

The Changing “Power Geometry” of the Sakhalin Projects

IT IS NOW MORE THAN A DECADE SINCE THE FIRST PRODUCTION SHARING AGREEMENT (PSA) WAS SIGNED TO LAUNCH THE SAKHALIN-2 PROJECT. OVER THE PAST DECADE THERE HAVE BEEN NUMEROUS CHANGES, BOTH INTERNAL AND EXTERNAL, THAT HAVE INFLUENCED THE PROGRESS OF THE FIRST GENERATION SAKHALIN PROJECTS (KNOWN AS SAKHALIN-1 AND SAKHALIN-2). THIS ARTICLE EMPLOYS THE CONCEPT OF “POWER GEOMETRY” TO ANALYZE THE CHANGING FORCES INFLUENCING THE DEVELOPMENT OF THESE TWO MULTI-BILLION DOLLAR PROJECTS.

The notion of Power Geometry is a product of globalization and refers to the ways that different groups of individuals interact at different scales, linking local development to national, international, and global processes. This may seem an overly academic approach for a business-oriented publication, but it does provide a useful way of mapping both the changing scales of influence and the cast of actors that are shaping developments offshore Sakhalin. Furthermore, the scope of current changes makes such a perspective worthwhile.

The underlying logic of foreign involvement in Sakhalin’s oil and gas potential dates at least back to the mid-1970s. At that time the Soviet Union struck a deal with a Japanese consortium, the forerunner to the SODECO consortium currently involved in the Sakhalin-1 project, to conduct seismic survey work offshore of Sakhalin. The Soviet Union recognised that it lacked the technolo-

gy necessary to tap Sakhalin’s offshore potential. The agreement was that any subsequent energy production would generate the revenues needed to payoff the initial loan. At that time the Soviet Union had signed a number of such compensation agreements with the Japanese government to develop the resource potential of the Far East.

To cut a long story short, the initial Sakhalin project never progressed beyond the exploration stage, but it did delimit the potential reserve base for the first generation Sakhalin projects. The important point is that from the onset, the development of Sakhalin’s offshore reserves required access to foreign capital and know-how. In other words, it was accepted by Moscow that without foreign assistance, the region’s potential could not be developed. This made Sakhalin different from the established onshore production base in the Volga-Urals and West Siberia. Mikhail Gorbachev’s Perestroika brought renewed interest in the Sakhalin projects, this time from South Korean and US companies. In the last days of Soviet power, Sakhalin acreage was put out to tender; but it was one of the first tasks of the new Russian Government to award the development rights of the first two Sakhalin projects.

The first generation Sakhalin projects have become a litmus test for large-scale Greenfield investment in Russia’s oil and gas industry. The initial risks were immense and new territory has been explored at every stage, from the signing of the Sakhalin-2 PSA in 1994, to first oil in 1999, to stage-2 commercial development in 2003. The Sakhalin-2 project

Continued on page 15

Continued from page 3 – Power Geometry

blazed a trail but Sakhalin-1 soon charted a different course, resulting in two very different development strategies.

From the very onset, project operators Sakhalin Energy and Exxon Neftegas Limited found themselves involved in a complex network of decision makers and stakeholders. In the mid-1990s Yeltsin's Russia was a chaotic place and the regions seized more and more influence as Yeltsin carried favour to get re-elected. The economic situation meant that the Federal Government lacked the resources necessary to meet its obligations.

On Sakhalin project operators had to garner the support of the Governor, the Sakhalin Oblast Administration, and the Sakhalin Oblast Duma (Parliament) to get their PSAs approved; likewise licenses and permits had to be obtained locally as well as in Moscow. At these initial stages, the focus was primarily on actors in Russia and the demands were largely technical; but once the projects gained momentum they quickly attracted global attention.

The election of Vladimir Putin as Russia's President in 2000 marked a change in the domestic Power Geometry of the Sakhalin projects. Putin moved quickly to reign in Russia's regions and to recentralize authority in what he calls the "Power Vertical." He changed the role of the regional governors and reformed the tax system to regain fiscal control; he also strengthened the Federal Ministries and reasserted the primacy of federal legislation. Consequently, the local political elite on Sakhalin lost influence over the Sakhalin projects and the federal authorities on the Island regained control over their areas of jurisdiction.

