2006 Sakhalin Oil and Gas Conference, Yuzhno-Sakhalinsk.
Photo by: Rob Stapleton

Sakhalin -2 In the Firing Line

Environmental Protection or Administrative Leverage?

In the last week of September, the 10th Sakhalin Oil and Gas Conference took place against the backdrop of a growing international criticism of the actions taken by the Russia's Ministry of Natural Resources (MNR) against the Sakhalin-2 project being developed by Shell's Sakhalin Energy Investment Company (SEIC). The previous nine conferences, organized by IBC Global Conferences, had all been held in London and the fact that it was taking place on the Island was a source of great pride for Sakhalin's Governor Ivan Malakhov.

Unfortunately, what was supposed to be an opportunity for the region and its foreign investors to showcase their achievements was instead dominated by events in Moscow orchestrated by the Russian Minister of Natural Resources Yuri Trutnev and the Deputy Head of Russia's Inspectorate for the Use of Natural Resources (Rospirodnadzor) Oleg Mitvol. The week before the conference Minister Trutnev announced his intention to revoke the State Environmental Expertise Review (SEER) governing the development of phase 2 of the Sakhalin-2 project, which would have halted all construction activity on the $22 billion project. Minister Trutnev suggested that the 2003 decision by his own ministry to approve the SEER was incorrect and should be cancelled. If followed through, such action could result in an 18-month delay and possibly cost $10 billion, plus it would severely damage Sakhalin-2's reputation as a reliable supplier of LNG even before the first shipment is made.

At the same time as the Sakhalin-2 project is under pressure: ExxonNeftegaz's Sakhalin-1 is experiencing problems with regulators as it begins oil exports from its DeKastri terminal in Khabarvosk Krai; Total's Kharyaga PSA project in the Nenets region of the Arctic is also under threat, as is TNK-BP's license to develop the giant Kovytka gas field in Irkutsk Oblast in East Siberia. Gazprom also has made public its interest in buying out BP's Russian partners in TNK-BP should they wish to sell next year. Most recently, TNK-BP's Rospan operations in West Siberia have come under regulatory scrutiny.

More than Coincidence?

The pressure on the Sakhalin-2 project seems to be more than coincidence and has been seen by the western media as a "softening up"

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exercise (one Russian commentator used the term "administrative leverage") to force the international oil companies (IOCs) to revise the terms of their investments to allow greater Russian participation in their projects. President Putin, various Russian ministers, including Foreign Minister Lavrov at the oil and gas conference, government representatives from other ministries and agencies, and Kremlin spokesmen have all denied that environmental regulations are being used deliberately to target foreign companies in Russia. To prove their point, there have even been efforts to extend the current heightened scrutiny to examine the environmental record of Russian companies, such as Lukoil; but this may backfire if major problems are found.

The pressure placed on Sakhalin-2 has been unrelenting and now threatens to end up being resolved in the International Court of Arbitration in Stockholm. Clearly, oil and gas companies must abide by national legislation and should minimize the environmental and social impacts of their projects. In fact, Shell's own business guidelines, which have been adopted by SEIC, make such a commitment. Shell has accepted that there are problems related to the implementation of Sakhalin-2 and has vowed to put them right as quickly as possible. But are those problems of sufficient scale to warrant suspension of the project when such actions are clearly not in the interest of the Russian Government, the foreign investors, or the people of Sakhalin? The project is 80-percent complete and suspension now would create as many problems as it might solve.

In Moscow's Interest

When the two Sakhalin projects hit peak oil production at the end of the decade they will account for about 7-percent of regional demand in the Asia-Pacific region, reducing the region's reliance on the Middle East. Sakhalin-2's LNG already is sold out—63-percent going to Japan; 16-percent to Korea; 19-percent to the US and Mexico; and 2-percent being retained for operational flexibility. Sakhalin-2 will account for about 8-percent of Japan's total LNG consumption and Sakhalin Energy is now considering adding a third train to its LNG plant and final capacity could be boosted to 16 million tons a year.

Thus these truly are projects of global significance that will make a major contribution to energy security in the Asia-Pacific Region (APR). In so doing, they will also bolster Russia's economic significance in the region, promoting a key foreign policy goal of the Kremlin. Accordingly, the timely completion of Sakhalin-2 is clearly in Moscow's interest.

