and Russia and, in the face of growing instability, reinforce the long-held view that the need for democratic development in the long term should be sacrificed for short-term stability.

The most obvious challenge, and the one that received an enormous amount of political and industry attention in the years leading up to the project's commencement, is the logistical challenge of getting Caspian oil to Western markets safely. The 1,768 km long BTC pipeline is the main infrastructure for transporting the oil, and as such is a key investment by oil companies operating in the region. It needs protection, and as one step towards achieving this

in a manner consistent with ethical standards, BP has been a vital actor in both launching and sustaining the Voluntary Principles on Security and Human Rights (VPs). Implementation of the VPs in the South Caucasus has to date focused mainly on the public and private security components of the principles. More needs to be done in this regard, in particular, by the admission of BP representatives consulted as part of this study, little has been done to progress the conflict analysis component of the risk assessment section of the VPs.

Oil companies are keen to share the financial and reputational risks of operating in unstable regions with international financial institutions (IFIs). The involvement of the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC), which are backing the BTC project, led to an extensive Environmental and Social Impact Assessment (ESIA) of the pipeline. In response to the assessments, BP launched a Community Investment Programme (CIP) and an Environmental Investment Programme (EIP). The company has consulted over 450 communities and 30,000 landowners affected by the pipeline over a 20-month period, complying with the IFC's policy on disclosure of information. Because the study only identifies the potential negative environmental and social impacts associated with the construction and operations of the pipeline in a 4km corridor around it – in line with IFC and EBRD requirements – in this sense it is blind to the wider regional dynamics that are inextricably bound up in the investment. ESIA methodologies also tend to be limited in the processes used for community consultation.<sup>8</sup>

Controversy around the pipeline, in particular scrutiny from international NGOs such as Amnesty International, Caspian Revenue Watch, Rising Tide and others, also prompted BP to commission a *Regional Review* that explores the wider impacts of the project. This *Review* recognises some of the broader regional impacts on stability, and is progressive in as much as it acknowledges a link between the project and violent conflict, however, it falls short of a

---

<sup>8</sup> See Goldwyn, R. and J. Switzer (2003) 'Assessments, Communities and Peace – A Critique of Extractive Sector Assessment Tools from a Conflict Sensitive Perspective' (London, UK: International Alert/International Institute for Sustainable Development). The limitations and missed opportunities in current multilateral development bank approaches to supporting investment in unstable countries are explored further, and recommendations made, in *Multilateral Development Banks and Export Credit Agencies: The Case for Conflict-Sensitivity* (International Alert, forthcoming 2005).

comprehensive regional conflict analysis and is therefore limited in its application to conflict mitigation strategies.

Although the *Regional Review* document is a step in the right direction, the impact of the oil industry as a whole has received less attention than the pipeline route itself. There is a natural tendency on the part of oil companies to limit the acknowledged ‘sphere of responsibility’ regarding their operations to the immediate, but as discussed above, it is clear that the BTC pipeline is one element of an oil industry that will have an impact not only on communities within the 4km wide pipeline corridor, but also on the geopolitics and political economy of the region more broadly.

As a major source of revenue in an otherwise weak economy, the impact of oil will be felt across the whole of Azerbaijan, and the wider region, either positively or negatively, offering opportunities for both governments and groups wanting to progress their political and economic agendas. BP is working with others to try and promote scrutiny of SOFAR funds. It is addressing a fundamental dimension of this more macro-level impact, through its participation in the Extractive Industry Transparency Initiative (EITI) and commitment to transparency and promoting strong business principles in its own conduct. These are important channels of influence on the region’s stability that should be built on.

*Table 1: Summary of key needs and interests sustaining conflict over NK*

	International	Azerbaijan – National	Azerbaijan - Local
Governance	<ul style="list-style-type: none"> <li>o Lack of political (and economic) framework common to South Caucasus States.</li> <li>o Impartiality of Minsk Group.</li> <li>o Armenian Diaspora in US.</li> </ul>	<ul style="list-style-type: none"> <li>o Fear of losing power prevents long-term visioning by Azerbaijani government.</li> <li>o Democratic rhetoric, but Soviet methods.</li> </ul>	<ul style="list-style-type: none"> <li>o Political freedoms sacrificed for personal security.</li> <li>o As long as there is a threat of conflict, ‘strong’ tactics of current political regime perceived as necessary.</li> </ul>

		<ul style="list-style-type: none"> <li>o Tension between local authorities (government-appointed) and municipalities (elected).</li> <li>o Fragmented opposition and lack of new leadership</li> </ul>	
Economy	<ul style="list-style-type: none"> <li>o Main beneficiaries of 'shadow economy' depend on frozen conflict.</li> <li>o US &amp; Western European interests in oil and the alliances that these interests determine.</li> </ul>	<ul style="list-style-type: none"> <li>o Slow transition from centralised, planned Soviet economy to market-based economy.</li> <li>o Lack of investment in non-oil sector.</li> <li>o Lack of broad-based tax regime.</li> </ul>	<ul style="list-style-type: none"> <li>o Economic insecurity – unemployment, economic migration.</li> <li>o Gaps between old and young generations.</li> <li>o Corruption of local government administration blocks entrepreneurs.</li> <li>o IDPs seen as threat to economic opportunity.</li> </ul>
Security	<ul style="list-style-type: none"> <li>o Turkey balancing the economic potential of links with Armenia, with its 'security pact' with Azerbaijan.</li> <li>o Russia's interest in securing it's 'near abroad'.</li> </ul>	<ul style="list-style-type: none"> <li>o Heydar Aliyev's firm response to law and order issue following chaos during aftermath of Soviet Union collapse still maintains some respect. Many still prepared to sacrifice personal freedoms for personal security.</li> <li>o Oil revenues provide opportunities for strengthening military.</li> </ul>	<ul style="list-style-type: none"> <li>o Perceptions that oil will provide revenues and alliances to leverage a change of fortune over NK.</li> <li>o Manipulation of IDPs for political purposes – also makes this group vulnerable to recruitment by groups with differing political interests.</li> </ul>
Culture/Identity	<ul style="list-style-type: none"> <li>o International alliances sometimes appear to reflect a Christian v Muslim divide.</li> </ul>	<ul style="list-style-type: none"> <li>o Variety of Islamic-based faith groups at odds with Azerbaijani secularism – creating potential recruits for those with more radical agendas.</li> </ul>	<ul style="list-style-type: none"> <li>o Economic insecurity helps fuel images of Armenia as enemy.</li> <li>o Assimilation policy towards ethnic groups (eg. Talish &amp; Avars) strengthens intolerance towards different groups.</li> </ul>

## **Summary of interactions: oil, oil companies and conflict**

The report's analysis of the potential future interaction between the conflict context in the South Caucasus and the BTC project – framed as both risk and opportunity at regional, national and local levels – is summarised in the following tables. These interactions recognise that whilst the two-way interaction between business and conflict has in the past been damaging both for companies and host societies, business can be a force for good. Maximising the positive opportunities that the oil industry offers the region will also have a positive impact on the oil company. It is the authors' view that these two positives are intertwined. As conflict imposes a range of costs on companies, a conflict sensitive approach to doing business, involving a consideration of these interactions, is a strategic choice for company managers.

Table 2: Risks and opportunities of context/ oil interaction at the regional level

	<b>Context</b>	<b>BP/Oil industry response</b>
<b>Risks</b>	<ul style="list-style-type: none"> <li>o Azerbaijan uses importance of BTC to the West to resist moves towards democratic reform.</li> <li>o Armenia attempts to strengthen links with EU unilaterally, further alienating Azerbaijan.</li> <li>o Turkey withdraws from diplomatic role vis-à-vis Azerbaijan &amp; Armenia - border with Armenia remains closed.</li> <li>o Russia seeks to stamp control on Caucasus as BTC seen increasingly as feeding a Western agenda. Turkish/Russian relations deteriorate.</li> <li>o Turkey increases support to Azerbaijan, Russia to Armenia. Economic migrants from Azerbaijan deported from Russia.</li> <li>o Military conflict erupts between Armenia and Azerbaijan. Turkey and Russia withdraw to let them fight it out, in order to avoid a Russia-NATO military confrontation.</li> </ul>	<ul style="list-style-type: none"> <li>o BP and other oil companies focus their thinking on pipeline corridor – strengthens Azerbaijan/Georgia/Turkey alliance, keeping Armenia and Russia out.</li> <li>o Turkey engages with oil industry to strengthen security arrangements along pipeline.</li> </ul>
<b>Opportunities</b>	<ul style="list-style-type: none"> <li>o Moves towards a common framework internationally – increased diplomatic role of EU and Turkey (which aspires to EU membership). South Caucasus becoming EU's neighbour.</li> <li>o NK conflict elevated on agenda of international community and addressed by a wide range of actors.</li> <li>o Turkey and Russia relations improve , consolidating political relations and future of Blue Stream project, in exchange for stability and shared economic space in South Caucasus.</li> <li>o Structure of Minsk Group revised so as to portray a more neutral role.</li> </ul>	<ul style="list-style-type: none"> <li>o BP and other oil companies adopt a more regional approach to their investment activities, working with the international community.</li> <li>o This includes a South Caucasus wide approach to security.</li> <li>o Oil industry supports establishing business development centres in the region, which can benefit from new economic opportunities provided by opening up of trade links.</li> </ul>



Table 3: Risks and opportunities of context/oil interaction at the national level

	<b>Context</b>	<b>BP/Oil industry response</b>
<b>Risks</b>	<ul style="list-style-type: none"> <li>o Georgian moves towards legalising Ergneti market and clamping down on informal economy heighten tension in Abkhazia and South Ossetia, since the only available economy for non-recognised entities is informal economy.</li> <li>o With worsening situation in Georgia, Azerbaijan can maintain corrupt system of governance – elites under little pressure to change and remain cocooned in urban centres.</li> <li>o Expulsion of Azerbaijani economic migrants from Russia puts pressure on labour market. Oil industry cannot provide the 2 million jobs required.</li> <li>o Political parties advocating war with Armenia gain political and economic strength (particularly from IDPs).</li> <li>o Hawkish political groups set on return of NK challenge softening government position on NK</li> <li>o Military conflict erupts between Armenia and Azerbaijan. Turkey and Russia withdraw to ‘let them fight it out’.</li> <li>o Violent demonstrations suppressed with casualties and imprisonments.</li> </ul>	<ul style="list-style-type: none"> <li>o Oil companies and Western governments paralysed by need for oil on the one hand and need for human rights on the other.</li> <li>o Azerbaijan pays lip service to the EITI.</li> <li>o Oil companies stop supporting NGOs that can scrutinise oil revenues as government cracks down on NGO activity. There is therefore no scrutiny of any transparency.</li> <li>o Non-oil sector companies similarly unsupported as companies concentrate on protecting their operations, which are threatened by hardening of Azerbaijani government’s position on security.</li> </ul>
<b>Opportunities</b>	<ul style="list-style-type: none"> <li>o Georgia leads the way in challenging corruption, in tandem with growing potential for finding sustainable solutions to conflict in Abkhazia and South Ossetia.</li> <li>o This enables movement towards a different, more open kind of economy.</li> <li>o Benefits are felt throughout the South Caucasus.</li> <li>o Pressure builds on Azerbaijan and Armenia to follow suit, including from EU in international arena.</li> <li>o Azerbaijan sees anticorruption/ market economy package as opportunity to build its profile and economic strength on global stage.</li> </ul>	<ul style="list-style-type: none"> <li>o EITI helps keep oil revenues visibly within formal economy and prevents further fuelling of corruption.</li> <li>o NGOs mandated to scrutinise the oil industry and strengthen the non-oil sector are supported (e.g. Himayadar Oil Information Resource Centre and the BDA).</li> </ul>

	<p>Peace becomes greater political and economic incentive than conflict.</p> <ul style="list-style-type: none"> <li>o Also, existing corruption system unsustainable for elite – e.g. Georgia no longer a destination for money laundering.</li> <li>o Elites weakened, and oil fund visibly benefiting rural communities and infrastructure.</li> </ul>	<ul style="list-style-type: none"> <li>o Outcomes are better business environment – i.e. low interest loans, tax reform, database for joint ventures, etc. – and increased scrutiny of use of oil revenues (without scrutiny, transparency is meaningless).</li> </ul>
--	--	--

*Table 4: Risks and opportunities of context/oil interaction at the local level*

	<b>Context</b>	<b>BP/Oil industry response</b>
<b>Risks</b>	<ul style="list-style-type: none"> <li>o Images of Armenia as the enemy are maintained.</li> <li>o Pressure builds for war with Armenia as only solution to economic plight.</li> <li>o Expectations grow that Western oil industry will support this effort.</li> <li>o As oil fund increases and relations with Turkey strengthen, so does Azerbaijan’s belief that it can win a war. NK also believes it can resist successfully, as Armenia and the Armenian Diaspora express their alliance, and Russia informally backs them at least with weapons.</li> <li>o Corruption at local authority level continues to stifle business development.</li> <li>o Neglect of agriculture, infrastructure and non-oil sector generally.</li> <li>o Radical religious groups and ethnic separatists strengthen their hold on rural communities.</li> <li>o Talish in the South align more with Iran, as a way out of poverty becomes less likely. Avars align with Russia.</li> </ul>	<ul style="list-style-type: none"> <li>o Oil companies retreat to a ‘no intervention’ position in order to safeguard business interests.</li> <li>Space for more enlightened policy dialogue shrinks.</li> <li>o CIPs focus on pipeline corridor to help protect the pipeline.</li> <li>o CIP resources are misused at local authority level as corrupt system continues.</li> <li>o Pipeline becomes target for increasing number of alienated groups, particularly in Georgia where sabotage of pumping stations severely disrupts supplies.</li> </ul>
<b>Opportunities</b>	<ul style="list-style-type: none"> <li>o Gradual improvement in local economy – e.g. through SME start-up funds and legitimisation of informal economy. More open environment enables businesses to</li> </ul>	<ul style="list-style-type: none"> <li>o Oil company social investment programmes focus on those regions least likely to feel influence of</li> </ul>

	<p>talk about their needs in the region.</p> <ul style="list-style-type: none"> <li>o Images of Armenia as the enemy begin to be broken down as employment increases and second generation IDPs more settled.</li> <li>o Spread of radical religious groups and separatist movements decreases, as government gives more freedom of expression, economy improves and recruitment for radical groups becomes increasingly difficult.</li> </ul>	<p>economic development.</p> <ul style="list-style-type: none"> <li>o Funding channelled through partnerships between local authorities and community-based organisations.</li> <li>o This in parallel with capacity building programmes for local authorities to improve efficiency and legitimacy.</li> <li>o CIPs target IDPs and meetings of businesspeople from Armenia and Azerbaijan – perhaps within regional framework.</li> </ul>
--	--	---

**Recommendations**

Steps taken by BP towards addressing some of the complexities associated with its presence in the South Caucasus should be built on and developed in and of themselves, and in order to address the gap that the authors of this report have identified in terms of the company’s response to the conflict context in the South Caucasus. The following recommendations are offered in this report as areas for further exploration and discussion at a time when BP is about to launch its RDI programme.<sup>9</sup>

**Conflict-sensitive company management systems**

1. Comprehensive conflict impact assessment

BP should consider commissioning a comprehensive conflict impact assessment in order to ensure that its operation minimises conflict impacts and maximises peacebuilding potential

---

<sup>9</sup> Additional generic recommendations to the multilateral development banks involved in the BTC project will be made in *Multilateral Development Banks and Export Credit Agencies: The Case for Conflict-Sensitivity* (International Alert, forthcoming 2004).

across all areas of the business, and at all levels (local, national and regional)<sup>10</sup>. This should be done in parallel with, and hence inform, its RDI. It would also help progress implementation of the risk assessment component of the VPs.<sup>11</sup>

## 2. Broaden out the definition of 'stakeholder' and form of consultation

BP has recognised the high expectations surrounding its presence in Azerbaijan and has taken steps to address these expectations. However, these steps have been focused on what the company interprets as the 'project-affected communities', i.e. those residing within the 8km wide pipeline corridor. This increases the likelihood of opening up further the fault lines that underpin conflict by ignoring key stakeholders in the development of the region as a whole.

In addition, the form and process of consultation and dialogue with stakeholders is an area where, from the conflict-sensitive perspective, corporate methodologies typically used to date are weak. More inclusive, informal, and empowering channels of communication are required if BP is to combat some of the conflict issues it faces.<sup>12</sup>

## 3. Contributing to the broader discussion about oil and conflict through education and awareness-raising, in collaboration with other agencies

Partnership is at the heart of a conflict-sensitive approach to business, and BP should continue to collaborate with the UK government and other international agencies in seeking ways of addressing economic security, personal security, governance and cultural issues in the South Caucasus. In particular, it should explore ways of channelling funds to support international efforts that potentially counterbalance the negative impacts of oil in the region

---

<sup>10</sup> Due to limited resources, International Alert's research into the conflict impacts of the pipeline was not comprehensive, with field research being limited to Azerbaijan. In addition, the methodology for conducting such assessments has been in development in parallel with the South Caucasus research, and is now due to publish in March 2005.

<sup>11</sup> The risk assessment section of the VPs states that 'identification of and understanding the root causes and nature of local conflicts, as well as the level of adherence to human rights and international humanitarian law standards by key actors, can be instructive for the development of strategies for managing relations between the company, local communities, company employees and their unions, and host governments. Risk assessments should also consider the potential for future conflicts.'

<sup>12</sup> Zandvliet, L. 'Stakeholder Engagement and Consultation' (part of the CSBP guidance to extractive industries, London, UK: International Alert 2005, forthcoming).

(e.g. the work of the EU). In addition, the company should set up mechanisms that will enable oil companies with a stake in the BTC pipeline, and the oil industry more generally, to come together to discuss these issues.<sup>13</sup> Another mechanism could be to establish opportunities for company staff to study the issue and get training on conflict analysis relating to the South Caucasus region.

## **Regional level**

### 1. Broaden and deepen the company's approach to security

BP has already proved itself to be a key actor in the VPs initiative and should continue to lead the way for other companies both in the South Caucasus and internationally. Recognising that protection of the immediate project environment is a key company responsibility, it is also a basic recommendation of this report that, given continued instability in the region, and the potential for minority groups to target oil industry infrastructure to further their agendas, focusing on security issues within the confines of the pipeline corridor will be insufficient to safeguard the BTC pipeline in the long term. Focusing on the pipeline corridor only runs the risk of strengthening the Azerbaijan, Georgia and Turkey alliance, keeping Armenia and Russia out. BP and BTC Co. should collaborate with the international community and local organisations to support conflict resolution initiatives aimed at increasing regional security.

### 2. Develop a regional strategy for economic security

Similarly, efforts should be made to support those seeking to foster business development from a regional perspective, e.g. by helping to establish business development centres in the region. Recent efforts by local businesses to develop a regional network of enterprises offer opportunities to open up trade links not only between Armenia, Azerbaijan, Georgia and Turkey, but also encompassing Russia. Companies such as BTC Co. and BP would add weight to these efforts, helping to address the economic security issue from a regional perspective, enhancing the reputation and value of the oil industry, and lessening the likelihood of direct sabotage of pumping stations and oil industry infrastructure.

---

<sup>13</sup> One such mechanism, the Oil Industry Forum, was set up in Baku in 2001 but was not sustained.

