A Sustainable Economic Future for Sakhalin?

A RECENT ARTICLE IN *THE ECONOMIST* MAGAZINE REFLECTING ON THE CHANGING NATURE OF RELATIONS BETWEEN THE FEDERAL GOVERNMENT IN MOSCOW AND RUSSIA'S REGIONS, DESCRIBED SAKHALIN AS "DEVELOPING INTO A CARICATURE OF PETROSTATE INEQUALITY. ITS DISMAL TOWNS ARE STILL DOMINATED BY STATUES OF LENIN; FACTORIES BUILT BY THE JAPANESE, ARE IN DISREPAIR; MUCH OF THE FISHING FLEET IS RUSTING IN THE WATER." NOT EXACTLY A GLOWING ADVERTISEMENT FOR THE BENEFITS OF LARGE OIL AND GAS DEVELOPMENT PROJECTS.

Participation in the 10th Anniversary meetings of the Russian-American Pacific Partnership (RAPP) on Sakhalin in mid-September, gave me a chance to talk with others who have been visiting the Island over a period of time (this was my seventh visit since 1997), and to reflect on the relative progress that has been made since the oil and gas projects started in the mid-1990s, now a decade ago. The general consensus seems to be that, despite the obvious commercial milestones achieved by the projects, there is not as much wider economic progress as one would expect to see given that the first generation Sakhalin projects together already have invested well over $10 billion (total investments could top $30 billion). While there are pockets of prosperity and a growing "petro elite" the wider population of Sakhalin has relatively little to show for a decade of development. The juxtaposition of gleaming new oil company offices against a background of crumbling apartment buildings is a graphic expression of this growing inequality.

When one walks around Yuzhno-Sakhalinsk, a hazardous task given the state of the roads and sidewalks, listens to local politicians and the views of local people there is a clear sense of frustration that their quality of life is not improving as hoped, but there also is recognition that this is as much to do with the attitude of Moscow as it is the failings of the foreign oil companies.

In many ways, a decade on Russia is a different country from the mid-1990s when the projects started. On Sakhalin the foreign oil companies had to garner the support of the Governor and his Administration and the Oblast State Duma to get their PSAs approved. The region was the gatekeeper and it used this position to leverage certain benefits from the oil companies, such as the Sakhalin Development Fund. It also expected to share oil and gas royalties with the Federal Government and looked forward, eventually, to substantial revenues from oil and gas exports. There was even talk of the

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Oblast Administration borrowing money against future revenues to address pressing social and economic problems; however, Russia's 1998 financial crisis put an end to that.

Since 2000, President Putin has done much to reign in the power of Russia's regions. Changes to the tax system have concentrated revenue in Moscow. In his first term, introduction of Presidential Districts and Presidential Representative was used to keep a closer eye on the Governors; they were stripped of immunity from prosecution and evicted from the Federation Council. In his second term, and after the tragedy at Beslan, President Putin decided that he, and not the region's electorate, would appoint a region's Governor. Now, in marked contrast to the chaos of Yeltsin's Russia, Moscow controls the purse strings and also gets to decide who runs Russia's regions.

As noted in the summer issue of *Pacific Russia Oil & Gas Report*, the political landscape also has changed for the foreign oil companies and it is clear that it is Moscow that calls the shots. Moscow's increasing control over tax revenues has seen Sakhalin's share of oil and gas revenues dwindle to virtually nothing. While the Governor and his administration complain about this, the other regions in the Russian Far East seem unsympathetic, as they believe any special deal for Sakhalin will be at their expense. They are also jealous of the attention heaped upon Sakhalin because of the oil and gas projects.

Shortly after the RAPP meeting, German Gref, Minister for Economic Development and Trade, visited the Russian Far East and pledged greater Federal support for the region, including funds from a new $2.5 billion state investment fund, which is funded by oil revenues and money saved from foreign debt servicing through early repayment. On the issue of Sakhalin's share of oil and gas royalties, he noted that the sums involved are not as big as people think. That may be the case now, but with Sakhalin-1 just starting production and planning year-round exports in

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2006 and Sakhalin-2 planning year-round LNG and oil exports in 2008, the sums involved will soon become substantial. But, the lack of federal funding and the tax situation alone do not explain that lack of a "feel good" factor on Sakhalin today.

When the oil companies were lobbying for local support in the mid-1990s they made claims about the positive multiplier that would be associated with their investments. Furthermore, it was assumed that the Russian-content requirements would insure that the Island's industries benefited from the projects. The late Governor Farkhutdinov used to speak of "Sakhalin First" when it came to Russian-content. With the benefit of hindsight this may have been wishful thinking.

While one should not belittle the scale of the infrastructure that is being built on the Island and offshore, or the operators' commitments to promote "Russian-content," it seems likely (though there have been no studies to date) that Sakhalin has not been able to benefit as much from the multiplier effect as initially expected. This is because of the underdeveloped nature of the Island's economy. Much of Sakhalin's economy has simply been unable to participate in the projects. It is true that there are examples of successful Sakhalin companies and many joint ventures have been created, but a lot of the "Russian-content" has been achieved on the Russian mainland or is Russian in name only. Foreign companies often bemoan their inability to find a reliable local partner.

In short, Russian-content does not mean Sakhalin-content. At present, about one-third of the workforce on the projects comes from Sakhalin, which means two-thirds does not. A shortage of skilled workers is particularly problematic and the more service-oriented areas of activity have long ago stripped the local administration and educational establishments of their most skilled individuals.

