

# The Sakhalin End Game: Two Wrongs Don't Make a Right

“THE WORLD HAS WATCHED AS THE RUSSIAN GOVERNMENT HAS TAKEN GREATER AND GREATER CONTROL OVER RUSSIA’S ENERGY RESOURCES, WHILE PRIVATE ENTITIES HAVE BEEN MARGINALIZED. FOREIGN INVESTORS HAVE STOOD ON THE SIDELINES, WAITING FOR RUSSIA TO CLARIFY THE LAW ON STRATEGIC INDUSTRIES AND TERMS FOR DEVELOPING ITS SUB-SOIL RESOURCES. WE HAVE VIEWED WITH ALARM AS FOREIGN COMPANIES HAVE BEEN SUBJECT TO THE ARBITRARY APPLICATION OF UNCERTAIN REGULATIONS, AND NEW DEMANDS FOR THE PAYMENT OF UNEXPECTED TAX LIABILITIES. AND OF COURSE THESE DEVELOPMENTS ARE THREATENING TO POTENTIAL NEW INVESTMENT, BUT EVEN MORE DAMAGING TO WHAT I PERCEIVE TO BE RUSSIA’S LONG-TERM INTERESTS.”

These are the words of Clayton Sell, US Deputy Secretary of Energy, addressing a meeting at the Carnegie Moscow Center on energy issues on March 14, 2007. His views accurately summarize current Western sentiment towards Russia following the “Sakhalin Episode,” as it was described by the UK’s Secretary of State for Trade and Industry,

Alistair Darling, when he visited Moscow in early February 2007. At the time Mr. Darling said, “the episode caused concerns...and after what happened in Sakhalin people are apprehensive....it would be far better if these matters were settled in accordance with established laws.” Unfortunately, TNK-BP’s problems at Kovytko and uncertainties over the Sakhalin-1 project suggest that the only lesson the Kremlin has learned is that in the current environment of “energy insecurity” it can get away with its strong-arm tactics.

The last issue of *Pacific Russia Oil & Gas Report* went to press with the dispute over Sakhalin-2 unresolved. My purpose here is to summarize both sides of the argument, to report on the eventual outcome, and to assess the implications of the episode for the development offshore Sakhalin and foreign investment in Russia’s oil and gas industry more generally.

## Cynical on Sakhalin: the Western Media’s View

During November and December 2006 the dispute over Sakhalin-2 became front-page news in the western media. A relatively small number of correspondents and informants shaped a consistent criticism of the actions of

*Continued on page 12*

*Continued from page 3 – Sakhalin End Game*

Russian Government agencies against Sakhalin Energy and its shareholders. These actions were portrayed as part of longer term move against private ownership of Russia's oil and gas industry that had started with the destruction of Yukos and had continued with the state regaining controlling ownership of Gazprom, which subsequently purchased Sibneft. In their Russia Country Survey, published in November 2006, the OCED were highly critical of this trend, which could see the state-owned share of the total oil production increased from 16 percent in 2000 to almost 40 percent.

The move against Sakhalin-2 was also seen as part of a wider trend of pressure being applied to projects across Russia that involved significant foreign investment, from Total's Kharyaga Production Sharing Agreement (PSA) project in the Nenets region in European Russia, to TNK-BP's Kovytko project in East Siberia, to Exxon Mobil's neighboring Sakhalin-1 project. In all of these cases Russia's regulatory system was being used to delay progress and threaten the validity of licenses and agreements.

So why was Sakhalin-2 singled out for such harsh treatment? The reasons become clear when one considers the "Russian position." The fact that the Sakhalin-2 project was increasingly high profile and had no Russian involvement was seen as a key factor. The Sakhalin-I project has Rosneft (and SMNG) as a partner and TNK-BP is a joint venture between a Russian and a foreign company. The foreign shareholders in the Sakhalin-2 project were well aware of this problem and since 2005 had been trying to agree on an asset swap with Gazprom to bring them into the project. Unfortunately, that deal was derailed by the project's cost overrun problems shortly after it was announced. However, negotiations were continuing and for the Western media the fact that Gazprom clearly wanted to get into the project provid-

ed a rationale for "administrative pressure" to be applied to the foreign shareholders to insure Gazprom the best possible deal. Thus, the Russian Ministry of Natural Resources' concerns about the ecological impact of the project did not reflect a new environmental consciousness on the part of the Russian state; rather it was a cynical use (to paraphrase a headline from the *Financial Times*) of legitimate environmental concerns to achieve the state's political and economic goals.