## **National level**

### **1. Supporting scrutiny of oil revenues**

The EITI is one example of the growing international momentum on transparency of oil revenues to combat misappropriation and misuse of funds. However, transparency is of limited value if there is no scrutiny of what becomes transparent. Local NGOs need the capacity and support to play a scrutinising role. BP, SOFAR and international agencies should jointly review the mechanisms in place to scrutinise oil revenues and increase efforts to strengthen them. National governments also need to be encouraged to adopt the EITI themselves.

### **2. Support economic security at the national level in Azerbaijan**

BP should move beyond its project with local oil suppliers to work more comprehensively with the Azerbaijani government and the donor community to develop a strategy for improving economic security in Azerbaijan. This strategy should take into account the role of oil, but also of other regional economic and governance factors highlighted in this report.

## **Local level**

### **1. Target corruption at the local level**

Many local authorities are perceived to be a major source of corruption in Azerbaijan. Single channels of information and funding via local authorities risk fuelling these perceptions, making the company vulnerable to accusations of condoning misappropriation of funds. In this context, providing support to capacity-building initiatives that target local authorities is important. The company should also explore more inclusive ways of distributing information and funds relating to CIP and EIP projects, e.g. by including municipalities and councils of elders.

### **2. Manage expectations**

In the face of growing expectations that oil companies will solve the perceived interlinked problems of economic insecurity, repatriation of internally displaced persons (IDPs) and the loss of NK, improved consultation and dialogue processes with communities are of paramount

importance, including engaging those regions least likely to feel the influence of investment. Efforts should also be made to address some of the structural causes of conflict by, for example, exploring opportunities to strengthen 'economic diversification' organisations and supporting those initiatives aiming to transform the NK conflict.

# 1. Introduction

This report sheds light on the nature of the relationship between the oil industry and conflict in a region that has been unstable since the collapse of the Soviet Union in the early 1990s – with a particular focus on the Baku-Tbilisi-Ceyhan (BTC) pipeline (currently being built to transport oil from the Caspian to the Mediterranean). Once fully operational (2006 is predicted) the BTC will have a capacity to deliver 1 million barrels per day to the Turkish port of Ceyhan. The report recognises that construction of the pipeline is largely the responsibility of BTC Co. set up for this purpose, but directs its recommendations and analysis to BP, the largest stakeholder in the project and region, and therefore the company with highest responsibility for addressing conflict-related issues.

The research behind it grew out of two areas of International Alert's Business and Conflict programme of work: a conflict transformation field project in the South Caucasus region; and development of tools for conflict-sensitive corporate practice, that is part of the policy project of the programme.

This introduction outlines the report's basic framework and origins, going into more depth on available tools and frameworks for understanding corporate 'conflict sensitivity'. Chapter 2 gives an outline of the BTC investment itself. Chapter 3 explores the context in the region and the nature of its instability, from the perspective of different actors. Chapter 4 then places the BTC pipeline and the oil industry alongside the context, beginning to draw out the two-way dynamic between the context and the BTC investment project. It attempts to predict some of the future impacts that the pipeline might have on the context and vice versa, exploring some of the areas for action that companies might contribute to if the oil industry and the BTC pipeline in particular is to be a positive influence in the region. Chapter 5 sets out recommendations that are designed to be a contribution to the search for better informed approaches to foreign investment in conflict contexts.



## ***1.1 The contribution of the oil industry to conflict prevention – emerging conflict-sensitive management systems***

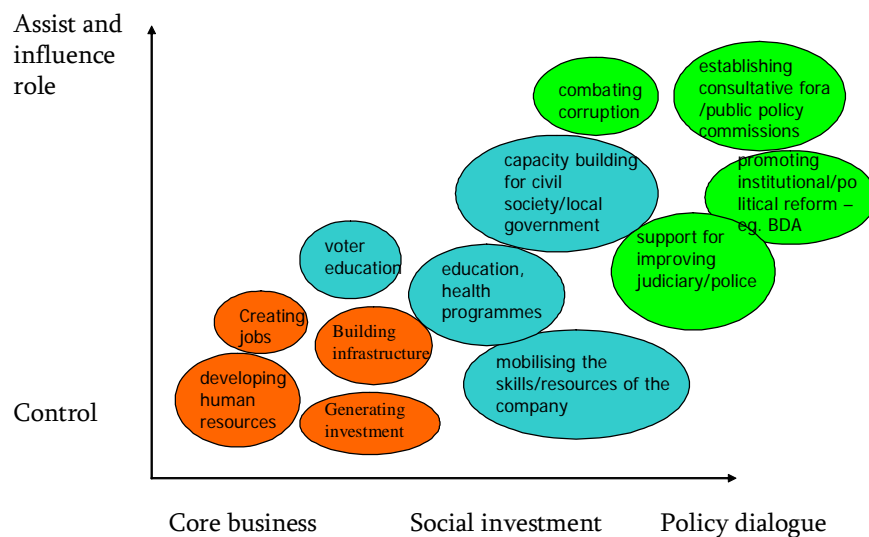
‘The economic dimensions of armed conflict are often overlooked, but they should never be underestimated. The role of business, in particular, can be crucial, for good and for ill.’

*UN Secretary-General Kofi Annan, speech to the Security Council, 15 April 2004.*

As companies such as BP are well aware, companies operating in societies threatened or affected by violent conflict face particular difficulties. As conflict imposes a range of costs on companies, a conflict-sensitive approach to doing business is a strategic choice for company managers. Oil, gas and mining companies are particularly exposed to the costs and risks of conflict through the large-scale and long-term nature of their investment. The various costs and risks can be broken into two categories: direct costs that hit the company; and indirect costs imposed by conflict on the country, which in turn have a negative impact on the business environment.

In addition, company investments in conflict-affected areas often have unintended impacts on the conflict itself. These impacts occur at both local and national levels ranging from relationships between a particular company and local communities and employees, and the ways in which these relationships can reinforce tensions, to the kinds of security arrangements in which companies engage, to issues relating to the structural causes of conflict (governance and corruption, revenue transparency and expenditure, environmental damage and human rights). Negative impacts often occur because companies may not fully understand the pre-existing context, or the dynamic interactions between their projects and that context, rather than any deliberate intention.

Whilst the two-way interaction between business and conflict has in the past been damaging both for companies and host societies, business can be a force for good when it takes steps to minimise the potentially negative impacts of operations and to maximise the positive, as the quote from Kofi Annan above also indicates.



*Figure 1: Peacebuilding interventions across business activities*

At the core of a conflict-sensitive approach to doing business is improved conflict analysis and understanding of the potential impacts of a particular investment on existing or potential conflict at all levels. Analysis enables companies to identify key issues in order to prevent harmful and promote positive impacts across different areas of the business, as depicted in Figure 1. A company may have ‘control’ over those issues relating more closely to its core business operations, whilst it may adopt a more ‘assist and influence’ role when addressing those issues it relates to less directly. Adopting a conflict-sensitive approach across key areas of business (core business, social investment and ‘policy dialogue’ – defined as the relationship with local and national government, as well as among international policy actors) can have real business benefits by limiting the costs imposed on operations by violent conflict, particularly in terms of risk management, reputation, security and personnel costs. Over the longer term, peace strengthens the rule of law and makes for a better operating environment, as well as providing a healthy basis for any society, which in turn creates customers, suppliers, qualified employees and investors. Better investment opportunities arise, and reputational value is created locally and internationally. Conflict sensitivity can be a branding opportunity

akin to sustainability; whilst at the same time bringing enormous benefits to local communities and states.

### *International Alert's CSBP guidance for extractive industries*

The Conflict Sensitive Business Practice: Guidance for Extractive Industries (CSBP) project has grown out of International Alert's wider Business and Conflict programme work that from the start has identified the need for improved conflict analysis as a major gap in corporate actors' approach to operating in conflict contexts.<sup>14</sup> A key milestone in its development was the UN Global Compact's 'Dialogue on Companies in Conflict Zones' *Business Guide to Conflict Impact Assessment and Risk Management* (2001), to which International Alert contributed. International Alert's wider work on conflict impact assessment tools for other sectors, such as the development and humanitarian aid sector, has also contributed.<sup>15</sup>

CSBP aims to assist extractive sector companies in addressing the underlying and trigger causes of conflict and contributing to long-term structures of peace. CSBP is a collection of tools and guidance notes, tied to different stages of a typical project cycle, that carefully explore the two-way relationship between business operations and their context – where context relates not only to violent conflict, but also situations of tension or unstable peace.<sup>16</sup> Ranging from the 'go or no go' decision through to the form of closure and withdrawal, CSBP tools enable companies to anticipate, monitor and assess the impact of business operations on local, regional or national tensions, triggers and accelerators of conflict, and to develop mitigating strategies that contribute to conflict prevention and peacebuilding. At its core are

---

<sup>14</sup> Nelson, J. (2000) *The Business of Peace – The Private Sector as a Partner to Conflict Resolution and Peacebuilding* (London, UK: International Alert, International Business Leaders Forum and Council on Economic Priorities).

<sup>15</sup> *Conflict-Sensitive Approaches to Development, Humanitarian Assistance and Peacebuilding: A Resource Pack* (2003) (London, UK: FEWER, Saferworld, International Alert).

<sup>16</sup> Component parts of CSBP include: Operational charts, Flowchart of CSBP tools, Screening Tool, Macro-level Conflict Risk and Impact Assessment, Project-level Conflict Risk and Impact Assessment and Flashpoint Issue papers on: stakeholder engagement; resettlement; compensation; indigenous peoples; social investment; dealing with armed groups; security arrangements; human rights; corruption and transparency

improved mechanisms for stakeholder engagement, consultation and relationship building – key to conflict analysis, and identification of both impact and prevention approaches.

A steering committee of experts and representatives from companies in the oil, mining and gas sectors – BP, Newmont, Nexen and Shell – has guided the research and tool development to date. Elements of the tool and core ideas behind it were used for to guide the research for this report (see Annex 1).

### ***1.2 Balancing macro and micro perspectives***

In line with our analysis that companies affect conflict at all levels, not simply in their immediate operating environments, in putting together this report we have struck a balance between an analysis of the macro- and the micro-level issues. Guided by International Alert's *Code of Conduct*, we have engaged with people living in the region and most affected by conflict and instability.<sup>17</sup> In collating these more micro/community level perspectives we have focused mainly on Azerbaijan (limited resources have prevented similar interviews in Georgia and Turkey). In other parts of the South Caucasus we have taken a more macrolevel perspective, in collaboration with local researchers and experts. This combination has resulted in a report that provides an analysis that brings together regional and international issues with those at the community level in Azerbaijan.

In terms of conflict, the dispute over Nagorno-Karabakh and concerns to have it resolved, emerged strongly at both local and international levels. There is also a marked focus on political economy in this report. The links between economy and conflict are attracting more attention of late, and it is important to position the BTC project within the broader political economy of the South Caucasus in order to understand its role in the region.<sup>18</sup> International Alert has established the Economy and Conflict Research Group (ECRG) of the South Caucasus to contribute to such analyses and the alleviation of conflict. This group published a

---

<sup>17</sup> International Alert's Code of Conduct states that 'we believe that genuine conflict transformation is only possible with the participation and involvement of those most affected by conflict'.

book comprising seven individual research papers analysing the links between economy and conflict from the perspectives of Armenia, Azerbaijan, and Georgia, and including Abkhazia, NK, South Ossetia and Turkey.<sup>19</sup> This report draws on the research process of the ECRG as part of its context analysis.

### ***1.3 A peace pipeline?***

Oil has of course been part of the context in the South Caucasus for decades, and ‘pipeline politics’ has given the BTC project a regional significance that goes well beyond the shores of the Caspian Sea. As BP’s own *Regional Review* points out, the BTC pipeline is ‘a project of regional significance as it represents the first direct transportation link between the Caspian and the Mediterranean’.<sup>20</sup> With this regional significance comes both a potential for peace and a danger of deepening existing conflict divides.

Initial negotiations over the routeing of the pipeline in the early 1990s included the option of taking the pipe through NK itself – a trade-off between territory and economic gain that was ultimately rejected by Armenia. This routeing was supported by the US, who perceived the NK conflict as a major impediment to extracting oil from the land-locked Caspian Sea. The rejection of any routeing via Armenia effectively led to the Georgian option and the construction of the Baku-Supsa pipeline, following which the prospects for routeing a pipeline via Georgia to Ceyhan markedly increased. Turkey’s support for the pipeline and its alliance with Azerbaijan over NK was to prove important in pushing through the project and determining the routeing. The idea of the BTC pipeline as a ‘peace pipeline’ was raised again at the Organisation for Security and Co-operation in Europe (OSCE) summit held in Istanbul in November 1999, once again illustrating how the coming together of political and economic agendas could have led to the convergence of a Caucasus peace plan with the easing of oil exports from the Caspian.

---

<sup>18</sup> See also Tony Vaux’s ‘Strategic Conflict Assessment of Georgia, Humanitarian Initiatives’, July 2003. One of the working groups at the EU presidency meeting in The Hague on 27 May 2004 was on political economy, and the UN has just set up a formal process looking at the political economy of conflict.

<sup>19</sup> Champain, P., D. Klein and N. Mirimanova (eds.), *From War Economies to Peace Economies in the South Caucasus* (London, UK: International Alert, ECRG 2004, forthcoming).

<sup>20</sup> *BTC Regional Review*, February 2003.

Ultimately, the OSCE summit failed to deliver such a convergence and, as the BTC project gradually became a reality, the links between Turkey and Azerbaijan were seen by many as a factor contributing to the freezing of the Azerbaijan-Armenia conflict. Indeed, Turkish diplomatic efforts to facilitate some movement in the impasse over NK were curtailed by Turkey's commitment to help uphold Azerbaijan's security. In addition to other factors, Turkey's role in the post-conflict situation as a supporter of Azerbaijan may have been determined to a certain degree by its interest in the BTC pipeline project. However, the main factors determining Turkey's relationship with the two states in conflict over NK are still the joint Turkic identity and unresolved historical issues between Turkey and Armenia.

From a geopolitical standpoint, the BTC pipeline has therefore had a degree of impact on regional politics and the dynamics of negotiations over NK. However, it is also the case that the project, in aiming to 'avoid becoming a catalyst for ethnic or other conflict', has the potential to mitigate tensions by becoming a trigger for the opening up of South Caucasian economies and the anchor of joint investment projects of neighbouring countries.<sup>21</sup>

#### ***1.4 Challenges posed by the political economy of the South Caucasus***

The International Alert/ECRG research mentioned above has highlighted the complex web of economic and political relationships that exist within and between the different states and non-recognised entities. As a consequence of conflict in the region, trade patterns have evolved to compensate for closed borders. For example, without officially recognised passports, the Abkhaz are restricted in their freedom to travel, and despite a 325km long border between Turkey and Armenia, regular flights between Istanbul and Yerevan represent the only direct connection between Turks and Armenians.<sup>22</sup> With contact so difficult, it is easy to see how 'images of the enemy' are sustained, and how grievances and ongoing issues remain unresolved. Trade is inevitably driven underground when borders between Armenia

---

<sup>21</sup> Regional Review, op. cit.

<sup>22</sup> Direct land communications were severed in 1993 as Turkey, in support of Azerbaijan's territorial integrity, decided to close its border with Armenia. This closed border, a barrier to human and business interactions, has

and Azerbaijan, Georgia and Russia, and Armenia and Turkey are, if not closed, then at best 'semi-porous'. The resulting 'shadow economy' offers some rich pickings for those involved in trafficking of illicit goods (including guns, drugs, people), but little reward for those struggling to survive on a daily basis through trade in licit goods (including fruit, grain and livestock).

'Shadow economies' such as those in the South Caucasus pose serious challenges for those struggling to live and work there, and serious dilemmas for others engaged in trying to improve the situation. For example, how can assistance be channelled to all actors, when the political status of the non-recognised entities remains unresolved? How can the development needs of the non-recognised entities be addressed without alienating the recognised states? How can an economic dynamic based on competition and co-operation be compatible with a political dynamic based on confrontation and domination? How can the needs of small-scale traders be brought to the attention of those in positions to influence the political context within which they operate? And how is it possible to engage the gatekeepers and beneficiaries of the current economic system as stakeholders in future alternatives?

Those companies large and powerful enough to negotiate their own legal frameworks, such as BP (see Chapter 2), can create a situation in which the company is, to a degree, seemingly protected from this often predatory context in which others have to operate. In this sense, smaller, local companies face challenges of a different kind to those of TNCs. This sense of protection may, however, be illusory in the long run. As the scenarios in Chapter 4 of this report suggest, the political economy of the South Caucasus poses real threats to all private investment, including the BTC project.

In this sense, and in the context of the region as a whole, joint investment projects between Azerbaijan, Georgia and Turkey could exacerbate conflict by excluding Abkhazia, Armenia, Nagorno Karabakh and South Ossetia. If BTC Co. does have the potential to help open up the

---

become the frontline of conflicting interests, preventing these two populations from bridging the century-old gap separating them.

South Caucasian economies through joint investment projects with neighbouring countries (as stated above), it needs to consider what this means for the non-recognised entities in the region. Ignoring the political economy of the region as a whole will only serve to weaken the effectiveness of community investment programmes (CIPs). In some instances, such programmes may unintentionally exacerbate conflict by ignoring the needs of key conflict stakeholder groups, and by providing increased resources for competition between groups (as has been seen in various other settings, perhaps most violently in Nigeria). If the oil company is truly committed to meaningful social investment in the South Caucasus, then it needs to consider the nature of the context in which it is operating, a context that has been shaped by conflict.

Hard issues need to be confronted then, when designing a conflict-sensitive approach to private sector investments such as the BTC pipeline. To what extent is the BTC project specifically, and the oil industry more generally, helping to sustain conflict in the region by working around, rather than addressing, the hard issues? What is a company like BP mandated to do in such a context? To what extent does the context in the South Caucasus negatively impact on the BTC project itself? What responsibility does an oil company therefore have to consider, and act upon, the conflict risk and impact of its operations? And what management systems can it develop to mitigate those risks? These questions set the agenda for subsequent chapters of this report.

### ***1.5 International frameworks influencing TNCs in conflict zones***

A report by International Alert in 2003 showed that some international policy-making institutions (both government agencies and multilaterals) 'are beginning to make certain connections between conflict prevention and corporate social responsibility (CSR), in ways that reflect the increasing volume of research into the issue, and that create opportunities for a more coherent approach to corporate activity in conflict prone zones'.<sup>23</sup> Some emerging international frameworks, such as the Extractive Industry Transparency Initiative (EITI),

---

<sup>23</sup> Banfield, J., V. Haufler and D. Lilly (2003) *Transnational Corporations in Conflict Prone Zones: Public Policy Responses and a Framework for Action* (London, UK: International Alert).



which explicitly draws a link between revenue transparency and conflict, are clearly potentially relevant to the BTC project and the oil industry operating in the South Caucasus, if they can be made to work effectively. International Alert's report encourages the international policy community to:

- (a) influence TNC activity in conflict-prone zones through regulation (including clarifying the legal framework for doing business in conflict zones with regard to international humanitarian law, strengthening legal accountability of companies accused of 'complicity' in conflict, and strengthening relevant voluntary initiatives such as the EITI, the Voluntary Principles on Security and Human Rights (VPs), the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, etc.);
- (b) engage TNCs as partners in fulfilling conflict prevention targets as part of development policy;
- (c) influence TNC behaviour through project finance and other forms of support to foreign direct investment (FDI) (e.g. through introducing conflict impact assessment as part of export credit and other lending criteria – such an input from the International Finance Corporation (IFC) or EBRD; regarding the BTC project would have been useful in this regard);
- (d) convene and facilitate multi-stakeholder dialogue to address TNCs and conflict issues; and
- (e) encourage coherence between CSR and conflict sensitivity.

