



Report and Recommendation of the President to the Board of Directors

Project Number: 50117-001
November 2016

Proposed Loan Southern Gas Corridor CJSC Shah Deniz Gas Field Expansion Project (Azerbaijan)

This is an abbreviated version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 5 October 2016)

Currency unit	–	Azerbaijan manat/s (AZN)
AZN1.00	=	\$0.6211
\$1.00	=	AZN1.61

ABBREVIATIONS

ADB	–	Asian Development Bank
bcm	–	billion cubic meters
EITI	–	Extractive Industries Transparency Initiative
ESIA	–	environmental and social impact assessment
GSA	–	gas sales agreement
PSV	–	Punto di Scambio Virtuale
SD1	–	Shah Deniz Stage 1
SD2	–	Shah Deniz Stage 2
SCP	–	South Caucasus Pipeline
SDPSA	–	Shah Deniz Production Sharing Agreement
SGC	–	Southern Gas Corridor CJSC
SOCAR	–	State Oil Company of the Azerbaijan Republic
SOFAZ	–	State Oil Fund of the Republic of Azerbaijan
TANAP	–	Trans-Anatolian Natural Gas Pipeline
TAP	–	Trans Adriatic Pipeline

NOTES

- (i) The fiscal year of Southern Gas Corridor CJSC ends on 31 December.
- (ii) In this report, “\$” refers to US dollars.

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan of up to \$500 million to Southern Gas Corridor CJSC (SGC) for the Shah Deniz Gas Field Expansion Project in Azerbaijan.¹ A separate report and recommendation for a partial credit guarantee (PCG) with sovereign guarantee of up to \$500 million in favor of commercial lenders to SGC is being processed concurrently.²

II. THE PROJECT

A. Project Identification and Description

2. **Project identification.** The Shah Deniz gas field is one of the world's largest gas fields, with around 1,000 cubic meters (bcm) of gas reserves. In 1996, the State Oil Company of the Azerbaijan Republic (SOCAR) signed the Shah Deniz Production Sharing Agreement (SDPSA) with six foreign oil and gas companies including BP (the operator) for the exploration, development, and production of natural resources from the Shah Deniz gas field. Construction and development of Shah Deniz Stage 1 (SD1) started in 2003 and gas production commenced in December 2006. In September 2013, subsequent to the discovery of a new high-pressure reservoir within the Shah Deniz gas field, gas sales agreements (GSAs) for the expansion of the gas field were signed with nine European energy companies. In December 2013, the SDPSA partners announced their investment decision for the development of Shah Deniz Stage 2 (SD2).

3. SGC has a 16.67% interest in the SDPSA.³ SGC approached the Asian Development Bank (ADB) in January 2016 to partly finance its share of the capital expenditure for the Shah Deniz Gas Field Expansion project.⁴ From initial discussions between ADB and SGC, ADB determined that the project possessed sound fundamentals, including high-quality project preparatory work, an experienced operator, and strong local employment-generation potential. The project is the largest gas field development project to date in Azerbaijan, and will help increase the total gas production in Azerbaijan from 20 bcm per annum in 2015 to 36 bcm per annum by 2022. ADB's familiarity with the project (through its earlier financing to one of the other parties to the SDPSA⁵) and its experience in structuring emerging and frontier market transactions will be crucial for the successful financing of the project and to demonstrate the bankability of large-scale financings for future upstream and downstream processing projects in Azerbaijan.

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5. SD2 includes the construction of two new bridge-linked offshore production platforms, 26 subsea wells drilled with two semi-submersible rigs, 500 kilometers of subsea pipelines, and expansion of the onshore gas processing terminal at Sangachal. Gas extracted from SD2 will be

¹ The design and monitoring framework is in Appendix 1.

² Asian Development Bank (ADB). 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Partial Credit Guarantee for the Shah Deniz Gas Field Expansion Project in Azerbaijan*. Manila.