### **The Kremlin's Response: Consistent and Legitimate Concerns**

The Russian response to the accusations made in the media came from a variety of sources including various government ministries and Kremlin spokespersons. By summarizing their views, it is possible to build up a consistent and legitimate assessment of the problems surrounding the Sakhalin-2 project.

Firstly, whether cynical or not, there are legitimate concerns about the environmental impacts of the project. After all, a global network of environment NGOs has been waging a campaign to dissuade the EBRD from investing in the project on the grounds of its negative economic and social impacts. For a short while, there was a strange alliance of interests as the Ministry of Natural Resources sided with the environmentalists.

While nobody would contest the Russian Government's right to protect its natural environment nor the view that foreign companies should abide by Russian legislation, it seems that Sakhalin Energy was never given an adequate chance to put things right. They had acknowledged there were problems, but maintained that they were short-term and reversible and were being dealt with in a transparent manner. In a press release following Minister Trutnev's visit to Sakhalin at the end of October 2006, Sakhalin Energy made the following observation: "Onshore and offshore construction schedules have largely been shaped by environmental considerations

to ensure minimal impact. Such an approach is without precedent in Russia and while a project of this size will never be perfect in terms of detail implementation, the degree of transparency and accountability demonstrated by Sakhalin-2 can be seen as a benchmark for future energy developments in Russia.”

Secondly, the Kremlin’s position on the cost overruns was consistent. The announcement by Shell and its partners in July 2005 that the costs of the project had doubled from \$10 to \$20 billion and that the start of gas exports was delayed until the second half of 2008 clearly angered the Kremlin. The terms of the Sakhalin-2 PSA, which have never been made public, are such that the cost increases and delays would push back the date at which the Russian state would start to share in profits. The Kremlin suggested that Sakhalin Energy should renegotiate the terms of the PSA.

Since the cost increases were announced, Sakhalin Energy had been in a process of explaining the reasons for the new budget. As the IEA’s World Energy Outlook for 2006 makes clear, delays and cost overruns are an industry-wide problem. Sakhalin Energy pointed out that the current high price for oil and gas would result in higher than projected income that could offset the impact of the costs and delays. According to Alf D’Souza, Vice President for Corporate Affairs in Russia for Shell Exploration and Production Services,: “Despite the higher cost and schedule delay, Russia still stands to receive some \$50 billion of revenues from the project at an assumed price of \$34 per barrel, and much more at higher prices.”

Clearly, this was not good enough for the Kremlin and a view was articulated that the terms of the PSA were just too good a deal for the foreign investors. It is more than coincidence that this was also a view long promoted

by the NGO campaign against the project. The initial agreement had been reached in the early 1990s when the economic situation in Russia was very bad and the government wanted to encourage foreign investment. Times are now different. Russia has recovered and energy prices are much higher and likely to stay that way, therefore it is necessary to renegotiate the terms of the agreement.

Throughout all of this Gazprom denied that it was behind the campaign. Negotiations continued with Shell, but Gazprom maintained that the environmental problems and the matter of the cost overruns would have to be resolved before an agreement could be reached. On the face of it, none of the concerns expressed by the Russian Government were unreasonable. The Kremlin also pointed to a rising tide of resource nationalism across the globe and the growing significance of national oil companies. Thus, the tide was clearly against Shell and its partners.

### **The Sakhalin End Game**

By mid-December 2006 the pressure on Sakhalin Energy and its shareholders had increased to such a level that multi-billion dollar fines and prosecutions were threatened. The senior management at Shell was involved in shuttle diplomacy between The Hague, Moscow, and Sakhalin in an attempt to reach a deal with Gazprom and the Russian Government. On December 21, 2006 a meeting was held in the Kremlin between President Putin and the CEOs of Gazprom, Shell, Mitsui, and Mitsubishi and it was announced that agreement had been reached for Gazprom to acquire a 50% plus one share stake in Sakhalin-2 for a price of \$7.45 billion. Each of the foreign partners would reduce its shareholding by half. At that meeting President Putin said: “I am glad that the environmental authorities of Russia and the

*Continued on page 16*

*Continued from page 13 – Sakhalin End Game*

investors have agreed to a procedure for settling these issues....I am also glad that a solution has been found for the problem of risks associated with the increase in spending on the project.” Suddenly, all the problems had been solved!

A Shell press release announced that: “SEIC will remain the operator of the Sakhalin-2 project. Gazprom will play a leading role as majority shareholder while Shell will continue to significantly contribute to SEIC management and remain as Technical Advisor.” A few days later the Russian Government leaked a document suggesting that the three foreign partners would absorb \$3.6 billion of the cost overrun outside the terms of the PSA agreement; Shell refused to comment.