The conflict-affected context of the South Caucasus poses hard challenges for those living and working there. Finding solutions requires collaborative approaches that recognise the contribution of all stakeholders. This report is about focusing on the contribution of BTC Co. and the oil industry. In doing so, it also recognises the importance of partnerships between oil companies, their contractors, and other actors in the region, including the international community, and the responsibility of home governments in providing guidance to companies that find themselves in such situations.

## 2. The BTC project

This section briefly takes stock of the parameters of the BTC project. That is, who is involved in its construction, what stage the construction has got to and how much more is still to be done, who finances it, what levels of oil and oil revenue are anticipated, what community, environmental and social investment programmes have been put in place so far, what security arrangements look like, and what opportunities the project provides for local employment and sub-contractors.

### *2.1 Basic parameters*

The 1,768 km long BTC pipeline is primarily constructed as an outlet for oil produced during the full field development of the offshore Azeri-Chirag and deepwater Guneshli (ACG) fields in Azerbaijan,<sup>24</sup> as well as providing an alternative export route for other oil fields in the Caspian. ACG is being developed in four phases. The Early Oil Project has been productive since 1997, and the last fields will start production around 2008. In addition, the Shah Deniz offshore gas field south-east of Baku is being developed, mainly for export to the Turkish market, and will be transported through the South Caucasus Pipeline (SCP).<sup>25</sup>

### *2.2 BTC consortium profile*

The BTC pipeline is being developed by an international consortium of 11 partners, the Baku-Tbilisi-Ceyhan Pipeline Company (BTC Co.). Its members are:

- BP (UK) – the largest shareholder with 30.1%, and the operator of the pipeline;
- SOCAR (the state oil company of Azerbaijan) – the second largest shareholder with 25%;
- Unocal (USA) – 8.9%;
- Statoil (Norway) – 8.71%;

---

<sup>24</sup> ACG is being developed by an oil consortium of ten companies that together form the Azerbaijan International Operating Company (AIOC), and is operated by BP.

<sup>25</sup> The field and the pipeline are also constructed by BP on behalf of another consortium including some companies from AIOC and BTC Co.

- TPAO (Turkey) – 6.53%;
- Eni (Italy) – 5%;
- TotalFinaElf (France) – 5%;
- Itochu (Japan) – 3.4%;
- INPEX (Japan) – 2.5%;
- ConocoPhillips (USA) – 2.5%;
- Amerada Hess (USA) – 2.36%.

The pipeline is 1,768 km long (445km in Azerbaijan, 245km in Georgia and 1,070km in Turkey), and is buried along its entire length. Pipeline construction commenced in April 2003, with the CIP and environmental investment programme (EIP) starting in July of the same year, with projects running for 2-3 years. The pipeline will be completed by end 2004, with first oil exported from Ceyhan early 2005. The SCP will become operational in 2006.

### ***2.3 Finance***

The estimated aggregate cost of the BTC project is \$2.9 billion (\$3.6-3.7 billion including line fill and loan interest during construction), including \$2.4 billion of total debt. The estimated total cost of the ACG phase 1 oil field project is approximately \$3.2 billion. Financial institutions involved include the IFC and the EBRD, plus eight export credit agencies<sup>26</sup> and a consortium of 15 commercial banks.<sup>27</sup>

---

<sup>26</sup> UK Export Credit Guarantee Department (ECGD) - provides cover for \$150 million line of credit for UK contractors involved in the project; US Export-Import Bank (EXIM) - \$160 million guarantee for US equipment and services, including engineering services, control systems and pump system. Japan Bank for International Cooperation (JBIC) - loan of \$580 million to the BTC Co., co-financed with private financial institutions; Nippon Export and Investment Insurance (NEXI) - *amount unknown*; US Overseas Private Investment Corporation (OPIC) - \$100 million in political risk insurance; Italian Servizi Assicurativi del Commercio Estero (SACE) - cover for \$50 million; French Compagnie Française pour le Commerce Extérieur (COFACE) - *amount unknown*; German Euler Hermes Kreditanstalt - *amount unknown*.

<sup>27</sup> Together they are providing between \$900 million - 1.2 billion: ABN AMRO, Citibank, Mizuho and Société Générale with Banca Intesa, BNP Paribas, Crédit Agricole Indosuez, Dexia, HypoVereinsbank, ING, KBC, Natexis Banques Populaires, San Paolo IMI, West LB, Royal Bank of Scotland.

## ***2.4 Legal framework***

BTC Co. does not take the applicability of national and international laws to the project as a given, since, according to the company, all three countries represent ‘economies in transition within evolving legal frameworks’ that ‘cannot consistently supply either the clarity or the high international standards required for BTC’.<sup>28</sup> Therefore, it was deemed necessary to formulate the legal regime that governs the construction and operation of the project in a series of distinct treaties and agreements between the host countries and BTC Co. In its entirety, this body of legal agreements is called the ‘Prevailing Legal Regime’ (PLR). BTC Co. states that ‘it is important to note that the legal arrangements for BTC do not replace existing laws and regulations, but are designed to build on and *supplement* the legal framework, and *only supersede provisions that directly conflict with project agreement requirements*’.<sup>29</sup> The PLR and Host Government Agreement (HGA) between BTC Co. and the three countries hosting the pipeline have been criticised by some NGOs for overriding fundamental principles and rights enshrined in the countries’ domestic laws, particularly relating to human rights, as well as for contravening international law in some cases.<sup>30</sup>

## ***2.5 Security***

BTC Co. awarded a contract to Equity International (Switzerland) to provide human rights training to policy security personnel who will protect the pipeline in all three countries. The VPs form part of the legal framework applicable to the pipeline. ‘Work with the community’ is regarded as a critical component of pipeline security, e.g., where possible, local security guards will be hired. Under the Security Protocol, a Joint Pipeline Security Commission comprising the three host governments’ relevant authorities will be established to facilitate

---

<sup>28</sup> From ‘Citizen’s Guide to the BTC Project Agreements: Environmental, Social and Human Rights Standards’ (available at [http://www.caspiandevlopmentandexport.com/ASP/PD\\_BTC.asp](http://www.caspiandevlopmentandexport.com/ASP/PD_BTC.asp)).

<sup>29</sup> *Ibid.*, emphasis added.

<sup>30</sup> Some of these concerns were addressed by BP, notably through a unilateral Deed Poll, securing the three governments’ right to regulate with regard to human rights, health and safety and the environment, without this being a breach of the HGA. Amnesty International, which had initially raised concerns about this aspect of the HGA (see *Human Rights on the Line – The Baku-Tbilisi-Ceyhan pipeline project*, Amnesty International, May 2003), welcomed BP’s initiative, but pointed out that it did not address all human rights issues raised by its initial report (see <http://www.amnesty.org.uk/business/btc/#concerns>).

security co-operation. This is to meet at least once a year, or at other times, upon the agreement between the three countries or BTC Co. itself.

## ***2.6 Construction contractors and local content***

In order to facilitate Azerbaijani small or medium-sized enterprise (SME) access to international oil contracts, BP set up the Baku Enterprise Centre (BEC) in May 2002 on behalf of its partners in the Azerbaijan International Operating Company (AIOC), the Shah Deniz, and the BTC oil export pipeline projects. The BEC provides training and consultancy services. Tendering is done through standard Invitations to Tender, whereby BP initially selects the companies it then invites to enter the tendering process. In order to become eligible to tender for BP contracts, local companies have to:

- (a) register with BP's supplier database (registration forms are available online or by mail from the BEC);
- (b) commit to BP's ethical principles, including respect for law and human rights (relevant documents such as the Universal Declaration On Human Rights and the OECD Guidelines for Multinational Enterprises are available from the BEC website, as well as BP guidelines on business conduct); and
- (c) take responsibility for implementing BP Health, Safety and Environmental policies.

## ***2.7 Employment***

The size of the construction workforce is approximately 2,300 in Azerbaijan, 2,500 in Georgia and 5,000 in Turkey. The employment period for unskilled labourers like caterers, cleaners and labourers, which will be mostly drawn from local communities, will be between 1-3 months following the construction path. At a meeting with the BTC Co. managers in London in April 2004 it was confirmed that there are currently a total of ca. 12,000 people working on the pipeline<sup>31</sup>. Priority is given to local residents. In Georgia, recruitment centres are located

---

<sup>31</sup> The workforce figures refer to estimates made by the company and other experts at the time of the field research in July 2003. The peak of the workforce was reached in September 2004- 21,000 people. This fell to 18,000 employees in December 2004.

along the route, and 100 staff will be retained during the operational phase. Likewise in Azerbaijan, 100 operational staff will be employed long-term. In Turkey, it is anticipated that about 150 people will operate the pipeline and aboveground structures, and 200 people will be employed on the marine terminal, most of whom will be skilled or semiskilled. BTC Co. states that it will attempt to give the majority of these jobs to nationals. It was stated during the above-mentioned BTC Co. meeting that in both Georgia and Turkey (Azerbaijan was not mentioned, but not excluded from this observation), the hourly pay of labourers caused problems. As the working day during the winter season is much shorter than in summer, the wage-levels dropped significantly for workers in Georgia. In northeastern regions of Turkey, work had to stop entirely because of the weather conditions, meaning a complete cut in salaries for workers there. This of course created discontent among staff – as will the dramatic drop in employment opportunities post-construction.

## ***2.8 Project-affected communities***

BTC Co. defines ‘pipeline-affected communities’ as those living or owning land in a 2km stretch of land on either side of the pipeline right of way, or within a 5km radius from Above Ground Installations (AGIs) such as workers’ camps or pumping stations. As a result, CIP activities are also restricted to these areas. Impacts beyond this area are not taken into account (for instance, the secondary impacts for communities living downstream from river crossings, or the more indirect impacts of revenue mismanagement on infrastructure, education and social services, etc.). According to BTC Co.’s definition, there are ca. 455 ‘project-affected communities’: 83 in Azerbaijan, with a total population of more than 257,000;<sup>32</sup> 72 in Georgia, with a combined population of 425,000;<sup>33</sup> and 300 in Turkey. An important aspect of BTC Co.’s strategy for community relations (channelled through

---

<sup>32</sup> According to BTC Co., of these 257,000+, 96% are permanent residents, 0.3% are temporary residents, and 3.3% are IDPs and refugees. The majority of the population rely on land for subsistence, and engage in farming and animal husbandry. Access to energy as well as water is problematic in all districts, and all communities suffer from a lack of services and sanitation infrastructure.

<sup>33</sup> The surveyed communities are ethnically mixed, with Georgians forming the majority, and substantial minorities of Armenians, Azerbaijanis, Greeks and Russians. Again, access to energy is problematic for most residents, and livelihoods rely mainly on subsistence agriculture. Ca. 80% of adults surveyed during the ESIA process are unemployed.

‘Community Liaison Officers’ whose role it is to inform affected communities, as well as receive complaints about project impacts etc.) is ‘management of expectations’. In particular, consultations revealed that affected communities had expectations that were ‘too high’ in terms of the number of jobs the project would create, as well as the level of the increase in energy supply. In order to ‘manage’ these perceptions, BTC Co. implemented an assertive information dissemination campaign along the route. According to the Environmental and Social Impact Assessment (ESIA) for Azerbaijan, ‘after more than a year of regular consultation these expectations have since been reduced, but will still require careful management in the future’. The community consultation process forming part of the ESIA has included only those in communities defined as ‘project-affected’ by BTC Co., namely those within the corridor. Typically, consultation processes used in an ESIA are limited from the conflict-sensitive perspective, and while full information about these has not been available, there is little to indicate that the BTC process was an exception to this rule.<sup>34</sup>

## ***2.9 Community and environmental investment programmes***

The main project investment is complemented by a CIP and an EIP in all three countries. Objectives for the community projects were determined in consultation with other organisations with previous experience in the region, including the United Nations Development Programme (UNDP). The four main objectives for the CIP are employment, agriculture, social infrastructure and capacity building. The CIP and EIP are targeted at ‘pipeline-affected communities’ and include \$9 million for investment in Turkey, and \$8 million each for Azerbaijan and Georgia. In BTC Co.’s current plans, the CIP projects are designed to run for the duration of the construction phase *only*, however the company is currently considering whether, and if so how, to extend the CIP to the operational phase (extension of the CIP was recommended by the Caspian Development Advisory Panel). In order to ensure ‘ownership’ of the projects by local communities, the CIP requires a 20% contribution in cash or labour from beneficiary communities. At the community level, the

---

<sup>34</sup> Goldwyn, R. and J. Switzer, op. cit. International Alert’s CSBP guidance (see Chapter 1) includes best practice recommendations on consultation process, see Zandvliet, L. ‘Stakeholder Engagement and Consultation’ (part of the CSBP toolbox, London, UK: International Alert 2005, forthcoming).

‘operational environment’ for the CIPs has been predetermined by other actors’ involvement, and by the latent conflicts within the communities. International Alert’s field research has identified the following potential problems<sup>35</sup>:

- Lack of information: communities do not distinguish between various international actors; therefore successful previous projects by development agencies were sometimes attributed to oil companies, as were the failures. This translated into an unwillingness to participate in any future community mobilisation schemes, in particular if they included funds being raised by the community itself.
- Corruption: the relationship between local authorities on the one side and the local population on the other (sometimes supported by the municipality) is very tense, and if the CIP is channelled via local authorities, it reinforces the existing power structures, which is a point of contention amongst many in the rural areas.
- The two most important negative factors in the rural settlements are unemployment and lack of infrastructure. In a developed society, both are assumed to be the responsibility of the government. If oil companies replace the government in providing some of the basic services, this will increase people’s expectations of the company and further diminish the expectations of the government. In the long term, channelling funds via international development agencies may also undermine the role of the government.<sup>36</sup> This presents companies in similar circumstances everywhere with a dilemma.

## ***2.10 Revenue management***

In 2000, Azerbaijan established the State Oil Fund for the Azerbaijan Republic (SOFAR), designed to receive oil revenues stemming from oil fields developed post-Soviet Union, i.e. by international oil companies, including all BTC project funds. SOFAR has an executive director and a supervisory council, which should include community-based organisations, but

---

<sup>35</sup> The field research was conducted in July 2003, at a time, when the CIP was just beginning to be implemented via international agencies.

<sup>36</sup> Although one national NGO, UMUD, has been subcontracted to participate in the CIP, the programme is seen as ‘BP’s programme’, which is interpreted as foreign aid to Azerbaijan.



which to date has not. The Azerbaijani president has ultimate authority over the fund and all its activities. EBRD will give technical assistance to SOFAR, which is also monitored by the International Monetary Fund (IMF). In terms of transparency, SOFAR publishes its annual report on its website, and is audited by an independent international firm on an annual basis. The Azerbaijani Chamber of Auditors also has the right to audit the fund. BP arranged a series of consultations with other governments of resource-rich countries, like Botswana, Indonesia, Norway and the US in order to facilitate exchange of experiences. BTC Co. has made a commitment to publish all payments made in each host country, including local spend and local taxation, and is a supporter of the EITI. A triple bottom-line report is to be published in late autumn. On the civil society side, the Open Society Institute has established Caspian Revenue Watch, which scrutinises oil-related public funds in the region. It publishes regular reports, including one on SOFAR. A coalition of local NGOs has also been established in Azerbaijan as part of a move towards greater more comprehensive scrutiny. Resistance from the government to engage with this coalition, plus some attempts by NGOs to use the coalition to push other agendas are some of the challenges facing this new initiative.

The oil industry in Azerbaijan has already generated large amounts of revenue from early oil and signature bonus payments. The total assets of SOFAR stood at approximately \$806 million as of end 2003.<sup>37</sup> Estimates of future revenue from oil (the capacity of the BTC is 1 million barrels a day) stand at anything between an accumulated \$20-40 billion by 2024. Although estimates of the size of oil fields in the Azerbaijan section of the Caspian Sea are now less than predicted in the early 1990s (the 'Deal of the Century' being in 1995), this still represents a considerable amount of revenue – enough to justify some scenario planning based on the impact of this rapid accumulation of dollars on a country in political, economic and social transition following the collapse of the Soviet Union at the beginning of the 1990s.

---

<sup>37</sup> SOFAR financial report, audited by Ernst & Young, April 2004.

### 3. Context

This chapter aims to analyse the context in Azerbaijan within which the BTC pipeline is being constructed. It studies actors, their interests and needs, and conflict issues arising from clashing interests. It also recognises that the BTC cannot be considered in isolation from the broader oil industry, which has more far-reaching impacts than just those along the pipeline corridor. The analysis below therefore considers actors not only in terms of their relationship with the BTC pipeline, but with the oil industry in the wider sense.

Violent conflict in the South Caucasus is manifested mainly in the confrontations between Abkhazia and Georgia, Georgia and South Ossetia, and between Armenians and Azerbaijanis over NK. There are, of course, other actors both at the international level, and within the three official states of the region at a more local level. This report focuses mainly on Azerbaijan and the conflict over NK, with some insights into Georgia.

This chapter examines the context at three levels – the international, national and local (proximity to the pipeline route). Each section comments on issues in so far as they relate to the most relevant aspects of the public domain: governance, security, economics and society/culture. The latter is reduced in most cases to identity, which has been a major cause of conflict in the South Caucasus.<sup>38</sup>

#### *3.1 International level*

There are a multitude of international actors with a stake in Azerbaijan or the conflict over NK, motivated by a combination of various interests in the region ranging from political ideology to practical security. This report briefly analyses the following: Russia, the Azerbaijani Diaspora in Russia, Turkey, the US, Armenia, the Armenian Diaspora, Georgia, Iran, the UK, the EU, Norway, and the OSCE via the Minsk Group.

---

<sup>38</sup> Most protracted ethnic conflicts, in particular the asymmetric ones, have a strong identity element, usually manifested through a minority denied access to political power and other rights.

### 3.1.1 Russia

Russia is, of course, hugely influential, as it is the direct successor of the Soviet Union that effectively ruled Azerbaijan for over 70 years, creating an ethno-political legacy that was a determining factor in causing the NK conflict. During the Soviet period, Azerbaijan had significance for the USSR both in terms of security, and the economy (particularly oil and cotton production). Therefore, when national sentiments in Azerbaijan emerged during the *perestroika* and *glasnost* period in the 1980s, they were violently suppressed, in a way symptomatic of a dying regime.<sup>39</sup> The USSR collapsed, and the lack of a joint political framework and the end of a forcibly sustained economic interdependence created an environment in which member countries literally fought for their identity. The speed of the collapse made it difficult for Azerbaijan to adjust. Currently, Russia is trying to re-establish its influence in Azerbaijan, partly for security reasons.

A US presence in Georgia and Central Asia is perceived as a 'foot in Russia's back yard'. Russia's military presence in Georgia's Armenian populated area and its backing of Armenia during the NK war are sometimes interpreted as an alliance of Christian states against Muslim Azerbaijan, although geopolitical interests are clearly the main determining factor in rendering military assistance.