³ A 6.7% interest was transferred to SGC by SOCAR in July 2014 under an outright sale and purchase agreement, while the remaining 10.0% interest will be transferred by SOCAR pursuant to the provisions of a deferred sale and purchase agreement.

⁴ Capital expenditures for the project are funded by SDPSA partners in proportion to their percent interest in the SDPSA.

⁵ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for the Shah Deniz Stage II Gas Field Expansion Project in Azerbaijan*. Manila.

delivered from Azerbaijan to Europe via three adjoining pipelines: (i) the South Caucasus Pipeline (SCP) from the Caspian Sea to the Georgia–Turkey border, (ii) the Trans-Anatolian Natural Gas Pipeline (TANAP) from the Georgia–Turkey border to the Turkey–Greece border, and (iii) the Trans Adriatic Pipeline (TAP) from the Turkey–Greece border to Italy.

6. The SDPSA sets the basic principles, rights and obligations, production sharing, cost reimbursement, and other terms and conditions of the Shah Deniz project. A steering committee consisting of an equal number of members from each SDPSA partner is responsible for managing the consortium. BP, designated as the operator for the project by the SDPSA partners, is responsible for construction and operation of the Shah Deniz gas field. The remaining SDPSA partners, including SGC, are purely financial investors and are not involved in day-to-day operation of the project. Table 1 lists the composition of the SDPSA.

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9. The sponsors of SGC are the Republic of Azerbaijan and SOCAR. The Azerbaijan economy depends heavily on the hydrocarbon sector, which represented about 31% of the gross domestic product and 87% of merchandise exports in 2015.⁶ The sharp decline in oil prices in 2015–2016 has led to a significant drop in foreign exchange reserves to \$5 billion in 2016 from a peak of \$15 billion in 2014, resulting in a devaluation of the Azerbaijan manat by 50% against the United States dollar. The Azerbaijan economy is expected to contract by 1% in 2016. Sustained investment in the expansion of the Shah Deniz gas field and timely completion of the project are important to return the Azerbaijan economy to real positive growth in 2017. Standard & Poor's credit rating for Azerbaijan as of July 2016 stood at BB+ with a negative outlook. SOCAR is a vertically integrated oil and gas company active in exploration and production of oil and gas, production of petroleum products and petrochemicals, and marketing and distribution of these products in Azerbaijan and international markets. SOCAR is 100% owned by the Republic of Azerbaijan. SOCAR had total revenues of AZN33,103 million in 2015, with an operating income of AZN1,287 million and a loss after tax of AZN1,785 million. As of 31 December 2015, the total assets of SOCAR were AZN39,954 million and its net worth was AZN14,648 million.

10. Confidential information deleted.

B. Development Impacts, Outcome, and Outputs

11. **Impacts.** The successful development of SD2 will lead to the following beyond-project development impacts:

- (i) The overall Azerbaijan natural gas sector will expand by encouraging foreign operators to develop similar gas reserves, bringing in much-needed technical knowledge, development experience, and foreign capital.
- (ii) The increase in gas production and opening of the European market to Azerbaijan gas exports will improve regional integration and diversify Azerbaijani exports of natural gas.

⁶ Standard & Poor's Rating Services. 2016. *Azerbaijan Country Rating Update*, 29 January. London.

- (iii) The successful experience of foreign commercial banks financing a large project in Azerbaijan will help increase foreign direct investment for the development of other upstream gas field development projects as well as midstream and downstream petrochemical projects, which use natural gas as feedstock.

12. **Outcome.** The project will result in successful production of natural gas from SD2, with first production estimated in 2018 and peak incremental production of 16 bcm per annum achieved by 2022. The increased gas production for the export market will result in increased revenues for the government.

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13. **Outputs.** The successful implementation of the project will result in two outputs: (i) the environmentally safe and technically sound development of the largest proven gas reserve in Azerbaijan, and (ii) the creation of over 19,000 temporary jobs during construction and 1,800 permanent jobs during operation of the project.

