

## RUSSIA'S OIL AND GAS: STATE CONTROL, THE ENVIRONMENT AND FOREIGN INVESTMENT

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# Battle for Sakhalin

**The World's largest oil and gas companies are working off Sakhalin island in Russia's Far East to develop a new energy province. The Sea of Okhotsk has the potential to become another North Sea, located next door to Asia's energy-hungry economies. The Kremlin wants a greater share of the profits and is pressing the foreign companies to reconsider the terms of their involvement. This has prompted widespread condemnation in Japan, Europe and the United States and added to the growing concerns about Russia's reliability as an energy partner.**

AT PEAK, OIL PRODUCTION THE TWO SAKHALIN PROJECTS will account for about seven percent of demand in the Asia-Pacific region.

These are developments of global significance that will make a major contribution to energy security. They will also bolster Russia's economic significance in the Asia-Pacific - a key Kremlin foreign-policy goal. At the recent Valdai Discussion Club of policy analysts and journalists, Russian President Vladimir Putin stated that the share of Russian energy exports going to Asia should be increased from the current three percent to around thirty percent over the next ten to fifteen years.

Sakhalin-II's liquefied natural gas is already sold out, with the majority of exports going to Japan, and the rest to South Korea, the United States and Mexico. Sakhalin-II will provide about eight percent of Japan's total liquefied natural gas consumption and Sakhalin Energy is now considering boosting capacity to sixteen million tons a year.

Following a judgment by the General Prosecutor's Office on September 18, the Minister of Natural Resources Yuri Trutnev declared that the decision three years ago by his own ministry to approve the State Environmental Expertise Review for the Sakhalin-II project was illegal and should be revoked. The project's operator, Sakhalin Energy, has yet to receive official confirmation of this, but it could result in an twelve to eighteen-month delay and possibly cost \$10 billion. It would severely damage Sakhalin-II's reputation as a reliable supplier of liquefied natural gas even before the first shipment is made.

Foreign involvement in Sakhalin's offshore originates from the

mid-1970s when Japan and the Soviet Union signed an agreement to explore for oil and gas. After initial success, the project fell foul of deteriorating east-west relations and the economic slump of the early 1980s. However, exploration continued and renewed commercial interest in the late 1980s led to an international tender in May 1991.

Eventually, two development licenses were awarded and Russia's first production-sharing agreements were signed, first with Sakhalin-II in 1994 and a year later with Sakhalin-I. Today the Sakhalin-II project includes Shell from Britain and the Netherlands, Mitsui and Mitsubishi - both Japanese. The Sakhalin-I project involves ExxonMobil - US, SODECO - Japan, ONGC Videsh - India, Rosneft and Sakhalinmorneftegas - both Russian.

## Managing Risk

In the 1990s Russia was a very unstable place. To manage the risks the foreign investors required the protection of production-sharing agreements to secure a profit. These are internationally-binding legal agreements customised to a specific project.

In July 1999, Sakhalin-II produced Russia's first offshore oil and by the end of last year had exported over eleven million tons. In winter ice conditions prohibit offshore transshipment. So in May 2003, Shell and its partners announced an investment of almost \$10 billion to allow year-round export of oil and liquefied natural gas. Sakhalin-II Phase 2 is the largest integrated oil and gas development project in the world.

Both Sakhalin projects have been plagued by delays and cost overruns. In July 2005 Shell announced the cost of Phase 2 had doubled to \$20 billion. ExxonMobil recently said its project has increased from \$12.8 to \$17 billion. Undoubtedly it

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is proving more difficult and expensive to develop them than first envisaged, but there are also external inflationary pressures such as the price of labour and raw materials and the weakness of the dollar.

The terms of the Sakhalin-II production-sharing agreement mean increased costs and delays extend the point of cost recovery after which the Russian government shares in the energy production, so-called profit oil and gas. The Sakhalin-I terms are different and it is already delivering profit oil and gas.

The Russian government has yet to approve the new budgets for both projects and the director of the Kremlin's Expert Analysis Department, Arkady Dvorkovich, maintains that the additional costs will not be agreed and that both projects must work to the original budgets within their production-sharing agreements or proceed on the basis of normal tax and royalty; but these projects would not be viable under the current tax regime.