Russia is concerned about Chechens raising funds in or via Azerbaijan, which, like Georgia, has allegedly been sympathetic to the Chechen cause. Its role in the Minsk process is seen as negative by Azerbaijan, which at this point does not see the group to be at all neutral. The Avar and the Lezghin ethnic minority groups in the north of Azerbaijan form the core ethnic composition of Dagestan within the Russian Federation, and represent potential separatist groups, distinct from other ethnic minority groups such as the Talish and the Tat.

---

<sup>39</sup> Perestroika (restructuring) and Glasnost (publicity) triggered change, since they opened opportunities for questioning the Soviet ideology, in response to which national identities emerged as a means through which to engage in the debate about ideology. This trigger also contributed to the strengthening of Karabakhi Armenians' identity away from Azerbaijan.

Economically, with Azerbaijan becoming independent, Russia has lost an important cotton and tobacco supplier. Both industries have been virtually eradicated.<sup>40</sup> Potentially, Azerbaijan could once again become a major supplier of fruit and vegetables to Russia. Russia's interest in the Caspian Sea is significant, both in the energy and the non-energy sector.<sup>41</sup>

Russia's security need (perceived or real) to put a satellite on the ground in Azerbaijan may guarantee a striving towards a more positive relationship with Azerbaijan, for example, Russia has allowed a large number of Azerbaijani labour migrants in, albeit under not too favourable personal conditions.

### **3.1.2 Azerbaijani Diaspora in Russia**

This group is a relatively new actor. Numbers in the Diaspora are used for political purposes, commonly deflated or inflated. Estimates range from 800,000 to 2 million. The Diaspora is an outcome of large-scale labour migration resulting from the economic crisis attributable to the fall of the Soviet Union.<sup>42</sup> Its interests range from pure survival to the economic development of Azerbaijan, depending on the wealth of the individual. The wealthier can send remittances to relatives, invest in their home communities or accumulate wealth abroad.<sup>43</sup> The benefits for the Russian economy from Azerbaijanis living in Russia are quite significant, and one might claim that the improving official relations between Azerbaijan and Russia are partly a result of this. However, as the example of Georgia shows, Russia is capable of sacrificing that benefit for other ends.<sup>44</sup> Being Muslim, Azerbaijanis in Russia suffer from discrimination and

---

<sup>40</sup> In the centralised Soviet agricultural system, Azerbaijan, like many other republics, particularly those of Central Asia, was coerced to grow cotton and tobacco without due regard to the environmental impact.

<sup>41</sup> There is an international legal dispute about the definition of the Caspian. If it is defined as a sea, it allows equal access to the 'high seas seabed' – that is, the central, deep waters as distinct from the shoreline. Russia can lean towards either side, using this as leverage with Azerbaijan.

<sup>42</sup> The causes of the economic crisis are somewhat complex in people's minds: collapse of industry is indeed seen as caused by the fall of the USSR, whereas unemployment (perceived usually through a more personal prism) is attributed to the NK war.

<sup>43</sup> The only actual example of this is Shamkir, where the Head of Executive authorities creates 'favourable conditions' for Azerbaijanis in Russia to invest, i.e. does not consider remittances for investment as a source of income for those who are corrupt. The result is a major difference in development – Shamkir is one of the richest rural districts of Azerbaijan.

<sup>44</sup> Russia imposed a visa regime on Georgia that jeopardised the well-being of the entire Georgian Diaspora and labour migrants in Russia.

racism towards Muslims, with intolerance rising because of the Chechen war. The Diaspora's effects on Azerbaijan are:

- (a) *economic* – there are reports of significant, though unquantifiable, cash flows;
- (b) *political external* – despite the economic benefits, the Diaspora can be used as a threat by Russia – for if Russia were to expel all the Azerbaijanis working there, Azerbaijan would not be able to cope with the sudden influx;
- (c) *political internal* – a significant factor explaining why the Azerbaijani population tolerates an oppressive regime is that, in most rural areas, there is no one to revolt (many young men from rural areas have left the country, while women, children and the elderly will not stage large-scale anti-government demonstrations). Furthermore, remittances feed corruption. Perhaps the most obvious testimony is the 'disappearance' of remittances from Russia. In 2000 these were estimated at \$1 billion and the number of labour migrants at 650,000.<sup>45</sup> In a society where corruption became a widespread phenomenon, and in small rural communities where it is precisely known whose relatives send remittances home, remittances are used partly to support a family's survival and partly to pay off the authorities. In very few occasions are they used for business development.

Currently, relations between Russia and Azerbaijan are relatively stable. However, Russia's influence in Azerbaijan has rapidly declined since the end of the Soviet era and Moscow has been left with two main means to reassert itself over Baku: to use the labour migrants as a political trump card or to control the region with indirect military intervention (at best increasing arms supply to Armenia in order to keep Azerbaijan at high alert or, at worst, destabilising the region by reigniting the war).

### **3.1.3 The US**

Amongst the many interests that regulate US conduct in Azerbaijan or the Caucasus as a whole, two stand out: the US foreign policy goal of counterbalancing Russia, and the

---

<sup>45</sup> IOM quotes official sources for the number of labour migrants, and unofficial sources for the size of remittances.

interests of the Armenian Diaspora within the US. US interest in Azerbaijan is a mixture of security (Azerbaijan is a secular, Muslim country, bordering Iran with its 20-30 million ethnic Azerbaijanis) and economics (Caspian oil reserves and access to Central Asia). Both interests have become more significant since the late 1990s, and security particularly since 9/11. The US is increasing its military presence on the ground in the Caucasus, and its recent statement about providing support for the withdrawal of Russian troops from Georgia has further unnerved Russia.<sup>46</sup> In March 2004, the US military reached agreement with Azerbaijan to train Azerbaijani troops and to use bases in the country to deploy its own forces if necessary<sup>47</sup>. However, a permanent presence in Azerbaijan was ruled out. US military and financial strength in the region challenge Russia's influence, and could trigger counter-responses. The importance of Azerbaijan as a source of oil for the US is balanced with the interests of the US Armenian Diaspora, which, through section 907(a) of the Freedom Support Act, imposed sanctions on US aid to the Azerbaijani government. The suspension of this Act in 2003 was linked to Azerbaijan's support for the US in the 'war on terror'. The ties between the Azerbaijani and US administrations have been growing stronger of late. In the aftermath of the October 2003 elections, and while many other Western countries hesitated in their response to the brutal suppression of demonstrations, the US immediately recognised Ilham Aliyev as the legitimate successor to his father. This sparked strong anti-US and anti-Western sentiments among sections of the population that may have a negative backlash on the perceptions of Western oil companies, in particular BP, which is seen as the most prominent symbol of Western commercial interest and a significant testimony to political interests. It has already been picked out by Islamic fundamentalist groups, which oppose the BTC pipeline on the grounds of 'undesired Western influence' in Azerbaijan.<sup>48</sup> It is perhaps significant, in light of the war on terror and the long-lasting animosity between Iran and the US, that one can recognise the desire of the US to prevent the rise of radical Islamic

---

<sup>46</sup> The US deputy assistant Secretary of State, Lynn Pascoe, said in Tbilisi: 'We would be happy to provide some assistance ... to pull out the forces.' (*The Guardian*, 14 January 2004).

<sup>47</sup> The US has been providing assistance through 'Caspian Guard' to the Navy. An actual in deployment of US troops in "meaningful numbers" would be restricted by an Azeri law on national security that bans foreign military bases

fundamentalism in Azerbaijan. Promoting democracy whilst working with the current regime tends to alienate the local population from the West increasingly, mostly because sections of the population had hopes that spreading democratic ideas would promote better governance in the country, attract foreign investment, and lead to an improvement in economic conditions.

### **3.1.4 Turkey**

Politically, Turkey has an interest in balancing Russia's influence in the region as a whole, as well as in neutralising Russia's influence over Azerbaijan as the 'younger Turkic brother'. It is also wary of the century-old gap dividing Turkey from Armenia and of the potential political influence of Azerbaijani Kurds.

Following the fall of the Soviet Union, the South Caucasus has become a large potential market for Turkey, as well as an important route providing access to Russia. This link has been disrupted by the conflicts of the 1990s, and its restoration is now being considered as a step towards normalisation.

Turkey's political and economic interests sometimes clash. The will to maintain good relations with Azerbaijan has been overshadowed by the economic interest of profiting from accessing the Armenian and Russian markets. The result is a seemingly contradictory scenario in which Turkey ties the opening of the border with Armenia to the resolution of the NK conflict. Although Turkish businesspeople develop trade relationships with Armenian businesspeople, there are no official diplomatic relations between the two countries. Turkey as a member of NATO has been providing military assistance to Azerbaijan, in the form of training and equipment.

---

<sup>48</sup> Islamic groups, receiving funds from within Saudi Arabia and Kuwait, oppose the BTC pipeline due to perceived economic competition. BTC is presented and seen as linking Azerbaijan to the West, diminishing the chances of Islamic influence over the country

Turkey therefore has to balance its economic and political interests. It strives to maintain influence in Azerbaijan whilst gaining economic advantage in Armenia. Its political interests are a combination of wanting to retain influence in the region and trying to gain access to the EU, which is conditional on Turkey resolving its own conflicts.

### **3.1.5 Armenia**

Armenia's relationship with NK is complex, expressing both an alliance with and distance from the enclave. To some, Armenia gives the impression that it is aiming to annex NK, once NK gains independence. However, if Karabakhi Armenians are to be able to claim the right to self-determination, then Armenia needs to keep its distance and play down its role in the war. Attitudes towards the conflict amongst Karabakhi Armenians and Armenians are further complicated by the fact that Armenia's current president, Robert Kocharian, is himself from NK. Kocharian has ruled in a rather autocratic manner, although freedom of speech is more respected than in Azerbaijan or NK for that matter. Armenia's dwindling population may also be wary of unleashing an ideologically hard-line population residing in NK and are further influenced by the declining economic situation in the country, which is blamed on the conflict.<sup>49</sup>

Closer alliance with Russia is seen as necessary, since it is the main protector of Armenia's interests. Iran has been an ally, although more intensive relationship building with Iran has seemed to be prohibited by the US as well as Russia. In particular, this might make it more difficult to raise support for Armenia among the Diaspora in the US.

Economically, Armenia is in dire need of economic development and an end to outward migration. Armenia claims that it can survive without ending the economic blockade. However, the benefits of active trade links with Turkey and with the shadow economy of

---

<sup>49</sup> Armenia has been subjected to a double blockade by Azerbaijan and Turkey since the time of the war. Its economic relations with Georgia have also been very uneven given Georgia's own conflicts, the role of the Armenian minority there, the fact that Georgia highly values its relations with Azerbaijan and Turkey (who see any growth in ties with Armenia as support of a side in conflict), and also because of anti-Russian sentiments in Georgia (Armenia is perceived as being pro-Russian).



Azerbaijan suggest that without blockades, standards of living would rise. Joining the EU is regarded as a long-term political and economic goal.

The Armenian government gives incentives to those willing to settle in NK, and grants Armenian passports to Karabakhis, enabling them to acquire Armenian citizenship. Armenia's persistence in shaking off responsibility for the conflict is one of the major factors leading to deadlock in the negotiations. Armenia defers responsibility to Karabakh, which in turn is not recognised by Azerbaijan as a party to the conflict.

Armenia felt relatively safe in the immediate aftermath of the NK war up until recently, since it has a large buffer zone (NK and the security zone-i.e. the districts of Kelbajar, Lachin, Zangelan, Jebrail, Kubatly and Fizuli and Agdam in part), an economically weaker neighbour and Russia as an ally. This sense of security has been strengthened by Azerbaijan's weak army (at the time of the conflict) and lack of one unified identity, but has been on the decline, as the internal situation in Azerbaijan has changed (identity being constructed around NK, steeper economic development, etc.).

Politically, any settlement will require Armenia to budge from its current hardline position, and compromises are not compatible with electoral success. Each new leader has to take a hard-line on the conflict – a similar situation to that in Azerbaijan.

The link between Armenia and NK is essential to Armenian identity. The link between Armenia and the Diaspora is ideological (the triangle of nation, land and religion, where the sanctity of the land is elevated to a level equal with the two others). Although Armenia managed to 'deal with' refugees from Azerbaijan quite effectively, they still did not fully assimilate, having retained a distinct identity, in particular those from Baku.<sup>50</sup> Their positive

---

<sup>50</sup> Many of Armenia's refugees were placed in rural areas, or NK, despite the fact that most of them were previously urban residents.

experience of living in Soviet Baku, mixing with the local population, is an important but rapidly diminishing factor in favour of peace.

The first president of independent Armenia, Ter-Petrosian, was ousted eventually via a peaceful coup of his close associates, who played key roles during the conflict and were themselves often from Karabakh. Amongst them was Robert Kocharian, who later became president. The trigger for the coup was Ter-Petrosian's declaration of his readiness to compromise over the 'step by step' approach to resolving the Karabakh conflict. Kocharian's legitimacy is currently under question, and public unrest is growing, resulting in demonstrations in the spring of 2004, partly affected by the events in Georgia. Further deepening of the political crisis cannot be ruled out.

Armenia remains vague and ambiguous about its relationship with NK, about its role in the conflict and about its role in conflict resolution. This approach allows the current status quo to continue, since Armenia defers main responsibility to NK, while Azerbaijan denies NK Armenians access to the negotiating table. The sense of uneasy security is further nurtured by Russia, which responds to Armenia's fear with military assistance, and economic and cultural ties.

### **3.1.6 Armenian Diaspora**

The active Armenian Diaspora has achieved special positions in the US and Russia, and created pro-Armenian lobbies in or around political leadership there. Russia has the largest Diaspora, although the political influence of the American and French Armenians has been more visible.<sup>51</sup> The only foreign investment in NK is that of Armenians living abroad. NK can always count on the support of the Diaspora in case of renewed confrontations, not only in financial terms, but also in supplying fighters. The Diaspora has been successfully mobilised

---

<sup>51</sup> This is because the US Diaspora has been able to lobby US governments throughout the 20th century, whereas the Diaspora in Russia could not lobby the Soviet government for a national cause, since the Soviet ideology was officially anti-nationalist/internationalist, and has only started its lobbying policies following the collapse of the USSR.

for war and itself generated a ‘rally around the flag’ effect in Armenia and NK. It is unlikely that it can be equally successfully mobilised for peace as long as peace is perceived as unfair from a nationalist perspective. The hopes of the Armenian mainlanders that the Diaspora would bring in significant investment have not materialised. Negotiations with Diaspora business leaders brought in more aid than proper investment, partly because Armenia has refused to create a conducive legal climate. Whatever has been invested, has been subject to corruption, although Armenia is regarded as the least corrupt of the three South Caucasus states. Funds are usually channelled through official bodies, which steer large chunks to private/elite pockets. This phenomenon is particularly true in NK, where no political recognition means no external scrutiny.

### **3.1.7 Armenians from Nagorno-Karabakh**

The NK Armenians frame the conflict in terms of the principle of the right to self-determination. This principle of war against a colonial power is contested by Azerbaijan, since it claims that NK is aspiring to join Armenia after a transition phase of independence. Karabakh is surviving on its own with great difficulty, and thanks to significant ties to Armenia and the Diaspora. It has developed governance bodies similar to a state, conducted a referendum and declared itself a self-proclaimed state, although it is not recognised by the international community, even by Armenia itself.

NK Armenians periodically conduct elections and maintain a relatively large army considering the size of the population. They travel abroad on Armenian passports.

To safeguard its security, and to have a bargaining chip, NK aims to keep all its territory gained during the war, including the ‘buffer zone’ that keeps Stepanakert/Khankendi out of range of Azerbaijani artillery fire. This security will also enable NK to exploit its natural resources (timber, gold, nature-tourism) and agricultural land.

Security is perhaps the most important issue for NK Armenians, both in terms of personal/physical security and in the sense that, as a former minority whose rights were not

respected by the majority, they fear repetition of past abuses if they come under Azerbaijani rule again.

Karabakhi Armenians have developed a unique identity, due to a combination of geographic isolation and perceptions of being ruled by ‘foreigners’ – first Soviet, later Azerbaijani. This identity is translated into cultural and national values that make them stand out from Armenia. Some fear this uniqueness would disappear through assimilation with Armenia.

### **3.1.8 Georgia**

Georgia has two frozen conflicts, with Abkhazia and South Ossetia, and is juggling a number of latent ones, which occasionally escalate to low intensity violence. The ousting of the leader of Ajara, Aslan Abashidze (subsequent to the Rose Revolution of November 2003, when the young Mikhail Saakashvili came to power via a populist movement and on an anticorruption platform), using threats but in general without recourse to violence, has created new hope in Georgia and new opportunities. These changes also increase uncertainty.

While Georgia cooperates with Azerbaijan in the BTC project, and in general maintains good relations with Armenia, relations between Georgia and Azerbaijan are not without problems, particularly because of Kvemo-Kartli, which is home to a large Azerbaijani population that has been negatively discriminated against. Also, Georgia entertains hopes of becoming a member of NATO and the EU before its two neighbours, which adds a significant further challenge to the resolution of conflict. Georgia has refused so far to develop regional co-operative relations or significant bilateral ties with either Azerbaijan or Armenia. The result is that the European approach to the South Caucasus as a region may not materialise.

Armenians in Samtskhe-Javakheti feel to a certain extent protected from Turkey by a Russian military base and close proximity to Armenia. However, the threat of the removal of the Russian base and the possible return of the Meskhetian Turks increase their worries. Their sense of Georgian citizenship is almost non-existent, which creates a need for a variety of developmental programmes, ranging from road-building to teaching Georgian. Official ties

between the Armenians in Samskhe-Javakheti and Armenia itself are also nonexistent. Unofficially, however, these ties are strong. Fearing a rise in secessionist tendencies, the Georgian and Armenian governments do not encourage the development of ties across the border officially, which would be in many respects significantly beneficial for both Armenia and Georgia. Another reason for the fact that ties in this area are frozen is the lack of a desire by Georgia significantly to counterbalance the economic blockade of Armenia imposed by Turkey and Azerbaijan insofar as the NK conflict is not resolved.

In both Kvemo-Kartli and Samskhe-Javakheti, many socio-economic issues may acquire ethnic dimensions and thereby exacerbate the latent conflict. Therefore, the most advantageous and secure strategy in both of these areas is to address the socio-economic issues of the local population in ways that will ameliorate tensions, and to separate socioeconomic issues from ethnic issues.

If Georgia decided to address the conflicts by violent means, the effects could spill over to the neighbouring countries. Abkhazia and South Ossetia can count on Russian support, and the likelihood of Russia, Armenia and the Armenian Diaspora supporting the Armenians in Samtskhe-Javakheti is considerable, as is the likelihood of Azerbaijan supporting Azeris living in Marneuli.

President Saakashvili has promised to return South Ossetia and Abkhazia as soon as possible. This increases the tensions in the region. Recently, his police, security and military forces closed down the Ergneti market next to South Ossetia — a major artery of illicit and licit trade and a source of survival for thousands of people. His bold actions regarding Ajara and the Ergneti market have considerably raised the levels of tension in Abkhazia and South Ossetia, particularly since it seems that there are some grounds to assume that Russia will change its policy from geo-military support to these entities to economic and business influence. On the other side of the coin, the influence of NATO, the US and the West in Georgia is on the ascendant. Georgia continues to be a focus of attention for regional and international actors alike.