For the project operators this required a form of "shuttle diplomacy" between Moscow and Yuzhno-Sakhalinsk as they tried to determine the locus of power and decision-making in Russia's fluid political landscape. Both pro-

ject operators maintain a watching brief over events in Moscow as the dictates of the Kremlin now determine the contours of the economic and political landscape in Russia. Thus, along the center-region axis, Moscow now clearly calls the shots. A case in point is Moscow's decision to reduce the share of the royalty from oil exports paid to the Sakhalin Oblast Administration budget. This decision presents a real problem to the project operators as it reduces the positive financial benefits delivered locally, yet they are in no position to influence the Federal Government on this matter.

As the Sakhalin projects gained momentum in the late 1990s, they became part of a national debate over the role of foreign investors in the Russian oil and gas industry, and in particular, the role of PSAs. Strong private domestic interests lobbied against the expansion of the PSA regime as they felt it gave unfair advantage to foreign companies. Despite a statement made by President Putin at a conference on Sakhalin in 2000 that "PSAs are for Russia," the revision of the PSA regime floundered on a rising tide of economic nationalism.

The anti-PSA lobby, however, wasn't really focused on the Sakhalin projects, the Russian oligarchs had no interest here; it was more about control in established producing areas. Just as the governors were targeted in Putin's first term, so the oligarchs have become the focus of attention in his second term. The "Yukos affair" is symptomatic of a state strategy to regain control over key assets, such as the oil and gas industry.

In parallel to the recentralization of control over the regions, the Kremlin is regaining control over the "commanding heights" of the economy. However, internal divisions within the Kremlin have thwarted attempts to create a single national oil and gas company through the merger of Gazprom and Rosneft. Instead,

Continued on page 17

Continued from page 15 – Power Geometry

the sale of shares in Rosneft is being used to finance the purchase of a controlling share of Gazprom. Now the Kremlin controls both companies. This adds a new dimension to the domestic Power Geometry of the Sakhalin projects.

Historically, Rosneft and its local affiliate SMNG, have represented Russian interests on Sakhalin. Rosneft-SMNG has a 20% share in Sakhalin-1 (which was 40% until they sold 20% to OMGC Videsh Ltd.) and a 51% share of the Elvary Neftegas joint venture with BP to develop Sakhalin-5. They also had shares in the Sakhalin-3 consortium Pegastar

Program,” Gazprom has indicated that it wants to purchase Rosneft’s 20% share in Sakhalin-1. Gazprom Deputy CEO Alexander Medvedev was reported in the Moscow Times on July 14, 2005 as stating that: “we are ready to make Rosneft an offer it can’t refuse.” However, Rosneft is hesitant to sell, though it is now heavily indebted after the purchase of Yukos’ main production unit Yuganskneftegaz. Reportedly, Gazprom has been in talks with ExxonMobil (the operator for Sakhalin-1) about constructing a gas pipeline from Sakhalin to China.

Aside from these developments, Shell and

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(that lost the rights to develop two blocks of the Sakhalin-3 acreage in early 2004) and have rights to various other Sakhalin blocks, including the Venin acreage of Sakhalin-3, which is the subject of a recent agreement with China’s Sinopec to create a joint venture to carry out exploration activity.

Despite Rosneft’s current position, it is actually Gazprom that has been assigned the task in Russia’s Energy Strategy of coordinating energy exports to Northeast Asia. Had the Gazprom-Rosneft merger taken place, Gazprom would have gained a prominent position on Sakhalin. Since the failed merger Gazprom has made it clear that it wants to participate in the development of Sakhalin’s offshore. Gazprom is already participating in construction of a gas pipeline from Sakhalin to Khabarovsk that is linked to the Sakhalin-1 project.

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On July 7, 2005 Alexei Miller, Chairman of the Management Committee of Gazprom, and Jeroen van der Veer, Chief Executive of the Royal Dutch/Shell Group of Companies, signed a Memorandum of Understanding (MOU) regarding a swap of shares in the Zapolyaroye-Neocomian and Sakhalin-2 projects. Under the agreement Gazprom will get 25% plus one share in the Sakhalin-2 project (leaving Shell with 30% of the project)

Continued on page 18

Continued from page 17 – Power Geometry

and Shell will get 50% of the Zapolyarnoye field in West Siberia. Any difference in the valuations of the assets will be compensated through a cash package and other assets as agreed.

