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## **Executive Summary – Azerbaijan Trade Logistics Study**

### **Introduction**

Azerbaijan encompasses a land area of 86,600 square kilometers. In addition to its country population of 8.5 million, over twenty five million of Azeri diasporas live and work in Russia, Iran, Georgia and other countries.

Situated on the Caucasus region and adjacent to the Caspian Sea, Azerbaijan offers one of the most attractive transit links along the East – West trade route between Asia and Europe, as well as the North – South trade route between North Europe, Russia on the one hand and Middle East, South Asia on the other. Both CAREC Corridor 2 and the TRACECA Corridor pass through Azerbaijan.

Among CAREC countries, Azerbaijan is the closest to open sea and has four attractive access routes. The Black Sea is only 300 km overland from its border with Georgia and can be accessed through the Volga - Don Canal from May to October. The Baltic Sea is accessible through the Baltic-Volga Canal except the winter months. The Persian Gulf Port of Bandar Abbas is only 1800 km from the Azerbaijan's border with Iran. In addition, each route to open sea requires transit through only one country, reducing geopolitical risk substantially.

Azerbaijan is well served by a diverse group of international, regional and local freight forwarders and logistics companies. It has a strong air transport sector, led by flag carrier AZAL that operates 39 planes on scheduled routes between Baku and major cities like London, Paris, Milan, Vienna, Moscow, Dubai and Istanbul. The state owned water carrier - Caspian Shipping Company (CASPAR) is the leader on the Caspian Sea, operating 86 vessels, of which 41 are tankers, with total deadweight of 443,782 tons.

Overcoming economic and social disruptions from the Armenia conflict, the country has bounced back strongly after its 1991 independence. Driven by 37% growth in the oil sector, Azerbaijan's real GDP surged 23% in 2007 – leading the world in GDP growth.

USAID is currently assisting Azerbaijan in meeting the requirements of WTO membership by 2009. Much progress was achieved in reforming its trade laws and in making the government more open and transparent. Gaining WTO membership will position Azerbaijan to be a future member of the European Union.

Despite its enviable geographic position and increasing prosperity and openness, Azerbaijan Logistics Performance Index (LPI) rank is a disappointing 111<sup>th</sup> out of the 150 countries surveyed in the 2007 World Bank Report, "Connect to Compete – Trade Logistics in the Global Economy".

LPI measures a country's trade logistics performance using a number of parameters. It profiles the trade logistics of the countries covered and identifies the factors that explain the wide differences in logistics performance among countries. Countries with high LPI scores have lower trade costs and are better connected to the global value chain.

Azerbaijan's 116<sup>th</sup> Infrastructure Rank, (5 notches lower than its composite rank) highlighted the poor condition of its road and rail infrastructures. Its 128<sup>th</sup> Logistics Competence rank reflected the shortage of qualified logistics professionals.

### Challenges

Logistics and supply chain management education and training is weak in Azerbaijan. Frequently, large Azeri firms and multinationals have to recruit logistics managers from outside the country. The paucity of professionals made it hard for Azerbaijan to achieve rapid advances in trade logistics.

Even though Azerbaijan's air and sea transport infrastructures are modern, its roadways and railways are underdeveloped.

Azerbaijan's 29,000 km of highways are not designed and built to the standards of most developed countries. Large sections of the road surface have disintegrated, with huge potholes and crumbled pavements. Destination direction signs, turn off lanes and passing lanes are virtually non-existent. Road travel is slow and treacherous in Azerbaijan.

Azerbaijan's 2,100 km rail network is in even worse shape. Most of the rail ties have rotted away and the ballast badly contaminated. On the main east-west line, 24 percent of the track require immediate repair. The poor track condition cause derailments and restrict average train speed to 30 km per hour. The majority of the rail locomotives are past retirement age and cannot operate far from the assigned repair base. Specific crew are appointed for operating a given locomotive so it can be jury rigged back to shop should there be a failure. 80% of the passenger wagons are over 15 years old and more than half of the freight wagons are no longer usable.

Azerbaijan's motor carrier industry is small, only a few carriers have 50 or more trucks. Lacking capital and access to favorable leases, most of the Azeri trucks are old, polluting and do not meet European standards. With the exception of the Baku Cargo Terminal, large long term logistics investment by the private sector is rare. Entrepreneurs focus on businesses that can produce a quick profit and do not require substantial capital expenditure.

Multimodal transportation is at a very early stage of development. Azerbaijan Railway utilizes old and dilapidated equipments in handling intermodal shipments, e.g. 5 ton rail containers. Unlike U.S. railroads running fast, scheduled, dedicated, double stack trains that carry 100 or more containers, Azerbaijan Railway transports just a few containers in slow, mixed trains. Whereas a typical U.S. intermodal terminal handles several thousand containers and trailers a day, a typical Azeri intermodal terminal handles only a handful of containers a day.