### **3.1.9 Iran**

Politically, Iran seeks to take advantage of the vacuum left after the fall of the USSR to gain influence in the region. Iran also seeks to gain influence over Azerbaijan, perhaps out of religious motivation, but mostly as an effort to eliminate the influence of Azerbaijan on the Azeri population of Iran, and to prevent the increase of Turkish and US influence in Azerbaijan. The region provides an opportunity for Iran to counterbalance the isolation that the US tries to impose on it.

Economically, Iran wants access to Azerbaijan's markets and natural resources. This interest is manifested by the Iranian government's projects for road and gas connections with Azerbaijan and Armenia, which seem to be blocked currently, particularly by the US and Russia.

Of primary importance is the prevention of self-determination for the 20 million plus Azeris living in Iran, which would very likely plunge the country into violence and result in the partition of Iran. Since the country is united by religion, any division along ethnic lines would invalidate the unifying element. Certain limited national rights of Azeris in Iran, as opposed to religious rights, cause discontent in Azerbaijan and are a frequent reason for calling for the reunification of 'Northern and Southern Azerbaijan'.

Azerbaijan is suspicious of Iran for a number of reasons. During the NK war, while the Azerbaijani and Armenian delegations were negotiating in Teheran, Shusha/Shushi was taken. This planted a seed of suspicion that Iran was in some way colluding with Armenia. Relations deteriorated in 1994 when Iran was denied a part in the future oil consortium, and was accused by Azerbaijan of favouring Armenia in the war.

Pro-Iranian activities in refugee camps focus on recruiting support for Islamic groups. Perhaps the most notable opponent within the Azerbaijani political arena is the Popular Front of Azerbaijan, supporting the idea of reunification of the 'two Azerbaijan', although it

is unlikely that the idea would be translated into action in the near future. Nevertheless, its threat defines security issues in the region.

Iran is also growing wary of Azerbaijan's ties with the US and with Israel. The leader of the Azeris in Iran, Mohammad Chokhragani, has frequently visited both Baku and Washington, heightening suspicion amongst the Iranian authorities.

The desire for access to the Caspian (for oil and sturgeon) has led to incidents of minor violence between Azerbaijanis and Iranian border patrols, and is the main reason why there is a dispute over the status of the Caspian Sea or Lake.

Iran has been continuously trying to play a more significant role in the South Caucasus. However, as it is seen to threaten both US and Russian interests, the South Caucasus countries have been frequently reprimanded if seen to be too close to Iran and, on the other hand, have been rewarded if they have severed ties. Iran has emerged as a pariah of the region, sharpening the political differences between East and West.

### **3.1.10 The UK**

The UK has a strong interest in promoting democracy in the region, particularly in Azerbaijan. Although the 'Great Game' is politically over, an economic Great Game is just starting. Caspian oil has been of great interest to the UK, especially since the 'war on terror' could threaten relations between the West and the Organisation of the Petroleum Exporting Countries (OPEC) (Azerbaijan is not an OPEC member). The UK is therefore seeking closer ties with Azerbaijan, and is promoting the EITI and other democratic governance initiatives.

### **3.1.11 Non-Governmental and Inter-Governmental Organisations**

On the inter-governmental side there are UN offices present in both Armenia and Azerbaijan, although not in NK. The developmental and humanitarian activities of UN agencies can potentially contribute to creating an environment more conducive to conflict transformation (e.g. efforts aimed at poverty reduction, democratisation and economic development),

although, due to government links, they are not always best placed to take on a direct conflict resolution role. Non-governmental organisations are, on the other hand, better placed to play a more neutral, third party role in resolving the conflict. Examples include the UK Government financed NK Consortium Initiative bringing together Conciliation Resources, International Alert, Catholic Relief Services and LINKS. These NGOs are also engaged in their own conflict transformation programmes outside the consortium project. There has been a trend for Inter Governmental Organisations to build peacebuilding components into their activities and potential exists for greater levels of partnership between these agencies and conflict transformation NGOs.

### **3.1.12 The EU**

The EU is well positioned to catalyse peace in the region.<sup>52</sup> The EU's political interests largely coincide with those of Germany, Italy and the UK that have been the most significant destinations of Azerbaijani oil. The EU invests in trade and communications routes that have been destroyed, and adopts a more regional all-inclusive approach. Its TRACECA (Transport Corridor Europe Caucasus Asia) programme does not isolate Russia or Iran.

The EU is currently the only geopolitical and geo-economic global project that is equally attractive to all three South Caucasus states. Whilst until recently its role has been mainly financial (in addition to its influence on democratic processes and human rights), with the new Neighbourhood Policy and Common and Foreign Security Policy (CFSP), the EU will probably increase its political presence in the region. Finance remains its main lever, however, with conditionality becoming an important component of the EU approach.

---

<sup>52</sup> In light of the recent enlargement of the EU, the EU's new strategy on 'Neighbourhood Policy' (announced on 12 May 2004), which also includes the South Caucasus, is significant. Although Azerbaijan is no less eager to join than Armenia, the recent statements by President Aliyev show that Azerbaijan rules out the possibility of participating in the policy if it means co-operating with Armenia. This is a clear indication that Azerbaijan will not compromise simply to gain international political and economic advantages.



### **3.1.13 Norway**

Norway is not a member of the EU and has developed a particular foreign policy in the South Caucasus, especially in Azerbaijan. The Norwegian oil company, Statoil, operates in Azerbaijan. Statoil is commercial operator of SCP – responsible for gas sales. Politically, Norway has been the most consistent and uncompromising international supporter of democratic principles in Azerbaijan.

### **3.1.14 OSCE - Minsk Group**

The Group's mandate is to find a framework for resolving the conflict over NK, and to support a peace process by deploying OSCE multinational peacekeeping forces. The Group has not been successful in either task, despite managing to secure a ceasefire agreement. There have been numerous negotiations, and although the group is genuinely involved and could be best placed to bring about and support a political negotiations process, it is co-chaired by France, Russia and the US, none of whom are seen as objective by the parties to the conflict. Azerbaijan vehemently opposes France's participation in the group, and proposes different, more neutral actors.

## ***3.2 National level***

### **3.2.1 Azerbaijani government**

The Azerbaijani government is a closed, elite group. In small communities, allegiances to either the government's ruling YAP party, or to the opposition, determine many aspects of people's lives. The competition for power is not restricted to the government and opposition, however. The ruling elite is also divided along clan lines – mainly the Nakhichevanis, led by the Aliyev family, and the Armenian/Yerevan Azerbaijanis ('Yerazi') clan. The two share strategic alignment on major issues, but can also be future rivals, since they are almost as powerful and wealthy as each other. Another important clan is Mutalibov's clan from Baku's Apsheron settlements, supported by Moscow. Since the state controls the economy, it is the ultimate prize. Different parts of the governing elite control different parts of the economy.

The need to maintain wealth and influence put pressure on the late Heydar Aliyev to make concessions to certain party members.<sup>53</sup>

Heydar's death and the October 2003 presidential election results created a new sort of competition, which according to some might even escalate into an open fight for power between the old and the young elite. The old, representing Heydar's regime, has been running the country 'Soviet style', the only way its members know how to govern whilst Ilham Aliyev has brought in many of his younger peers.

The new young elite enjoy the fruits of this system, but are beginning to feel a backlash: extortion only works if people are able to pay. In a situation with large-scale labour migration, extreme poverty and around 800,000 internally displaced persons (IDPs) and refugees, there are limits to what can be extorted. The new elite have invested in the country (mostly in real estate) and now need a buyer.<sup>54</sup> Foreign investors brought along an expatriate population (about 8,000-10,000 people), which encourages a consumer-centred industry. This new trend towards consumerism, combined with increasing levels of poverty and Saakashvili's clampdown on corruption, makes economic reforms more appealing to the new elite, while the old one is desperate simply to maintain the status quo.

Fear of losing power is present in all government decisions, which makes it very difficult for the government to have any long-term vision. There is a need to rid the government of this fear. Economic and political power are so intertwined that the president and those surrounding him fear tomorrow on a personal level. Levels of government objectivity may increase as direct personal gains from the economic affairs of the country decline.

---

<sup>53</sup> Heydar Aliyev was confronted at a press conference about his tolerance for corruption. He openly admitted not being able to dismiss the most corrupt ministers, because if he did, they would begin to support the opposition financially.

<sup>54</sup> Although many claim that as long as there is a Diaspora in Russia that sends large remittances home, there will always be plenty of money to extort, this system can only function under totalitarian conditions. The young elite have an interest in decentralising power as a means of getting into power.

The most destructive symptoms of the current form of governance are autocracy and corruption. These impact on political and economic development equally negatively (curtailment of human rights, negative business environment, etc.). Azerbaijani society has had no direct experience of a democratic regime, although it may see certain concessions as signs of democracy. Independence from the Soviet regime is widely interpreted as a regime change, although it can be argued that the form of governance has not changed much. Corruption is the most powerful mechanism hindering economic development, penetrating all aspects and levels of society, ranging from large-scale abuse of public funds to the inability of small-scale farmers to sustain and grow their businesses.<sup>55</sup> Furthermore, the nepotism within the ruling elite makes it difficult to change important post-holders, many of which have only Soviet/Communist experience of governance.<sup>56</sup>

The Azerbaijani government has been going through an identity crisis since the collapse of the Soviet Union. It uses Soviet methods to control its own population, but preaches democracy and respect for human rights. The ineffectiveness of the tax system and the decade-long state-sponsored kleptocratic system of 'gifts for services' have left an impoverished and disempowered population, which is unlikely to stand up to its own government. Although some recent government appointments suggest a move toward a different style of governance, the slow pace of reform suggests that members of the government remain wary of falling out of favour with the President. Heydar Aliyev's personality cult has been gradually transferred to his son Ilham. Western countries' emphasis on diplomatic tact when addressing these issues perhaps sends the wrong signals to the local population who (particularly in the rural areas and with very few exceptions) has no direct experience or understanding of democracy.

---

<sup>55</sup> A local farmer spoken to as part of research for this report put this in very basic but powerful terms. He cannot buy another cow even though he can afford to, since the money he would have to pay to the authorities if they discover he bought another cow is much higher than the price of the cow itself.

<sup>56</sup> Perhaps the best point concerning the form of governance and economic stagnation came from one of the interviewees spoken to during research for this report, when referring to Heydar Aliyev: 'A communist can be a good man, but he cannot be a capitalist.'

### 3.2.2 Other governing bodies

#### *Executive local authorities*

These structures function in a paradoxical way. On the one hand, the Heads of the Executive Power behave as 'warlords'. They have full control of their territory, allocating jobs, deciding levels of development and investment, controlling freedom of speech; on the other hand, they are appointed and dismissed by the central government – in fact by the President himself. In return they have to ensure that there is no crime, not too much opposition (over the minimal level required to maintain an illusion of a free society) and that the President is loved by his nation.

#### *Municipalities*

The local municipalities' power in a community is juxtaposed with that of the local authorities, since in contrast to the latter, the municipal officers are elected. In many regions, municipalities are governed by opposition party representatives (or at least this is how it was before the October 2003 elections). Local authority executive committees are government appointed, representing the views of YAP. The municipality representatives, elected through a different process, usually enjoy more genuine popular support than the local authorities. This creates tension between the two main structures governing each region, which can escalate in times of crisis.

The municipalities favour the decentralisation of power, away from the local authorities. The 1995 Land Distribution Act allocated land to the municipalities. However, in many places the local authorities are accused of allocating the 'least favourable' land to the municipalities, both in terms of land quality and location (of particular relevance when it comes to the value of land in the pipeline corridor). Land rent is an important income for municipalities and so is political power, which comes with access to extortion mechanisms.

The system of governing the country via local authorities created a very powerful means of imposing total control over the country's territory. In reality, there is very little separation between the local governing bodies, the judiciary or the police, although they ought to

function as separate structures. Visitors and other channels of information are carefully monitored. The heads of the local authorities do not know the length of their term (dismissal is the President's decision), and therefore hurry to accumulate wealth from the local population.

### **3.2.3 Opposition**

The opposition is fragmented, but more along personality lines than according to significant political differences. For example, nobody expects the opposition to be any less corrupt than the existing government if it comes to power. There is an enormous degree of acceptance that 'this is the way it has always been and always will be', which has led many people actually to prefer Ilham Aliyev over the opposition, even if they disagree with him politically, because the Aliyev family is wealthy, whereas the opposition is poor. Furthermore, the opposition is not experienced in running the country, and may not remain in power for long, so there are perceptions that they will try to 'fill up their pockets' as quickly as possible, at the expense of the already impoverished nation.

The opposition needs more protection for their basic human rights, such as freedom of speech, freedom from persecution for political dissent etc. Perhaps because of this shared notion of being deprived basic human rights, the opposition supports selected NGOs. Having said this, the situation is complex in that some NGOs are platforms for opposition parties, and others are mouthpieces for the government. Distinguishing NGOs from political agendas is difficult.

There are three main factors preventing the opposition from being elected in Azerbaijan:

- (a) Lack of unity: the opposition remains fragmented and open to the divide and rule tactics of the government.
- (b) Money: the current government perceives freedom of speech, and the right to free and fair elections, as an obstacle to a steady stream of income.
- (c) Lack of leadership: there is a need for new charismatic leaders capable of changing the attitudes of Azerbaijanis towards the opposition.

### **3.2.4 Islamic faith-based groups**

These groups (with the more radical ones having a clear recruitment agenda, particularly amongst the youth in poor, rural areas and refugee camps) face challenges in Azerbaijan that stem from the country's long tradition of secularism (due to communist rule), the ideological vacuum following the fall of the USSR and the indifference of the population towards the political distinction between Sunni and Shiite Islam.<sup>57</sup> The mixed version of Islam in Azerbaijan attracts a large variety of Islamic movements, from Iran to Saudi Arabia. Perhaps the most prominent ones are the Iranian-based groups and the Wahabbists. Wahabbism found fertile ground in Azerbaijan, since it is modest in its appearance, attracts the poor, advocates unification of Sunni and Shiite Islam, frequently publishes in Azerbaijani, and propagates war against the 'infidel' in order to free Karabakh.

There are numerous warnings of increasing radicalism amongst Islamic faith-based groups in Azerbaijan. Alienation from the West could speed up this process.

## ***3.3 Local level***

### **3.3.1 Rural population**

The following section summarises the findings from the authors' interviews with people in settlements along the pipeline as well as in rural areas geographically remote from the pipeline. This section had a specific approach designed for directly engaging with the rural population, based on one element of International Alert's CSBP toolbox (see Annex 1). The interviews were conducted in July 2003, prior to elections in Azerbaijan and to Heydar Aliyev's death.

---

<sup>57</sup> Although the vast majority identifies itself as Shiite, the sense of one unified Azerbaijani identity is arguably stronger than the differences between Shiite and Sunni Muslims.

## *Governance*

The Aliyev regime is seen as a stabilising factor for Azerbaijani politics, restraining a volatile society. For the government's detractors, this is seen as a negative trait because it restricts political and economic development.

There is a widespread perception that Azerbaijan went through a regime change when the communist ideology was formally abandoned as a state form after Azerbaijan gained independence. Only a small minority of respondents described the current rule as a continuation of the Soviet system, both personally (same politicians, same leadership) and functionally (in the type of governance and control).

Independence is listed as one of the most important developments in the post-Soviet era. Yet, very few could explain what independence meant to them or how they had benefited from independence.

There is a dividing line between opposition party supporters and pro-government supporters. The depth and significance of these divisions can impact on all aspects of people's lives, ranging from employment opportunities to education.

Another dividing line, also created after the fall of the USSR, namely pro-Western versus pro-Soviet style thinking, does not break down cleanly between pro-government and pro-opposition thus adding another layer of complexity to the schisms starting to appear in the Azerbaijani social fabric. Even though the ruling party puts on a pro-Western façade, their actions, thinking and style of governance are strongly reminiscent of Soviet times.<sup>58</sup>

---

<sup>58</sup> The Azerbaijani elite during the Soviet era was very typical of the rest of the USSR (or most of the Soviet bloc). There was the ruling elite, strictly supporting Moscow at any cost and fully indoctrinated, not always well-educated, but good as bureaucrats fulfilling orders, and then there was the intelligentsia, which was not allowed to accumulate wealth or reach high positions in governmental offices, but shaped most of the 'soft' issues in the country. The former, while trying to stay in power at any cost after the fall of the USSR, has seemingly adopted Western ideals (e.g. democracy and the free market), but in fact are just the gatekeepers to many financial resources and the only group that knew how to 'run a country'. The combination of these three factors (adopting new ideals, control over money and good bureaucratic expertise) kept the Soviet-communist type elite in power,

Government supporters credit Heydar Aliyev with managing the signing of the 'Deal of the Century' and see this as the most significant positive change since the fall of the USSR.

The frozen conflict could serve the interests of those currently holding power, since as long as there is a danger of conflict, there is a need for someone like Aliyev to guarantee political stability. 'If the conflict was resolved, the government would not be able to keep its power', and the means of generating wealth from corruption would be diminished. In this sense, political stability may be a trade-off for Karabakh.

The army was mentioned as a source of corruption, as were IDPs, in that some people claimed that IDPs had sold their own land to Armenians during the NK war and would therefore be unlikely to welcome another war with Armenia.

### *Security*

Findings revealed extremely high levels of personal security, with respondents almost unanimous in their lack of experience of violent crime and only minor experience of petty crime. While respondents in Gazakh and Balakan also shared a strong sense that their communities are very safe, both cited incidences of violence perpetrated by what they characterised as outside forces.<sup>59</sup>

Perceptions of economic security, however, were consistently extremely low, and respondents feared for their ability to provide for themselves and their families.

A number of respondents also refused to answer relatively banal questions, on the grounds that the questions were 'political', suggesting that respondents' sense of political security may

---

whereas their advocacy of new ideas gives the impression of a regime change. However, the collapse of the USSR was a significant factor in itself to justify the perception of a regime change.

<sup>59</sup> Although there were sporadic incidents of violence, people have reported the most recent one only: a group of local Avars took over a police post jointly with an armed group of Avars from Dagestan. Although arrests were made, there have been no incidents since, yet there are signs of oppression of ethnic minorities.



be somewhat fragile. These responses also suggest, perhaps, a willing trade-off between political stability and political security.

President Heydar Aliyev's regime was perceived as bringing political stability to the country, following the NK war. This stability gives people a sense of security, whilst replacement with a different government will undermine it. Ilham Aliyev (who subsequent to the research succeeded his father) was perceived as likely to continue his father's legacy rather than introduce regime change.

The negative examples from Soviet times that were mentioned were travel restrictions, forced labour and political repression. These were regarded by respondents as the problems of a by-gone era.

### *Economy*

The overwhelming economic issue at the local level is the high unemployment rate resulting from plant and factory closures following the collapse of the Soviet Union, which in turn has widespread social implications. Endemic corruption undermines the establishment and expansion of local businesses that have the potential to mitigate the unemployment crisis. Personal economic/job insecurity is attributed to the collapse of the Soviet Union and to the NK conflict directly. Poverty, unemployment and the growing gap between rich and poor are seen as undermining the social fabric of society.<sup>60</sup>

Collapse of the economy is attributed to the NK war, but the closure of industrial facilities (factories, plants, etc.) to the collapse of the Soviet Union, mostly due to the Soviet system of interdependence of factories with other USSR states.<sup>61</sup>

---

<sup>60</sup> Gaps between rich and poor contribute to social disintegration. For instance, people have to stop visiting each other since it is a cultural norm to invite guests for meals, and few can afford to host these meals anymore. In a society where hospitality is high ranking in cultural and social norms, this leads to alienation, and can have disastrous effects, particularly on small, rural communities.

