

New gas deal with Azerbaijan for Europe's energy security: aspiration and reality

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Azerbaijan is a country rich in oil and gas but with poor human rights and sky-high levels of corruption. Despite this record, the country signed a memorandum of understanding with the European Union to increase cooperation in energy production when the President of the European Commission, Ursula von der Leyen, visited Baku on July 18, 2022. This was described as a potential step toward using Azerbaijani gas as an alternative to Russian energy; the document signed was simply a statement of intent and served a more political purpose.

This agreement envisages a substantial increase in the annual volume of gas exported from Azerbaijan to Europe over the next five years. Under the new agreement, the country is expected to increase its gas exports to the European Union within the framework of the Southern Gas Corridor to 20 billion cubic metres by 2027, and up to 11.6 billion cubic metres by 2023.

Ursula von der Leyen called Azerbaijan a "reliable partner" in energy. She said that because the European Union can no longer rely on Russian gas supplies, it "has therefore decided to diversify away from Russia and to turn towards more reliable, trustworthy partners." She was "glad," she said, to count Azerbaijan among those new, trustworthy partners. The agreement signed envisions a substantial increase in the annual volume of gas exported from Azerbaijan to Europe over the next five years and seems to aim at making Azerbaijan a key partner for the EU. But how feasible is it for the EU to use imports from Azerbaijan as an alternative to Russian gas and how reliable is Azerbaijan, as a partner for the European Union?

Although reducing dependence on Russian gas has been an essential task for the European Union since the beginning of the war in Ukraine, Europe has a long way to go to ensure its energy security. Brussels' decision to sign a memorandum of understanding with the Republic of Azerbaijan has been widely criticized as abandoning one authoritarian country and cooperating with another. Instead of focusing solely on replacing Russian energy supplies - no matter the source - the European Union should focus on using the energy deal with Azerbaijan to usher in positive change by including norms and its standards of transparency and accountability for resource-rich countries.

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How is Azerbaijan a “Reliable Partner”?

According to reports from international human rights organizations, Azerbaijan’s record has long been marred by authoritarianism, high corruption rates, and numerous human rights violations. Azerbaijan has never been a reliable partner in upholding human rights treaties and political promises, but the country is called a reliable partner in business deals. Investors has many reasons to consider before investing to Azerbaijan, when a country’s investment environment is full of corruption, unreliable courts and official can easily disregard the law. Simply calling for the investors or giving promises on TV doesn’t establish the country as a reliable investment partner. Albeit, European Union calling Azerbaijan a reliable partner, gives the guarantee to the world on behalf of Azerbaijani government. The country benefits from being EU’s reliable partner for the future contracts and proves itself as a “fair” player. ”

Undeniably, investors are reluctant to approach Azerbaijan as a business partner, as the country ends up on last places for corruption index, dependency of courts to presidential administration, and arbitrary and unlawful interference, detention and arrests. Azerbaijan is considered one of the most corrupt countries in the world. According to the 2022 Corruption Perceptions Index , Azerbaijan was ranked 157th, Russia was 137th, Ukraine 116th, Turkey 101st, Armenia 63rd, and Georgia 41st place among 180 most corrupt countries. According to this report, the corruption indices have worsened in potential gas trade partners (except for Italy, Bulgaria, Romania and Greece) of Azerbaijan. For example, Corruption Perceptions Index in Serbia decreased to 36 index points in 2022 after 2012 and it was the lowest indicator in history after 2012. Corruption Perceptions Index in Turkey decreased to 36 index points in 2022 and it was the lowest indicator in history after 2006. Corruption Perceptions Index in Bosnia and Herzegovina decreased to 34 Index Points in 2022 and it was the lowest indicator in history after 2018. Corruption Perceptions Index in Hungary decreased to 42 index points in 2022 and it was the lowest indicator in history after 1996. Hungary are the lowest Corruption Perceptions Index performers in the EU region. These indicators are proving that the country’s current business partners are also risky places for investments At the same time, a gas deal between such corrupt countries requires strict adherence to transparency and accountability standards.

Von der Leyen in her speech in Baku indicated that “to reach Azerbaijan’s full potential, it is important to create the right conditions for investor confidence” and that “this includes a greater involvement of civil society, and a free and independent media.” However, these were not conditions for the deal and many Local Civil Society members and human rights organization (Human Rights Watch, Global Witness and Amnesty International) expressed regret that the Commission did not directly support the development of independent civil society and the free press in Azerbaijan. Local social activists complained that European officials visiting Azerbaijan did not meet with representatives of opposition parties and civil society - the Europeans were accused of selling out democracy for energy interests.

