

CASPIAN DEVELOPMENT ADVISORY PANEL

Final Report and Conclusions

January 2007

This final public report by the Caspian Development Advisory Panel presents recommendations arising from our activities in 2006 and draws some broader conclusions based on our involvement in the BTC and associated projects over the last four years.

2006 was the last full year of our mandate, following BP's request that we remain in place as a Panel for a further year as the construction phase drew to an end and operations began. We have tracked the final stages of construction and the transition into operations actively over the last twelve months and continued our engagement with international financial institutions and non-governmental organizations with an interest in the project. As in previous years, we visited all three countries -- this year in late October and early November -- to review developments on the ground in person. Again this year, our consultant, Dr. Richard Fuggle of Cape Town University, paid a preparatory visit to the region, in August and September, to make a detailed evaluation of conditions along the pipeline route and identify issues for follow-up by the full Panel. As has been the case throughout our nearly four years as a Panel, we received excellent support during our visit as well as the remainder of the year from BP and BTC staff in London and the region.

This report is organized in four parts, Part I provides a brief overview of BTC's key achievements to date and the challenges ahead as the project moves into operations. Part II provides an assessment of key issues associated with the completion of the construction phase, including reinstatement of the Right of Way ("ROW"), access roads, and construction camps; waste management; the process of residual land acquisition and handback; and construction-related grievances. In Part III, we examine various ongoing challenges in the transition into operations, such as project safety; arrangements for security and respect for human rights; grievances; the future development of the Iskenderun Bay; and the potential injection of trans-Caspian shipments of oil into BTC. Finally, in Part IV we consider BP and BTC's longer-term presence in the Caspian region, focusing on the Regional Development Initiative; support for civil society; Azerbaijan's economic development; and BP/BTC's potential role in broader regional energy issues.

I. Overview: BTC's Achievements To Date and the Challenge Ahead

In our first report, in August 2003, we noted the "immense strategic significance" of BTC and the other Caspian projects in which BP and its partners in the various pipeline and production consortia are engaged. As the sole oil and gas export route from the Caspian that both avoids the overcrowded and environmentally sensitive Turkish straits and transits neither Russia nor Iran, BTC and SCP are an important contribution to the future energy security of an important part of the world. As a major source of revenue for Azerbaijan, and reliable supply and transit fees for Georgia and Turkey, the pipelines and the Caspian fields they serve create

opportunities for development in a region threatened in recent years by political instability, ethnic tension and economic uncertainty. Developments over the last four years -- notably including the growing concern about the reliability of Russia as a supplier of natural gas -- have only enhanced the strategic importance of these projects.

Also in our first report, we endorsed BP's goal of making BTC and its associated projects a new model for large-scale, extractive-industry investments by major, multinational enterprises in developing and transition countries. Over the last four years, we have offered over 150 recommendations designed to help BP and BTC achieve that goal. In so doing, we have encouraged the companies to commit themselves to a long-term, sustainable contribution to the development of the Caspian region, building on the exacting social and environmental standards they have set for the construction phase of the project. A commitment of this sort is fitting for companies that have chosen to become long-term corporate citizens of each of the three pipeline countries. Such a commitment is also in the economic interest of BP and its partners, for which the return on a multi-billion dollar investment in the Caspian Projects will take decades to realize and which all therefore have a long term stake in the stability and prosperity of the region.

In this, our final public report, we assess how well BP and BTC are doing in turning their vision into reality. We find that the companies have made an impressive start. The Caspian Projects can already boast a long list of accomplishments, many of which break new ground for investments by extractive industries in developing and transition countries. To name just a few:

- The pipelines have significantly raised the standard for environmentally-sensitive infrastructure development in the Caspian region, despite the engineering challenges of laying pipe in steep and inhospitable terrain.
- The Projects have generally lived up to an array of exacting environmental and social standards accepted by BP and its partners during the project-design phase. The companies' performance has been subjected to comprehensive monitoring -- by the World Bank, private-sector financial sponsors, and others -- and has, with few exceptions, been found compliant with these project standards.
- A vast program of land acquisition has been undertaken expeditiously but fairly, with landowners and users paid fair market value for the rights acquired by BTC and any disputes resolved in accordance with national law.
- With BP's and BTC's encouragement, the host countries have committed themselves to observe high standards for the protection of human rights in connection with the pipelines' operations. Azerbaijan and Georgia have already acted on this commitment by accepting human rights training of their pipeline protection forces funded by BP and its partners.
- BP and BTC have undertaken concrete steps to empower and build the capacity of local NGOs, thereby helping to foster the growth of civil society in all three pipeline countries.

- With the encouragement and participation of BP and its partners, Azerbaijan has successfully piloted the Extractive Industries Transparency Initiative (EITI), setting an example for other resource-rich countries around the world.
- BP and its partners have committed themselves to the long-term sustainable development of the Caspian region and have launched and funded a Regional Development Initiative to design and implement projects in furtherance of this commitment. Taken together with the Community and Environmental Investment Programmes (CIP and EIP) that BTC has been funding since the start of construction, this represents an approach to supplemental investment of that is notable for both its breadth and ambition.

Indeed, BP's decision to establish the Caspian Development Advisory Panel -- building on its experience with the external panel it appointed to monitor its Tangguh gas project in Indonesia -- has itself been an important step in achieving a new model. We are aware of no other extractive industry project that has voluntarily opened itself to the kind of scrutiny that BP has empowered CDAP to undertake. We are gratified that BP has acted on so many of our recommendations over the last four years and pleased that we have thereby been able to contribute to some of the accomplishments noted above and in the balance of our reporting.

As we commend these important achievements, we also note that the largely construction-oriented activity that we have observed during the four years of our mandate represents only a small fraction of the approximately 40 year operating life of BTC and its associated projects. Thus, **while the companies have laid the foundation for the new model at which they aim, we also conclude that an equally significant, if not greater, challenge lies ahead. Meeting this challenge will require sustained senior management attention and a continued -- indeed, in some respects, enhanced -- commitment of human and other resources.** The importance of maintaining a commitment to safety throughout the life-cycle of major oil and gas projects, and the potential for a single incident to erase in a stroke the reputational benefits of many years of previous effort have become more obvious. **Similarly, the commitment that BP and BTC have made to long-term regional development must be sustained -- and, we believe, enhanced -- over the entire operations phase if it is to make a meaningful and lasting impact.** So, while in this report we recognize the important progress achieved so far, our main focus is on identifying obstacles that will need to be overcome if BP's and BTC's vision is to be achieved over the full operating life of the pipelines, and on recommending actions the companies can take now to that end.

II. Completion of the Construction Phase

A. Reinstatement and Restoration of the ROW

We have commented extensively in previous reports on the progress of reinstatement, generally commending the outstanding quality of the work undertaken to date while underlining the importance of keeping the necessary resources in place so that the job could be completed to a uniformly high standard. Our previous assessments have, however, noted that some of the toughest reinstatement was still to be done, given the tendency for work on the more challenging, higher-altitude segments of the ROW to lag behind that elsewhere. We were therefore pleased to

have the opportunity on our visit this year to see the ROW in a substantially restored state, and to view some of the final segments to be reinstated in the mountains of Georgia. We have also benefited from the expert observations of Dr. Fuggle who was able to make a more detailed review of reinstatement along significant portions of the ROW during his own two-week visit.

Viewed as a whole, we find the quality of reinstatement along the pipeline route to be world-class. BTC and the contractors working under its supervision have done an outstanding job of refinishing the ROW to fit the contours of the surrounding landscape. Although it will take time, especially in freshly reinstated high altitude areas, for plant cover to reestablish itself fully, BTC's careful top soil management practices are already being rewarded with the reappearance of native pioneer plants. In lower-lying areas where reinstatement took place relatively early, the ROW marker posts are frequently the only visible evidence of the pipelines' presence. BTC's restoration work is also to be commended for its attention to biodiversity in environmentally sensitive areas along the pipeline route, through the planting of native saplings and a comprehensive monitoring program to verify that local species reestablish themselves in appropriate numbers on the ROW.