<sup>61</sup> Each factory was part of a chain of production, the other parts of the product manufactured in different USSR member states. The process was directed and controlled from Moscow (Russia was always a link in the chain, and frequently the manufacturer of the end product), and served as an economic guarantor of the Soviet Union.

Unemployment is seen as the primary cause of the bad economic situation of the country. Job creation (particularly the reopening of factories or ‘production units’), credit lending agencies (with more favourable conditions, particularly for farmers), and the elimination of corruption were listed as the three main factors that could eradicate unemployment. Many respondents hope for some form of foreign assistance, but never ‘handouts’. They were eager to show that all that Azerbaijan needs is employment opportunities and some credit, since people can and want to work.

Economic prosperity is predicted in the future and linked strongly to oil production. Respondents thought oil revenues would turn Azerbaijan into a rich country, although they said political stability in the country was a pre-condition.

Gaps between the old and young generations are emerging as a result of unemployment and changes in belief systems. On the one hand, new values are being reinforced through modernisation and globalisation. On the other hand, the country is run by a Soviet-style elite, adopting a Soviet style of governance.

Labour migration due to the lack of employment opportunities in Azerbaijan (mostly to Georgia, Russia and Turkey) has had a negative effect on individual communities (in some cases, up to 70% of young men migrated for work). Many families get torn apart. Interestingly, despite the high proportion of people working abroad, foreign remittances as an additional source of income were mentioned only in a few cases.

At the local level, authorities and other powerful figures collect ‘taxes’ from local business owners, most often when business owners look to expand their businesses. This prevents economic growth of small-scale enterprises, since the fees for allowing expansion are greater

---

Inevitably, after the collapse, most of these links were disrupted, resulting in the collapse of economies of those countries which had been solely dependent on producing goods for the Soviet Union.

than the anticipated benefits. Taxes are also collected for transporting produce to market (in one case, at a rate of 800%). Predatory monopolistic business practice is common.

#### *Economic dimensions of the NK conflict*

According to the respondents, Armenians have strong economic incentives to prolong the conflict (especially the arms and drugs dealers). Karabakh is seen as a storage depot for drugs. Respondents thought only the OSCE, the UN and the EU have the power to coerce these dealers into abandoning the pursuit of illegal activities which support the status quo of a frozen conflict.

The economy is unstable and failing due to the conflict, because of the loss of land and labour force. Unemployment is the most prominent negative economic factor and, after lack of infrastructure, the second major source of discontent. Unemployment is perceived as being a direct result of the conflict: the economy has collapsed due to the war. The influx of refugees/IDPs puts an extra strain on the state budget, on employment opportunities and on access to agricultural land. The perception of the dire economic situation in the country being due to the unresolved conflict naturally leads to the claim that NK ought to be returned by peaceful or violent means as soon as possible. All respondents see the full return of NK and the adjacent 'security zone' to Azerbaijan as the only way of resolving the conflict.

#### *Society/culture/identity*

The NK conflict is perhaps the most defining factor of people's lives. The politics of identity underpins all aspects of the NK conflict at the community level. Azerbaijanis seem to feel violated and taken advantage of by Armenians. They see no possible rationale or justification for the Armenian position, believing their perspective to be the uncontested 'truth'. IDPs provide a constant reminder of the insult.

There is a sense of betrayal. Azerbaijanis coexisted with Armenians and with other nations peacefully, until Armenians 'abused their good will and wanted to take their land'. Armenians, pre-war, are often portrayed as being 'guests', indicating that the Armenians were

'hosted' by Azerbaijan, as a 'tolerated' minority. Armenian women who married Azerbaijani men are accepted since their children are perceived as being Azerbaijani.

Armenians are seen as cowards and Azerbaijanis as good fighters, with the only possible explanation for losing the war being that the Azerbaijanis on the front lines (soldiers and residents) sold out, and because Russia supported Armenia. Respondents indicate no Azerbaijani responsibility for the war.<sup>62</sup> Iran and Russia provoked the war, while Russia heavily backed Armenia. There was an occasional reference to 'dark powers', which caused the war, and control the faith and future of the Caucasus.

Although most of the respondents refrained from admitting any common traits with Armenians, there was a strong sense of similarity in terms of attachment to land. There is a widespread assumption that NK can only be returned by violent means, since Armenians will not leave their houses of their own free will. The reason for this assumption is that many Azerbaijanis were forcibly displaced, an experience that does not leave much room for understanding why anybody would leave their home freely.

Their claim was reinforced by the perception that people who fight for land are even less likely to leave freely. Generally, there is a great deal of support for IDPs, and for a sense of all belonging to one nation. IDPs are a leitmotif in identity consolidation, which is part of the basis for people's willingness to go and claim NK back by force.

However, people either feel overwhelmed by the number of IDPs in the settlements, or feel discriminated against in terms of land allocation. This sense of being overwhelmed sometimes led respondents to feel there was a significantly larger influx of refugees than there actually is, or that their impact was significantly greater than evidence would support.

---

<sup>62</sup> One possible dissenting voice was an interviewee who claimed that the current government would not be able to guarantee the rights of the Armenian population if NK is returned, since it is not democratic. This refers to the claim that the Azerbaijani- Soviet government violated the rights of Armenians in NK, which was one of the causes of the conflict, indicating that a truly democratic government might be able to guarantee minority rights and restore the relationship between the two nations.

### *Rural attitudes towards the oil industry (prior to BTC)*

The oil industry and oil extraction played a significant role in the country's life even before the arrival of the Western oil companies that are building the BTC pipeline. Azerbaijanis are proud of their knowledge and experience in oil extraction.

The onshore oil fields are operated by joint ventures between Azerbaijani and foreign oil companies. There is an existing relationship between these operations and the surrounding settlements. This relationship has deteriorated recently, with many complaints about ill treatment of oil workers (old people close to pension age being fired, workers having to sign blank work agreements, women being harassed, etc.). Moreover, the companies have increased the number of employed foreign workers recently, which reduces employment availability and creates a sense of inferiority amongst locals.<sup>63</sup> Oil pumps operated by these companies continue to be seen as an environmental hazard.

### **3.3.2 Internally Displaced Persons (IDPs)**

Areas of high concentration of IDPs are numerous and scattered. Key IDP interests are the full, facilitated return (including funds for reconstruction and/or compensation for displacement) of IDPs to their original homes and the full return of NK.

IDPs are not a homogenous group, and their needs vary. However, a large proportion of them still reside in tent towns, student dormitories or other temporary structures. IDPs are the largest unemployed segment of the population within Azerbaijan. Their political needs include political representation, mostly since there are frequent accusations against the government for not trying to resolve the NK conflict and for using the IDPs as pawns for political gain.<sup>64</sup>

---

<sup>63</sup> Onshore oil companies in the areas of Ali Bayramli and Hajigabul are treated with great suspicion due to a poor relationship with the local population. These areas have traditionally employed a large number of oil workers, and if these are continually laid off in order to make room for foreign workers, this can have a negative effect both on increasing expectations concerning BTC Co., and in terms of a hostile attitude from the local population towards a 'new company'.

<sup>64</sup> The registration of IDPs for elections is a political issue, since those who are not registered can be used as 'votes' given to any political party – if the elections are rigged.

This is a group, the size of which is unknown, who are frequently manipulated for political purposes. The persistent condition of displacement has turned them into a population easily recruited by others if promised better conditions.

### **3.3.3 Ethnic minorities**

The main groups are Avars (north-west), Lezghins (north), Talish (south), Tats (north) and Russians. There are a considerable number of Armenian women, who married Azerbaijanis before the war. This group, however, has been assimilated and has no political power.<sup>65</sup>

The Talish are perhaps the most politically active ethnic minority (followed by the Lezghins), since their leader, Aliakram Gummatov (now jailed), was the first one to annul Soviet power in Lankaran and to declare independence from the Soviet Union, and was therefore initially regarded as the leader of the Azerbaijani fight for independence. Both Talish and Lezghins are 'divided' nations, i.e. a significant part of the population is situated on the other side of the Azerbaijan border – in Iran and Dagestan, respectively.

Both groups attempted to establish an independent republic, uniting the two halves of their nation and separating from Azerbaijan. These interests prevail on the fringes of the two groups. The majorities do not aim for independence.

The Azerbaijani government deals with the minorities through denial and oppression. Their rights are curtailed, and the only strategy undertaken is that of assimilation. The Talish are more distant from Baku, more concentrated in one area and therefore still able to preserve their own language. Their proximity to the Iranian border causes the government to regard them with high suspicion. The area has been the agricultural 'fruit-basket' of Azerbaijan, and during Soviet times it directly supplied the vast Russian market. The perception of self-

---

<sup>65</sup> Under the current political circumstances, it is difficult to establish whether the 'Armenian wives' are more likely to support peace or war. On the one hand, they are naturally seen as favouring a peaceful settlement, so that their husbands and sons need not fight their relatives, on the other, since they have been trying to assimilate, they might take a harder line on the conflict, in order to appear more patriotic.

sufficiency, with Russia's support, heavily influenced the aspirations for independence, and is the reason why the Talish have closer ties with Russia, despite the geographic proximity to Iran. The Lezghins face similar problems. Their aspirations for independence have been less motivated by self-sufficiency.

The promotion of one Azerbaijani identity through the assimilation of ethnic groups into the local culture is encouraged. In many places Kurds and Meskhetian Turks are viewed as an integral part of the nation. All significant minorities have unsuccessfully attempted at times to break away from Azerbaijan. The only successful one was the Armenian minority, plunging the country into war. It may be the case that the three remaining minorities (Avars, Lezghins, Talish) may have been unsuccessful in their attempts since the separatist leadership did not enjoy the support of all the members of the given minority. Nevertheless, rural Azerbaijan is an environment not conducive to toleration of different ethnic groups, being highly xenophobic, and only tolerant to those willing to embrace the Azerbaijani version of history.

### **3.3.4 Baku residents**

Baku is regarded as a separate 'Azerbaijan', highlighting the difference between the urban and rural areas. The urban elites have become more isolated, reassured that they do not need the rural population, and encourage foreign investment in Baku. A similar process has been materialising in Yerevan. Both cases demonstrate a situation in which the rulers are removed from the rural populations, and as such at risk of losing their legitimacy. The only way of ruling in such a situation is by tight control and fear.

Furthermore, IDPs have overcrowded Baku, which was not built to absorb such high numbers of people. Residents of the city have difficulties with housing, employment and traffic, which put pressure on the government to speed up the repatriation or resettlement of IDPs.

## 4. Links between oil and conflict: some future scenarios

### *4.1 Introduction*

This chapter is based on the research conducted by International Alert engaging local communities and researchers in trying to understand the relationship between oil and conflict in the South Caucasus (see Annex 1 for an outline of the methodology used). Its purpose is to offer some insights from the research into the likely future impact of the BTC project, as a key component of the broader oil industry, on the context in Azerbaijan and vice versa. To a lesser extent, we will also make some judgement about impacts as they relate to Georgia and the wider region. However, the main focus, as in other chapters, is on Azerbaijan. From a conflict perspective, NK is thus of particular significance.

The BTC project is already underway, building as it does on decades of engagement by oil companies in the region. Some of the patterns of impact therefore relate to the history of the oil industry in the South Caucasus, as well as to the ‘non-oil’ context. A key question will be whether the BTC pipeline, as the main transport for Azerbaijani oil to market, is in fact contributing to a continuation of historical patterns, or whether it can potentially contribute to the development of new, more positive ones.

It is recognised that BP, perhaps more than any other oil major, has taken steps to make its definition of CSR more sophisticated. This relates both to headquarter activity and allocation of considerable resources, and to BP operations around the world.

Instances of CSR activity in the South Caucasus have already been identified in this report. Such initiatives are valuable, and need to be sustained and advanced. However, the company should also begin to frame these actions within the broader conflict context, through comprehensive analysis of the diffuse conflict impacts of its presence. BP has recognised the high expectations around the oil industry in Azerbaijan and has taken steps to address these.



However, these steps have been focused on what the company interprets as being the 'project-affected communities' (see Chapter 2).

The central issue is not the pipeline itself; it is oil and the oil industry. Expectations of what oil will do for Azerbaijan are not confined to those living in close proximity to the pipeline, but exist throughout the country, as this report has shown. Sticking to an interpretation of 'affected communities' as those along the pipeline not only misses the point, but also risks opening up the fault lines that underpin conflict further, by ignoring key stakeholders in the development of the region as a whole.

It is important, of course, not to personalise this flaw in analysis. The mainstream tools available to a company like BP do not encourage a conflict-sensitive approach, and some of them, such as the ESIA, are regulated in part by the EBRD and the IFC as BTC financiers. BP's *Regional Review* was a first attempt to take a broader approach to the company's contextual analysis, but this was a drop in the ocean when compared with the resources put into the ESIA. As discussed, the ESIA took a narrow focus, with an emphasis on environmental and social issues along the pipeline route, and within the three countries through which the pipeline is routed. The combination of the *Regional Review* and the ESIA failed to paint a picture of the broader context in the South Caucasus in which the BTC operates, including the political economy. It also failed to frame the impacts of the BTC as a component of the oil industry that has, and continues to have, such an impact on the region as a whole. A conflict-sensitive approach might have brought this into sharper and earlier focus.

This section attempts to draw some of these impacts together, in a way that will add value to the narrower assessments by BP, in so far as they have not touched on the conflict dynamics in the region and how these relate to the BTC as a component of the oil industry. Only when the company has a more rounded analysis can it design effective conflict sensitive mitigation measures that will maximise its contribution to peace and sustainable development in the South Caucasus region, as well as to its own longer term security.

## ***4.2 Regional level – what framework?***

The gradual breakdown of the Soviet framework for co-existence between Azerbaijan and Armenia has been a major contributor both to causing conflict over NK, and sustaining it. The regional framework that replaces the Soviet Union will probably be one of the most important factors in resolving it.

The current stalemate could be explained by the two states aspiring to belong to a new framework (at least nominally) –one endorsing principles of democracy – that of the EU and NATO. Furthermore, the decision to place NK under Armenian or Azerbaijani control in the 20th century has been taken by external actors. The widespread notion in Azerbaijan that the international community is responsible for resolving the conflict over NK can be interpreted as ducking responsibility. It is a notion, however, supported by at least the experience of the last 100 years.

In addition to the need for a new overarching, and potentially unifying, international political framework for the South Caucasus, key factors that sustain conflict at the regional level include: major beneficiaries of the ‘shadow economy’ in the region; the perceived partiality of the Minsk Group; and Russia’s interest in securing influence over its ‘near abroad’. Oil itself has an impact in that it forges geopolitical alliances that sustain, rather than cut across, conflict divides. Turkey’s balancing act between economic advances towards Armenia and its security, and identity-based alliance with Azerbaijan, also diminishes the potential transformative role it could play in the region.

### **4.2.1 Outlook**

Success of the EU’s Neighbourhood Policy in courting the South Caucasian states could have a positive impact on relations between Azerbaijan and Armenia. If the EU decides to extend the notion of its neighbourhood to the South Caucasus, then there is also the possibility of its adopting a mediating role between Russia and the Caucasus. Turkey can potentially play a diplomatic role in bringing its Turkic brother closer to the notion of regional co-operation, particularly if it is successful in its aspiration to join the list of those lining up to join the EU

next.<sup>66</sup> Turkey's engagement in helping to stabilise the South Caucasus would also lend itself to warmer relations with Russia, which continues to be an important economic partner. Azerbaijan also has the potential to reconnect with Russian markets if it can reinvigorate its agricultural industry. Positive movement towards a resolution to the NK conflict would also require a revisiting of the constitution of the Minsk Group, since Russian, French and US leadership tend to create perceptions of the group's being partisan.

However, recent statements by Ilham Aliyev that Azerbaijan would on no account co-operate with Armenia within any political or economic framework illustrate the stark challenges ahead. The importance of oil in this regard should not be underestimated. Turkey's BTC pipeline partnership with Azerbaijan and Georgia, at the expense of routes through Armenia, Iran and Russia, has compromised its potential diplomatic role. The BTC project commits Turkey to upholding Azerbaijan's security agenda, weakening its diplomatic potential.. As Turkey is on its way (long and windy) towards the EU, it is under pressure to resolve old conflicts and ensure that the EU lives in a 'good neighbourhood'. Turkey's BTC-bond with Azerbaijan does not allow Turkey to play a more subtle mediating role between Armenia and Azerbaijan and it diminishes the chances for full rapprochement between Turkey and Armenia. Economically, the pipeline excludes Armenia from the regional benefits oil can bring. A weak Armenia will lean further towards Russia for support, emphasising the geopolitical alliances that underpin the current conflict context and fuelling suspicion of the Minsk group as partisan. The combined effect would be a hardening of positions, with Armenia and Russia on one side and Azerbaijan, Turkey and the US on the other. The implications of this for, for example, the spread of radical religious groups and for strengthening enemy images at the local level, are clear to see.

In addition, it can be argued that the strategic importance of Central Asia to the US could result in the US turning a blind eye to corrupt practices and human rights abuses in

---

<sup>66</sup> In December 2004, the EU agreed to start accession talks with Turkey in October the following year. While the talks will be open-ended and thus does not guarantee Turkey's eventual membership in the organization, it is commonly believed that the process is likely to take an estimated 10-15 years

Azerbaijan if it means the longevity of the Aliyev regime, and therefore stability. On the other hand, scaling up of international initiatives to combat corruption and increase transparency of oil revenue flows (through, for example, the EITI) is providing more space for public scrutiny of oil revenue flows and arguably contributing to, for example, Ilham Aliev's promise to create 600,000 new jobs (presumably using investment from the oil fund), and to use a portion of the oil fund to provide permanent living structures for IDPs near the buffer zone between Azerbaijan and Karabakh.<sup>67</sup>

#### **4.2.2 Oil industry response**

If the BTC, as a manifestation of the international role of the oil industry in the conflict dynamics of the region, is to become part of the solution rather than part of the problem, ways must be found to frame the benefits of oil more regionally. This will require greater regional co-operation between oil companies and the international community, and a regional approach to the issue of security. Furthermore, efforts should be made to support those seeking to foster business development outside the confines of the pipeline corridor and the three states that host it. Recent efforts by local businesses to develop a regional network of enterprises offer opportunities to open up trade links not only between Armenia, Azerbaijan, Georgia and Turkey, but also encompassing Southern Russia. Those companies within the Western oil industry (including BTC Co. and BP) would add weight to these efforts, helping to address the economic security issue from a regional perspective, enhancing the reputation and value of the oil industry, and lessening the likelihood of direct sabotage of pumping stations and oil industry infrastructure. A narrower response, maintaining a focus on the pipeline corridor and ignoring the economic needs of those in the wider region will only serve to expose the oil industry to reputational and physical attack. The company came to a realization that such a risk is real, designing the Regional Development Initiative as a response. The RDI however, will begin to be implemented only in a part of what constitutes a conflict region, not taking the regional conflict dimension into account, creating a margin for error that might jeopardize the long term economic benefits intended by the project.

---

<sup>67</sup> In May 2004, 30 Azerbaijani NGOs created a coalition on Improving Transparency in Extractive Industries.