Azerbaijan gas production and its potential challenges for export to EU market

President of Azerbaijan Ilham Aliyev advertises his country as an oil-rich country. During the 9th Southern Gas Corridor Advisory Council Ministerial Meeting on 03 February 2023, he said, “our natural gas export is growing. In 2021, it was around 19 billion cubic meters. Last year it was 22.6. And this year, we expect 24.5.” However, according to the data of the Ministry of Energy, Azerbaijan's natural gas export to the European Union market was 43.15 percent of the total gas export or 8.2 billion cubic meters in 2021. 50.67 percent or 11.3 billion cubic meters in 2022 and it is expected to be 47.34 percent or 11.6 billion cubic meters in 2023 year. In the annual review of Shell, it is said that Europe consumed 480 billion cubic meters of gas in 2022, 10 percent less than the previous year (535 billion cubic meters). This means that gas supplied by Azerbaijan to the European Union market last year was 2.35 percent of its consumed volume and 7.35 percent of the Russian gas imported to the European market in 2021.

As you see, 11-12 billion cubic meters is undersized for the European market, covering a tiny part of demand in the EU. However, owing to the commissioning of the Greece-Bulgaria interconnector, the Azerbaijani gas flows uninterruptedly to Bulgaria. Therefore, Azerbaijan makes a difference in individual countries – such as Greece and Bulgaria, where it now supplies 1/3 and 12 percent of Italy’s annual gas consumed. Probably Serbia, Albania, Hungary, and Slovakia, too, in the future. Additionally, Azerbaijan gas now has a route to Moldova and Ukraine, bypassing Russia (through Bulgaria and Romania).

Azerbaijan's gas export to Europe will double up to 20 billion cubic meters by 2027, depending on domestic consumption and production. Fitch Ratings international rating agency's forecast for natural gas production in Azerbaijan until 2032 shows that gas production in the country will change in a wavelike manner during this period. So, in the interval between 2023 and 2025, gas production will increase, and in 2026, it will begin to decrease, but from 2030, it will go back to growth. According to the forecast, between 2023 and 2031, the highest indicator of gas production - 37.3 billion cubic meters, will be recorded in 2031, and the lowest indicator - 36.2 billion cubic meters, will be recorded in 2023 and 2028.

Alongside this slowly increasing gas production, there is also steadily growing gas demand from Azerbaijan’s population and the country’s growing economy. Launching new production capacities in the industry creates excess demand for additional gas volumes. Population growth and the restoration of territorial integrity will also increase the demand for gas. Currently, Azerbaijan’s domestic consumption is approximately 12-13 billion cubic meters per year, and the government must consider this when making export plans.

So, until 2027 in Azerbaijan, not only gas production but also the demand for gas in the country's industry and the population is constantly increasing. Despite the existence of the policy of improving energy efficiency to reduce the growth rate of domestic demand, the indicators confirm that no significant results have been achieved in this direction. So, one of the means in this field is to increase the share of renewable energy sources in the energy balance and reduce the losses in gas delivery in order to reduce domestic gas consumption. According to the statements of the State Statistical Committee, the specific weight of electricity from renewable energy sources in the total electricity production in Azerbaijan during 2012-2021

reached its peak in 2016, when this indicator was 8.8 percent, and it was 3 percentage points lower than that in 2021, i.e. 5.8 percent.

Current trends suggest domestic consumption will hit 14 billion cubic meters in 2023 and 15 billion in 2026. Meanwhile, forecasting models indicate that gas production in Azerbaijan will be around 47.8 billion cubic meters in 2023, 49.2 billion cubic meters in 2024, and 49.7 billion cubic meters in 2025. Considering domestic consumption, exports can be increased by an additional 2.5 billion cubic meters by 2026. This means Azerbaijan's EU exports can be increased to only 14-15 billion cubic meters by 2026.

The capacity of the TAP pipeline can be expanded to 20 billion cubic meters. In addition, the Southern Gas Corridor project requires additional investment and time. This project needs to be developed, and its annual capacity can be increased first to 24 billion cubic meters and then to 31 billion cubic meters. At the same time, European gas buyers must make legal and commercial commitments to Azerbaijani gas producers. These changes will take time.

To increase the gas supply to Europe, there will also need to be an investment in improving the current transmission capacity of the South Caucasus (SCP), Trans-Anatolian (TANAP), and Trans-Adriatic (TAP) pipelines. Of these, only the Trans Adriatic pipeline is largely under the control of EU companies. Currently, 19.9 percent of the South Caucasus pipeline is owned by the Russian oil company Lukoil, while the National Iranian Oil Company owns 10 percent (NIOC). Both companies could work together to create obstacles to increasing the gas supply to Europe. This creates obvious political difficulties for the European Union when making financial and management decisions.

A significant limitation of the agreement is that it was signed without conducting political and financial risk assessments or resource and stakeholder analyses. It only considered the interests of the buyer and the seller. Realizing such projects depends on the interests of transit countries, joint-stock companies managing gas fields and pipelines, and investors. When the interests of these stakeholders are properly assessed, it becomes clear that using Azerbaijani gas as an alternative to Russian energy remains unrealistic.