BTC's commitment to high-quality reinstatement is particularly important for the example it sets for future large infrastructure projects in the countries through which BTC and SCP pass. This is especially the case in a country like Azerbaijan, which continues to endure the economic, health and environmental costs and suffer the aesthetic blight associated with poorly planned and constructed Soviet-era energy infrastructure. The care and attention with which BP and its partners have designed, laid and reinstated BTC and SCP serve as a powerful statement that economic progress need not be reduced by the high costs of environmental degradation. This is an important lesson for a country like Azerbaijan as it enters a period of oil and gas wealth in which infrastructure development will doubtless be a top public priority. As the following paragraphs make clear, this lesson also remains highly relevant for Turkey.

As we have commented in our previous reports, the benefits from BTC's investment in high quality reinstatement could be diminished by substandard work on associated installations over which BTC does not exercise contractual control, with significant risks to BP's reputation. This is particularly the case in Turkey where, although the main BTC ROW has been reinstated to a very high standard by BOTAŞ and its subcontractors under the terms of the Lump Sum Turnkey (LSTK) Contract, BOTAŞ has neglected to devote similar care to ancillary pipelines outside the scope of the LSTK. The most glaring examples of this are the Turkish segment of SCP, from the point where it diverges from the BTC ROW shortly after the Georgia/Turkey border, and the gas pipeline built by BOTAŞ to serve Pump Station 1 (PT1). Both of these lines leave visible scars on the landscape, contrasting markedly with the main BTC ROW. This outcome is particularly disappointing in view of the assurances the Panel received in prior visits from BOTAŞ representatives about the company's general commitment to reinstatement on project-related facilities and to raising the company's broader operational capacity in this regard. Indeed, the Panel was troubled to hear from a BOTAŞ official on its most recent visit that BOTAŞ' commitment on these ancillary facilities extends only to "clean-up," and not reinstatement.

Although the Panel accepts that BP and BTC have no ability under the LSTK Contract to compel corrective action by BOTAŞ, we recommend that they continue to

encourage BOTAŞ to make good its deficient reinstatement. More generally, BOTAŞ' failure to reinstate to a uniformly high standard serves as an example of the reputational and other risks to BP stemming from the LSTK's provision that BOTAŞ, and not BP, would build and operate BTC in Turkey. Future observers are unlikely to distinguish between the different parts of the BTC/SCP network in Turkey and may well incorrectly assume that BP, rather than BOTAŞ, is responsible for any environmental shortcomings. As we note below in relation to security, BP will have a continuing long-term exposure to the potentially adverse consequences of decisions made unilaterally by BOTAŞ International Limited ("BIL"), the BOTAŞ entity that will operate the pipeline in Turkey. Notwithstanding some encouraging signs of fresh thinking from BIL during our last visit, as well as some useful steps to transition BTC project personnel to BIL's staff, **we therefore recommend that BP and BTC monitor BIL's performance as operator closely and ensure that they are fully consulted and involved in decisions that affect their interests, as well as those of the communities living along the pipeline route.**

A third contentious reinstatement challenge is the East Anatolia Natural Gas Pipeline ("NGP"), built prior to BTC but which runs alongside the BTC ROW for some 200 km in eastern Turkey. Here, BTC deserves positive recognition for its agreement to pay BOTAŞ to correct deficient reinstatement of the NGP in those areas where the two pipelines are adjacent to each other, thereby resolving a dispute over which party was responsible for fulfilling the corresponding commitment in the Environmental and Social Impact Assessment (ESIA) for Turkey. **The Panel understands that this remedial work will begin in 2007 and recommends that BTC supervise the work closely to ensure that a high standard of final reinstatement is achieved.**

B. Reinstatement of Access Roads and Construction Camps

In Azerbaijan and Georgia, we found that BTC needs to address questions concerning the reinstatement of roads built or improved by project contractors to provide access to the ROW during construction and of camps built to support the construction crews. Despite its commitment to reinstate access roads and camps back to their original condition, BTC is under some pressure in Azerbaijan and Georgia to return them to the local communities (or, in the case of camps, to their previous owners) in their improved condition. Although the idea of leaving improvements in place for the benefit of local residents is appealing in principle, acceding to this pressure carries risks of its own. For example, in Georgia especially, leaving the improved access roads in place could open up areas of pristine forest to illegal logging. In both countries, contractors may have an incentive to encourage the original owners of camps to save the contractors the cost of full reinstatement in return for some financial consideration, even if the owner has no further use for -- or means of maintaining -- the improvements he will thereby acquire, certain of which were not originally designed for long-term use. In both cases, therefore, the stated desire of the community or landowner needs to be balanced against the risk that a decision *not* to reinstate back to their unimproved state could generate negative environmental or other impacts over the longer term that mar the landscape as well as the pipelines' reputation over the next forty years of operation.

In order to avoid such impacts, **the Panel recommends that BTC adopt a three part test when confronted by requests to leave in place the improvements made to access roads or camps during the construction process.** First, a short Environmental and Social

Assessment (or comparable analysis) should be conducted to ensure that the intended use of the improved facility serves a real need and will not cause or encourage social or environmental harm. Second, the road or camp should be rendered “fit for purpose” for the intended use, for example -- in the case of roads -- by installing reinforced earth banks and adequate drainage. And, third, the road or camp should only be returned in its improved condition if an authority or owner has agreed to assume long term responsibility for its maintenance.

C. Waste Management

Waste management has been a challenge for BTC throughout the construction phase of the project. Having agreed to meet European standards of waste management in countries that typically lacked facilities capable of meeting those standards, and which in the case of Azerbaijan and Georgia were still burdened by inadequate arrangements inherited from the Soviet Union, BP and its partners have often struggled to live up to their commitment. During construction in Turkey, for instance, project waste had to be driven more than 1,000 km by truck from eastern Anatolia for disposal in a landfill west of Istanbul. In Azerbaijan and Georgia, the early failure of two EU-compliant project incinerators forced BTC to fall back on storage of waste pending the identification of a workable solution and implementing arrangements with local authorities. Despite broad efforts to honor its initial undertaking, BTC’s waste management practices have repeatedly been found by the IFC’s Independent Environmental Consultant to be non-compliant with its project commitments. In some cases the delays in establishing infrastructure capable of meeting the agreed standards were attributable to local regulatory and implementing obstacles. Importantly, and whatever the cause, the project's failure to meet the very high waste disposal standards does not appear to have harmed humans or to have led to environmental contamination. Nevertheless, having signed up to those standards at the outset, BTC’s failure to meet them represents a blot on an otherwise impressive environmental record during construction. As such, **the Panel recommends that BP conduct an after-action review of the waste management procedures employed during construction of BTC, and of the planning that was undertaken to meet the target standards at a local level, to determine whether there are lessons to be learned for future projects.**

The difficulty BP has had in addressing its recurring waste management problems in the course of this project, and the potential for similar problems to present themselves in BP’s operations elsewhere in the world, underline the importance of maintaining focus on these issues at a corporate level. Given the importance of waste management practices in an extractive industry setting, and the potential for economic, health, environmental and reputational harm if they are not dealt with effectively, **we recommend that BP review the resources it devotes to these issues on a group-wide basis and consider the scope for consolidating policy responsibility for them to a greater extent at the executive level.**

Looking forward, the challenges BTC now faces are how to dispose of waste that has been stored and how to develop more sustainable, long term arrangements for waste management. The challenge is particularly acute in Georgia, where a significant amount of waste is currently being stored in sub-optimal conditions at a Central Waste Accumulation Area (“CWAA”) adjacent to Pump Station 1. Given the unsuitability of the CWAA as a permanent waste site and BP/BTC’s goal of contributing to the long-term development in the three pipeline countries, **the Panel recommends that BTC continue its promising work with the Georgian**

authorities to develop a sustainable solution that will contribute to the country's modernization in this area. The Panel welcomes the progress already achieved in the other pipeline countries towards long-term sustainable solutions, including the development of two new EU-compliant sites in Turkey that will alleviate the need to send waste by truck to the far west of the country.

More generally, the waste management issues BTC has encountered in the region are well-suited for action under the Regional Development Initiative, given the convergence of BP/BTC's interests, those of the host governments, the economic, health and environmental benefits associated with safe and efficient disposal of hazardous wastes, and the benefits that EU-compliant waste disposal infrastructure would impart to the economies of the pipeline countries. The Panel notes the early benefits that have already flowed from an RDI-funded initiative in Georgia to help improve local waste management practices and resources in the Borjomi region, and we welcome the consideration being given by the local BTC team in Turkey to including a waste management component in the local RDI program. Those experiences may produce lessons from which the RDI program as a whole can learn. Indeed, given the regional dimension to these waste disposal issues, **the Panel recommends that BTC explore the scope for a transborder initiative in this area under RDI auspices.**

D. Land Issues

One of the most logistically challenging aspects of this project has been the need to acquire land rights along the entire 1,768 km length of the ROW, from countless individual and communal landowners or users under three different legal regimes. That the process has been achieved with a minimum of controversy says a great deal about the efficiency and sensitivity with which it has been conducted.

