

Environmental Groups Campaign Against Sakhalin-2 Project Financing

IN THE LAST FEW MONTHS THE GLOBAL ENVIRONMENTAL MOVEMENT HAS STEPPED UP ITS PROTESTS AGAINST SAKHALIN ENERGY'S PHASE 2 DEVELOPMENT. THIS MORE THAN \$10 BILLION DOLLAR PROJECT IS THE LARGEST INTEGRATED OIL AND GAS PROJECT CURRENTLY BEING DEVELOPED IN THE WORLD AND BY FAR THE LARGEST FOREIGN INVESTMENT PROJECT IN RUSSIA TODAY. THEREFORE, IT IS NOT SURPRISING THAT THE GLOBAL ENVIRONMENTAL GROUPS (HEREAFTER ENGOs) THAT FOLLOW "BIG OIL" AROUND THE WORLD SHOULD TARGET THE SAKHALIN PROJECTS.

The Sakhalin-2 project, however, is coming under much greater pressure than Exxon Mobil's Sakhalin-1 project. The reason for this is quite straightforward—Sakhalin Energy is seeking a substantial amount of project financing (a sum of \$5 billion is reported in the media), while the partners involved in the Sakhalin-1 project are using their own funds.

The issue for Sakhalin-2 is that the International Financial Institutions (IFIs), such as the European Bank for Reconstruction and Development (EBRD); Export Credits Guarantee Department (ECAs), such as the US EXIM bank; Japan's Bank for International Cooperation (JBIC); and the UK's Export Credit Guarantee Department (ECGD) all have rigorous processes for assessing the environmental and social impacts of large-scale resource development projects. Furthermore, since 2003 a growing number of commercial banks have signed up to the so-called "Equator Principles" that are based on International Finance

Corporations (IFCs) policies, which provide "a framework for financial institutions for managing environmental and social issues in project financing" (www.equator-principles.com). Sakhalin Energy's own financial adviser, Credit Suisse First Boston (CSFB) is an active member of the "Equator Banks."

"Greening" of Project Financing

The "greening" of global project financing amounts to a new set of benchmarks when it comes to managing the environmental and social impacts of large resource projects. Both Sakhalin projects stress that their activities are in full compliance with Russian legislation, which should be true; but the requirements of the IFIs, ECAs, and Equator Banks amount to a "higher level" benchmark when it comes to issues relating to sustainable development. Furthermore, Shell's own business principles make a strong commitment to contribute to sustainable development, as does Sakhalin Energy's. Thus, to meet the needs of the lenders and its own corporate policies, the Sakhalin-2 Phase 2 development must meet stringent environmental and social standards; this provides the ENGOs with leverage as they can test the track record and plans of Sakhalin Energy against this international benchmark. That is precisely what they have been doing by focusing on Sakhalin-2's project financing. At the same time, the ENGOs do not believe that funding large energy projects is inline with EBRD's charter. Following the World Bank's Extractive Industries Review, the EBRD is currently assessing its own energy policy, thus the Sakhalin-2 decision comes at a sensitive time for the EBRD.

The current situation should not come as a

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surprise to Sakhalin Energy; they sought project financing worth \$348 million for their Phase 1 development from EBRD, OPIC (US), and JEXIM (Japan). The loans were approved, but the ENGOs did succeed in forcing some changes in areas such as oil spill response and public consultation. This time the stakes are higher as Sakhalin Energy is seeking as much as \$5 billion in debt financing, to come from a variety of sources including IFIs (EBRD), ECAs (US EXIM, JBIC and UK ECGD), commercial lenders, and/or a project bond issue. It is expected that JBIC will provide the bulk of the funding; the Japanese Government considers the

was critical. In 2003 the EBRD had ruled that Sakhalin Energy's environmental impact assessments were "unfit for purpose" and postponed a decision on the loan. In April 2004 at the EBRD's Annual Meeting, the Bank's President stated: "We are not yet satisfied with the answers we have received (in relation to the environmental and social impacts of the project) and the present situation, and we have said so to the sponsors."

ENGOs Unite Against Sakhalin-2

So what are the main issues that are being pursued by the environmental groups and what is the current state of play?