However, a week later on July 24, 2005 Shell announced that the cost of the Sakhalin-2 project is likely to double from \$10 billion to \$20 billion. It was generally accepted that the cost of the project was going to be more than \$10 billion and a figure of \$12 billion was often cited; but a 100% increase in costs was way beyond expectation. Shell has blamed the increases on currency fluctuations, rises in steel prices, problems with getting its onshore pipelines

Assuming the deal goes ahead, Gazprom will be well placed to increase its presence on Sakhalin, either through purchasing Rosneft's share of Sakhalin-1 and or bidding for the Sakhalin-3 acreage that it is due to be tendered this fall, possibly in cooperation with Shell or ExxonMobil. Thus, in a very short period of time the Power Geometry of the Sakhalin projects has shifted in favour of the Kremlin, both in terms of regulatory and fiscal control, and also in ownership of assets.

So far this discussion has focused on the impact of domestic changes on the Power Geometry of the Sakhalin projects and it is fair to say that the strengthening of Moscow's influence has been at the expense of local

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It is reported that the true scale of the cost overruns was not apparent until Sakhalin Energy had collated reports from all parts of the project and this was after the MOU was signed with Gazprom and well after Shell's recent annual general meeting. Higher oil and gas prices will compensate in part, but the terms of the PSA mean a further delay before "cost recovery" is reached and when the Russian parties can expect significant profit oil and gas. Gazprom's involvement also will increase Russia's share of the profits but Gazprom was not aware of the cost overruns when it agreed to the asset swap and now wants to revisit the deal. Clearly the Sakhalin-2 project will be worth less and Shell may have to make substantial cash payment to get 50% of Zapolyarnoye.

Sakhalin interests. However, there are strong links between local actors and global interest groups that serve to counteract these domestic centralizing tendencies. For the most part these global-local issues are related to the Sakhalin-2 project: first, because it is further advanced and much larger than the Sakhalin-1 project; second, because it is at a stage of securing markets for its gas production; and third, because the project partners have gone to the international financial institutions (IFIs) for project financing.

The spring issue of *Pacific Russia Oil & Gas Report* discussed the environmental movement's campaign against the Sakhalin-2 project. In this case, local actors, such as Sakhalin Environment Watch and the Ingenious Peoples' representatives, have used links to the global environmental movement to exert pressure on the project operators. The arena

Continued on page 21

Continued from page 18 – Power Geometry

for this lobbying is not Moscow, but the offices of the IFIs, principally the EBRD in London, as well as the headquarters of the financial advisor to the Sakhalin-2 project CSFB in Zurich and New York.

The point of reference is not Russian law but the charters of the various institutions and the so-called “Equator Principles” that define best practice in the area of corporate social responsibility. The local actors, and associated NGOs in Moscow, want to insure the best deal for Sakhalin, they are not necessarily anti-development; however, some of the global NGOs are using the Sakhalin case in their fight against “big oil.” This makes constructive dialog between the NGOs and the oil companies difficult and the IFIs find themselves caught in the middle; wishing to protect their own interests, but also concerned to give both sides a fair hearing. Sakhalin Energy is working hard to meet local demands and appease global concerns, but its cause will not be helped by the cost overruns. Some of the cost increases are a direct result of meeting those environmental and social concerns; but “cost escalation” is clearly a component of the NGO strategy that seeks to halt the projects.

There is also an emerging dialog about “energy security” that parallels that counters the dialog on the environmental and social impacts of the Sakhalin project. Sakhalin Energy now has sold 80% of its LNG and the buyers are located in Japan, Mexico, and South Korea. The availability of Russian gas in close proximity to the Asia-Pacific market has been a strong suit in Sakhalin Energy’s marketing campaign. Buying Russian gas further diversifies supply and close proximity reduces transport costs. It also promotes gasification at the expense of more environmentally unsound coal, oil-fired, and nuclear powered electricity generation.

The Japanese Government faces a potentially difficult situation that clearly illustrates the complex Power Geometry of the Sakhalin projects. It is reported that Sakhalin Energy is seeking upwards of \$5 billion in project financing and that the bulk of those funds will come from the Japan Bank for International Cooperation (JBIC). But it is also reported that it is the EBRD that is leading the way on the final decision about the Sakhalin-2 loan and that if the decision is no, then the other banks (JBIC, US EXIM Bank and the UK’s ECGD) will also say no.