Cost Increases Not Surprising

Sakhalin-2 is described by Shell as the largest integrated oil and gas project in the world today and it is being implemented in challenging environmental conditions and in a region with limited economic infrastructure; therefore it is not surprising that there have been problems. First, the project has been plagued by delays and cost overruns. In July 2005 Shell announced that the cost of phase 2 had doubled from just under $10 billion to over $20 billion (the sum of $22 billion now is generally reported). It also pushed back first exports of LNG from mid-2007 to third-quarter 2008. But this problem is not restricted to Sakhalin-2. ExxonMobil's phase 1 has been delayed and the company recently announced that the total cost of its project has increased from $12.8 billion to $17 billion; this includes the gas phase.

The reasons for these cost overruns are both internal and external to the projects. Both Shell and ExxonMobil have worldwide experience of executing mega projects, but Sakhalin presents many unique challenges, both in terms of the natural and the regulatory environments. The bottom line is that it is proving more difficult, time consuming, and costly to develop them than first envisaged and minimizing environmental impact is part of this additional cost, as is the onerous regulatory environment of the Russian Federation.

It also is the case that there are external inflationary pressures, such as the cost of labor and raw materials, and the weakness of the dollar. The nature of the Sakhalin-2 PSA means that increased costs and delays extend the point at which the Russian Government shares in the production of oil and gas, so-called cost recovery. It has been suggested that the cost recovery has been pushed back from 2006 to 2014, but it is difficult to be precise.

The Russian Government audited the project over the summer but has yet to approve the new budget. Kremlin spokesman Arkady Dvorkovich has commented on more than one occasion that the Russian Government is very unhappy with the cost overruns and that while the PSAs will not be revoked, it feels that the foreign investors should shoulder part of the cost increases. This issue is a separate matter from the actions of the MNR, but it adds to the Kremlin's negative view of the Sakhalin projects.

Why So Much RF Criticism?

It often is observed that the Sakhalin-2 project has received far more criticism than the Sakhalin-1 project. Why is this so? There are at least three reasons for it being more exposed. First, it has no Russian involvement and there have been consistent calls to allow a Russian partner into the project. Second, the terms of the two Sakhalin PSAs differ. Sakhalin-1 has a Russian partner and is already delivering profit oil to Russia, whereas Sakhalin-2 will not do this until it has reached cost recovery. Thus, Sakhalin-1 may be considered a better deal for the Russian Government, which puts pressure on Sakhalin-2 to reconsider its terms. Third, Sakhalin-2 is seeking $5 to $7 billion in project financing from the European Bank for Reconstruction and Development (EBRD) and various export credit agencies and this has opened the project up to a global campaign by environmental non-governmental organizations (ENGO) who do not think public funds should be used to support a project that has such a negative environmental impact.

Finally, in July 2005 it was announced that Shell and Gazprom were entering into negotiations for an asset swap that would see Gazprom obtain 25-percent of Sakhalin-2 in return for Shell getting 50-percent of the Zapolyarnoye field in West Siberia. Unfortunately, the cost overruns were made public soon after and the two parties have been unable to agree to final terms. This is no straightforward matter; 25-percent of Sakhalin-2 is relatively easy to value, but the Zapolyarnoye field is technically challenging and undeveloped, therefore one is valuing potential. Gazprom remains interested in doing a deal, but now requires that the current environmental problems and the issue of the increased costs must be resolved before agreement can be reached. The western business media maintains that the current conflict with the MNR is directly related to Gazprom's interest in joining the project; both the Russian Government and Gazprom deny that this is the case. The government sees the asset swap as a bilateral issue between Shell and Gazprom; negotiations are continuing.

ENGOs Challenges

The current environmental concerns are not without precedent. In 2003 the EBRD declared the Sakhalin-2 phase-2 Environmental Impact Statement "unfit for purpose" and entered into a period of engagement with Sakhalin Energy to address the areas of concern. In December 2005 it announced the amended EIA and associated documents "fit for the purpose of public con-

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sultation" and entered into a 120-day public consultation process that ended in April 2006. Since then it has delayed a final decision and now no decision can be made until the current conflict with the Russian Government is resolved.

The ENGOs have campaigned to persuade the EBRD not to grant the loan. Among the key issues are the impact of offshore activity on the critically endangered Western Gray Whale; the impact of pipeline construction on salmon spawning rivers (the pipeline route crosses 1000 rivers); the impact of construction activity at the LNG plant on the ecology of Aniva Bay; the impact of all this activity on the lifestyles of the Indigenous Peoples; and finally, the fact that the PSA is not a good deal for Russia.