As construction has drawn to an end, BTC has faced two further land-related tasks. First, there has been a need for some supplemental land acquisition to accommodate the relatively minor disparities between the path of the ROW as initially planned and as built. This appears to have gone smoothly, based on the discussions the Panel and its consultant, Dr. Fuggle, had with the state authorities and interested NGOs in the three pipeline countries.

Second, with construction completed, BTC is engaged in a process of handing land back to the original landowners or users, subject to a number of restrictions on activities in the ROW designed to protect the integrity of the pipelines. Again, the Panel was impressed on its recent visit with how smoothly this closing-out process appears to have gone and commends BTC for producing pamphlets in each of the local languages explaining in simple terms and diagrams the precise nature of the restrictions now affecting the ROW. In Georgia, however, the Panel heard concerns from one NGO that, while BTC's representatives had met with and explained the restrictions to the owners and users of land located on the ROW, no similar effort had been made to explain to people living inside the 500 meter safety zone around the ROW the restrictions on what new buildings may be constructed within that zone. The Panel understands that BTC's approach has been to engage the local zoning authorities with regard to this latter set of restrictions, with the expectation that those authorities will communicate and enforce the restrictions as necessary in the course of reviewing applications for new buildings. While this approach does not strike the Panel as unreasonable, **we recommend that BTC engage the NGO**

in question and be prepared to communicate directly with affected individuals in the safety zone where a legitimate need can be shown or lingering confusion exists.

While BTC's overall performance on land acquisition during the construction phase has been highly commendable, the need to enforce land use restrictions throughout the operational life of the pipelines is a classic example of the extent to which continuing effort and sustained levels of resources are required if the project is to live up to BP and BTC's vision for it. Helpful though BTC's explanatory pamphlets have proved in the initial handback process, BTC cannot afford to assume that the restrictions are now universally understood and will be effectively self-enforcing. As memories fade, land changes hand, or the restrictions start to conflict with the self-interest of local landowners, disputes will inevitably arise between those landowners and BTC over the application of the restrictions within and adjacent to the ROW. In fact, in our own visit to the pipeline ROW in Turkey, we observed the early encroachments of local farmers who had recovered their lands and begun plantings that were not always in conformity with planned use restrictions. BTC needs to anticipate that inevitability now, by putting in place necessary procedures for monitoring, community engagement, and dispute resolution, and ensuring that it makes available qualified personnel and other resources required for their implementation over the operational lifetime of the pipelines.

For example, given the importance of community support for the smooth and secure operation of the pipelines, it will be in BTC's interests to ensure that disputes over the land use restrictions are handled with sensitivity and transparency. As we explain in more detail in Part IIIB below, BTC's technical staff, community liaison officers, horse patrols drawn from the communities themselves, and local security forces, will all have a presence on the ROW. It will be important to avoid inconsistent and potentially counterproductive enforcement of land use restrictions by the various patrols. **The Panel therefore recommends that BTC develop a protocol for dealing with violations of the land use restrictions and that this protocol be communicated to each official -- security, technical or otherwise -- responsible for patrolling the ROW. The Panel further recommends that this protocol be used to facilitate resolution of such disputes in the first instance by community liaison officers and only as a last resort by security officials.**

E. Construction-Related Grievances

As construction has drawn to an end, BTC has been faced with a number of demands for compensation from landowners and communities claiming that the project has damaged local infrastructure, as well as some home and monuments. In farming areas, there have been numerous claims of damage to communal irrigation channels caused by the excavation of the trenches for BTC and SCP. In addition, some villages along the pipeline route have argued that the volume of construction-related traffic is responsible for the deterioration of road surfaces or damage to residences. The Panel understands that most of the claims pertaining to irrigation channels have now been resolved and that, in a number of instances, BTC has repaired damage out of project funds. **The Panel recommends that BTC seek a similarly speedy resolution of any remaining claims related to road use which, if left unresolved, have the potential to erode local support for the pipelines. Given the absence of adequate baseline data that could provide an authoritative basis for resolving these claims, the Panel recommends that**

BTC engage independent fact-finders or arbitrators as necessary to help close these grievances out in a timely fashion.

We have commented in our previous reports on the large number of construction-related grievances that have been filed with the World Bank's Compliance Advisor Ombudsman (CAO) by individuals and organizations in Georgia. In our view, the responsibility for this situation lies partly with BTC for failing to establish a credibly independent mechanism to which decisions by its own grievance body could be appealed. The situation has been aggravated, however, by the lack of clarity over whether the CAO is acting in its compliance, advisory or ombudsman role with respect to the complaints filed with it -- and the related uncertainties, for both local communities and BTC, about how such complaints would be evaluated by the CAO and resolved. We therefore welcome the fact that only one of these previously filed complaints currently remains to be resolved, and that steady progress is reportedly being made in that direction. Although we understand that one new complaint was received recently by the CAO, with BTC's agreement this complaint was immediately designated for compliance review. We understand from BTC that this designation has made for a much speedier and effective process than that applied to the previously-filed complaints.

As this episode draws to an end, and as BTC enters on a lengthy operational phase during the course of which it can expect to receive new and different complaints, **the Panel recommends that BP and BTC assess frankly the lessons to be learned from the apparent shortcomings of the grievance mechanisms in Georgia.**

III. Transition into Operations

A. Safety Issues

The Panel has been consistently impressed with BTC's commitment to safe working practices during the construction phase of the pipeline projects and its responsiveness to potential missteps in this area. For instance, like the lenders' monitors, we noted in an earlier report the potential risks to the local communities of an accelerated construction schedule that had the effect of leaving exposed large stretches of open trench. BP and its partners addressed this problem in a timely manner and more generally responded to isolated safety incidents with appropriate training and new safeguards. Perhaps most impressive has been the culture of safety that we have seen throughout our four years of work. This culture includes the small but important steps of briefing participants in a meeting on the emergency exit routes, requiring passengers to wear seat belts and electronically monitoring the speeds driven by BTC's drivers.

With construction coming to an end and the transition to operations underway, the nature of the safety issues confronting BTC will evolve as the focus shifts from the immediate risk of physical injury associated with laying pipe in such challenging terrain, toward a concern with ensuring proper maintenance of the terminals and other major facilities and the long term physical integrity of the pipelines. This will require BP and BTC to remain vigilant and to furnish necessary resources throughout the operational life of the pipelines, especially in later years when diminishing volumes and profitability may make further investment superficially unattractive from a commercial perspective. There are huge potential costs to individuals, as well as to BP's business, reputational and environmental record if BP and BTC fail to get these

longer term safety issues right. The Panel has accordingly devoted particular attention this year to the procedures and physical measures being put in place by BTC (and, in Turkey, by BIL) to guard against failure of the pipeline.

On the whole, the Panel has been favorably impressed, not only by the sophistication but also by the range of measures adopted by BTC to ensure the safe and uninterrupted operation of the pipelines. The terminal at Sangachal houses an impressive command center using advanced technology to monitor fluctuations in pressure and flow rates, giving it the ability rapidly to detect leaks or taps at any point along the entire length of the pipelines. “Smart pigging” will also permit BTC periodically to check every inch of the oil pipeline from the inside for corrosion or other flaws that might present a safety issue. **The Panel recommends that BTC commit itself now to the rigorous implementation of industry best standards with respect to pigging, including smart-pigging the full length of the pipeline regularly throughout its operational life.** At the other end of the technological spectrum, technical officers will patrol the ROW regularly to check for safety problems visible from the surface, and resources should remain in place to support this important safeguard as well.

Public concern about the future integrity of the pipelines has been expressed most vocally in Georgia, where the previous government’s decision to route BTC across the watershed of the Borjomi River sparked fears that an oil spill could harm tourism in one of the country’s premier vacation destinations and impair the value of its renowned mineral water. Reflecting these concerns, the current government headed by President Saakashvili and Prime Minister Nogadeli has urged BTC -- and BTC has agreed -- to install a wide range of supplemental safety measures in the segment of the pipeline crossing the Borjomi watershed. These include a drain-down tank and secondary containment systems to capture any released oil and a security base to facilitate enhanced patrolling against the risk of terrorism. When the Panel visited the region in November, work on constructing these special safety measures was well underway. The Panel commends BTC for its responsiveness to Georgian concerns in this regard.