The rapid reaction of foreign governments to the potential suspension of Sakhalin-II suggests that renegotiating would bring widespread protest. But then so did the Yukos affair, when company assets were taken over by the state in 2004, following the arrest and trial of its head Mikhail Khodorkovsky.

Another way to increase the Russian share of the profits is to bring a Russian company into the consortium. In July 2005 Shell and Gazprom announced they were negotiating an asset swap to give Gazprom twenty-five percent of Sakhalin-II in return for fifty percent of the Zapolyarnoye field in west Siberia. Unfortunately, the cost overruns were then made public and final terms have not been agreed. But, this is no straightforward matter, while twenty-five percent of Sakhalin-II is relatively easy to value, the Zapolyarnoye field is technically challenging and undeveloped, so a price has to be decided based on its potential.

## Whale of a Problem

The environmental concerns raised by Moscow are genuine. In 2003, the European Bank for Reconstruction and Development (EBRD), which has been asked to finance the project, declared the initial Sakhalin-II Phase-2 Environmental Impact Statement 'unfit for purpose', but in December last year it began a public consultation process on an amended statement. The process ended in April but a decision has been delayed and will now wait until the dispute with the Russian government is resolved.

A coalition of environmental non-government organisations has campaigned to persuade the EBRD not to grant a loan to Sakhalin-II. Among their concerns are the impact of offshore activity on the critically-endangered Western Gray Whale and of pipeline construction on salmon spawning rivers. They also question the effect of construction activity at the liquefied natural gas plant on the ecology of Aniva Bay and how of all this activity will alter the lives of indigenous peoples. These groups also maintain that the production-sharing agreement is not a good deal for Russia.

In its defence, Sakhalin Energy points out that it is funding research on the whale population, has re-routed one of its pipelines and created an independent advisory panel to monitor the impact of the project on the whales. On the matter of river crossings, it admits there are

problems and has even suspended construction on some sections of the pipeline. But this is because contractors have not worked to international standards. A revised river-crossing strategy is now in place and subject to independent review. It is also implementing an indigenous peoples action plan. Thus, Sakhalin Energy would maintain, with justification, that it is working to both Russian and international standards when it comes to managing of the project's environmental and social impacts.

## Russian Differences

For many commentators recent events are seen as a cynical move to improve the terms for Gazprom's entry. While on the island attending the Sakhalin Oil and Gas Conference, Russia's Foreign Minister Sergei Lavrov denied that this was the case, but there does seem to be a difference of opinion in the Russian government.

Earlier, the Russian Ambassador to Japan, Alexander Losyukov, had suggested the entry of a Russian company would assist the rapid completion of the project, and the former Deputy Minister of Fuel and Energy Valery Garipov told the opening session of the conference that when Gazprom joined the project the problems would go away.

The arrival on Sakhalin of Oleg Mitvol, the deputy head of Russia's Inspectorate for the Use of Natural Resources - Rosprirodnadzor, with his media circus, added to the confusion when he proceeded to make unfounded statements about the scale of the environmental damage caused by Sakhalin-II.

Meanwhile, back in Moscow, Trutnev clarified the situation by stating that the State Environmental Expertise Review would not be revoked while further inspections were carried out. But there have already been over two hundred inspections this year alone. A range of issue has been identified and Sakhalin Energy is now working through them. The new review will be completed by late October and then battle will resume.

## Self Defeating

Foreign oil companies should abide by national legislation, but the current example of administrative leverage is part of a wider, longer-term strategy to increase state control over Russia's oil and gas industry. Ultimately this will prove self-defeating. Oil and gas revenues are fuelling the country's economic revival and its continuation is dependent on maintaining and even increasing levels of oil and gas production, particularly if the price falls. But established fields are running out and new fields need to be developed.

The Sakhalin projects are a key part of the future of Russian oil and gas production, and are best developed in partnership with the international oil companies. However, such cooperation must be commercially viable, transparent and backed by the rule of law. The battle for Sakhalin suggests this is not the case in Russia today.

The result will be delays in the development of frontier production, which will impact on oil and gas revenues and Russia's ability to contribute to global energy security. In such circumstances, it is more than a little ironic that Russia put energy security at the top of the agenda for the G8 group of leading economies this year.