C. Alignment with ADB Strategy and Operations

14. **Consistency with ADB strategy and country strategy.** The project supports two of the ten strategic priorities under ADB's Midterm Review of Strategy 2020: infrastructure, and regional cooperation and integration.⁷ ADB is committed to be a provider of catalytic solutions to upper middle-income countries such as Azerbaijan, which include increasing leveraging opportunities with private capital. The project is also aligned with ADB's country partnership strategy, 2014–2018 for Azerbaijan, which supports ADB's participation in the development of natural resources in instances where it would be instrumental in attracting third-party commercial sources of credit.⁸

15. **Consistency with sector strategy and relevant ADB operations.** The project is consistent with ADB's Energy Policy, which provides for assistance to gas field development, and transportation and distribution of gas.⁹ The project promotes effective regional cooperation in the energy sector to strengthen energy security and is consistent with ADB's Regional Cooperation and Integration Strategy as well as the Operational Plan for Regional Cooperation and Integration.¹⁰ In 2008, ADB endorsed the Extractive Industries Transparency Initiative (EITI), which encourages governments to disclose their revenues, as well as companies to publicize their payments from oil, gas, and mining projects, in order to promote transparency and good governance. Azerbaijan has been a member country of the EITI since 2005 and was classified as an EITI-compliant country from 2009 to 2015. In April 2015, Azerbaijan's EITI status was downgraded from compliant to candidate based on concerns related to the ability of civil society to participate meaningfully in the EITI process in the country. Azerbaijan is currently implementing corrective actions recommended by the EITI. Notwithstanding Azerbaijan's EITI status, the operator of the project, BP, regularly discloses production volumes as well as capital and operating expenditure incurred in connection with the project. SOFAZ also discloses the revenue earned from the project along with taxes and other payments received from the SDPSA partners. The SDPSA has also been publicly disclosed.

⁷ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

⁸ ADB. 2014. *Country Partnership Strategy: Azerbaijan, 2014–2018*. Manila.

⁹ ADB. 2009. *Energy Policy*. Manila.

¹⁰ ADB. 2006. *Regional Cooperation and Integration Strategy*. Manila and ADB. 2016. *Operational Plan for Regional Cooperation and Integration: Promoting Connectivity, Competitiveness, Regional Public Good and Collective Action for Asia and the Pacific (2016-2020)*. Manila.

16. The project strongly complements ADB's ongoing initiatives in the oil and gas sector in central and west Asia. In August 2015, the ADB Board of Directors approved a loan facility of up to \$475 million to Lukoil Overseas Shah Deniz to partly fund its share of the capital expenditure for the Shah Deniz Gas Field Expansion Project (footnote 5). In August 2011, the ADB Board of Directors approved financial assistance for the Kandym Gas Field Development Project in Uzbekistan, comprising a loan of up to \$100 million and a partial risk guarantee of up to \$200 million to commercial lenders for development of the Kandym gas field in Uzbekistan.¹¹ ADB's continued engagement in oil and gas in the region will help improve standards of corporate governance and transparency in the sector.