Although it is done for understandable reasons, the relative isolation of the bulk of the wage earners on the project from the Island's economy also reduces the amount of money circulating locally. Instead, the service economy that has developed in Yuzhno-Sakhalinsk provides for a relatively small expatriate managerial elite that seems to live an isolated parallel life physically separated from the town in their own housing developments.

A combination of the limited capacity of the Island's economy to absorb the economic benefits of the projects and their tendency to create enclaves that do not spread benefits more widely has served to limit the multiplier benefits associated with the projects. These problems are compounded by the tendency of the local administration to expect the oil companies to solve their problems for them, either directly or by providing an additional source of rent. That said, they have a justifiable complaint that the projects have done little to solve the Island's energy problem. The gasification of the Island's energy system and the resultant reduction in energy costs would do much to bolster the local economy. However, following the old adage that you

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have to speculate to accumulate, and with the 20-20 vision of hindsight, it is clear that much more should have been done by the Federal Government and the Oblast Administration to develop the necessary infrastructure and skills base to enable Sakhalin to make more of the opportunities afforded by the projects, but for the moment at least, that opportunity has been missed.

So where does this leave us? Is *The Economist* right, is Sakhalin developing into a caricature of petrostate inequality? Clearly there are worrying signs and progress to date has been limited. It is all the more disappointing because there is an air of inevitability about the current situation; it seems to happen frequently where there are large-scale resource projects. So much so that the World Bank has reconsidered investing in extractive industries as a means of promoting poverty alleviation. So, to paraphrase Lenin, what is to be done?

First, the Sakhalin Oblast Administration and local companies should learn from the current situation and develop programs to prepare the local economy for the downturn expected in 2007 when the current projects are completed and move to an operational phase. But they should also prepare now for the next generation of projects so that they can benefit from a second phase of the Sakhalin-1 project and an eventual development phase for Sakhalin-5 and the next generation of projects.

ExxonMobil is now discussing a phase 2 strategy based on a gas pipeline to China, the expansion of production would require additional infrastructure on Sakhalin, but the pipeline construction activity would be on the mainland and in China. Sakhalin-5 plans to drill two further exploratory wells next year and, all being well, could be in development by the end of the decade. Meanwhile, the current operators are doing their part by investing in training schemes to create a local labor force to operate and maintain their production facilities, but they cannot be held accountable for the failings of the regional and federal governments.

The emphasis for a local economic development strategy must first be upon the creation of a sustainable industrial and service base to support the offshore oil industry and second on the diversification of the Island's economy to guard against the boom and bust nature of resource industries. This is a job for the private sector, but the regional and federal governments can help by playing a facilitating role, as can the foreign support companies, by making a longer-term commitment to the Island.

Second, Moscow should revisit the question of revenue sharing, but revenues should be targeted at specific programs that address the major social and economic problems facing the Island and that enhance the local skills base so that Sakhaliners can play a greater role in future developments. This also would help to stabilize the Island's population by creating opportunities for the younger

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generation. Sakhalin does not really need assistance from the new federal investment fund; it just needs an equitable share of the oil and gas revenues generated offshore. An extension of the Sakhalin Development Fund to serve as a depository for a share of oil and gas revenues would be more targeted and transparent than simply increasing general revenues to the Oblast budget.

During his visit to Sakhalin, Minister Gref announced that financing from the Federal budget would be increased four times for Sakhalin and ten times for the Kuril Islands. Unfortunately, the world over, there is tendency to misappropriate such rents or to squander them on prestige projects that bring little lasting benefit. Aside from being dependent on the local administration's ability to deliver, there is another flaw in my proposal to bolster the Sakhalin Development Fund and that is the problem of delayed gratification. The nature of the Production Sharing Agreements (PSA) governing the first generation Sakhalin projects is such that it is the investors who will get first call on the revenues generated by oil and gas output and it will be well into the next decade before there will be substantial revenues flowing to the Russian party. However, Moscow currently is flush with cash from oil and gas revenues and, if it had the will, could easily afford to support Sakhalin now to insure that it has a more sustainable future. This may be wishful thinking, but the alternative is clear, as *The Economist* suggests, Sakhalin will become yet another example of petrostate inequality, where resource wealth is regarded as a curse rather than an opportunity.

- Dr. Michael Bradshaw

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help get the project to this watershed moment, said that successful implementation of the Sakhalin-1 project became possible thanks to mutually-beneficial cooperation between Federal and regional Russian authorities and the members of an international consortium, including operator ExxonMobil.

From a health and safety standpoint, the project is setting a new standard for industry operations in Russia, where domestic oil and gas companies have had accident rates higher than international averages. During the more than 36 million worker hours of construction and drilling activities associated with the Sakhalin-1 project so far, personnel achieved a level of safety performance that was more than four times better than the average for the oil and gas industry worldwide.

In addition to the government revenues generated from production royalties and taxes, the project has created a number of economic benefits that include improved roads, bridges, airport and seaport facilities, and public-use medical facilities. Other benefits include technology transfer, hands-on training at ExxonMobil facilities worldwide for local-hire of operations technicians, and contract awards to Russian companies in excess of $3.2 billion. More than 13,000 direct and indirect jobs will be created for Russian nationals as a result of the initial development.

Exxon Neftegas Limited (ExxonMobil interest 30%) is operator for the project, which includes the Japanese company Sakhalin Oil and Gas Development Co. Ltd., (30 percent); RN-Astra, affiliates of Rosneft, the Russian state-owned oil company (8.5 percent); Sakhalinmorneftegas-Shelf (11.5 percent); and state-owned India oil company ONGC Videsh Ltd. (20 percent).

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