Any large-scale energy project is bound to have environmental impacts; in fact it is somewhat of a misnomer to talk about "sustainable development" in relation to a process that aims to exploit a non-renewable resource base. The issue is whether or not the developers are minimizing those impacts.

Sakhalin projects of strategic significance. The level of US EXIM support will be modest as the project no longer has a US partner.

However, it is the EBRD that is acting as the "gatekeeper" on the project finance decision as it has the expertise necessary to assess the environmental and social impacts of the project. In addition, EBRD involvement means that their loan should be able to demonstrate "transition impact." The "transition impact" of the Phase 1 loan relates to providing a demonstration effect of establishing an effective production-sharing framework in Russia, as well as implementation of sound environmental practices. As a vehicle for new foreign investment in Russia, the PSA is all but dead and it is the project's environmental practices that are being questioned by the ENGOs.

This makes one wonder where the transition impact lies in phase 2, save for providing income to the Russian Government. The EBRD's initial response to phase 2 development

A global network of ENGOs has developed to protest the Sakhalin projects. At its heart is the Sakhalin-based "Sakhalin Environment Watch"(SEW) (www.sakhalin.environment.ru/en) and the California-based Pacific Environment (www.pacificenvironment.org). In addition to these two organizations, there is an inner sanctum that includes the likes of Friends of the Earth (England and Wales), WWF Russia, CEE Bankwatch, ECA Bankwatch, and International Fund for Animal Welfare (IFAW), Greenpeace, Platform, and the Wild Salmon Center. All of these organizations have websites that carry information on the Sakhalin-2 project. The involvement of SEW gives the network local legitimacy, but it is also the case that there are differences between the members of the network in terms of their attitudes toward oil and gas companies. SEW is not anti-development and it does not want to stop the projects; rather it wants to minimize their environmental impact and safeguard what is left of Sakhalin's natural environment. The campaign against the

Sakhalin-2 project has focused on three sets of issues: environmental impacts, social impacts, and economic benefits of the Sakhalin-2 PSA.

Any large-scale energy project is bound to have environmental impacts; in fact it is somewhat of a misnomer to talk about “sustainable development” in relation to a process that aims to exploit a non-renewable resource base. The issue is whether or not the developers are minimizing those impacts. The ENGOs find fault in a number of key areas. First and foremost as far as the international organizations are concerned, is the impact of offshore activity on the endangered western grey whale. The summer feeding

In August 2004 they commissioned the World Conservation Union (IUCN) to create an independent panel of experts to study the situation and assess Sakhalin Energy’s risk mitigation strategies and the assessment of these three routes. The panel’s report concluded “the underlying question was whether the risks associated with Sakhalin-2 Phase 2 are being, or will be, managed in an effective manner that will allow oil and gas development to proceed without further jeopardizing the survival and recovery of this critically endangered whale population.”

The report makes clear that the dynamics of the population are poorly understood and the

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grounds of this dwindling whale population, now thought to number some 100, is located along the northeast coast of Sakhalin in close proximity to both Sakhalin projects.

Whale Research Delays Operations

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impact of oil and gas development difficult to predict. The report concluded “the most precautionary approach would be to suspend present operations and delay further development of the oil and gas reserves in the vicinity of the grey whale feeding grounds offshore Sakhalin....” However, it also goes on to recognize that, given the inevitability of oil development off Sakhalin Island, a conservative risk based approach to the whales should be adopted and sets out a number of suggestions and recommendations.

Not surprisingly, the environmental groups seized on the precautionary statement and demanded the immediate suspension of the project. It also identified suspension as the most precautionary approach, but also highlighted a number of issues that should be addressed if the project was to progress.

The report also was critical of the amount of information provided by Sakhalin Energy and noted that it could not assess the cumulative

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impact of the two Sakhalin projects as Exxon Neftegas declined to provide any information on their development. In a statement from Moscow, Shell's Russia Country President John Barry, made it quite clear that the project was going ahead. In fact, the release of the IUCN report coincided with a Sakhalin Energy statement that they had closed a deal to sell LNG to South Korea's Kogas. The EBRD and other potential lenders now must consider the report.

