

## Sakhalin Projects Show Why Russia Still Needs Foreign Investors

DESPITE THE CURRENT CONSOLIDATION OF STATE CONTROL OVER THE OIL AND GAS COMPLEX, THE SAKHALIN EXPERIENCE SUGGESTS THAT IF RUSSIA IS TO SUSTAIN ITS POSITION AS A MAJOR PRODUCER AND EXPORTER OF OIL AND GAS, IT MUST CREATE THE CONDITIONS NECESSARY TO DEVELOP NEW PARTNERSHIPS BETWEEN RUSSIAN AND FOREIGN OIL COMPANIES.

The last 12 months have seen dramatic changes in the locus of ownership and control in the Russian oil and gas industry. Just over a year ago the Kremlin was planning to combine Gazprom and Rosneft to create a state champion capable of competing on the global stage. Thanks to internal conflict in Moscow this did not happen. Instead, Rosneft acquired Yukos' main production unit Yuganskneftegaz for \$9.4 billion and the Russian government subsequently spent \$7.5 billion acquiring a controlling share in Gazprom. Most recently, Gazprom has purchased Sibneft for \$13 billion, the largest takeover in Russian history.

Thus, we now have two state-controlled oil and gas companies: Gazprom and Rosneft. The state now controls over 90 per cent of Russia's gas production and a third of its oil production. In mid-January the ring fence on foreign ownership of Gazprom shares was lift-

ed. At the time of writing, Gazprom's stock was valued at \$8.50, giving it a market capitalization of over \$200 billion, making it the world's seventh largest company. The next stage will be Rosneft's IPO as it seeks to sell shares to raise up to \$20 billion.

The Russian state's control over the oil and gas complex is completed by Transneft, which owns the country's oil pipeline network. Gazprom has always controlled the gas pipeline network. Now, only two large private oil companies remain in Russia: the pro-Kremlin Lukoil, which has ConocoPhillips as a minority share holder, with 16 percent and TNK-BP, created in 2003 when BP and Sidanco merged their interests in a 50-50 venture. In addition to the Russian state gaining ownership of more oil and gas production, it also is using changes to the Sub-soil Law to insure that "strategic assets" do not fall under the control of foreign investors and it is abundantly clear to all that any major move in the oil and gas sector now needs the Kremlin's approval.

As a result of these changes, the political landscape in Russia's energy sector has been dramatically transformed and the only choice for the foreign majors seems to be with which state company to partner. It also seems clear that majority foreign ownership is no longer likely to be an option; Gazprom will soon

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acquire a 25 percent share of Shell's Sakhalin-2 project, while ExxonMobil and BP are with Rosneft in the Sakhalin-1 and Sakhalin-5 projects respectively. Interestingly, TNK-BP is reported to have sold its share in the Sakhalin-5 block to Gazprom's Sibneft. Gazprom has made no secret of its desire to increase its presence offshore Sakhalin. None of the foreign companies involved in Sakhalin are in the running for the Shtokhman project in the Barents Sea. Those short-listed are: ChevronTexaco, ConocoPhillips, Total, Norsk Hydro and Statoil. Given the high price of energy and the healthy state of the Kremlin's coffers, the question now being asked is does Russia actually need foreign investment in its oil and gas industry? The Sakhalin experience suggests that it is about a lot more than money and that the answer is an emphatic yes!

In November 2005 some 320 delegates attended IBC Global Conferences' 9th Sakhalin Oil and Gas Conference in London. This annual event is now well established as a showcase for the companies involved in developing Sakhalin's offshore potential. The presentations at the conference not only highlighted the challenges involved in developing greenfield and offshore production in Russia, but also made it clear that foreign expertise and technology are essential and that Sakhalin's offshore would not be being developed without the substantial involvement of foreign companies. However, the level of foreign involvement in Sakhalin today seems unlikely to be replicated in the future.

The Sakhalin Oil and Gas Conference now

has a well-established format and this year it started with a presentation from Vladimir Saenko, head of the Energy Policy Division of the Department of Fuel and Energy of the Russian Federation's Ministry of Industry and Energy. Mr. Saenko presented the Russian Government's energy strategy for Eastern Siberia and the Far East. A grandiose scheme of pipelines and greenfield development was described in a fashion akin to Soviet central planning. There was little or no attention to who would carry out the development or who would pay for it. However, a step-by-step approach is to be followed and Sakhalin and Kovytko (in East Siberia) are clearly the first steps. There were various scenarios with different roles for Sakhalin's oil and gas production, but a gas pipeline from Sakhalin to neighbouring states in Northeast Asia figured in the majority of them. If this integrated strategy is realized, development then will need to take place in some extremely challenging and fragile environments and a huge amount of investment will be required. The presentations that followed by the Sakhalin-1 and Sakhalin-2 project operators made clear the scale of those challenges.

