

# **The Baku Tbilisi Ceyhan Pipeline and BP: a Financial Analysis**

## **Building Tomorrow's Crisis?**

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## EXECUTIVE SUMMARY

The Baku-Tbilisi-Ceyhan pipeline (BTC) project aims to take oil from Azerbaijan, on the Caspian Sea, to the Turkish Mediterranean port of Ceyhan. It is being developed by a consortium led by BP. This report conducts a financial analysis of the project, considers the risks involved and looks at the implications for BP shareholders, project financiers and international financial institutions.

Our assessment of the project is as follows:

- The project looks marginal on financial return, even assuming all goes to plan. Total return may be around 10.9%, less than BP's target rate of return on capital. Without Kazakh oil supplementing that from Azerbaijan, the return is likely to be significantly less than this – around 8.7%, even with high transit fees.
- BTC is a profoundly political project – its desirability is more from a particular set of political circumstances than from a clear economic rationale. Changes in those circumstances will seriously impact on its viability. Indeed, were the project more commercially viable, it would be less susceptible to political shifts.
- The pipeline is fundamentally a speculative project in that it does not have the secured oil revenues to make the project viable – the only oil that is committed to the pipeline and where there is financial approval for development is for Phase 1 of BP's Azeri-Chirag-Guneshli (ACG) oil project in offshore Azerbaijan.
- The BTC project is likely to require significant volumes of non-ACG oil to make the returns reasonable, particularly to equity investors. With Azerbaijani oil finds failing to live up to expectations, BP has had to look for Kazakhstan to identify sufficient volumes. While some Kazakh oil is probable, it is far from certain – BTC does not provide an ideal long-term solution for exporting Kazakh oil.
- The benefits to the host countries are small, and potentially even negative, highlighting the risks to the project, as local support, both political and practical, may not be reliable. Public international financial institutions, such as the World Bank, are essentially being invited into the project to relieve the consortium of risk, with little opportunity to pursue their mandates of supporting development.

Financing of the project has been delayed, and closure will probably not be achieved before September 2003 at the earliest, with indications now appearing that further delays are likely. Yet the consortium has already started construction with its own money – sponsors' equity making up 30% of the finance package, an amount that will expire in late 2003. BP and its partners have thus left themselves exposed to unknown availability and terms of financing. If there were a further delay, the consortium would either have to up the stakes, putting in yet more of its own money, or begin to demobilise contractors on the construction,

thus incurring penalty payments and further costs and delay, or restructure the whole project. Meanwhile, the haste sends an unwelcome signal, particularly to the development banks whose support it hopes for.

Given the marginal nature of the project return, it is worrying that substantial risks exist with the project:

- The largest risks include political risks arising from succession changes in Azerbaijan and Georgia, and regional tensions. All three host countries, as well as Kazakhstan, are subject to substantial fiscal instability. There is also concern over legal and construction risks. Recent news reports indicate significant problems with the Turkish section, which could lead to reassigned contracts (with cost increases and delay) or even the pipeline being diverted to the Black Sea port of Supsa.
- Of particular concern is the potential interplay for one risk to exacerbate another.
- There is a significant possibility of delay, cost over-run and reduced volumes – each with the potential to push the project return well into single figures.
- The current Iraqi situation is unlikely to benefit BTC – if stability is restored and tension is reduced; the oil price is likely to fall. This would reduce the return on investments in Caspian oil, potentially to the point where they cease to be viable. If instability continues, especially in the Kurdish regions, it could directly increase the risks to the project. Most importantly, politically, BTC has slid down the list of US priorities.
- BP has made great play of the social and environmental sensitivity of BTC, to the extent that it has chosen a more expensive route. However, BTC still traverses some high-risk terrain in political, social, environmental and physical terms.

## Conclusions

- Returns on the project for BP are unlikely to be satisfactory, especially given that BP itself will probably need to provide significant loans to the project consortium to make the financing work. And the probability of high transit cost in early years to repay the banks will reduce its margins on the ACG development, potentially until after 2010.
- For investors in BP the project highlights BP's increasing focus on high-risk areas in its development strategy. Worryingly, after the "safe decades" in the North Sea and Alaska, BP is now going back to risky countries – which nearly proved its downfall in the 1950s.
- BP investors should also be wary of the reputation risks – particularly given the way BP is emphasising its green credentials. Arguments about the benefits of avoiding the Bosphorus should be treated with caution – a pipeline bypassing the Bosphorus (receiving oil from tankers crossing the Black Sea)

would be a cheaper way of realising the benefits – and the Bosphorus will soon be forgotten if controversy arises with BTC.

- Banks providing project finance should be very conservative in any lending they provide and ensure that risks are reflected in the conditions they impose. For example, due diligence should take a broad view of the risks and consider the stresses in the contracts and their robustness in the broadest terms.
- Development Banks particularly need to carefully consider their involvement. The consortium appears keen to bring them into the project for political reasons, almost more than for the finance they bring. However, the development benefits in many respects may be modest, and development banks should consider how well they fit in with their fundamental mission. Furthermore, supporting a project, which has already started, and where there is decreasing scope to influence project development, sets a very dangerous precedent.