D. Project Cost and Financing Plan

17. Confidential information deleted.

18. Confidential information deleted.

E. Implementation Arrangements

19. Table 4 summarizes the implementation arrangements.

Table 4: Summary of Implementation Arrangements

Aspects	Arrangements
Regulatory framework	<p>Exploration of, development of, and production from the Shah Deniz gas field is being carried out under the SDPSA, which sets the basic principles, rights and obligations, production sharing, cost reimbursement, and other terms and conditions for the Shah Deniz project.</p> <p>Confidential information deleted.</p> <p>The SDPSA governs the main compensation and cost recovery mechanism, which compensates the SDPSA operator (BP) for all operating costs. The balance of the production is shared between the Government of Azerbaijan and SDPSA partners according to an industry-typical R-factor model, which compensates the SDPSA partners at higher levels when capital expenditure is higher.</p>
Management	SGC's management structure consists of the general assembly of its shareholders, its supervisory board and its general director, who together with other officers of SGC, are responsible for the day-to-day management of SGC.
Implementation period	Gas production from Shah Deniz Stage 2 is expected to commence in 2018, gradually ramping up during 2019–2021, and stabilizing at 16 bcm per annum from 2022 onward.
Construction arrangements	
Type of arrangement	A contracts committee and a management committee supervise the procurement of goods and services in line with the provisions of the JOA. BP, as SDPSA operator, will construct the main offshore works and will subcontract specialized subsea construction works and onshore construction works to a number of contractors.
Contractor	BP, the SDPSA operator, is one of the world's leading integrated oil and gas companies. BP has been operating in Azerbaijan since 1994 and has adequate experience and capability to execute the project.
Operations arrangements	
Revenue structure	The Consolidated Upstream Purchase Agreement governs the sale of gas by the SDPSA partners to AGSC. BP is appointed as the sellers' representative and agent for the sale of gas to AGSC. The shareholder composition of AGSC is similar to that of the SDPSA.

¹¹ ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Partial Risk Guarantee for the Kandym Gas Field Development Project in Uzbekistan*. Manila.

Aspects	Arrangements
	<p>Confidential information deleted.</p> <p>In addition, each party to the SDPSA has the right to sell the by-product condensate from the Shah Deniz gas field in proportion to their shareholding. SGC has signed a crude oil sales agency agreement with SOCAR Marketing and Operations (a wholly owned subsidiary of SOCAR) for the sale of condensate from the project.</p>
Transportation arrangements	<p>Natural gas from the project will be delivered to end-use off-takers via three contiguous pipelines: the South Caucasus Pipeline from the Caspian Sea to the Georgia–Turkey border, the Trans Anatolian Natural Gas Pipeline from the Georgia–Turkey border to the Turkey–Greece border, and the Trans Adriatic Pipeline from the Turkey–Greece border to Italy. AGSC has entered into gas transportation agreements with the South Caucasus Pipeline, the Trans Anatolian Natural Gas Pipeline, and the Trans Adriatic Pipeline.</p>
Operation and maintenance	<p>BP, as SDPSA operator, will be responsible for operation and maintenance activities.</p>
Performance monitoring	<p>Key performance indicators will be reported by SGC and monitored by the Asian Development Bank.</p>

AGSC = Azerbaijan Gas Supply Company, bcm = billion cubic meters, GSA = gas supply agreement, JOA = Joint Operating Agreement, SDPSA = Shah Deniz Production Sharing Agreement, SGC = Southern Gas Corridor CJSC, SOCAR = State Oil Company of the Azerbaijan Republic.

Source: SGC.

F. Projected Financial and Economic Performance

20. Confidential information deleted.

III. THE PROPOSED ADB ASSISTANCE

A. The Assistance

21. The proposed ADB assistance to SGC to finance its share of the Shah Deniz Gas Field Expansion Project comprises a direct nonsovereign loan of up to \$500 million.

Confidential information deleted.

B. Value Added by ADB Assistance

22. The proposed transaction merits ADB's assistance for the following reasons:
- (i) The ADB loan will play a leading catalytic role, as it facilitates the raising of large-scale, long-term commercial financing from international banks, which will set a precedent for international banks to participate in upcoming projects in the oil and gas sector in the country.
 - (ii) ADB's participation in the transaction will further improve corporate governance and transparency in the oil and gas sector in the country. ADB's participation in the transaction has prompted the disclosure of certain safeguards-related documents, notably the fishing livelihood management plan.
 - (iii) ADB's participation in the transaction will help the government to continue the development of one of its largest revenue-generating assets in challenging times globally for oil and gas investments.

C. Risks

23. Confidential information deleted.

24. **Construction and completion risk.** BP is responsible for the construction of the project. The construction plan is highly complex, but benefits from BP's extensive technical experience. Construction is progressing as per schedule with adequate contingencies for any increase in project costs. However, challenges in project completion remain, and the comprehensive government guarantee for the tenor of the loan is a useful credit enhancement.