In practice, no spill remotely resembling these fears has occurred in Georgia to date, but there was a venting of some 200 liters of oil from a faulty block valve far removed from the Borjomi watershed in May 2006. This release was quickly contained and cleaned up by BTC personnel, and engineering changes made to all block valves in Georgia to prevent its reoccurrence. The technical response to this incident appears to have been rapid and effective. The Panel was surprised to learn, however, that BTC did not proactively communicate the fact of the release to the environmental NGOs with which it works in Georgia, and that initially the release was not reported to BP management in the UK because the amount vented was below the threshold at which such reporting was required. Given the well-known public concern about spills from BTC in Georgia, **the Panel recommends that local management develop and implement new procedures for reporting to BP management in the UK and to interested NGOs any future releases of oil not only above but also below the mandatory reporting threshold.** Effective communication with local NGOs and community leaders will continue to be important throughout the operational phase of the pipelines to maintain public confidence in the pipelines.

As a further expression of these concerns, and reviving concerns that attracted significant attention early in the project, a Georgian NGO has filed a complaint with OPIC citing alleged

deficiencies in the field joint coatings applied to BTC during construction. BP has said that any technical concerns with the coatings were fully resolved during the construction process. It has also noted that three external reviews, including one by the UK Government, have found the coatings to be satisfactory as designed and installed. The Panel was briefed by BP/BTC on this issue and the operational safeguards that were implemented in the field when the matter was first raised by international NGOs in 2004, and we have no separate basis to question BP's technical conclusions regarding the safety of the coatings now in place. An OPIC report responding to the complaint is due to be released soon and, it is to be hoped, may help resolve these longstanding allegations. The Panel recognizes the effort that BP has put into investigating these allegations over the last three years. We also note, however, that any failure in the coatings during the 40 year operational life of the pipeline could have serious environmental consequences. **We accordingly recommend that BP continue to engage with interested parties and retain an open mind towards any new information that has a bearing on the safety of these coatings.**

As operator of the Turkish segments of BTC and SCP, BIL has a crucial role to play in ensuring that the pipelines operate smoothly and safely. On its recent visit, the Panel was favorably impressed by the apparent smoothness of the transition from BOTAŞ to BIL as the Turkish lead during construction and operation respectively. The Panel was also encouraged by the efforts BTC has taken to promote effective coordination with BIL. These include the placement of a senior and experienced BTC manager as BIL technical director, a number of other staff secondments, as well as daily conference calls among operations managers along the length of the pipeline. The Panel understands that these measures have helped to increase the efficiency of the BTC pipeline and to decrease the amount of down time due to technical or other interruptions. However, as noted above, BTC will need to continue monitoring BIL closely to ensure that this strong start is maintained. It seems quite probable, for example, that having assumed responsibility for the pipeline only after the completion of construction, there will be gaps in BIL's knowledge base compared to that of BTC. And, notwithstanding BIL's stated commitment to high operating standards, BP and BTC should, however, ensure that these high standards are achieved in practice.

B. Security Arrangements and the Protection of Human Rights

An important requirement for the safe operation of the pipelines is the existence of security arrangements capable of deterring or frustrating threats to the physical integrity of BTC and SCP created, deliberately or otherwise, by human activity. Achieving the correct mix of measures is a particularly complex and delicate task, but one that must be achieved if BP and BTC are to establish the new model at which they aim during the operational life of the pipelines. To be effective, security arrangements must be capable of addressing a spectrum of possible risks ranging from violations of the land use restrictions by local landowners, to efforts by criminal interests to tap into the pipelines and steal their contents, to physical attacks by terrorist groups. But, if BP and BTC are to maintain the support of communities living along the pipeline and avoid allegations that the security arrangements for the pipelines contribute to human rights abuses, the response to each of these potential risks must be calibrated, using no more force than necessary to secure the pipelines' physical integrity while respecting the legitimate interests of local residents. As with the technical safety issues discussed above, security thus represents a difficult and ongoing challenge with huge implications for BP's and

BTC's business and reputational interests and one that will require sustained attention and resourcing for the entire operating life of the pipelines.

As discussed in prior reports, the legal framework for the Caspian Projects -- particularly as clarified and supplemented by the *Human Rights Undertaking*, *Joint Statement on the Baku-Tbilisi-Ceyhan Pipeline Project (Joint Statement)*, and the *Protocol Relating to the Provision of Security for the East-West Energy Corridor (Security Protocol)* -- provides robust legal safeguards against human rights abuses in connection with the agreed security arrangements. The project participants and host governments have committed themselves to upholding a broad set of international human rights standards in the operation and protection of the Projects. We have previously commended BP and the project participants for undertaking and organizing these steps, but highlighted the importance of putting these legal commitments into practice to ensure that the safeguards have practical meaning for the communities in which the Projects operate. The Panel continues to believe it essential that concrete steps be taken in each of the host countries to give effect to the principles set out in the *Joint Statement*, in particular in the areas of project security and the protection of human rights.

In the Panel's view, project security must be approached in a holistic manner, drawing on the efforts of several different groups of actors with a physical presence along the ROW, but ensuring that all operate according to common protocols designed to limit the use of force to the minimum required for the situation at hand. The array of resources upon which BTC is already relying in Azerbaijan and Georgia to police the pipeline route provides a good illustration of this principle. This includes community liaison officers responsible for maintaining relations with the local populations, field security officers responsible for liaising with local law enforcement agencies and local authorities, technical officers inspecting the pipeline for structural defects and risks, horse patrols recruited from the local villages and charged with covering every yard of the ROW on a daily basis, and finally armed personnel of the local security agencies (the State Special Protection Service in Azerbaijan and the Strategic Pipeline Protection Division in Georgia).

Between them, these various groups represent a healthy resource pool able to detect and report security issues across the full spectrum described above. We welcome the establishment of a system of horse patrols in both countries as a valuable low-tech addition to the project's security arrangements and an effective means of building a long-term relationship with the communities along the pipeline route. We especially commend the decision to retain a full complement of community liaison officers after the completion of the construction phase, consistent with the recommendation in our last report. While the role to be played by these CLOs has no doubt evolved with the transition into operations, we believe that they have an integral role to play in ensuring balanced security arrangements during the operational life of the pipelines. **We accordingly recommend that BTC retain a team of experienced CLOs, capable of establishing and retaining the trust of the local communities, for the duration of the pipelines' operation.**

To make the most effective use of this resource pool, **the Panel recommends that BTC ensure that clear procedures are in place in each of the pipeline countries, addressing how the various groups will respond to the different categories of threat.** The objective should be a hierarchy of responses designed to reserve the threat or use of force as a last resort, for those

situations that genuinely require it. One aspect of this is to ensure an effective division of labor between the different groups. We recommended in Part IID above, for example, that responsibility for dealing with violations of the land use restrictions by local landowners should fall in the first instance to community liaison officers. By the same token, the unarmed resources in BTC's employment must have clear guidelines on the kinds of situations -- for example, imminent physical threats to the pipelines -- in which it is appropriate to call in the local armed security forces for a first response. Another important aspect is to ensure that individuals patrolling the ROW, including members of the local security forces, have a clear understanding of the kind of response that is appropriate to each of the varying security situations with which they may be faced.

The Panel is not convinced that BTC has yet done everything in its power to establish and implement the procedures needed to guarantee an appropriate hierarchy of responses to individual security threats in Azerbaijan and Georgia. In both countries, the security agencies appear to have been eager to affirm the primacy of their remit for security along the ROW. In Azerbaijan, for example, BTC has apparently yielded to pressure from the SSPS not to reinstate installations that facilitate patrolling of the ROW by car. This has led to the unfortunate result that BTC's efforts to restore the ROW to its natural state in Azerbaijan have in some cases been immediately undone by SSPS vehicles driving up and down its length. While the SPPD in Georgia appear to have taken a less extreme view of this issue, the ROW in that country nonetheless showed at the time of our visits notable evidence of vehicle tracks established by security patrols alongside the ROW.