The Western media saw the terms of the agreement as being less than generous to the

foreign partners and felt vindicated in their view that the campaign against Sakhalin-2 had been a cynical use of environmental concerns to leverage a good deal for Gazprom. What is important is that the Sakhalin-2 project is now controlled by Gazprom, which will dramatically change things on Sakhalin, and that the regulatory pressures seem to have gone away.

On January 11, 2007 the EBRD released a statement that it was no longer considering the current financing package for Sakhalin-2. In that statement the EBRD noted that: “Through its engagement in the development of the project, the EBRD has helped to introduce commitments to consultation, transparency, and the treatment of indigenous people. The EBRD has worked with Sakhalin Energy on many enhancements during the construction phase.” The EBRD also noted that, “the closer the project comes to completion...the less value EBRD financing could add.”

It remains unclear whether or not the UK’s ECGD, Japan’s JBIC, the US EXIM Bank, or the commercial banks will continue to finance the project. The NGO network clearly feels that no foreign financial institution can now consider funding the project. In a press release on January 15, 2007, Igor Chestin, Director WWF Russia said,

“Today the international NGO coalition has sent a letter to Gazprom requesting the commencement of a constructive dialogue that would take into consideration our demands regarding Sakhalin-2’s compliance with national legislation and international environmental and social standards. These are the same demands that we asked of Sakhalin Energy under the project’s previous ownership.”

What is clear is that with the departure of the EBRD, the NGOs have lost an opportunity to leverage compliance on environmental and

*Continued on page 18*

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social issues.

### **Implications: New Rules of the Game**

The “Sakhalin Episode” is a classic case of where two wrongs don’t make a right. At a conference at Chatham House (but not under Chatham House Rules) in London in early February 2007, Jean Lemierre, President of the EBRD, observed that “too good a deal is never a good deal.” He did not name Sakhalin-2, but it was clear to all in the audience that it was his point of reference. Shell and its partners should have found a way to renegotiate the terms of the PSA and to bring Gazprom into the project on an equitable basis.

Unfortunately, the nature of the campaign waged against the project and the pace of events made such an outcome impossible. Shell might now reflect on how things might have been done differently, as there are clearly many lessons to learn. The Kremlin won’t, as it got what it wanted. As this issue goes to press, Gazprom and its new partners are discussing how to manage completion of the project, and while it remains unclear how Gazprom will pay for its controlling share, it is already talking about expansion.

The outcome of the “Sakhalin Episode” marks a clear change in the “rules of the game” in terms of the role of foreign investors in the Russian oil and gas industry (more specifically, projects that involve natural gas and thus impinge on Gazprom’s monopoly position).

Clearly, the Russian state is not concerned about any reputational damage that might be caused by its actions. At the end of the day the current struggle is about control and once control is asserted, a new deal will be struck with the IOCs. The Kremlin must judge that the IOCs need access to Russian reserves on whatever terms it wishes to set. Furthermore, energy-importing countries, such as China and Japan, are now competing against each other for access to Russia’s energy exports.

The struggle for control is not yet over and at least two further battles remain to be fought: Gazprom clearly wants control over TNK-BP’s Kovytko project (and probably a 50% share in TNK-BP as well) and Gazprom also wants to control what happens to the gas phase of Sakhalin-1, which is operated by ExxonMobil. This gas will be needed to supply a third train at Sakhalin Energy’s LNG plant.

The issue of the Sakhalin-2 blocks also remains unresolved and new tenders are promised by the end of 2007. But before they can take place the much-delayed revisions to the Sub-Soil Law must be approved and a new law on Foreign Investment passed. However, it is clear that consortia bidding for the blocks must be 51% owned by a Russian company, almost certainly Gazprom or Rosneft. All of these developments make it clear that the state will orchestrate Russia’s energy relations and will use energy to promote its external political and economic interests.

