cal functions, which might further undermine their efficiency.

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In sum, the development of Russia's East and efforts to work in the Asian energy markets face formidable challenges. Major breakthroughs in creating an eastern hydrocarbon province appear unlikely in the immediate future. Most likely, sporadic progress will be achieved in easier-to-implement projects where national objectives coincide with the corporate interests of Gazprom and Rosneft.

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## Analysis

# Regional Influence in Oil and Gas Development: A Case Study of Sakhalin

By Elana Wilson Rowe, Oslo

### Abstract

The offshore oil and gas reserves off Sakhalin Island in Russia's Far East are one of Russia's more promising locations for new field development and by 2010 Sakhalin's oil production is expected to account for 7 percent of the demand in the Asia-Pacific region. Not surprisingly, Sakhalin regional authorities seek to ensure a level of regional control over offshore oil and gas development, along with the corresponding economic benefits, despite a relatively weak position in light of Moscow's efforts to centralize authority. This article examines ways in which regional administrations can and do influence the process of offshore oil and gas development in the Russian federation through a case study of the Sakhalin Oblast Administration. Regional authorities on Sakhalin have managed to retain an influential role for themselves via: 1) encouraging onshore infrastructure for offshore oil and gas operations; 2) working to smooth the way for development at the federal level; 3) insisting on local content and contracts when possible; and 4) finding opportunities for regional and local benefit via impact assessment processes. This analysis is based on a review of publicly available primary sources (e.g. company documents) and interviews carried out with regional authorities and foreign executives in Yuzhno-Sakhalinsk in September 2006.

### Changing the Federal-Regional Relationship

The early days of the post-Soviet period were marked by a pronounced decentralization, with many formerly centrally-held competencies being delegated to regional governments. Technically, sub-soil development was considered a shared federal-regional competency, with the federal government leading new initiatives and the regional government enjoying more involvement in proposal approval and implementation. However, most regional governments took a more pro-active role by establishing their own oil and gas concerns and taking an active and influential interest in negotiating licenses and monitoring projects.

Upon taking power at the end of 1999, President Vladimir Putin reversed the decentralization trend and replaced it with a policy to recentralize power and revenue. In August 2004, the State Duma passed a revised law on subsoil resources that effectively returned their management to the federal government exclusively. The recentralization of power helped the federal government gain greater control over regional revenues, including profits from oil and gas development. While the regions used to retain 50 percent of tax revenues, this balance has shifted in favor of Moscow, which then is to allocate revenues back to regional budgets. As becomes clear with the case of Sakhalin, much of the activity of the regional authorities is directed towards locating ways in which the revenues of oil and gas development can, despite recentralization, be captured at the regional level.

### Regional Interventions and the Ambiguities of Russian Federalism

Historically, Sakhalin Oblast authorities did not gain as much control as other resource-rich regions during the post-Soviet decentralization, as offshore oil and gas fields fell clearly under federal jurisdiction. Regardless, regional authorities have been largely supportive of development and can continue to be characterized as pro-development. In fact, it was primarily regional voices (although still only a few) that publicly supported the companies of the Sakhalin-2 consortium when the consortium announced cost overruns that could delay the stage at which the Russian federal government would gain substantial revenue from the project as outlined in the relevant production sharing agreement (PSA). The cost overrun, in tandem with record-high oil prices, a general push for greater federal control of energy projects and dissatisfaction with PSAs, resulted in enough regulatory and political pressure being placed on the consortium to ensure that Gazprom became the controlling shareholder. At a point where the tenor of the debate within Russia had become rather apocalyptic, Evgeny Galichanin, a member of the State Duma from Sakhalin and chairman of the Duma subcommittee on the oil industry stated, calmingly: "The situation must not be exaggerated and there must be no panic… Sensational statements and threats to withdraw the license are unacceptable."

Representing Sakhalin oil and gas interests at the federal level is perhaps the most important (and only) role that regional authorities have to play for projects in early licensing or exploration phases (such as the Sakhalin-3,4,5 and 6 projects). The regional government had, throughout the 1990s and early 2000s, been pro-active at the federal level in working to speed such nascent projects along, lobbying authorities in Moscow for improvements and clarifications to PSA legislation. Although it is now clear that Russia will not sign any further PSAs due to dissatisfaction with the existing PSAs concluded in a period of economic turmoil in Russia and low world oil prices, regional authorities continue to work in Moscow to facilitate further development. As one oil executive put it in an interview with the author, "the regional government is our primary cheerleader because of the jobs and revenues that are evident at the local level." This interviewee argued that regional authorities often work at the federal level to expedite Sakhalin-related issues. More room, however, for regional influence opens up within advanced projects and a brief review of aspects of the Sakhalin-1 and Sakhalin-2 projects illustrates ways in which this influence is acquired and wielded.