Both Sakhalin-1 and Sakhalin-2 have achieved significant milestones during 2005. In October the Sakhalin-1 project achieved first oil production and the Sakhalin-2 project's phase 2 is now 60 percent complete. At the conference both operators stressed the variety of ways that their technology and management expertise were being used to rise to the challenges of Sakhalin. In the case of Sakhalin-1, the use of 3-D seismic surveying

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and extended reach drilling has improved the efficiency of offshore development and reduced its environmental impact.

In the case of the Sakhalin-2 project, the scale of the investment alone is daunting. This past summer saw the installation of two concrete sub-structures offshore and significant progress in the construction of Russia's first LNG plant onshore. A recent report in the Financial Times noted that the Sakhalin-2 project is now spending \$100 a second and occupying 60 million person-hours a year. By Shell's own admission, this is one of the biggest projects that the company has ever undertaken. They also admit that the problems they have encountered with cost overruns are a result, in part, of underestimating the scale of the challenges involved in developing an integrated oil and gas project from

scratch in such a remote region of Russia. That same Financial Times article suggested that the Sakhalin-2 project is an indicator of what future will be like: "expensive, complex and big," descriptors that certainly capture Russia's plans for East Siberia and the Far East.

The next generation of Sakhalin projects promise to be even more challenging. Elvarg Neftegaz, the joint venture between Rosneft (51 percent) and BP (49 percent) has enjoyed a second successful drilling season and plans two further wells this coming summer, but it is exploring acreage some 40-km offshore in much deeper water than the first two projects.

It is not just technology and exploration and production know-how that the foreign companies have brought to Sakhalin; they have also brought project management and marketing skills and are working to international standards of corporate responsibility. Both projects highlight the management challenges imposed by the lack of pre-existing infrastructure; the demands of the Production Sharing Agreement (PSA) regime, particularly the issue of Russian-content; and the complexities of the regulatory environment. All of these issues add time and cost. It is already clear that if the PSA is not to be the basis for future frontier development in Russia, a more generous tax regime is required to compensate for the additional costs involved in such activity.

The Sakhalin projects also are significant because they are selling Russian energy to new markets in the Asia-Pacific region, plus the West coast of the US and Mexico. Sakhalin Energy's marketing managers have now sold more than 75 per cent of the nameplate capacity of the first 2 trains of their LNG plant. They are now courting more buyers than they have remaining capacity and there is talk of expanding the capacity of the LNG plant. The company is also acquiring a

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While these are new markets for Russia, they are not new for Shell and its partners. Given the recent dispute between Russia and Ukraine involving Gazprom, it may be that future buyers will be happier to deal with the likes of BP, ExxonMobil, and Shell when buying Russian energy, rather than Gazprom or Rosneft alone. If there are problems with Russia, the global majors have alternative sources of supply with which to meet their commitments. Thus, joint ventures between Russian companies and the foreign majors not only provide access to technology and know-how, they also spread the risk for both producers and consumers.

Russia's national energy strategy suggests that the domestic oil and gas industry needs over \$400 billion of new investment between now and 2020 and most of this is expected to come from private sources. The current Sakhalin projects alone may amount to \$40 to \$50 billion of investment. The difficulties experienced by Sakhalin Energy in relation to project finance suggest a further key role for foreign expertise. It is now clear that the environmental and social standards expected by the international financial institutions and demanded by the international environmental movement, place new requirements on oil and gas companies in terms of corporate responsibility.

The comparison between the experience of Sakhalin-1 and Sakhalin-2 shows that seeking external project financing exposes a project to a level of international scrutiny beyond that associated with internal financing. Both projects are in full compliance with Russian Federation legislation and standards and both have their own corporate responsibility standards; yet by seeking funding from the EBRD and other IFIs and export credit organizations, Sakhalin Energy has to work to a different set of benchmarks. This is no bad thing if

it results in a more environmentally sensitive and socially responsible project, and this is certainly the case with Sakhalin-2, but it also is a lesson for those who seek project financing in the future. At present, Gazprom and Rosneft seem able to raise funds through bank loans and share offerings without concern, but these activities are not tied to specific projects with clear environmental and social impacts.

The future plans for East Siberia and the Far East will require billions of dollars of new investment and will have significant environmental impacts and both the domestic and international environmental movements are bound to monitor and protest future developments, they are already protesting against Transneft's oil export pipeline to the Pacific. Unless these issues are properly dealt with, involvement in such developments could bring reputational damage to foreign investors, be they oil companies or financial institutions.

In all sorts of ways, future development in Siberia and the Far East will have to be done differently than previously. For the reasons discussed above, Russia's oil companies are likely to gain much from partnering with their foreign counterparts to meet these new challenges. There is no doubting that the oil majors and banks want more business in Russia, but the question remains whether or not the Russian Government and the companies it controls, can create the kind of business environment needed to convince those foreign investors that they will get an adequate and secure return on their investments in Russia without damaging their reputation. ♠

~ Michael Bradshaw

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