One critical question remains unanswered, the Russian state has regained control, but do the state champions have the capacity to develop frontier regions? It is Shell and ExxonMobil that have developed Sakhalin’s offshore potential and Shell that has built Russia’s first LNG and marketized its gas. It is clear that, at present, neither Rosneft nor Gazprom are able to carry out such projects. Gazprom’s uncertainty over how to develop the Shtokhman gas field in the Barents Sea is a case in point. So how will Russia’s offshore potential be realized? ♣

- Dr. Michael Bradshaw

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# About Sakhalin Island Oil and Gas Development

## Sakhalin-1

Exxon Neftegas Ltd. USA (30 percent); ONGC Videsh Ltd., India (20 percent), RN-Astra, Russia (8.5 percent), Sakhalinmoreneftegas-Sheft, Russia (11.5 percent); and Sakhalin Oil and Gas Development Co., Ltd., Japan (30 percent). Exxon Neftegas Ltd., a subsidiary of ExxonMobil Corp., is operator. The project involves development of the Chayvo, Odoptu, and Arkutun-Dagi fields off the northeastern coast of Sakhalin. Estimated reserves are 2.3 billion barrels of oil (307 million tons) and 17.1 trillion cubic feet of natural gas (485 billion cubic meters). Projected investments are \$12 billion through the life of the project.

Development is initially focused on the Chayvo and Odoptu fields. First oil production from Chayvo was achieved on October 2, 2005. Initial production is expected at about 50,000 barrels (6,300 metric tons) per day increasing to 225,000 barrels per day by the end of 2006. Associated gas production began at 60 million cubic feet per day (1.7 million cubic meters) and is expected to increase to 250 million cubic feet (7.1 million cubic meters) per day by 2010. First production from Odoptu is expected in 2007.

## Sakhalin-2

Sakhalin Energy Investment Co. Ltd. (SEIC) is developing the Sakhalin-2 project, involving development of offshore oil and gas fields off the northeast coast of Sakhalin. Ownership of SEIC includes Royal Dutch Shell, Netherlands (55 percent); Mitsui, Japan (20 percent), Mitsubishi, Japan (25 percent). The project involves development of the Piltun-Astokhskoye oil field, with estimated oil reserves at 150 million tons of oil, and the Lunskeye gas field, with estimated reserves of 642 billion cubic meters of gas. Limited oil production began in July 1999 and first year round oil production, as well as

gas production, is expected in 2006. Seasonal production is now underway from the Vityaz Complex, which consists of the Molikpaq platform and the Okha floating storage and offloading unit.

The new Lunskeye Platform (LUN-A) in the Lunskeye field is 15 km offshore in a water depth of 48 meters. This facility will produce the majority of the gas for the LNG project. The Piltun-Astokhskoye-B (PA-B) platform will produce oil and gas from the Piltun field. It is 13 km offshore in a water depth of 30 meters.

## Sakhalin-3

Exploration in the Sakhalin-3 area is on hold pending the Russian federal government's decisions on leases in the project area. Sakhalin-3 involves development of two projects, the Kirinskii Perspective Block and the Vostochno-Odoptinskiy and Ayashskiy Block. Initial investors in the Kirinskii were Pegastar (USA), founded by Mobil Russia Ventures Inc., Texaco Exploration Sakhalin Inc., NK Rosneft, and Rosneft-Sakhalinmorneftegas JSC. The ownership changed with the ExxonMobil and Chevron Texaco mergers.

Investors in the second project include Exxon Neftegas Ltd., the ExxonMobil subsidiary, as well as NK Rosneft, and Rosneft-Sakhalinmorneftegas JSC. On January 29, 2004, the federal government's Commission on Production Sharing Agreements decided not to confirm the validity of a 1993 tender for the Sakhalin-3 oil and gas fields. The tender had been won by Exxon, Mobil, and Texaco and since that time the successor firms ExxonMobil and ChevronTexaco have invested more than \$60 million in exploration of these fields.

The U.S. government is concerned that the issue be resolved. The Department of State, in a statement on its website, said, "the cancellation and possible re-issuance of this tender in favor of another round of bid-

*Figure #1 - Sakhalin Oil and Gas fields with pipeline and terminal infrastructures currently under construction*

ding—which the Russian government has estimated could raise several billion dollars more than they would earn under the 1993 tender—would raise serious concerns about security of foreign investments in Russia.”

**Sakhalin-5**

BP and its Russian partner, Rosneft, made two discoveries in exploration wells drilled in this block in 2004 and 2005, and further exploration is underway in 2006. The exploration partnership was formed in 1998 to explore the K a i g a n s k y -

Vasukansky prospect area. A formal joint-venture organization, Elvany Neftegaz, was announced in 2003, with BP holding 49 percent and Rosneft holding 51 percent. BP announced that the first discovery, in the Pela Lache prospect, found “significant oil and gas accumulations in a number of high-quality

sandstone intervals.” The Pela Lache well is 49 km offshore and in water depths of 114 meters. In the second discovery in the Udachnaya structure, hydrocarbons were found in three intervals, according to BP. The location is 100 km offshore and in 100 m water depths. ♠