## Sakhalin-1

Sakhalin-1 consists of Exxon (30%); Japan Sakhalin Oil (30%); India's ONGC (20%); Sakhalin Morneftegaz (11.5%) and RN-Astra (8.5%). A Sakhalin-1 PSA became effective in 1996, but the project developed slowly until 2002. By 2006, Sakhalin-1 was one of the five biggest oil projects worldwide.

Sakhalin's regional leadership was reportedly unhappy with the Sakhalin-1 consortium's early decision to use primarily sea transport, as its aim had been to involve both Sakhalin-1 and Sakhalin-2 in order to spread the risk and investment needed to build an oil and gas pipeline along the length of the island. Exxon, the operating company for Sakhalin-1, balked at the cost of the pipeline. Some critical approvals were then delayed until the Kremlin's recentralization process greatly diminished regional authority and Exxon was able to pursue its preferred plans despite dissatisfaction at the regional level. Even though the regional authorities failed to realize their objective, this moment illustrates the overall desire of the regional government to bring offshore projects more "onshore" as soon as possible. Once projects are reliant on onshore infrastructure, there are more opportunities for local and regional influence. While the Sakhalin Oblast administration and constituent municipal governments do not exercise control over the continental shelf, they do have significant authority over important onshore elements, such as land and rights of way for onshore construction.

One such example of onshore activity is an airport construction project in the northern town of Nogliki. Extensive upgrades of this local airport were carried out by Sakhalin-1 and Sakhalin-2 consortia working in tandem and the airport opened with regional approval for public and company use in 2004. This airport is also an example of how ambiguity and uncertainty in the division of competencies between the federal and regional levels can play an unpredictable role in the process of development – the airport was closed by federal authorities for general use in 2005 due to an alleged lack of necessary federal permits. Reportedly, an important element for re-opening the airport to the public was a letter written by the president of Rosneft directly to Putin, who then ordered that the Nogliki Airport should be opened to commercial travel by June 2007.

## Sakhalin-2

Sakhalin-2 – the largest integrated oil and gas project in the world – is run by a consortium of corporations collectively called the Sakhalin Energy Investment Company (SEIC). Royal Dutch Shell was the majority partner until Gazprom gained a controlling share of the project as the result of a December 2006 deal. The Sakhalin-2 project illustrates: 1) ways in which regional authorities wield influence when new infrastructure or impact assessments are needed and 2) how the federal-regional fiscal relationship motivates the pursuit of such indirect power.

In terms of infrastructure and assessment, the first phase of the project involved the installation of an offshore platform with no onshore construction beyond staff housing and office space. With the commencement of phase two in 2003, the influence of the regional and municipal administrations increased as Sakhalin-2 needed to move its primarily offshore activities onshore.

Phase two construction included a pipeline extending more than 600 kilometers down the length of the island to a newly constructed LNG (liquefied natural gas) plant and oil export facility at the southern end of Sakhalin. Phase two, according to a 2005 company document outlining public consultation plans, resulted in $300 million in infrastructure development on Sakhalin, including the construction of new bridges, upgrading of public roads and improvements to docks and railways.

The expansion of onshore infrastructure opens another window for regional influence via the municipal level. In 2001, Putin proposed devolving more authority to the municipal level, partly as a counterweight for recentralization. This proposition resulted in a 2003 law "On Local Self-Government" outlining reforms that thus far remain largely unimplemented. The reform itself does not devolve specific authority relating to subsurface resource development and it is notable that regional governors and administrations, rather than municipal representatives, were involved in the commission that developed the law. However, the clarification of the land boundaries of municipalities may strengthen a card the municipal level already has to play – authority over land. As it stands now, oil and gas companies are frequently required to negotiate with municipal authorities when construction, such as a new pipeline, crosses municipal boundaries. Given the relatively low capacity of many municipal governments, it is likely that the regional administration intervenes in this supposedly municipal process and works to extract maximum benefit, including additional desirable infrastructure and lease payments, from the relevant companies.