It is understandable that local agencies should want to assert their authority on what remains sovereign soil, and BTC clearly faces a difficult task as a foreign investor in encouraging those agencies to see themselves as part of a larger team. However, the Panel believes that, if BP and BTC desire to achieve a new model during the operational life of these pipelines, it must make a much greater effort. In Azerbaijan, a good place to start would be in bringing to a successful conclusion the long-running, but apparently still fruitless, negotiations for a bilateral Security Protocol with the government, to match the protocol already agreed with Georgia. While a Security Protocol of this sort would not of itself meet the broader need for agreement on detailed working procedures, it could spur cooperative work in that direction by helping to operationalize Azerbaijan's commitment to observe the Voluntary Principles on Security and Human Rights (and other human rights standards referenced in the 2003 *Joint Statement*) in its policing of the pipelines.

We have previously commended BP and BTC for organizing creative, third-party human rights training for the responsible state security forces in Azerbaijan and Georgia. This training has made an important contribution to ensuring that these forces understand and respect the rights of the landowners and residents along the ROW and of other individuals they may encounter in their duties. We were disappointed recently to learn that the Azeri government has decided to forego -- hopefully only temporarily -- human rights training that Equity International had offered to provide in 2007. Our understanding is that the state forces in Azerbaijan have concluded that they need some additional time to implement their enhanced training strategy, which incorporates international standards taught by Equity International. **We recommend that BP and BTC continue to closely engage the Azeri forces in promoting and supporting**

compliance with the standards conveyed in the training to date and to make clear to the government of Azerbaijan their continued willingness to help fund further training.

The security situation confronting BTC in Turkey is quite different from that faced in Azerbaijan and Georgia. Under the LSTK, BTC plays a less direct role in monitoring and helping to ensure security along this segment of the ROW. As the operator in Turkey, BIL is responsible for security arrangements inside pipeline facilities and for liaising with the Turkish security and police agencies patrolling the ROW. In addition, the current security threats confronting BTC appear more substantial in Turkey than in either of the other pipeline countries. For example, at the time of the Panel's visit in November, every one of the 11 criminal attempts to tap the oil pipeline had occurred in Turkey. In addition to the greater incidence of theft from BTC in Turkey, both pipelines face a continuing and real threat of attack by hostile actors. In this regard, the Panel notes that there have been reports of recent attacks on pipelines transiting Turkey other than BTC and SCP.

Although the risk of physical attack appears more acute in Turkey, security arrangements must nonetheless be capable of dealing with the full spectrum of threats to BTC's physical integrity. The Panel was struck by the noticeable difference between the multi-faceted approach to security in place for BTC in Azerbaijan and Georgia and BIL's almost exclusive reliance on the Gendarmerie to guarantee security in Turkey. While BIL employs some CLOs -- including some with prior experience working for BTC -- it has shown no interest in instituting a system of horse/community patrols and has only limited resources available for vehicle-borne patrols by its own employees. The Gendarmerie, on the other hand, maintains 10 local stations and 36 patrol teams for the purpose of monitoring the ROW for security threats and responding as necessary. The Panel is concerned that reliance on armed gendarmes for security in Turkey will make it difficult to establish the hierarchy of responses discussed above in relation to Azerbaijan and Georgia.

While the Panel is not in a position to pass judgment on the record of the Gendarmerie, it notes that concerns have been expressed in the past by the U.S. State Department and human rights NGOs about the Gendarmerie's human rights performance. During our own visit, the Turkish authorities affirmatively resisted participating in the types of pipeline security and human rights training programs that have been organized in the other transit countries. Against this background, the Panel is concerned that BIL's heavy reliance on Gendarmerie patrols is inconsistent with the community-friendly policing approaches associated with BP's vision for BTC.

In sum, the Panel believes that the combination of a greater potential threat and a weaker ability to influence decision-making on security arrangements in Turkey amounts to a significant reputational risk for BP and BTC. In order to help manage this risk, **we recommend that BP and BTC take early and energetic steps to engage the Gendarmerie, the Ministry of Interior to which it reports, and the interagency Supreme Security Committee with the objective of putting themselves in a position to exert more direct influence over decisions affecting security arrangements for BTC in Turkey.**

Finally, the fact that responsibility for security is shared between three countries and two operators (BTC and BIL) makes it essential that there be effective coordination between these

various actors throughout the operating phase. As noted in the previous section, BTC and BIL operations managers along the length of the pipelines are already engaged in daily conference calls. The regular meetings now taking place between security officials from Azerbaijan, Georgia and Azerbaijan in the Joint Pipeline Security Commission pursuant to the *Security Protocol* are also a positive development. In order to achieve the model at which BP and BTC aim, such coordination mechanisms should be sustained and strengthened over the operational lifetime of the pipelines and used to promote best practice with regard to the protection of human rights., as well as considering current operational issues.

C. Security-Related Grievances

No matter how well-crafted the security arrangements turn out to be, BTC can expect periodically to receive complaints from individuals living along the ROW who believe that their human rights have been abused by state security personnel protecting the pipelines. In our report last year, we noted that international oil companies have been criticized for failing to do enough to prevent abuses by host authorities in the name of providing security for production or pipeline facilities. We also expressed concern about the absence within BTC of “an identified and credibly independent vehicle for elevating, reporting and resolving such human rights concerns.”

The Panel understands that BTC has now put in place mechanisms for collecting and reporting such complaints to the Azeri and Georgian authorities. We believe, however, that BTC must go further than merely transmitting complaints to the national authorities if it is to stay true during the operational phase to the goal of establishing a new model for other comparable infrastructure projects. Given BP’s and BTC’s reputational interest in actively discouraging human rights abuses in the name of pipeline security, **we recommend the appointment by BTC of separate ombudsmen for Azerbaijan and Georgia to whom aggrieved individuals can turn for assistance in seeking relief under national law.** In addition to conveying complaints to the respective national authorities, these ombudsmen would counsel complainants on their legal rights and -- depending on the seriousness and credibility of the allegations -- proactively engage the authorities with the objective of securing a speedy, administrative resolution of the grievance.

We recognize that BTC is not in a position to appoint an individual with comparable responsibilities in Turkey, where BIL is responsible for operating the pipeline. **We recommend, however, that BP and BTC engage BIL and other Turkish authorities as appropriate to encourage the creation of a comparable institutional vehicle in Turkey.**

D. BTC and Trans-Caspian Oil

As noted in our previous reports, BP and its partners have long anticipated the possibility that BTC might in the future accept additional volumes from oilfields in Kazakhstan and that some increase in the pipeline’s capacity might be needed to accommodate them. A number of developments this year have brought this prospect nearer. The Panel recognizes that BTC has no control over the standards used in oil production in the north Caspian. But, as the potential recipient of north Caspian volumes for export, we believe it is in a position to influence positively the environmental and safety standards applicable to trans-Caspian shipments of such oil. **The Panel accordingly renews its standing recommendation that BP and BTC do**

everything in their power to ensure that trans-Caspian shipments of oil destined for BTC are subject to the same high environmental standards as BTC itself.

Following a briefing by BTC, the Panel understands that the pipeline could begin to accept some volumes from the Tengiz field in western Kazakhstan in the relatively near term. This Tengiz oil would help to use existing spare capacity in the pipeline as the volumes of Azeri crude available for injection into BTC gradually ramp up between now and 2009. The Panel welcomes the fact that the relevant contractual arrangement between BTC and the international operator of the Tengiz field will require all such trans-Caspian shipments to meet the double-hulling requirement and other EU standards to which BP Shipping is subject.

In June 2006, Kazakhstan and Azerbaijan reportedly signed an intergovernmental agreement to provide a legal basis for the shipment of oil from Kazakhstan's Kashagan field through BTC via the Kazakhstan Caspian Transportation System (KCTS), utilizing additional capacity that could be created by modifications to BTC after the existing capacity is filled in 2009. The Panel has not seen this agreement, which apparently remains confidential between the two governments. We are accordingly unable to say whether the governments themselves will require the application of EU standards to trans-Caspian shipments of Kashagan oil. It also remains unclear what leverage BTC will have to insist on the application of EU standards to these shipments under the detailed commercial arrangements that will need to be negotiated before Kashagan oil can be injected into the pipeline.