25. Confidential information deleted.

26. Confidential information deleted.

27. Confidential information deleted.

28. Confidential information deleted.

29. **Operations risk.** The SDPSA operator, BP, has extensive experience in the development and operation of gas fields in Algeria, Angola, Azerbaijan, Indonesia, the United Kingdom, and the United States. BP has successfully operated SD1 since 2006, which provides invaluable technical knowledge and clear understanding of operational issues. The operating and financial strength of BP gives lenders comfort that the operations risk is manageable.

30. Confidential information deleted.

IV. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

31. In compliance with ADB's Safeguard Policy Statement (2009), the project is classified category A for environment, category B for involuntary resettlement, and category C for indigenous peoples. The potential environmental and social impacts of the project have been identified and effective measures to avoid, minimize, mitigate, and compensate for the adverse impacts are incorporated in the safeguard reports and plans. In line with ADB's Safeguard Policy Statement requirements for financing of existing facilities, an environmental and social compliance audit for the existing facilities of SD1 and ongoing construction activities as part of SD2 was carried out in July 2015 and updated in August 2016. The updated audit did not find any noncompliance with ADB policies associated with the ongoing construction activities that would require the establishment of a corrective action plan. The institutional capacity and commitment of SGC to cause the operator, BP, to manage the project's social and environmental impacts are deemed adequate.

32. Sangachal Bay in the Caspian Sea, where the project is located, contains key biodiversity areas. According to the environmental and social impact assessment (ESIA), the Shah Deniz contract area, existing terminal boundary, and SD2 expansion area are not located in the key biodiversity areas. The SD2 contract area overlaps with the migration routes and spawning areas of some fish species. The ESIA indicates that construction impacts are minimal, with fish having previously demonstrated avoidance behaviors. Fishing is the dominant threat to fish populations in the Caspian Sea. Existing fish population monitoring programs established for SD1 are satisfactory to ADB and will continue. The contract area may have some overlap with Caspian seal migration pathways. BP engages with and provides support to Caspian Sea conservation programs, which provide a whole-of-sea approach to seal conservation. BP has in place an ecological and wildlife management plan. ADB will require the borrower to procure

within its project powers, and will monitor that the operator implements the project, in compliance with the relevant plans and ADB's Safeguard Policy Statement requirements.

33. Under the terms of the SDPSA, land for terminal operations and any other facilities needed are to be acquired by SOCAR and made available to the operator. SOCAR has transferred all lands required for the SD2 project to the operator. The audit confirmed that no resettlement issues, including access rights or temporary usage of lands, existed as a result of the SD1 facilities and the sites proposed for expansion of the terminal as part of SD2. No indigenous communities are located in the project influence area, so impacts on indigenous peoples are not expected. The operator has prepared and implemented a small-scale fishing livelihood management plan to address economic displacement impacts on 48 fishermen involved in small-scale fishing activities resulting from SD2 pipeline installation works in Sangachal Bay, owing to enforcement of a marine exclusion zone for 9.5 months from December 2014 to September 2015. All affected fishermen have resumed their fishing activities at the same location, with the exception of six fishermen who voluntarily chose to move to another location about 40 kilometers from Sangachal Bay. These six fishermen have reported additional impacts due to increased transportation costs and lower productivity at the new fishing location. The operator is working out arrangements to address these unanticipated impacts in consultation with the affected fishermen. The operator will monitor the fishing livelihood management plan implementation and prepare a closure report once all residual grievances are satisfactorily addressed.

34. The borrower will be required to procure within its project powers that the operator complies with national labor laws and, pursuant to ADB's Social Protection Strategy (2001), will take measures to comply with the internationally recognized core labor standards.¹² The borrower will report regularly to ADB on the compliance of the operator (and its contractors) with such laws. Information disclosure and consultations with affected people are expected to be conducted in accordance with ADB requirements.