The pipelines from Azerbaijan would also pass-through Turkey and Georgia. Both countries are buyers of Azerbaijani gas. To increase the gas supply to Europe, it will be necessary to establish transit agreements with the Turkish state and Turkish companies to meet the growing needs of both European and Turkish consumers. Azerbaijan's President, Ilham Aliyev, noted that "negotiations are taking longer than we expected. We hope that we will reach this agreement. Because if we do not reach this agreement for certain reasons, then all our plans to supply additional gas to Turkey and Europe will be in jeopardy."

Finally, significant financial challenges are associated with increasing the gas supply from Azerbaijan to Europe. The level of investment required to extend the transmission capacities of pipelines is estimated at several billion US dollars. This creates financial difficulties from the point of view of investors, companies, and buyers.

Whether tangible results can be achieved will depend not only on the decisions made by the Azerbaijani government but also on the positions taken by transit countries and the companies

that own the associated gas fields and pipelines. Reconciling these competing interests will require considerable time and financial resources. All of this is likely to make the goal of substituting Russian gas imports with gas from Azerbaijan something of a pipe dream in the near term.

A viable alternative to Russian gas and unrealistic expectations

Azerbaijan's gas export to Europe will increase to up to 20 billion cubic meters by 2027, depending on domestic consumption and production. Fitch Ratings international rating agency's forecast for natural gas production in Azerbaijan through 2032 shows that gas production in the country will fluctuate in this period. In the interval between 2023 and 2025, gas production will increase, and in 2026, it will begin to decrease, but from 2030, it will increase again. According to the forecast, between 2023 and 2031, the highest level of gas production - 37.3 billion cubic meters – will be recorded in 2031, and the lowest level - 36.2 billion cubic meters – will be recorded in 2023 and 2028.

In 2023, Azerbaijan will increase its gas supply to Turkey by 19 percent to 10 billion cubic meters. At the same time, 2.5 billion cubic meters of gas are exported to Georgia annually. Suppose we add to these volumes the increasing domestic consumption every year and 13 billion cubic meters at last year's level. In that case, Azerbaijan's gas export to Europe will remain relatively high compared to its current levels in the coming years and will change by around 12-13 billion cubic meters.

The issue of increasing gas production in Azerbaijan needs to be solved in addition to expanding the transmission capacity of the pipelines under the Southern Gas Corridor Project. However, the forecasts show expanding capacity of pipelines can give medium- and long-term results.

There will likely be no significant increasing production in Azerbaijan before the end of the current decade. Therefore, we need more time to export 20 billion cubic meters to Europe in 2027.

Therefore, there are three ways that Azerbaijan might be able to fulfill its obligations under the Memorandum of Understanding signed with the European Union. 1. Azerbaijan meets a part of its domestic demand directly from Russia or Turkmenistan by buying Iranian gas based on a swap transaction; 2. Azerbaijan reduces gas supplies to Turkey and Georgia; 3. Azerbaijan reduces internal demand by increasing the efficiency of resource use. Among them, the first option is the relatively probable and feasible, while the probability of the second option is close to zero. Implementing the third option will be difficult due to the increase in industry demand and the population in the country. Furthermore, although the country plans to increase access to energy sources that will replace gas, it seems impossible to implement these plans in the short term.

Plans to increase the gas supply to Europe will likely be undermined by Azerbaijan's growing domestic demand (extra gas for industrial needs and gasification of residential areas) and

slow gas production. Indeed, the only viable way for the country to fulfill its obligations to Europe by 2027 would be to purchase additional gas from Russia and Turkmenistan. This would be entirely counterproductive given the political rationale of the EU-Azerbaijan energy memorandum.

Conclusion

The energy deal between Azerbaijan and the European Union brings trade issues to the fore and will also come with severe issues of human rights and democracy. Although this deal would bring Azerbaijan closer to the West economically, it distances Azerbaijan from the West politically. Due to the non-transparency management of oil and gas revenues in Azerbaijan, people are not interested in who buys the energy resources and how they are not interested in who buys the energy resources and how much they pay. Because the people of Azerbaijan do not benefit from the export of gas or oil, they want to reduce corruption in managing oil-gas revenues. This is only possible by applying western standards of good governance, transparency, and accountability in Azerbaijan.

Met Energy cooperation and promoting democracy are foreign policy priorities of the European Union. However, reducing dependence on Russian gas has been an essential task for the European Union since the beginning of the war., However, the Brussel's decision to sign a memorandum of understanding with the Republic of Azerbaijan has been criticized for abandoning one authoritarian country and cooperating with another.

The EU should focus on using the energy deal to usher in positive change by including normative provisions and its standards of transparency and accountabilities for resource-rich countries. It can create a severe problem of cooperation with countries such as Azerbaijan, which refused transparency standards even internationally. Despite dissenting voices in the European Union that advocated for applying human rights-based conditionality before the energy cooperation with Baku, there is still space to take such an approach.