Notwithstanding this uncertainty, the Panel observes that BP's contribution to achieving higher environmental standards in the Caspian will be substantially devalued if BTC is allowed to become the vehicle for Kazakh oil that has arrived at Sangachal without the benefit of safeguards comparable to those employed by BTC. **The Panel therefore recommends that BP and BTC use their influence to the fullest extent possible to ensure that such shipments are in fact subject to the same EU standards accepted by BTC and applicable to Tengiz shipments in the period between now and 2009.**

E. Iskenderun Bay

The Panel was struck during its visit in November to the Ceyhan terminal both by the sheer size and footprint of that facility and by the broad aspirations that the Turkish government has for industrial development in the surrounding area in Iskenderun Bay. This development will likely include additional regional pipelines and processing facilities, which will in turn spur the establishment of other related industries in the area. Some Turkish observers predict that Iskenderun Bay could become a "Turkish Rotterdam."

There is a risk, however, that if development occurs piecemeal and without due consideration of the implications for regional infrastructure it may produce unwanted economic, environmental and social effects. As a significant presence at Ceyhan for decades to come, BP and BTC have a direct stake in the long term development of this region. Given Ceyhan's current advantages as an alternative to the dangerously congested Turkish straits, it will not serve BP's or BTC's interests if unguided development creates similar overcrowding -- with all its associated economic, health, safety and environmental risks -- in the waters around Ceyhan. The

anticipated expansion of an existing BOTAŞ terminal adjacent to BTC's facility at Ceyhan only heightens the importance of coordinated and managed development of the area.

Similarly, BTC has gone to some lengths over the last four years to identify how its use of the Ceyhan terminal will affect the subsistence fishermen who have traditionally used the Bay and to compensate them appropriately. Yet, the broader regional development now gaining pace is likely to have a much more profound impact on traditional coastal communities, risking a sharp increase in social tension. During the Panel's visit in November, we heard concerns that the Turkish Coast Guard -- which has security responsibility for the Iskenderun Bay as a counterpart to the Gendarmerie -- was enforcing access limitations that arguably extended beyond the original exclusion zone and that were hampering local commerce. As regional development in and around the Bay accelerates, the challenge of managing the relationships between infrastructure security, local commerce and environmental management in the area will only increase.

Iskenderun Bay thus seems to be an ideal candidate for a regional development plan designed to ensure that the industrialization that BTC itself has helped spur does not carry unacceptable economic, environmental, social or cultural costs. BP and BTC are well-positioned to play a catalytic role in bringing such a plan into being, with funding from RDI or other ongoing supplemental programs. **The Panel recommends that BP/BTC give early and sympathetic consideration to such an initiative.**

IV. BP and BTC's Longer Term Presence in the Region

A. Regional Sustainable Development

The foregoing discussion of Iskenderun Bay is a good illustration of the capacity BP and BTC have to influence positively long-term development in and across the three pipeline countries, and of the extent to which such efforts are aligned with their vision of BTC as a model and with their own self-interest. The companies have shown great imagination and leadership in adopting the novel concept that long-term foreign investors can and should commit themselves to contributing to development in their host countries. Indeed, it is no exaggeration to say that the philosophy underpinning RDI lies at the heart of the new model which BP and BTC have set out to establish. How this program fares over the operational life of the pipelines will accordingly be one of the most telling measures of the extent to which the companies' vision has been accomplished.

The Panel commends BP and BTC on how far this program has come in a relatively short space of time, due in no small part to the RDI leadership team BP/BTC has established in Baku. This progress is all the more remarkable in view of the core commercial mission of these companies: BP and BTC are not development agencies, and there was no reason to expect them to be able to assimilate so quickly the project development and management skills peculiar to such agencies.

Yet, RDI has already produced a number of creative and effective projects. These include, as only a few recent examples, technical assistance for the refurbishment of Georgia's north-south gas pipeline; an innovative supply chain financing project in Azerbaijan,

accompanied by an impressive effort on BP's part to double (to \$500 million) by 2010 the value of contracts it places directly with Azeri-owned companies; the establishment of an Enterprise Center in Baku, together with an impressive range of training and other assistance for local suppliers designed to spur development of small and medium sized enterprises. In addition to the valuable content of such projects, the Panel commends RDI for its success in attracting matching contributions and leveraging funds from other donors, thereby multiplying the impact of the contributions of BP and its various project partners in BTC, SCP and the upstream consortia. For example, the Georgian pipeline project leverages significant funding from the United States' Millennium Challenge Corporation, and the supply chain financing project is being implemented with substantial financial and technical participation from the IFC. RDI's conclusion of a framework agreement with the EBRD, formalizing its collaboration with that institution, marks another important step in this process. The Panel encourages RDI to build on that agreement with a sustained effort to identify specific projects where EBRD funding can add value to BTC's own efforts.

Underpinning these early achievements is a significant financial commitment by BP and its partners extending over three years as a formal budgeting matter and at least over the next ten years for BP's own planning horizon. In the 2006-08 period, BTC expects to spend some \$41 million across the region under the auspices of RDI, and a further \$28 million under its other ongoing supplemental investment programs -- the Community Investment Programme (CIP), the Future Communities Program (FCP), and the Environmental Investment Programme (EIP). As the largest shareholder in BTC, BP will contribute a substantial share of these funds -- approximately \$12 million for RDI and a further \$8 million for CIP/FCP and EIP. In addition to these sums provided through BTC, BP plans to spend a further \$7 million on projects that it will fund unilaterally. Moreover, these figures do not include the substantial funding -- some \$30 million over the course of these three years (including \$13 million from BP)-- being provided to Georgia under a separate BP Pledge and BTC Grant Program. The impact of BTC's and BP's contributions will be enhanced by some \$40 million in leveraged funds (from the Millennium Challenge Corporation) and \$30 million in matching funds (from EBRD, IFC and others). Looking beyond the 2006-08 period, BP and BTC expect their total spend on RDI, CIP/FCP, EIP, and BP's unilateral projects to amount to some \$25 million per annum across the region, although it is unclear how far into the future this commitment extends. This level of funding would essentially maintain the average spend anticipated for 2006-08.

While these sums are impressive, their symbolic and practical impact is blunted by the fact that neither BP nor BTC have given an unequivocal commitment to fund RDI for the full 40 years of pipeline operation. At a symbolic level, a clear-cut commitment -- making explicit the commitment articulated in principle in past BP responses to Panel reports -- would add credibility and substance to RDI as an expression of BP/BTC's support for long-term regional development. Having made clear that they intend to contribute financially for a period of time commensurate with the anticipated life of the Caspian projects, BP and BTC will be better-placed to wield the influence needed to achieve the goals they have set for RDI and achieve the benefits that appropriately come from being fully recognized by the host communities as a long-term partner in regional social and economic development. At a practical level, the RDI team is likely to be better served by its local partners if they have confidence that BP and BTC are in the development business for the long haul. Based on our own visits in this and prior years, it is less

than clear that either the local partners for RDI or the communities that will benefit from the program fully understand the aims and aspirations of the initiative and the scale of resources that BP and its partners anticipate committing to it. **We accordingly recommend that BP and BTC make an explicit commitment to fund RDI for the full operating lifetime of the pipelines.**

The Panel also reiterates its existing recommendation that BP and BTC increase the level of their funding for RDI. Welcome though the sums already budgeted for RDI over the next three years are, they remain small when compared with both the scope of the Caspian projects and the scale of the development needs confronting the three pipeline countries. The Panel believes that a progressive step change in funding for RDI over the next few financial years is both desirable and should be achievable without compromising project quality.