Stripping away petroleum and petroleum based exports moving in specialized tank wagons that cannot be reloaded with other freight; inbound cargo into Azerbaijan exceeds its outbound cargo by several multiples. Azerbaijan's role as a transit country for its neighbors also contributes to its freight flow imbalance. The heavy freight flow imbalance causes poor equipment utilization, which in turn pushes up freight rates and increases the cost of trade.

Azerbaijan does not have an integrated national trade and transportation facilitation strategy. No institution below the Cabinet of Ministers is dedicated to trade and transportation facilitation or reform. Traders encounter many obstacles from excessive bureaucracy, inadequate transparency, uneven enforcement as well as laws and regulations that become effective with no advance notice. Getting goods through Customs is a challenge that requires special skills – a key reason why large number of freight forwarders does not provide customs clearance service.

The Azeri government protects its banking industry and restricts foreign investment. Therefore, the banking sector is dominated by two banks which together control over 50% of the market. Global financial institutions with strong trade finance capabilities (e.g. HSBC, Citi) do not have branches in Azerbaijan to support international trade. Lack of competition is a key reason for high bank fees and high trade financing cost.

Azerbaijan's light sweet crude commands a premium price in world markets. The completion of the Baku – Tbilisi – Ceyhan pipeline positioned Azerbaijan as a key player for transporting Caspian Sea region's oil to world markets. However, its oil and gas production is anticipated to peak in the next decade, Azerbaijan must develop other sectors of the economy to replace oil as its primary growth engine.

#### Opportunities

The convergence of the Asian and European production networks presents significant opportunities to Azerbaijan in bridging both regional production networks to form a Eurasian production network.

As the western most country in the CAREC region, Azerbaijan can play an important role as the Central Asia region's gateway to Europe or as Europe's gateway to the Central Asia region. Azerbaijan's position at the boundary of Asia and Europe gives it a special advantage as a center of trade and transport. Azerbaijan can use its favorable position in developing strong transport and logistics capabilities as well as nurturing industries that require superior trade logistics to compete.

Azerbaijan can exploit Baku's location on the pathway of long distance flight routes and the availability of competitively priced aviation fuel from two nearby refineries to develop Baku as a major intercontinental air hub. Azerbaijan carriers can carry cargo between Asia and Europe, and its logistics centers can support both Asian and European production networks. Baku can become a trade hub where merchants from Europe and Asia come to meet and to make deals.

Azerbaijan has both railway and highway running from its border with Russia to its border with Iran at Astara. Even though Azerbaijan's North – South Corridor through Baku is not a CAREC or TRACECA Corridor, it is a transit route important to the economic development of the country, and can be considered a feeder route to both CAREC and TRACECA Corridor. From Northern Europe and Russia, the North – South Corridor is shorter, cheaper and faster to Iran (continuing on to South Asia) as compare to all the competing routes, including:

- By rail via Russia to the Caspian Sea port of Astrakhan and then by conventional shipping to the Iranian port of Bandar Anzali

- The Volga River to the Russian Caspian Sea port of Astrakhan and then by conventional shipping to the Iranian port of Bandar Anzali (May to October only)
- By rail from Russia to Kazakhstan, Uzbekistan, Turkmenistan to Sarakhs, Iran where the cargo is trans-shipped from Russian broad gauge wagon to Iranian standard gauge wagon
- By sea from Russia ports through the Suez to Iranian Gulf ports

The benefits of the North – South Corridor are demonstrated by the growing North – South Corridor transit traffic.

Azerbaijan Law provides for the creation of Free Economic Zones. Service industries can be developed in future Free Trade Zones to repair and assemble machinery and equipment (e.g. oil production equipment) for Asian and European producers under simple, convenient and favorable customs regimes.

Azerbaijan can use its prominence in hydrocarbon production and proximity to rich oil and gas production zones to develop industries that supplies equipment for oil and gas extraction and for the manufacturing of petrochemicals. The product line can include drilling equipment, pumps, anti-eruption equipment, fluid and gas taps, land rigs, offshore oil platforms as well as petrochemical processing systems. These are all high tech industries with rich margins. Azerbaijan's status as a major supplier of oil and gas equipment during the Soviet era provides a springboard for launching these industries.

Agriculture is an important sector in Azerbaijan's economy. Currently, it employs 41% of the population, but contributing only 7% of the GDP. With fertile soil and diverse climate zones, this sector can grow substantially with improvements in marketing, production, transportation and cold chain logistics. Success in this sector will make a huge contribution to improving the rural living standards.