*Table 1: Risks and opportunities of oil/ context at the regional level*

	<b>Context</b>	<b>BP/Oil Industry response</b>
<b>Risks</b>	<ul style="list-style-type: none"> <li>○ Azerbaijan uses importance of BTC to the West to resist moves towards democratic reform.</li> <li>○ Armenia attempts to strengthen links with EU unilaterally, further alienating Azerbaijan.</li> <li>○ Turkey withdraws from diplomatic role vis-à-vis Azerbaijan &amp; Armenia - border with Armenia remains closed.</li> <li>○ Russia seeks to stamp control on Caucasus as BTC seen increasingly as feeding a Western agenda. Turkey/Russian relations deteriorate.</li> <li>○ Turkey increases support to Azerbaijan, Russia to Armenia. Economic migrants from Azerbaijan deported from Russia.</li> <li>○ Military conflict erupts between Armenia and Azerbaijan. Turkey and Russia withdraw to let them fight it out, in order to avoid a Russia-NATO military confrontation.</li> </ul>	<ul style="list-style-type: none"> <li>○ BP and other oil companies focus their thinking on pipeline corridor – strengthens Azerbaijan/Georgia/Turkey alliance, keeping Armenia and Russia out.</li> <li>○ Turkey engages with oil industry to strengthen security arrangements along pipeline.</li> </ul>
<b>Opportunities</b>	<ul style="list-style-type: none"> <li>○ Moves towards a common framework internationally – increased diplomatic role of EU and Turkey (aspiring to EU membership). South Caucasus becoming EU’s neighbour.</li> <li>○ NK conflict elevated on agenda of international community and addressed by a wide range of actors.</li> <li>○ Turkey and Russia relations improve , consolidating political relations and future of Blue Stream project, in exchange for stability and shared economic space in South Caucasus</li> <li>○ Structure of Minsk Group revised so as to portray a more neutral role.</li> </ul>	<ul style="list-style-type: none"> <li>○ BP and other oil companies adopt a more regional approach to their investment activities, working with the international community.</li> <li>○ This includes a South Caucasus wide approach to security</li> <li>○ Oil industry supports establishing business development centres in the region, which can benefit from new economic opportunities provided by opening up of trade links.</li> </ul>

### **4.3 National level – the struggle for transition**

With the collapse of the Soviet framework of governance, Heydar Aliyev became the saviour of an Azerbaijan struggling to restore order within a newly independent but rudderless state. As many of those in rural communities would attest today, Aliyev brought stability, at a cost to some personal freedoms, but a cost worth paying at the time. What has become increasingly apparent over the past 10 years is that economic hardship has worsened. Young men have had to find employment in Russia, between 800,000 and 1 million IDPs have put more pressure on a shrinking labour market, and the transition from a centralised, planned economy to a free market one has not materialised. Old habits of socialist-style social security die hard, and the economic transition remains an illusion, with the vast majority of the population suffering economically as a result.

The lack of economic development outside Baku has made rural communities fertile recruiting grounds for radical religious and separatist groups, fuelling fears, amongst the Azerbaijani and US governments in particular, of loss of power, control and influence to Iran, Russia and terrorist organisations. Meanwhile, the role of Georgia in the region developed a new dimension following the ‘Rose Revolution’ and the replacement of the long-standing regime of Eduard Shevardnadze with that of the younger, more Western-orientated, Mikhail Saakashvili at the end of 2003. The new president has already regained control of Ajara, is clamping down on what he interprets as ‘illegal trade’ at the Ergneti market on the border with South Ossetia, and has taken a firmer stand on the corruption issue generally.

#### **4.3.1 Outlook**

Corruption is a key issue at the national level, sustained by the shadow economy that has evolved in a region where conflict has hindered the development of regulatory mechanisms, and where informal economic activity has grown across closed borders. Corruption is therefore a major challenge to peace and stability.

The oil industry in Azerbaijan has already generated large amounts of revenue from early oil and signature bonus payments. According to Caspian Revenue Watch at a high price of \$25 per barrel from 2003-2010, the government of Azerbaijan's share of oil profits from the ACG will amount to about \$16 billion.<sup>68</sup> At \$18 per barrel Azerbaijan's total earnings would come to \$7.2 billion. However, if the prices at the time of writing of more than \$50 per barrel persist, both of these scenarios will be too low.

Impacts can be categorised at one level as those researched more thoroughly by Terry Lynne Karl and others.<sup>69</sup> These impacts are generic in that they can also be seen in countries such as Angola, Colombia and Nigeria, and Western oil-producing countries, such as the UK and Norway. In particular, large revenues from oil tend to strengthen the currencies of the oil producer, making its exports less competitive ('the Dutch Disease'). In such a context it is hard to imagine Azerbaijan's agricultural sector providing goods for export to Russia. Neither does the recent demise of the Business Development Alliance (BDA), initially supported by BP and highlighted as a positive contribution in a recent report of the Caspian Advisory Panel, bode well for efforts to broaden the base of the economy.<sup>70</sup>

Oil revenues also fuel corruption by strengthening elites who will do anything to hold onto power given that, with wealth from oil, state office becomes the main source of power and prosperity. If the current aspiration of Georgia's president to reduce corruption becomes a reality, and if the international community backs this development, then Azerbaijan may feel obliged to follow suit. However, if the South Ossetia conflict worsens because of a backlash against attempts to clamp down on the informal Ergneti market (which is a major source of funds for the South Ossetian authorities) then there will be a further setback in the transition

---

<sup>68</sup> Tsalik, S. (2003) 'Caspian Oil Windfalls: Who Will Benefit?' (New York, NY: Open Society Institute).

<sup>69</sup> Karl, T. L. (1997) *The Paradox of Plenty: Oil Booms and Petro-states* (Berkeley, CA: University of California Press).

<sup>70</sup> The BDA had to cease its activities due to withdrawal of promised funding from numerous donors. Although during 2004, other institutions with similar mandates sprang up, these are tightly aligned with either governments or the oil companies, and are thus unable to provide an independent forum for discussion.

to an economy in the South Caucasus that can arrest current economic decline.<sup>71</sup> In this context, the business environment in Azerbaijan is likely to remain problematic, with the continuation of patronage politics, neglect of the non-oil sector and, despite Azerbaijan joining the EITI, little or no support for building the capacity of NGOs to scrutinise any transparency of oil revenues.

In this scenario, sustained low standards of living will be seen as interconnected with the loss of Karabakh and IDPs, and oil as the solution to both economic betterment and the return of Karabakh, since oil revenue will strengthen the military, and Azerbaijan's alliance with the West will put political pressure on Armenia.<sup>72</sup> The President's promises of new jobs fuels these expectations and may ultimately attract Azerbaijani labour migrants in Russia to return. If the return of these (young, male) migrants is combined with expectations not being met, then the argument for conflict, generated by grievance and the political aspirations of opposition groups, is strengthened.

On the other hand, if oil money can be kept within the formal economy and directed towards strengthening the non-oil sector then there are prospects for the benefits to be felt beyond those cocooned in Baku. If this happens (in tandem with positive policy developments at the international level), there is a possibility that peace will become a greater political and economic motivator for Azerbaijan than conflict. The EITI may then gather momentum and Azerbaijan will begin to develop a more far-reaching economic role as the hub for regional economic development in the South Caucasus region.

---

<sup>71</sup> For more information on this see Champain, P., D. Klein and N. Mirimanova (eds.), *From War Economies to Peace Economies in the South Caucasus* (International Alert and the Economy & Conflict Research Group of the South Caucasus, 2004).

<sup>72</sup> Having said this, the government may feel so disconnected from the majority of the population (following the argument that oil money makes this connection/interdependence unnecessary) that those holding power do not need Karabakh, or 'the people's expectations', to prosper, and will therefore be happy to maintain the status quo. In this scenario, a build-up of the military seems unlikely.



Those political actors in Azerbaijan seeking nothing less than an unconditional return of NK to Azerbaijan are likely to remain a significant obstacle, no matter what direction the government takes.

### *Georgia*

Instability at the national level is, at the time of writing this report, most keenly felt in Georgia. The Ergneti market has been forcibly closed down by Georgian military and police, which has heightened tension in South Ossetia, with some commentators speculating that Russia's response will be less accommodating in this case than it was in Ajara when Georgian forces overran the administration of Aslan Abashidze earlier in 2004. Time will tell whether those predicting renewed conflict as a result of any closure of the market will be proved right. The growing unease of minority groups in Georgia in the face of these events brings into closer focus the possibility of the targeting of oil industry installations.

The natural and obvious reaction to the military escalation in South Ossetia is to increase security provision along the pipeline itself. This will inevitably lead to stronger alliances between those hosting the pipeline (Azerbaijan, Georgia and Turkey), with Russia and Armenia in particular left out of the equation. Consequently, the efforts of the EITI are likely to slip down the agenda of oil companies and host governments more preoccupied with the immediate physical security of their assets.

Of more direct concern to the oil industry, in July 2004, the Georgian government ordered BP to halt work on a section of the BTC pipeline in the environmentally sensitive Borjomi region. Although the construction had been resumed, the step, together the government's decision to relocate the GIOC from its offices, demonstrate the new government's attempt to regain full control of all the aspects of the political life. Although Georgia is not the main focus of this report, this development has highlighted the vulnerability of the BTC project to complex political circumstances.

The Georgian Ministry for Environment has requested and paid for outside expertise from the Netherlands government, since 2000, to evaluate BTC Co.'s activities and level of compliance with Georgian legal requirements, in terms of its ESIA and environmental engineering. In October 2003, the Netherlands Commission for Environmental Impact Assessment noted that 'a transparent comparative assessment of all potential environmental risks associated with both the new and the previously assessed alternative corridors ... has not been provided. This comparison is needed for a transparent justification of the preferred route. Of the three routes assessed in this report, the Central corridor would be the preferred route for construction of two large pipelines.' (Advisory Review, Commission for Environmental Impact Assessment in the Netherlands, p. 6.)

The central corridor is not the route through Borjomi. What these opinions suggest is that although BTC Co. feels justified in claiming they have produced the necessary information, and that they comply with international standards and best practice, the watchdogs and anti-pipeline lobbyists have a legitimate gripe that the process is not transparent, and that the Borjomi route is not ideal.

The alternative route – the ideal (Georgian) route environmentally – would run south of Borjomi, and through Akhalkalaki. The region has long been regarded as 'sensitive', due to the perceived 'separatist' sentiments among the Armenian population in the region. Some would argue that bypassing Javakheti (Akhalkalaki District) for 'geopolitical considerations' echoes the dilemma faced by Armenia, isolated internationally by political events linked to the NK conflict, and therefore ruled out as a potential route by 'political considerations'. The political decision-making processes that are employed at this level in the South Caucasus are not subject to transparency, democratic processes, civil society influences or political accountability.

From the BP perspective, the 'anti-pipeline' lobbying against them in Georgia is misdirected. At the international level, some of it is related to global processes (anti-globalisation) that are

bigger than BTC or the Caucasus. At the regional level, much of the most serious criticism of BTC is now focussed on Turkey and human rights issues that are incidental or generally not applicable to the Georgian process. But inside Georgia, BP might see itself as somewhat vulnerable to the capriciousness and disingenuousness inherent in Georgian economic and political structures and processes. Early in this research project, we proposed that there was a 'gap' or a discrepancy between BP's perception of their successfully conflict-sensitive engagement, and the ongoing civil, legal, and media-related criticism and friction generated within Georgian society. We still think that this would be an interesting framework for future analysis of the implementation of projects like BTC. Certainly, further conflict analysis seems well justified at this juncture.

#### **4.3.2 Oil industry response**

The closure of the Ergneti market has led some to predict renewed conflict in the area. Fears that oil industry installations may be targeted mean that oil companies and host governments are likely to become increasingly preoccupied with the physical security of their assets, to the detriment of the EITI. (See Box).

However, oil companies also have the opportunity to take the long view in Azerbaijan. By continuing to participate in the EITI, by exploring opportunities to strengthen 'economic diversification' initiatives, and by building the capacity of NGOs to scrutinise and influence the use of oil revenues, oil companies can contribute to the process of building a personally and economically secure future for the Azerbaijani people. This approach complements the short-term aim of securing the pipeline itself. Indeed, paying attention to the long-term view will help counter the potential negative impact of short-term security measures. This will have benefits not only for the region, but also for the reputation of the company and the security of the BTC pipeline.

Table 2: Risks and opportunities of context/oil interaction at the national level

	Context	BP/Oil industry response
<b>Risks</b>	<ul style="list-style-type: none"> <li>○ Georgian moves towards legalising Ergneti market and clamping down on informal economy heighten tension in Abkhazia and South Ossetia, since the only available economy for non-recognised entities is informal economy.</li> <li>○ With worsening situation in Georgia, Azerbaijan can maintain corrupt system of governance – elites under little pressure to change and remain cocooned in urban centres.</li> <li>○ Expulsion of Azerbaijani economic migrants from Russia puts pressure on labour market. Oil industry cannot provide the 2 million jobs required.</li> <li>○ Political parties advocating war with Armenia gain political and economic strength (particularly from IDPs).</li> <li>○ Hawkish political groups set on return of NK challenge softening government position on NK.</li> <li>○ Military conflict erupts between Armenia and Azerbaijan. Turkey and Russia withdraw to ‘let them fight it out’.</li> <li>○ Violent demonstrations suppressed with casualties and imprisonments.</li> </ul>	<ul style="list-style-type: none"> <li>○ Oil companies and Western governments paralysed by need for oil on the one hand and need for human rights on the other.</li> <li>○ Azerbaijan pays lip service to the EITI.</li> <li>○ Oil companies stop supporting NGOs that can scrutinise oil revenues as government cracks down on NGO activity. There is therefore no scrutiny of any transparency.</li> <li>○ Non-oil sector companies similarly unsupported as companies concentrate on protecting their operations, which are threatened by hardening of Azerbaijani government’s position on security.</li> </ul>
<b>Opportunities</b>	<ul style="list-style-type: none"> <li>○ Georgia leads the way in challenging corruption, in tandem with growing potential for finding sustainable solutions to conflict in Abkhazia and South Ossetia.</li> <li>○ This enables movement towards a different, more open, kind of</li> </ul>	<ul style="list-style-type: none"> <li>○ EITI helps keep oil revenues visibly within formal economy, and prevents further fuelling of corruption.</li> <li>○ NGOs mandated to scrutinise the oil industry and strengthen the non-oil sector are supported (e.g. Himayadar Oil Information Resource Centre and</li> </ul>

	<p>economy.</p> <ul style="list-style-type: none"> <li>○ Benefits are felt throughout the South Caucasus.</li> <li>○ Pressure builds on Azerbaijan and Armenia to follow suit, including from EU in international arena.</li> <li>○ Azerbaijan sees anticorruption/ market economy package as opportunity to build its profile and economic strength on global stage. Peace becomes greater political and economic incentive than conflict.</li> <li>○ Also, existing corruption system unsustainable for elite – e.g. Georgia no longer a destination for money laundering.</li> <li>○ Elites weakened, and oil fund visibly benefiting rural communities and infrastructure.</li> </ul>	<p>the BDA).</p> <ul style="list-style-type: none"> <li>○ Outcomes are better business environment – i.e. low interest loans, tax reform, database for joint ventures, etc. – and increased scrutiny of use of oil revenues (without scrutiny, transparency is meaningless).</li> </ul>
--	---	---

#### ***4.4 Local level – the search for economic security***

The more this situation of economic hardship continues, the more fertile the ground becomes for nurturing blame, and for seeking redress. With the government of Azerbaijan actively promoting Armenia as the enemy, the loss of NK is perceived by the rural family as a major cause of their economic decline. With the ‘Deal of the Century’ and public pronouncements of the value of oil to the West, oil and the oil company are increasingly seen as saviours. At the local level, with little understanding of alternatives, with payment of ‘taxes’ to local authorities, a crippling business environment and the deterioration of traditional social fabric, inroads have been created for those offering a different, more prosperous vision of life in which values and pride are restored. This vision is not only put forward by radical religious groups such as the Wahabbists, but is also seen as part and parcel of the image portrayed by the Western oil industry (there is no distinction between American or British companies), an industry with the influence not only to improve the economic situation, but to pressurise the international community to return the lands of NK to Azerbaijan.

#### **4.4.1 Outlook**

The trauma of the social upheaval of the past decade or more, since the collapse of the Soviet Union, has led to a strengthened sense of being Azerbaijani, in the face of continued economic hardship. It is perhaps at the local level that feelings about the war with Armenia, about defeat and pride, about solidarity with, but suspicion of, the IDPs, and about the influence of radical religious and separatist groups, are most felt and played out. Baku is in many respects isolated from these feelings and tensions.

The overriding sense of lack of economic security and all its manifestations, suggests that job creation is the way forward. Greater economic security would help break down images of the Armenians as the enemy and the key reason for economic decline. An improvement in agricultural production in Talish-populated areas, for example, would help improve relations with the government. Relations between IDPs and other rural communities would improve. The growing divisions between the younger generation and their elders would, perhaps, be softened. Such an improvement in the job market would, of course, need to be stimulated by investment in business development, in infrastructure connecting producers with markets, and ultimately with links between Azerbaijani exporters and other countries in the region.

In contrast to this, oil is currently in danger of pricing exports out of the market, reducing investment in the non-oil economy through preventing the development of a broad-based and effective tax regime, and sustaining a corrupt system of governance that hinders enterprise. Certainly, there is little evidence in rural communities of an improvement in economic security.

#### **4.4.2. Oil industry response**

Current CIPs initiated by BTC through international and local NGOs tackle some of these issues, significantly by providing certain services, rated as the most necessary, by the communities' along the pipeline route'. There are community mobilisation and development projects along the eastern part of the pipeline route, and projects aimed at improving

agricultural production along the western section of the pipeline route. There are also micro-finance projects along the entire route.

Focusing on the pipeline route only, however, is unlikely to address the conflict issues highlighted in previous sections of this report. On the contrary, existing CIP projects may make matters worse by, for example, creating tension between those communities targeted by the CIP projects because of their location, and those who are not but who nevertheless feel a strong need for assistance. Projects will need to deal with the corrupt nature of local governance and the competition between local authorities and municipalities. Furthermore, although oil company funds are being committed to CIPs, this money is tiny when compared with the oil revenues that are the subject of the transparency debate.

Although existing CIP projects are intended to contribute to job creation and business development, the focus of this contribution on the pipeline route detracts from the overall purpose. An alternative scenario would envisage CIP programmes targeted strategically on the basis of national and regional priorities, that is, determined by the context and conflict analysis rather than by the geographic location of the pipeline. Based on the issues brought to light in this conflict analysis, these could include, for instance: the establishment of business development centres in different regions of Azerbaijan; support for the government in developing a national economic development plan (including attention to infrastructure); and contributing to the channelling of oil funds to the implementation of this plan.