In addition to these funding issues, challenges remain in ensuring that RDI constitutes a coherent program representing more than the sum of its three country components. We have commented in our previous reports on aspects of RDI that would benefit from greater coherence. We remain concerned that, notwithstanding the stated goal of integrating the Environmental Investment Programme (EIP) and the Community Investment Programme (CIP) into RDI, the programs are still run as discrete country-by-country programs serving objectives distinct from those of RDI. Likewise, RDI has still not fully succeeded in finding a meaningful way of integrating the concept of sustainability -- so central to BP's own operating philosophy -- into project selection and design. The integration of EIP could help in this respect, by giving RDI a more substantial environmental component, especially if in future projects are designed to meet environmental objectives going beyond the concern with biodiversity that has been EIP's focus to date. In addition, however, **the Panel recommends that BP and BTC consider establishing sustainable development as a cross-cutting theme, to be taken into account in the selection and design of projects under the three existing themes: access to energy, enterprise development and effective governance.**

RDI also continues to struggle to strike an appropriate balance between central direction and delegation of decision-making responsibility to the country program level. Given the differences in their development needs -- particularly marked in the contrast between Turkey on the one hand and Azerbaijan and Georgia on the other -- some differences in strategy and execution between the country programs are appropriate and unavoidable. And it remains the case that country initiative can be an important source of creativity, driving the development of new best practices. The Panel welcomes the important steps taken over the last 12 months to share these best practices among the country teams through the establishment of an internal Regional Sustainable Development Forum. Nonetheless, the Panel believes there is scope for the RDI leadership team in Baku to exercise a greater degree of central direction, especially in the areas of priority setting, allocating funding, and the identification of cross-regional projects. The risk in the absence of such orchestration from the center is that RDI will become little more than a brand -- an organizational and bureaucratic structure with insufficient content of its own.

B. Support for Civil Society

Alongside and overlapping with RDI to some extent, support for the emergence of a healthy civil society in the pipeline countries is one of the more meaningful contributions BP and BTC can make to long-term development in the region. Here, too, the efforts expended by these

companies are utterly consistent with their own self-interest, as their investment is likely to prove more secure over the long term in societies where a diversity of political views, empowered media and vibrant NGO sector help to shape the public debate.

During and following its visit to the region, the Panel was pleased to receive reports on the outcome of the second round of NGO monitoring conducted by BTC in cooperation with OSI in Azerbaijan and with the Eurasia Foundation in Georgia. As in the first round of monitoring, the reports that emerged from this exercise were typically well-prepared and useful assessments of ongoing project performance, and BTC's responses to these assessments generally reflected careful consideration of the input. We were concerned to hear criticism by at least one NGO in Georgia, corroborated by the Eurasia Foundation's representative, that BTC representatives placed undue pressure on the Cultural Heritage working group to amend its monitoring recommendations. On the whole, however, the NGO representatives with whom we spoke in Georgia were generally very positive about the experience, an impression we understand has been out in a subsequent independent survey of the participants of the monitoring exercise funded by BTC. The Panel commends BTC for what was clearly a highly successful exercise overall.

It bears repeating, though, that while BP and BTC have laid a good foundation for continuing capacity-building efforts, the main challenge in developing civil society lies ahead of them. For example, it is especially clear in Azerbaijan that an independent civil society is still lacking, an impression confirmed by the reported decision of the Azeri government in late November to shut down opposition media outlets. Indeed, the Panel's visibility into the effectiveness of the project has been hampered, at times, by the lack of genuinely independent NGOs in Azerbaijan. While neither BP nor the Panel may agree with the views and conclusions of certain members of civil society in Georgia and Turkey, the fact remains that a vibrant and independent civil society exists in those countries, creating important checks and balances on the governments and major participants in the economies.

Perhaps more so in this area than any other, the quality of BP and BTC's commitment to long-term development will be measured by the constancy and consistency of their support over the full lifespan of the pipelines' operation. For the near to medium term, **the Panel recommends that BTC identify means for continuing and enhancing their efforts to build capacity within civil society. This should include a third round of monitoring or some alternative with the same or greater value to NGO participants.**

C. Azerbaijan's Economic Development

The stakes underlying BP and BTC's commitment to long-term regional development are perhaps most acute in Azerbaijan. Of the three pipeline countries, Azerbaijan faces the greatest challenges in promoting an open political culture, developing civil society, and overcoming the distorting macroeconomic influences of a sudden surge in resource revenues. Yet it is in Azerbaijan that the costs of future political, social or economic instability are likely to have their greatest impact on the companies' commercial interests. Against this background, BP and BTC have a compelling self-interest in promoting broad-based, long-term development.

In the near term, the most acute risk facing Azerbaijan is the potential for the country to become an early victim of so-called Dutch Disease -- the spiraling of inflation and declining competitiveness of the non-oil sector that so often afflicts developing countries once oil revenues start flowing. The Panel notes in this regard that inflation in Azerbaijan has mounted steadily over the last three years. The continuing dramatic growth in the Azeri state budget (President Aliyev told us in November that it will have quadrupled in just three years), while understandable in view of societal expectations, will only exacerbate the inflationary trend. The potential pressure for yet more increases in government expenditure as the 2008 elections approach could make an already bad situation worse.

As noted in our previous reports, BP has already taken a number of important steps to strengthen the Azeri government's capacity for macroeconomic management. The Panel warmly welcomes in this regard the signature in August 2006 of a Memorandum of Understanding between BP and the State Oil Fund (SOFAZ) setting out BP support of Oxford Economic Forecasting to work with SOFAZ to develop a long-term model of the Azeri economy. Notwithstanding these impressive efforts, it remains clear that Azerbaijan is lacking in the human capital needed to manage the explosion in oil and gas revenues without serious macroeconomic damage. **The Panel accordingly recommends that BP maintain and enhance the support it is already providing to the government of Azerbaijan in this area.**

At a more structural level, BP and its partners have played an important role in helping to make the Extractive Industries Transparency Initiative (EITI) a success in Azerbaijan. The transparent reporting of oil and gas revenue payments to the government that has been achieved under EITI represents an important start in building accountability. But an even bigger challenge lies in tracking what happens to these revenues after they enter the government's coffers. For example, while some of these funds are paid into the Oil Fund and are therefore subject to international monitoring, others go to projects identified by Presidential decree, and others still go directly to the state budget without earmark. **The Panel recommends that BP and BTC encourage and support initiatives by the government of Azerbaijan to monitor where and how effectively oil revenues are being spent.**

Finally, the Panel notes that in addition to these problems of economic management, an entrenched culture of corruption imposes a huge burden on society and the economy in Azerbaijan. The extent and cost of this problem is only emphasized by the recent successes of the Georgian government in reducing endemic corruption in that country -- successes reflected in the World Bank's decision to place Georgia top of its list of economic reforming countries in 2006. The Panel notes that BP's other efforts to promote long-term economic growth in Azerbaijan -- including the supply chain initiative and other support for the non-oil sector -- will be hampered in their effectiveness so long as corruption remains so pervasive in Azeri society. **The Panel therefore recommends that BP make combating corruption a key priority in its assistance program in Azerbaijan, for example by incorporating it more explicitly into the good governance theme of RDI.** At the very least, BP should take affirmative measures to operationalize and extend its existing corporate code of conduct, which could be the foundation but not the entire solution to the task of addressing corruption on the scale experienced in Azerbaijan. As the largest foreign investor in Azerbaijan, BP runs the risk of coming to be seen

as part of the problem if it does not take affirmative steps to help the government of Azerbaijan meet this pressing challenge.

D. Regional Energy Issues

Last year, we commented on the continuing challenge that Georgia faced in securing supplies of natural gas from Russia. We observed that, while further development of the Shah Deniz field might eventually free Georgia from this dependence, enhanced regional energy cooperation with Azerbaijan and Turkey was vital in the interim. While essentially a government to government issue, we noted that BP and its partners had an interest in ensuring that gas supplies to Georgia -- a key transit country for BTC and SCP -- remained reliable and stable in the short term.

Developments over the last 12 months have made regional energy cooperation an even more pressing requirement for the pipeline countries. Russia has continued to press its neighbors -- Ukraine and now, it seems, even Belarus, in addition to Georgia -- to accept steep increases in the price of its gas, and has proved all too ready to cut off supplies as a negotiating tactic. In addition, Georgia has suffered a significant economic impact in 2006 from Russia's decision to ban imports of some of the country's key products, such as wine and drinking water. The Georgian Prime Minister estimates the direct effect of these measures as equivalent to 1.5 percent of the country's GDP, with indirect effects amounting to a further 1.5 percent.

Azerbaijan has proved itself a good neighbor during this difficult period for Georgia, making good some of the shortfall in Russian supply during the last winter and preparing to do the same again this year. Azerbaijan's plan to put heavy mazut oil to use in its power stations promises to free up further volumes of gas that might thereby become available for export to Georgia. Construction delays on the Turkish segment of SCP may also work to Georgia's advantage this year, allowing it to take volumes which would have been delivered to Turkey if the pipeline had already been fully commissioned. All of these developments could contribute significantly to reducing Georgian dependence on Russian gas, in the short term at least.