Research Results Re-Routes Pipeline

On March 30, 2005 following their consideration of the report's recommendations, Sakhalin Energy announced that it would be rerouting the offshore pipeline to help protect the gray whale population. The most southerly of the three routes, which moves the pipeline 20 km further south, now has been chosen subject to approval by Russian government agencies. This route also balanced the offshore and onshore impacts of the pipeline corridor, as indigenous groups are concerned about the impact on reindeer pastures. However, Sakhalin Energy stopped short of moving the location of the Piltun-Astokhskoye-B platform. Ian Craig stated that: "We must minimize sub-surface and blow-out risks and this steers us to the location we have chosen."

The environmentalists are not satisfied with the revised strategy. Nick Rau of Friends of the Earth stated: "Shell has finally admitted the need to move the route of Sakhalin-2, but unless Shell moves the oil drilling platform, the future of the western grey whale is still in serious jeopardy."

Sakhalin Energy has requested IUCN to establish a workshop with scientists who sat on the panel to discuss their response to the more detailed elements of the report and how Sakhalin Energy has adopted these in its activities. The banks and NGO representatives also will be involved in this workshop in May.

The reality is that we simply don't know what impact the projects will have on the whales and the only sensible way forward is to monitor the whales as the projects evolve. But for some

environmentalists it is not about risk management, they will not rest until the projects are stopped. This is not, however, a position adopted by SEW, or the local population. In fact, SEW sees the whale issue as crowding out other issues that they consider of equal significance, particularly the impact of construction activity on the onshore and offshore fisheries.

Fisheries Groups Oppose Financing

The fishing industry is of critical economic and social significance to the Island. The pipeline route of the Sakhalin-2 project crosses almost 1,100 watercourses and SEW is concerned that burying the pipeline in all but the most sensitive crossings will lead to widespread disruption of the salmon fishery. They also are worried that burying a pipeline in such a seismically active region could lead to pipeline ruptures being undetected.

Sakhalin Energy has policies in place to minimize the impact on the fisheries, but SEW has obtained photographic evidence that suggests that Sakhalin Energy's subcontractors are not being as diligent as they should be.

There are similar concerns with respect to the construction of the LNG plant and oil export terminal at Prigorodnoye on the shores of Aniva Bay. Here Sakhalin Energy plans to dump material from the construction site in the middle of the bay. Local fishermen are concerned that this will damage areas where they trawl for crab, shrimp, scallops, and sea urchins. The local diving club already has reportedly found evidence of unapproved dumping in the bay by Sakhalin Energy subcontractors, this turned out not to be the case. Clearly subcontractor discipline is fast emerging as an issue for the project. In the case of Sakhalin Energy's plans to dump dredged material in Aniva Bay, they already have agreed to a financial compensation payment with the relevant Russian agencies; but SEW wants them to dump the waste in deeper water beyond the bay where it will have less impact on the fishery.

Impact on Indigenous Lifestyles

If all of the environmental concerns were not enough, the Sakhalin-2 project also impacts the traditional livelihoods of the Island's indigenous peoples. Like the grey whale, this is an emotive issue and one that garners international attention. When a group of indigenous peoples blockaded roads in the north of the Island in January 2005 it attracted international media attention. According to the 2002 Russian Census there are some 3,500 indigenous people in the Oblast, mostly in the north of the Island, which represents about 0.7% of the total population. The harsh reality is that the greatest damage to traditional lifestyles was done during the Soviet period thanks to collectivization and

itself divided) and the politicians in Yuzhno-Sakhalinsk, and some in Moscow, realize that they have leverage over the oil companies. The protests in January involved a strange coalition of an Indigenous Peoples' group called "Green Wave," SEW, the Green Party, and Vladimir Zhirinovskiy's Liberal Democratic Party (which is neither liberal nor democratic). This suggests political opportunism, rather than a real concern for the problems facing the indigenous peoples. Both the Sakhalin Administration and the Sakhalin Oblast Duma have added to the pressure by demanding that the oil companies provide \$12 million to finance the Oblast Administration's program for the socio-economic development of the indigenous peoples of

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the onshore development of oil and gas production, timber industry, and illegal fishing. Today large numbers of indigenous people live in towns and do not pursue their traditional lifestyles. Under Russian law they have no title to their traditional lands and their rights are not adequately protected by Russian legislation.