There is now a strange alignment of interests as all of the issues raised by the ENGOs are now part of the Ministry of Natural Resources' criticism of the project. In their defense, Sakhalin Energy points to the fact they have funded research into the ecology of the whale population, they have re-routed one of their pipelines to avoid the whales' feeding grounds, and they have created an independent advisory panel to monitor the impact of the project on the whales. On the matter of river crossings, they admitted as long ago as late 2005 that there were problems, in large part because contractors were not working to international standards. Prior to the current controversy they had revised their river crossing strategy and subjected it to independent review. In relation to the Indigenous Peoples, SEIC has implemented an Action Plan to help address this issue.

Thus, Sakhalin Energy would maintain, with justification, that they are working to both Russian and international standards when it comes to the execution of the project and the management of its environmental and social impacts. The ENGO community continues to refute this claim.

Sakhalin-2 has been subject to over 200 audits this year alone. The current audit by the MNR was completed in late October 2006, when Minister Trutnev visited the Island to inspect the pipeline construction activity first hand. The final outcome of the MNR inspection won't be known until late November. Following Minister Trutnev's visit, SEIC produced an Action Plan that explains how it will address the remaining problems, together with a timetable for completion. The scale of this response suggests that the MNR has valid concerns, but SEIC maintains that all of the current problems are "short-term and reversible". Thus, it is not the case that the environmental problems were "cooked up" to put pressure on SEIC; the problems are genuine.

However, the scale of the problem seems to have been exaggerated and the tone of the

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statements by Oleg Mitvol casts doubt on the impartiality of the review process and it is this that leads the foreign media to conclude that there is more than environment regulations at stake here. It must suit the Kremlin's purpose to have Mitvol continue to attack SEIC; the government has not supported his position – but they have not stopped him either.

Those familiar with the state of Russia's natural environment and its track record of environmental degradation and resource utilization will find it hard believe that the recent actions represent a new environmental consciousness on the part of the Russian Government. Although President Putin's insistence on the re-routing of the oil export pipeline north of Lake Baikal is seen by some as a signal of changing attitudes toward the environment, the current crisis surround the Sakhalin-2 project has conflated three separate, but interrelated issues.

First, there is the issue of the cost overruns. The Russian Government is considering the new budget for the project and has stated that it hopes to reach a conclusion by the end of the year. They maintain that SEIC changed the basis of the project by doubling the costs and that this damages the interests of the Russian Government. Second, there is the conflict with the Ministry of Natural Resources, which is primarily focused on erosion control measures along the oil and gas pipeline route. This could also be resolved by year-end once the final report has been received by SEIC, not withstanding the threats of prosecution, which could result in substantial fines. The final issue is the asset swap between Shell and Gazprom and this can only progress once the first two issues are resolved, but this could be by early 2007.

Thus, it is possible that by the spring the project could be back on track with Gazprom as a partner, but along the way a considerable amount of reputational damage has been done to all of the parties involved.

Economic Nationalism Self-Defeating

External commentators see this current episode as part of a longer-term process that has seen the state increase its control over Russia's oil and gas industry and the affirmation of the role of Gazprom as an arm of the state.

Ultimately this economic nationalism will prove self-defeating. Oil and gas revenues are fueling Russia's current economic revival and its continuation, in large part, is dependent upon maintaining and even increasing current levels of oil and gas production. But the signs are that the established fields are running out, new fields need to be developed, and many of these will be in more remote regions and offshore.

The Sakhalin projects represent the future of frontier oil and gas production in Russia, both in the Sea of Okhotsk and the Arctic. These projects are best developed by the likes of Gazprom and Rosneft in partnership with IOCs who have the technology and project management experience to develop this new frontier. For their part, the IOCs see Russia's frontier regions as a key element of their global strategies.

However, the terms of engagement and operation need to commercially viable, transparent and backed by the rule of law. The battle or Sakhalin, which is far from over, suggests that this is not currently the case in Russia. While the IOCs will fight hard to keep the value they have all created for the moment, at least they will have to reassess their view on Russia. The net consequence of this will be delays in development of Russia's frontier production, which will impact the country's oil and gas revenues and its ability to contribute to global energy security.-

- Dr. Michael Bradshaw

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

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