In early July the EBRD announced that it was delaying its decision on the Sakhalin-2 loan and no final date for a decision has been set. However, the logic of Japanese shareholder ownership of Sakhalin-2 and also purchase of Sakhalin LNG is that it is in Japan’s strategic interest to buy Sakhalin’s gas. One can also throw into the mix Japan’s commitment to finance the oil export pipeline from Angarsk in East Siberia to Nakhodka; but this is also muddied by environmental problems and the continuing territorial dispute between Japan and Russia over the Kurils Islands, which are administratively part of Sakhalin Oblast.

Moscow clearly sees energy exports as an important way of increasing its geopolitical influence in the Asia-Pacific region and Sakhalin LNG is part of that strategy, a convergence of interests that Sakhalin Energy exploits in its website banner “the new energy source of Asia-Pacific,” which paraphrases a speech made by Vladimir Putin at an APEC business summit in Bangkok in October 2003. Thus, there is a complex trade-off between economic and geopolitical benefits and environmental and social costs, with Sakhalin presently paying most of the costs and seeing relatively little of the benefits.

The second half of 2005 may turn out to

Continued on page 22

Continued from page 21 – Power Geometry

be a pivotal period in the changing Power Geometry of the Sakhalin projects. In domestic terms, it should hail the arrival of Gazprom as a key player on the Island, thus consolidating Moscow's control over the development of the offshore. The tender for Sakhalin-3 may further consolidate that grip; the acreage is defined as "strategically important" and under the new Sub-Soil Law can only be awarded to a company that is at least 50% Russian-owned. By the end of the year, Sakhalin Energy expects to have sold all of its LNG and the EBRD will pass judgement on project financing. A no decision by the EBRD will cause reputational damage to the project partners, but it will not stop the project that now aims to deliver its first LNG in the summer of 2008.

Meanwhile, and just as significant, Sakhalin-1 expects first oil and gas production in the second half of 2005 and an ExxonMobil agreement with Gazprom to build a pipeline to China could see progress on the next stage of the Sakhalin-1 project. Finally, Rosneft and BP are drilling again this summer and we can expect significant developments this fall in relation to Sakhalin-5. For most of the 1990s the Sakhalin projects were not really on the Kremlin's agenda, all that has now changed and with it, the map of power and influence surrounding the projects is being redrawn once again. ♠

- Dr. Michael Bradshaw

Dr. Bradshaw is a Professor with the Department of Geography, University of Leicester, UK.

Continued from page 13 – Concrete Base Structure

ence in a major new construction technology, which could lead to opportunities in the future for construction of such structures for other offshore developments.

In addition, the project created significant business opportunities for Russian companies who provided thousands of workers, materials such as steel and cement, and many other services and equipment to the construction site.

Over 250 Russian companies and suppliers, local ones from Nakhodka, those from the Primorsky Krai and from other parts of the Russian Federation, worked on the construction and supplied materials for the two concrete structures. Other contributors included Komplex, DV-Cement, Hydrotex, NPO Port, Astrakhan Korabel, Dalgidrostroy, Daltekhflot, Massis, NSRZ, and Zvezda.

Russian man-hours during the construction added up to almost six million and account for more than 80 percent of the overall labor used to build the LUN-A and PA-B CGBS. Russian nationals accounted for more than 92 percent of the overall construction workforce of workers, engineers, and other

staff. Russian subcontractors carried out work at all stages of construction and on virtually all elements of the activities.

A total of 97 percent of the total volume of materials used to build both CGBS were purchased in Russia. Altogether construction of both CGBS required over 43,000 tons of steel, which included reinforced, post tension, structural, and other steel. Much of this was supplied by Russian companies such as Amurmetal, Nosta, and Severstal. Some 63,800 cubic meters of concrete was supplied by Russian DV-Cement.

The Lunskeye Platform itself will comprise drilling facilities, accommodations, and minimum processing facilities. It will have the capacity to produce 51 million cubic meters of gas per day (1,800 million standard cubic feet per day), and approximately 50,000 barrels of condensate per day (8,000 cubic meters per day). Separation, including treatment and separation of the Lunskeye gas and condensate, will be undertaken at the Onshore Processing Facility, which also will supply power to the platform via submarine cable. ♠