However, those global benchmarks discussed above rather than Russian law, pay particular attention to the impact of resource development projects on traditional lifestyles. To be fair, Sakhalin Energy, Exxon Neftegas, and BP all have social programs that include support for the indigenous peoples and all are highly sensitized to the issue. Sakhalin Energy conducted an exhaustive social impact study for Phase 2 and has just completed additional work on the indigenous peoples issue.

Perhaps this is where the problem lies, the leadership of the indigenous peoples (which is

northern Sakhalin. While all parties have agreed to cooperate, there seems no easy solution to an increasingly complex situation. Undoubtedly the foreign oil companies want to be seen to be doing the right thing, but it is not clear what that is.

Who Benefits Financially?

The final dimension of the ENGO campaign against the Sakhalin-2 loan concerns the financial benefits of the PSA that accrue to the Russian parties. The ENGO network has commissioned an analysis of the by Dr. Ian Rutledge of Sheffield Energy and Resources Information Services (SERIS) entitled: "The Sakhalin-2 PSA-a Production 'Non-Sharing' Agreement" (available from www.carbonweb.org/documents). In the report Dr. Rutledge argues that the Sakhalin-2 PSA is not a good deal for Russia. According to the report: "[t]he benefits which flow to the Russian party...fall a long

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way short of those which would have been received had a ‘standard’ type PSA been used...(in which) the Russian party would receive 45% more economic rent.”

Sakhalin Energy has produced its own publication entitled: ‘The Sakhalin-2 PSA: What’s in it for Russia?’ For a number of years the Russian Audit Chamber has monitored the finances of the Sakhalin-2 PSA and in their most recent report they have claimed that Sakhalin Energy has denied the Russian Government of \$2.5 billion. They maintain that Sakhalin Energy inflated the cost of its capital expenditures. Sakhalin Energy has agreed to discuss the issue with the Audit Chamber. While there have been cost increases, there are legitimate reasons for them and the annual budget for the project has to be approved by the Russian parties, which includes representatives of the Federal Government and the Sakhalin Oblast Administration.

Nothing much is likely to result from the report though it provides the ENGOs with further ammunition in their campaign. The wider issue of the original terms of the PSA also seems a non-starter. Back in 1994 when the deal was reached, the Russian Government was desperate to attract foreign investment. No one would deny at that time the investment environment in Russia was extremely risky and would remain so; thus generous terms were required to attract investors.

Benefits Don’t Meet Expectations

The Russian Government also had no experience in negotiating PSAs, this was the first one signed. A bad deal for Russia may be a good deal for the investors. The Russian Government is unlikely to renegotiate the terms of the agreement, though it might promote other forms of increasing its revenue, such as sanctioning Gazprom’s entry into the project. Nonetheless, the 70% Russian-content requirement and the various bonus payments, including \$100 million to the Sakhalin Development Fund, are all requirements of the PSA that benefit Russia.

The biggest problem is that so far the project

has brought limited material benefit to the people of Sakhalin, an issue that is now gaining the attention of the international media. This is because the poor state of the Island’s economy and the unskilled nature of the workforce have limited the local economic multiplier associated with the project and because the Federal Government in Moscow has reneged on its revenue sharing deal with Oblast. Thus, while the foreign oil companies may have exaggerated the local benefits, aided and abetted by studies performed by an economic think-tank in Moscow, the Federal Government must share more of the revenue with the Island even if that revenue is not as large as it might be.

At the time of writing there is no sign that the ENGOs are going to let up on their campaign against the Sakhalin-2 loan. On April 5th and 6th protests were held outside CSFB offices in Zurich and New York with protesters calling on the bank to sever its relationship as financial advisor to Sakhalin-2. The protesters maintained that the project is in direct violation of the “Equator Principles.”

Clearly these are sensitive times for Sakhalin Energy and Shell. It is noteworthy that this struggle is not being played out on Russian territory but over the Internet, in the international media, and in places like Zurich, London, Tokyo, Washington, and New York. No time frame has been set for the EBRD’s decision. Approval of the loan will amount to a global mark of approval and will remove ENGO leverage over the project. A decision not to make a loan will not stop the project, but it will do substantial reputational damage. Either way, the Sakhalin-2 project will have been subjected to a level of scrutiny way beyond that required by Russian legislation. ♠

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