B. Anticorruption Policy

35. SGC was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

C. Investment Limitations

36. Confidential information deleted.

D. Assurances

37. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),¹³ ADB will proceed with the proposed assistance upon establishing that the Government of Azerbaijan has no objection to the proposed assistance to SGC. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

¹² ADB. 2003. *Social Protection*. Manila (adopted in 2001).

¹³ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

V. RECOMMENDATION

38. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the loan facility of up to \$500,000,000 from ADB's ordinary capital resources to Southern Gas Corridor CJSC for the Shah Deniz Gas Field Expansion Project in Azerbaijan, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board; and

Confidential information deleted.

Takehiko Nakao
President

4 November 2016

DESIGN AND MONITORING FRAMEWORK

Impacts the Project is Aligned with			
<p>The overall natural gas sector in Azerbaijan expanded by 2020 (Azerbaijan 2020: Outlook for the Future)^a</p> <p>Regional integration through increased exports and opening of the European market to Azerbaijan natural gas exports improved by 2020 (Azerbaijan 2020: Outlook for the Future)^a</p> <p>Foreign direct investment for natural resource development and processing projects in Azerbaijan increased by 2020 (Azerbaijan 2020: Outlook for the Future)^a</p>			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
<p>Outcome Contributions to government revenues from natural gas production for the export market increased</p>	<p>a. Volume of annual peak gas production from the Shah Deniz gas field (SD1 and SD2) of 26 bcm per annum achieved by 2022 (2015 baseline: 9.8 bcm per annum)</p> <p>b. Additional revenues to the Government of Azerbaijan from the Shah Deniz gas field amount to \$10 billion during 2016–2035 (2015 baseline: \$322.8 million)</p>	<p>a. ADB periodic reviews</p> <p>a, b. Annual company reports by BP on operations</p> <p>a, b. Annual reports of the State Oil Fund of the Republic of Azerbaijan</p> <p>a, b. Annual Extractive Industries Transparency Initiative reports</p> <p>a, b. Statistics and information published by general media and trade journals</p>	<p>Delays in (i) completion of Trans-Anatolian Natural Gas Pipeline and Trans Adriatic Pipeline projects, and (ii) expansion of South Caucasus Pipeline</p> <p>Volatile political climate in Europe related to European energy imports</p>
<p>Outputs</p> <p>1. Natural gas production and processing facility expanded in an environmentally safe and technically sound manner</p> <p>2. Local employment generation increased</p>	<p>1a. 2 bridge-linked production platforms constructed and commissioned by 2020 (2015 baseline: 0)</p> <p>1b. 26 subsea wells drilled and operationalized by 2026 (2016 baseline: 10)</p> <p>1c. Construction of 500 km of new subsea pipelines by 2020 (2015 baseline: 0 km)</p> <p>2. Creation of over 19,000 temporary local jobs during construction (2014–2022) (2015 baseline: 16,000) and 1,800 permanent jobs during operation of SD2 by 2022 (2016 baseline: 0)</p>	<p>1a–c. BP’s annual progress report</p> <p>1a–c. ADB periodic reviews</p> <p>2. BP’s environment and social safeguards monitoring reports</p>	<p>Unanticipated technical challenges during drilling of wells</p>

Key Activities with Milestones

- 1.1 ADB nonsovereign loan signing, commercial loan signing, counter-guarantee and indemnity execution, and ADB partial credit guarantee execution by December 2016
- 1.2 Satisfaction or waivers of conditions precedent for disbursements by December 2016
- 1.3 Additional wells drilled by 2026
- 1.4 South Caucasus Pipeline expansion completed by June 2018
- 1.5 Trans-Anatolian Natural Gas Pipeline and Trans Adriatic Pipeline completed by 2019 and 2020

Inputs

Confidential information deleted.

Assumptions for Partner Financing

Not applicable.

ADB = Asian Development Bank, bcm = billion cubic meters, SD1 = Shah Deniz Stage 1, SD2 = Shah Deniz Stage 2.

^a Ministry of Economic Development. 2012. *Azerbaijan 2020: Look into the Future* Development Concept. Baku. Source: ADB.

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