Phase two of the project also necessitated new rounds of consultation with local, regional and national stakeholders and environmental and social impact assessments. The impact assessment process is one in which regional law can be brought to bear in some ways. On the federal level, the SEIC impact assessment process was subject to 22 federal laws, 13 regulations and procedures and 8 guidance documents. On the regional level, 11 regional laws ranging from town planning to endangered species to taxation and 10 gubernatorial decrees had to be taken into consideration as well. It is noteworthy, however, that a 2003 SEIC text outlining the company's approach to environmental impact assessment states clearly that the assessment is in keeping with federal law and *considers* regional law. Obviously, regional law remains of secondary legal importance in the assessment process.

The question of federal-regional revenue sharing and the dramatic changes introduced in this field during the Putin presidency does much to explain why the regional level seeks to exert influence and capture profit in the rather indirect ways described above. The Sakhalin-2 PSA illustrates this change vividly. Once Sakhalin Energy recovers the cost of its initial investment it will begin sharing profits on a greater scale, as specified in its PSA, with the "Russian party." When the Sakhalin-2 PSA was first set up, there was no clear line made between the federal and regional components of the "Russian party." Subsidiary agreements clarified that the oblast would receive 60 percent of profits and the federal government 40 percent. The actual profit split between the regional and federal administrations, however, remains contingent on presidential decree and can be lawfully changed yearly or counteracted by new decrees. At present, and reflecting Putin's recentralization of authorities and revenues, the regional administration now receives 5 percent of those revenues already generated today with 95 percent going to Moscow.

The contingency of regional profits on federal decisions creates problems for the Sakhalin Administration, as it cannot achieve the level of revenue certainty required to secure long-term loans independently for infrastructure development. One interviewee from within the oil sector with a long-term involvement on Sakhalin described this uncertainty as motivating the municipal and regional levels to look for large-scale and concrete benefits, such as school and hospital infrastructure, from oil companies in exchange for granting approvals and leases on land use. The administration also seeks other opportunities for regional economic development and benefit. For example, the Sakhalin-2 consortium paid $100 million into the Sakhalin Development Fund in the five years following the commencement of commercial oil extraction. The oblast administration has also taken a keen interest in following how contracts are awarded and has promoted a "Sakhalin First" policy in relation to the award of tenders whenever this has been feasible, despite a lack of industrial capacity in the Russian Far East and the problem this poses to companies seeking to meet such local content requirements.

## Conclusions

Despite political and fiscal centralization, Sakhalin authorities continue to exert indirect, albeit greatly reduced, influence over the process of oil and gas development. Regional authorities have endeavored to expedite project development to the point where onshore infrastructure is both necessary and desirable. When offshore development requires onshore access, oil and gas exploitation becomes more directly profitable to, and controllable by, the region itself and the opportunities for capturing economic benefits at the regional level increase. This facilitating and expediting role is exemplified by regional authorities using their contacts in Moscow to intervene at the federal level on behalf of oil and gas consortiums active in Sakhalin and lobbying for expedited award of PSAs and stable PSA legislation, when these agreements still seemed like a feasible alternative for moving development forward.

However, local authorities have not refrained from intervening and sometimes slowing projects' development in order to increase regional involvement/control and potential regional benefits. For example, Sakhalin Oblast has lobbied for local awards of contracts whenever possible, forwarding a "Sakhalin-first" policy, and successfully ensured that payments to the Sakhalin Development Fund were included in Sakhalin-1 and -2's PSAs. This points to ways in which regional authorities are vigilant in holding oil and gas consortiums to the requirements of their contracts, particularly when these requirements result in direct benefit at the local and regional levels. Regional authorities also seem to be able to exercise some authority over the impact assessment process – an undertaking that certainly requires their knowledge of the local political and social environment.

Although the authority of the region is doubtlessly diminished, the ability of regional administrations to act as "cheerleaders" or "brakes" should not be underestimated. Thus it seems that although regional governments no longer possess the authority they once had, the complex and detailed processes entailed in oil and gas development necessitate good relationships on all levels of government. The regional level, in this way, retains residual power and also actively works to build up both formal and informal authority in new capacities.

*About the author:*
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