#### Government Infrastructure Plans

Since oil and gas production is anticipated to peak around 2012, Azerbaijan's government is nurturing other sectors of the economy to become the future engines of growth.

Recognizing the importance of trade logistics in spurring economic development, Azerbaijan's government has set ambitious plans to advance the country's road and rail transport infrastructure – a key deficiency that contribute to its low LPI score.

Aside from budgeting over half a billion dollars on highway improvement, Azerbaijan will invest \$1.5 billion in upgrading its rail system and to support the Georgian government with a \$200 million concessionary loan for building the Georgia portion of the Kars – Tbilisi – Baku (K T B) Railroad. In addition, Azerbaijan will also construct a short rail line from Astana to connect with a new rail line that Iran will construct to the border.

The \$1.5 billion rail restructuring program will include the acquisition of a new AC electrification system, a new signaling system, new locomotives, new wagons, and replacement of large sections of the existing tracks.

When completed, the K T B Railroad will connect Azerbaijan's rail system with the rail system of Turkey (its key trading partner and close ally) to form a sea to sea intercontinental rail link that runs from UK to China.

The Azerbaijan State Shipping Company (CASPAR) plans to increase its fleet size and scope of operations substantially in the next five years. It plans to add 27 permits for transiting Russian internal waterways. In addition, a new, modern sea port and ship yard will be constructed near Alat.

### Key Recommendations

The Azerbaijan Trade Logistics Study proffers a set of recommendations for improving Azerbaijan's trade logistics. Some of the key points are listed below:

1. Adopt comprehensive transport infrastructure planning to:
  - achieve the highest return on investment
  - balance the amount of investment in various types of infrastructure
  - ensure seamless air/truck/rail/sea modal integration
2. Reform transport and logistics curriculum. Recruit world class faculty to teach in Azerbaijan's universities.
3. Develop Special Economic Zones, multimodal cargo facilities, logistics centers, cold storage facilities and modern border crossing points.
4. Establish a pilot corridor with Special Economic Zones, multimodal cargo facilities, logistics centers, cold storage facilities and modern border crossing points, as a demonstration corridor to showcase the improvements achieved.
5. Simplify customs laws and regulations. Improve transparency of rules and regulations. Promote harmonization of border crossing procedures, forms and data requirements. Reduce regulatory burden on trade.
6. Encourage private sector participation. Enact laws that protect property rights and act to enhance quality of the judicial system.
7. Promote the development of Small & Medium Enterprises, especially those that are in agriculture, supply chain services, transportation and logistics.
8. Secure foreign investments that come with technology transfers.
9. Compile logistics performance indicators to assess the success of government policies, laws and regulations

10. Consider the bold move of constructing a standard gauge line from Baku to Kars, Poti and Batumi as part of the pending rail restructuring project.

#### Concluding Remarks

A route is a fragile chain; the breakdown of just one link will disrupt the entire route. The selection of trade routes is dynamic and constantly evolving. Merchants, manufacturers continuously monitor freight rates, transit time, service quality and reliability of alternate routes to optimize their choices. Ever cognizant of risks, the merchants are always seeking new routes - the key reason why there are so many routes that form the ancient "Silk Road".

Azerbaijan's transit traffic can easily be interrupted by its partner's political turmoil. As an example, transit oil traffic fell substantially in 2004 due to political turmoil in Georgia that forced the Batumi port - the main crude oil handling port on the Black Sea, to close twice. In response, oil traders redirected the crude oil to transit through Russian and Iranian ports, bypassing the Baku – Batumi route.

The Azeri government is adept in diplomacy, promoting cooperation and development with its trade and transit partners and enjoying good relations with Russia, Georgia, US, Iran, Israel all at the same time. This should solidify Azerbaijan's role as a leading transit country.

However, the China – Kazakhstan - Russia direction linking Asia and Europe is much simpler than the direction through Azerbaijan. Kazakhstan will soon have two rail connections with China (Alashankou and Horgas), increasing the competitiveness of the China – Kazakhstan - Russia direction. Further, Turkey is advocating a new rail route that connects with China through Iran. In the years to come, the trade routes crossing Azerbaijan will face even more intense competition from both existing and emerging transit routes.

Azerbaijan must be vigilant in defending its competitive advantages and constantly strive to make it the most trade and transit friendly country. Reinvestment in infrastructure is a good start, but the government must reform its laws and regulations, improve its transparency and increase the competitiveness of Azerbaijan's logistics industry.

Azerbaijan should use a significant portion of its oil and gas receipts towards developing industries that will sustain its economy for many future years. Trade, transport and logistics, supply chain services, oil equipment and agriculture are high potential industries that the government of Azerbaijan should focus on.