Table 3: Risks and opportunities of context/oil interaction at the local level

	<b>Context</b>	<b>BP/Oil industry response</b>
<b>Risks</b>	<ul style="list-style-type: none"> <li>○ Images of Armenia as the enemy are maintained.</li> <li>○ Pressure builds for war with Armenia as only solution to economic plight.</li> <li>○ Expectations grow that Western oil industry will support this effort.</li> <li>○ As oil fund increases, and relations with Turkey strengthen, so does Azerbaijan's belief that it can win a war. NK also believes it can resist successfully, as Armenia and the Armenian Diaspora express their alliance, and Russia informally backs them at least with weapons.</li> <li>○ Corruption at local authority level continues to stifle business development.</li> <li>○ Neglect of agriculture, infrastructure and non-oil sector generally.</li> <li>○ Radical religious groups and ethnic separatists strengthen their hold on rural communities.</li> <li>○ Talish in the South align more with Iran as a way out of poverty becomes less likely. Avars align with Russia.</li> </ul>	<ul style="list-style-type: none"> <li>○ Oil companies retreat to a 'no intervention' position in order to safeguard business interests. Space for more enlightened policy dialogue shrinks.</li> <li>○ CIPs focus on pipeline corridor to help protect the pipeline.</li> <li>○ CIP resources are misused at local authority level as corrupt system continues.</li> <li>○ Pipeline becomes target for increasing number of alienated groups, particularly in Georgia where sabotage of pumping stations severely disrupts supplies.</li> </ul>
<b>Opportunities</b>	<ul style="list-style-type: none"> <li>○ Gradual improvement in local economy – e.g. through SME start-up funds and legitimisation of informal economy. More open environment enables businesses to talk about their needs in the region.</li> <li>○ Images of Armenia as the enemy begin to be broken down as employment increases and second generation IDPs more settled.</li> <li>○ Spread of radical religious groups and separatist movements decreases, as government gives more freedom of expression, economy improves and recruitment for radical groups becomes increasingly difficult.</li> </ul>	<ul style="list-style-type: none"> <li>○ Oil company social investment programmes focus on those regions least likely to feel influence of economic development.</li> <li>○ Funding channelled through partnerships between local authorities and community-based organisations.</li> <li>○ This in parallel with capacity building programmes for local authorities to improve efficiency and legitimacy</li> <li>○ CIPs target IDPs and meetings of businesspeople from Armenia and Azerbaijan – perhaps within regional framework.</li> </ul>



## Recommendations

Based on the above analysis of the interaction between oil and conflict in the South Caucasus, and BP's response to these factors to date, the following recommendations are offered as preliminary pointers to where greater effort to ensuring a positive impact in the region could be directed. International Alert offers these recommendations in the spirit of engaging BP as a major actor, in a region where it has ongoing conflict transformation projects.<sup>73</sup>

### *Conflict-sensitive company management systems*

#### 1. Comprehensive conflict impact assessment

BP should consider commissioning a comprehensive conflict impact assessment in order to ensure that its operation minimises conflict impacts and maximises peacebuilding potential across all areas of the business, and at all levels (local, national and regional).<sup>74</sup> This should be done in parallel with, and hence inform, its RDI. It would also help progress implementation of the risk assessment component of the VPs.<sup>75</sup>

#### 2. Broaden out the definition of 'stakeholder' and form of consultation

BP has recognised the high expectations surrounding its presence in Azerbaijan and has taken steps to address these expectations. However, these steps have been focused on what the company interprets as the 'project-affected communities', i.e. those residing within the 8km wide pipeline corridor. This increases the likelihood of opening up further the fault lines that underpin conflict by ignoring key stakeholders in the development of the region as a whole.

---

<sup>73</sup> Additional generic recommendations to the multilateral development banks involved in the BTC project will be made in *Multilateral Development Banks and Export Credit Agencies: The Case for Conflict-Sensitivity* (International Alert, forthcoming 2005).

<sup>74</sup> Due to limited resources, International Alert's research into the conflict impacts of the pipeline was not comprehensive, with field research being limited to Azerbaijan. In addition, the methodology for conducting such assessments has been in development in parallel with the South Caucasus research, and is now due to publish in March 2005.

<sup>75</sup> The risk assessment section of the VPs states that 'identification of and understanding the root causes and nature of local conflicts, as well as the level of adherence to human rights and international humanitarian law standards by key actors, can be instructive for the development of strategies for managing relations between the company, local communities, company employees and their unions, and host governments. Risk assessments should also consider the potential for future conflicts.'

In addition, the form and process of consultation and dialogue with stakeholders is an area where, from the conflict-sensitive perspective, corporate methodologies typically used to date are weak. More inclusive, informal, and empowering channels of communication are required if BP is to combat some of the conflict issues it faces.<sup>76</sup>

3. Contributing to the broader discussion about oil and conflict through education and awareness-raising, in collaboration with other agencies

Partnership is at the heart of a conflict-sensitive approach to business, and BP should continue to collaborate with the UK government and other international agencies in seeking ways of addressing economic security, personal security, governance and cultural issues in the South Caucasus. In particular, it should explore ways of channelling funds to support international efforts that potentially counterbalance the negative impacts of oil in the region (e.g. the work of the EU). In addition, the company should set up mechanisms that will enable oil companies with a stake in the BTC pipeline, and the oil industry more generally, to come together to discuss these issues.<sup>77</sup> Another mechanism could be establishing opportunities for company staff to study the issue and get training on conflict analysis relating to the South Caucasus region.

### *Regional level*

1. Broaden and deepen the company's approach to security

BP has already proved itself to be a key actor in the VPs initiative, and should continue to lead the way for other companies both in the South Caucasus and internationally. Recognising that protection of the immediate project environment is a key company responsibility, it is also a basic recommendation of this report that, given continued instability in the region (South Ossetia being a case in point), and the potential for minority groups to target oil industry infrastructure to further their agendas, focussing on security issues within the confines of the pipeline corridor will be insufficient to safeguard the BTC in the long term.

---

<sup>76</sup> Zandvliet, L. 'Stakeholder Engagement and Consultation' (part of the CSBP guidance, London, UK: International Alert 2005, forthcoming).

<sup>77</sup> One such mechanism, the Oil Industry Forum, was set up in Baku in 2001 but was not sustained.

Focusing on the pipeline corridor only runs the risk of strengthening the Azerbaijan, Georgia and Turkey alliance, keeping Armenia and Russia out. BP and BTC Co. should collaborate with the international community and local organisations to support conflict resolution initiatives aimed at increasing regional security.

## 2. Develop a regional strategy for economic security

Similarly, efforts should be made to support those seeking to foster business development from a regional perspective, e.g. by helping to establish business development centres in the region. Recent efforts by local businesses to develop a regional network of enterprises offer opportunities to open up trade links not only between Armenia, Azerbaijan, Georgia and Turkey, but also encompassing Russia. Companies such as BTC Co. and BP would add weight to these efforts, helping to address the economic security issue from a regional perspective, enhancing the reputation and value of the oil industry, and lessening the likelihood of direct sabotage of pumping stations and oil industry infrastructure.

### *National level*

#### 1. Supporting scrutiny of oil revenues

The EITI is one example of the growing international momentum on transparency of oil revenues, to combat misappropriation and misuse of funds. However, transparency is of limited value if there is no scrutiny of what becomes transparent. Local NGOs need the capacity and support to play a scrutinising role. BP, SOFAR and international agencies should jointly review the mechanisms in place to scrutinise oil revenues, and increase efforts to strengthen them. National governments also need to be encouraged to adopt EITI themselves.

#### 2. Support economic security at the national level in Azerbaijan

BP should move beyond its project with local oil suppliers to work more comprehensively with the Azerbaijani government and the donor community to develop a strategy for improving economic security in Azerbaijan. This strategy should take into account the role of oil, but also of other regional economic and governance factors highlighted in this report.

### *Local level*

#### 1. Target corruption at the local level

Many local authorities are perceived as a major source of corruption in Azerbaijan. Single channels of information and funding via local authorities risk fuelling these perceptions, making the company vulnerable to accusations of condoning misappropriation of funds. In this context, support to capacity building initiatives that target local authorities are important. The company should also explore more inclusive ways of distributing information and funds relating to CIP and EIP projects, e.g. by including municipalities and councils of elders.

#### 2. Manage expectations

In the face of growing expectations that oil companies will solve the perceived interlinked problems of economic insecurity, repatriation of IDPs and the loss of NK, improved consultation and dialogue processes with communities are of paramount importance, including engaging those regions least likely to feel the influence of investment. Efforts should also be made to address some of the structural causes of conflict by, for example, exploring opportunities to strengthen 'economic diversification' organisations, and supporting those initiatives aiming to transform the NK conflict.

# Annex 1 - Methodology used for analysing oil/conflict impacts

## Overview

The International Alert team's approach to understanding the BTC project's relationship with conflict was guided by the following three broad components:

- *Understand the context* (e.g. history, geography, actors, pre-existing tensions and conflict);
- *Understand the intervention* (parameters, including rationale and timing of the BTC project);
- *Understand the existing or potential relationship between the context and the intervention.*

Table 4 provides an outline of the three principal steps taken to collect, synthesise and analyse information for the purposes of understanding how the BTC pipeline project is affecting, and will likely affect and be affected by, existing contextual issues in Azerbaijan and the region. Limitations of resources required a focus primarily on Azerbaijan, and to a lesser extent on Georgia and Turkey.

**Table 4: Collection, synthesis and analysis**

*1. Information collection*

- a. Scoping*
- b. Preparation*
- c. Interviews*
- d. Triangulation*

*2. Synthesis*

- a. Lens development*
- b. Deconstructing papers into grid*
- c. Project dimensions*
- d. Sorting grid-based information*
  - Actors' map*
  - Conflict pillars*

*3. Analysis*

- a. Scenario development*
  - Project components as fixed variables*
  - Conflict pillars as fixed variables (more rewarding)*

**The approach**

1. Information collection

The pipeline corridor typically used in social and environmental impact assessments is too limited to allow meaningful conflict analysis, given the intrinsic interplay between micro- and macro-level dynamics. Macro-political conflicts can have significant impacts on, for example, village-level social issues, just as micro-level conflicts can have national implications. Rather than using a corridor approach, the team determined that it would be more efficient to focus on project-impacted peoples. For instance, a village downstream from pipeline construction might fall outside of a limited corridor, but could still be impacted by water

disruptions or contamination.<sup>78</sup> Similarly, the economic impacts of pipeline development in Azerbaijan do not fall within a definable geographic area, as this report has argued.

#### a) Scoping

A challenge lay in determining how to identify project-impacted people, above all in a context of limited resources. Interviews would bring various issues to light, but deciding whom to interview in the first place introduced an element of theoretical circularity. The team decided to choose four general areas roughly equidistant across Azerbaijan and proximate to the pipeline, and then engage local coordinators from within those four areas to identify local issues. The scoping was also used for introducing the project to local authorities. From secondary sources, the team also knew of ethnic national issues in both the north and south of the country. It was decided that these six broad areas would serve as the basis for unearthing an initial set of issues, with the expectation that the preliminary discussions would reveal additional issues in other geographic areas that in turn would require subsequent exploration.

#### b) Preparation

The initial preparatory step was to select local co-ordinators. Criteria used for choosing local community co-ordinators (LCCs) included, political neutrality, good relations with local authorities, good relations with communities – both immediate and neighbouring (geographically), an ability to convene a meeting at which people will speak freely, and some degree of education (necessary for understanding the process).

Following the initial scoping trip and engagement of LCCs, the project team, a national Azerbaijan co-ordinator and the local co-ordinators met in Baku over the course of two days to refine the process. The meeting resulted in some clarity about the aims of the interviews, and some guidelines for how best to approach them. The LCCs identified the best way to engage community members for the purposes of eliciting potentially contentious and political

---

<sup>78</sup> This is a purely hypothetical example.

issues from a broad cross-section of the communities. Collectively, they determined that semi-structured interviews would garner the most information while having the least potentially negative impact. Community meetings and group dialogues were determined to be too high-profile at this stage, and thus risked antagonising some actors and encouraging reticence in others.

As stated, semi-structured interviews were selected as the most suitable methodological tool. The questions were structured according to a rough timeline, which was supposed to pinpoint changes the relevant community went through as a result of important events in the country's recent history. Sequencing questions along important benchmarks helped provide some structure whilst ensuring the neutrality of the interviewing team.

This particular framing of the interviews may have led respondents to focus on macropolitical issues in particular, although they did provide substantial information about local level issues. The timeline questions related to (a) the fall of the Soviet Union, (b) the NK conflict, (c) the arrival of Western oil companies in Azerbaijan (the Contract of the Century), and (d) future predictions. The first three of these were further broken down into categories of security (personal, crime, economic, etc.), politics and relationships (the latter mostly designed to identify gaps in the social fabric).

#### (c) Interviews

Following the preparation, two project team members (one female, one male) and an LCC had been engaged. Two areas in the north and south of the country were without LCCs. This absence of LCCs provided an informative perspective on the advantages and disadvantages of employing local contacts.

LCCs, together with the visits to the local leaders while scoping, provided a level of political acceptance for the team's work that did not exist in the two peripheral regions. In fact, in Lankaran District, the head of the executive power refused permission for the team to

---



interview anyone not directly in his employ, and thus under his control. On the other hand, LCCs had a tendency to want to use their positions either to show their areas in the best possible light, or to impress friends and relations with their affiliation to foreigners. As a result, LCCs sometimes arranged interviews for the project team with members of only one political party or one family. Additionally, they had difficulty understanding or accepting that the project team wanted to interview women, the unemployed, the uneducated or other representative members of the local community. Receiving local co-ordinator co-operation to interview these people was often challenging. In the northern area, where the project team had not engaged an LCC, it was less challenging to meet a representative cross-section of the population.

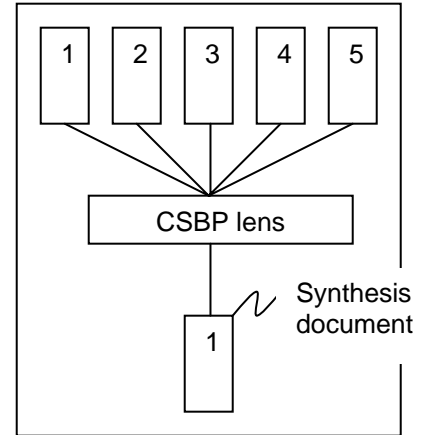
The project team interviewed 52 people in 12 towns and villages across Azerbaijan, the average ratio between men and women being 5:1. Interviews typically lasted between one and two hours. Whilst the interviewees do not represent a statistically significant sample, they did serve to identify a breadth of issues important to both the peaceful development of Azerbaijan, as well as the successful implementation of the BTC project.

#### (d) Triangulation

In an effort to gain perspectives from alternative country contexts, and alternative levels (national and regional), and to fill gaps identified through the preliminary research, the project team conducted an additional analysis in Georgia, and commissioned papers by specialists in Armenia, Azerbaijan and Turkey. These alternative perspectives helped identify issues and concerns that had not been detected during the community level research in Azerbaijan, as well as further elucidate issues that had been detected. For the purposes of triangulation, it would have also been helpful to have conducted community level research in Armenia, Georgia and Turkey; unfortunately time and resources did not allow for this level of detailed information collection.

## 2. Synthesis

At the conclusion of the information collection stage, the project team had amassed a total of five comprehensive research papers: one each on Armenia, Georgia and Turkey and two in Azerbaijan. The next step was to synthesise this information into one coherent document.



### (a) Lens development

In order to pull together the conflict-sensitive lens on this material, the team used the following three sub-components: deconstructing papers into a grid, adding project components, and sorting the grid-based information, in addition to the scenario development covered under the analysis stage.

### (b) Deconstructing papers into grid

The first component of the lens, or process of amalgamating the five papers into one, involved deconstructing each of the papers into their thematic components. As conflicts are generally analysed by economic, socio-cultural, governance and security issues, one axis of the grid included these components. The other axis of the grid focussed on scope (local, national and international). By deconstructing the papers into this type of grid, the project team anticipated it would be a simple task to see, for example, all the local economic issues across the South Caucasus, or the security issues from all perspectives at the national level in Azerbaijan. It was also anticipated that the grid would clearly identify gaps as represented by boxes in the grid for which no information was available. While the deconstruction process did highlight some gaps, other gaps continued to surface as late as the scenario stage.

	<b>Local</b>	<b>National</b>	<b>International</b>
<b>Governance</b>			
<b>Economic</b>			
<b>Socio-cultural</b>			
<b>Security</b>			

Although the process of amalgamating the five deconstructed papers into one grid was time- and labour-intensive, it made subsequent use and analysis of the information included in the papers much more explicable than it would have been had the information remained solely in the papers themselves.

(c) Company intervention (or BTC pipeline) components

As previously outlined, one key principle underlying the project team’s approach to the BTC analysis was the premise that to understand the interaction between an intervention and its context, one must first develop a solid understanding of both the intervention and the context. In this sense, oil was as important as the pipeline itself. The understanding of each of the two elements (intervention and context) in isolation from each other also provides valuable baseline information for future monitoring or evaluation.

The BTC project is enormous, complex and spans decades. The purpose of outlining the project components was not to provide an exhaustive account of every element of the project, but rather to sketch the broad parameters that are likely to have an impact on, or be impacted by, conflict. The project team examined a number of project variables, including revenue, employment, and the social investment programme.

(d) Sorting grid-based information

With the information about the project and the context deconstructed and formatted into a grid, the project team then needed to understand how the various components related to each

other, and to prioritise the most important factors. Two popular conflict analysis tools were used: an actors' map, and a conflict pillars schematic. At the conclusion of the synthesis stage, the project team had amassed a substantial amount of information, and had both amalgamated and deconstructed the information into various constituent components. The synthesis stage provided an element of systematic rigour to the understanding of how the BTC project could be expected to affect conflict factors in the region, and vice versa.

### 3. Analysis

While each of the preceding steps each involved elements of analysis, the project team developed a discrete component specifically to analyse the information that had been collected and synthesised. As with the previous steps, the challenge was to bring rigour and replicability to the understanding of how an investment on the scale of the BTC is likely to interact with a context of the complexity of the South Caucasus.

#### a) Scenario development

The development of various scenarios was introduced, largely to help the project team understand the potential dynamic interactions between the project and the context. It also served to further prioritise issues of concern and relevance to the BTC and to the South Caucasus.

The scenarios provide critical information about the plausible outcome of introducing various project components into the South Caucasus context with all the conflict-related issues inherent in that context. They highlight areas of concern for both the project and the people living in the region, and provide useful starting points for increasing the conflict-sensitivity of the BTC project, and for developing effective mitigation strategies.

#### b) Report and recommendations

Once all the various components of information collection, synthesis and analysis were complete, the project team compiled this report. Preliminary recommendations are included in the report, and International Alert is keen, as part of its ongoing project of work in the

South Caucasus, to use these as the basis for ongoing discussion with BP, at both regional and headquarter levels, regarding its effort to be conflict-sensitive.

## **Conclusions**

The application of the conflict sensitivity analytical framework to the understanding of existing and potential interactions between the BTC pipeline and the South Caucasus context was a challenging exercise for the project team. The project implementation schedule, and the needs of the BTC partners and UK Government were sometimes more accelerated than International Alert was able to keep pace with, given the limits of its resources. Research of this type also often chooses its own timeframes, and so one small concrete piece of research will unearth much larger and conceptually more challenging issues that do not necessarily fit within the timeframes of other activities.

An additional challenge existed in that, to the project team's knowledge, there is no precedent for this type of research. There is a robust literature on social impact assessments, and on the macro-political implications of oil resource development in poor countries. Very little, however, exists on the constructive engagement of foreign extractive companies to ensure the companies are not adversely affected by violent conflict, and equally to ensure they contribute to the development of sustainable peace in the regions where they work.

Despite these challenges, the methodology developed to understand the conflict implications of the BTC project in the South Caucasus makes an important contribution to information collection, synthesis, CSBP, and to the types of issues and processes enterprises such as BP and BTC Co. need to be engaged in.