Georgia's short term need to maximize its gas supplies from non-Russian sources may also present BP and BTC with difficult choices. For example, a reduction in the amount of gas reinjected into the Azeri-Chirag-Gunashli ("ACG") field could free up volumes for consumption in Georgia, but at the cost of potentially reducing both short and long term oil production. In the longer term, however, BP, BTC and the three pipeline countries have a shared interest in maximizing the productive potential of Azerbaijan's natural gas resources. Early full development of Shah Deniz, coupled with exploitation of so-called "deep gas" from ACG, would bring closer the day when both Azerbaijan and Georgia are both truly independent of Russia in energy terms. Parallel development of Azerbaijan's oil resources to their full potential would have a comparably significant impact on that country's economic fortunes, possibly extending the period of peak resource revenue for up to a decade.

With revenues already surging, Azerbaijan may currently have other priorities than planning further long term investment in its resource base. The benefits of early action for Azerbaijan and its neighbors are, however, compelling. **The Panel recommends that BP and**

BTC continue to encourage the government of Azerbaijan to make full development of these fields a priority.

Conclusion

As indicated at the beginning of this report, our overall conclusion is that BP and BTC have laid a good foundation in their effort to establish a new model, but that sustained effort will be required in many areas for the duration of pipeline operations if that vision is ultimately to be fulfilled. From the vantage point we occupy, a key ingredient in the success achieved so far is the sustained attention that BP's senior management has devoted to ensuring that BTC has met the high standards set for it. Maintaining that success over the lifetime of the Caspian projects will require the continued engagement of senior management. **We recommend strongly that an independent external body continue to conduct a periodic review of BP's performance on the ground in the Caspian region.** A biannual visit to the region by such a body throughout the operating life of the pipelines would in our view provide a cost-effective means of keeping local management focused on the goals described in this and previous Panel reports and catalyzing interventions as needed from senior management outside the region. As such, we believe that continued monitoring has an important role to play if BP's success to date in establishing BTC as a new model is to be maintained over the operational lifetime of the Caspian Projects.

APPENDIX: SUMMARY OF KEY RECOMMENDATIONS

| <u>Recommendation:</u> | <u>Page</u> |
|---|--------------------|
| <i>Overview</i> | |
| While the companies have laid the foundation for the new model at which they aim, an equally significant, if not greater, challenge lies ahead. Meeting this challenge will require sustained senior management attention and a continued -- indeed, in some respects, enhanced -- commitment of human and other resources. | 3 |
| The commitment that BP and BTC have made to long-term regional development must be sustained and enhanced over the entire operations phase if it is to make a meaningful and lasting impact. | 3 |
| <i>Reinstatement and Restoration of the Right of Way (“ROW”)</i> | |
| BP and BTC should continue to encourage BOTAŞ to make good its deficient reinstatement of pipelines ancillary to BTC and SCP, which are outside the scope of the Lump-Sum Turnkey Contract. | 4-5 |
| BP and BTC should monitor BIL’s performance as operator closely and ensure that they are fully consulted and involved in decisions that affect their interests, as well as those of the communities living along the pipeline route. | 5 |
| BTC should supervise closely BOTAŞ’ remedial reinstatement work on sections of the East Anatolia Natural Gas Pipeline running alongside BTC, to ensure that a high standard of final reinstatement is achieved. | 5 |
| <i>Reinstatement of Access Roads and Construction Camps</i> | |
| BTC should adopt a three part test when confronted by requests to leave in place the improvements made to access roads or camps during the construction process: (i) conduct a short Environmental and Social Assessment; (ii) render the road of camp “fit for purpose;” (iii) return in improved condition only if an authority or owner has agreed to assume long term responsibility for maintenance. | 5 |
| <i>Waste Management</i> | |
| BP should conduct an after-action review of the waste management procedures employed during construction of BTC, and of the planning that was undertaken to meet the target standards at a local level. | 6 |

BP should review the resources it devotes to waste management issues on a group-wide basis and consider the scope for consolidating policy responsibility for them to a greater extent at the executive level. 6

BTC should continue its work with the Georgian authorities to develop a sustainable solution to its waste management needs that will contribute to the country's modernization in this area. 6-7

BTC should explore the scope for a transborder initiative in the waste management area under the auspices of the Regional Development Initiative. 7

Land Issues

BTC should engage the Georgian NGO concerned that it has not explained to local residents the restrictions in the 500m safety zone around the ROW, and be prepared to communicate directly with affected individuals in the safety zone where a legitimate need can be shown or lingering confusion exists. 7-8

BTC should develop a protocol for dealing with violations of the land use restrictions and communicate this protocol to each official responsible for patrolling the ROW. 8

This protocol should be used to facilitate resolution of disputes over the restrictions by community liaison officers in the first instance and only as a last resort by security officials. 8

Construction-Related Grievances

BTC should seek a speedy resolution of any remaining claims related to road use, engaging independent fact-finders or arbitrators as necessary to help close these grievances out. 8-9

BP and BTC should assess frankly the lessons to be learned from the apparent shortcomings of the grievance mechanisms in Georgia. 9

Safety Issues

BTC should commit itself to the rigorous implementation of industry best standards with respect to pigging, including smart-pigging the full length of the pipeline regularly throughout its operational life. 10

BTC local management in Georgia should develop and implement new procedures for reporting to BP management in the UK and to interested NGOs future releases of oil falling not only above but also below the mandatory reporting threshold. 10

BP should continue to engage with interested parties and retain an open mind 11

towards any new information that has a bearing on the safety of field joint coatings.

Security Arrangements and the Protection of Human Rights

BTC should retain a team of experienced Community Liaison Officers, capable of establishing and retaining the trust of the local communities, for the duration of the pipelines' operation. 12

BTC should ensure that clear procedures are in place in each of the pipeline countries, addressing how the various groups responsible for policing the ROW will respond to the different categories of threat. 12

BP and BTC should continue to closely engage the Azeri pipeline security forces in promoting and supporting compliance with the standards conveyed in human rights training to date and to make clear to the government of Azerbaijan their continued willingness to help fund further training. 13-14

BP and BTC should engage the Gendarmerie, the Ministry of Interior, and the interagency Supreme Security Committee with the objective of putting themselves in a position to exert more direct influence over decisions affecting security arrangements for BTC in Turkey. 14

Security-Related Grievances

BTC should appoint separate ombudsmen for Azerbaijan and Georgia to whom aggrieved individuals can turn for assistance in seeking relief under national law for human rights complaints. 15

BP and BTC should engage BIL and other Turkish authorities as appropriate to encourage the creation of a comparable institutional vehicle in Turkey. 15

BTC and Trans-Caspian Oil

BP and BTC should do everything in their power to ensure that trans-Caspian shipments of oil destined for BTC are subject to the same high environmental standards as BTC itself. 15-16

BP and BTC should use their influence to the fullest extent possible to ensure that such shipments are in fact subject to the same EU standards accepted by BTC and applicable to Tengiz shipments in the period between now and 2009. 16

Iskenderun Bay

BP/BTC should give early and sympathetic consideration to an initiative to draw up a regional development plan for Iskenderun Bay, with funding from RDI or other ongoing supplemental programs. 17

Regional Development Initiative

BP and BTC should make an explicit commitment to fund RDI for the full operating lifetime of the pipelines. 19

BP and BTC should undertake a progressive step change in their funding for RDI. 19

BP and BTC should consider establishing sustainable development as a cross-cutting theme, to be taken into account in the selection and design of projects under the three existing themes: access to energy, enterprise development and effective governance. 19

Support for Civil Society

BTC should identify means for continuing and enhancing their efforts to build capacity within civil society, including a third round of monitoring or some alternative with the same or greater value to NGO participants. 20

Azerbaijan's Economic Development

BP should maintain and enhance the support it is already providing to the government of Azerbaijan in the area of macroeconomic management. 21

BP and BTC should encourage and support initiatives by the government of Azerbaijan to monitor where and how effectively oil revenues are being spent. 21

BP should make combating corruption a key priority in its assistance program in Azerbaijan, for example by incorporating it more explicitly into the good governance theme of RDI. 21

Regional Energy Issues

BP and BTC should continue to encourage the government of Azerbaijan to make full development of the Azeri-Chirag-Gunashli and Shah Deniz oil and gas fields a priority. 22-23

Conclusion

An independent external body should continue to conduct a periodic review of BP's performance on the ground in the Caspian region. 23