Analysis

Sakhalin-II in the Firing Line: State Control, Environmental Impacts and the Future of Foreign Investment in Russia's Oil and Gas Industry

By Michael Bradshaw, Leicester

Summary

The world's largest private oil and gas companies are working offshore of Sakhalin Island in Russia's Far East to develop a new oil and gas province. The Sea of Okhotsk has the potential to become another North Sea, located next door to Asia's energy-hungry economies. Now that the projects are starting to realize their potential, the Kremlin has decided that it wants a greater share of the benefits and is using "administrative leverage" to pressure the foreign companies into renegotiating the terms of their involvement. These actions have prompted widespread condemnation in Japan, Europe and the United States and added to the growing concerns about Russia's reliability as an energy partner following the gas dispute with Ukraine in January.

Russia threatens international companies

On 16 September the General Prosecutor's Office of the Russian Federation issued a public statement declaring that the State Environmental Expertise Review (SEER) governing the development of Phase 2 of the Sakhalin-II project approved by the Ministry of Natural Resources (MNR) had been issued illegally. This statement prompted Minister of Natural Resources Yury Trutnev to declare that the 2003 decision by his own ministry was incorrect and should be revoked. According to Sakhalin Energy, a consortium of Western companies which runs the Sakhalin-II project, such action would result in a 12–18 month delay and could possibly cost $10 billion, plus it would severely damage Sakhalin-II's reputation as a reliable supplier of liquefied natural gas (LNG) even before the first shipment is made.

At the same time that the Sakhalin-II is under pressure, Total's Kharyaga production sharing agreement (PSA) project in the Arctic is also under threat, as is TNK-BP's license to develop the giant Kovytka gas field in East Siberia. Exxon Mobil's Sakhalin-I project has delayed the start-up of oil exports because of permitting problems while the Russian authorities have also denied a request to extent the boundaries of one of its fields. Additionally, Gazprom has made public its interest in buying BP's Russian partners in TNK-BP should they wish to sell next year. The most obvious question is why is this happening now?

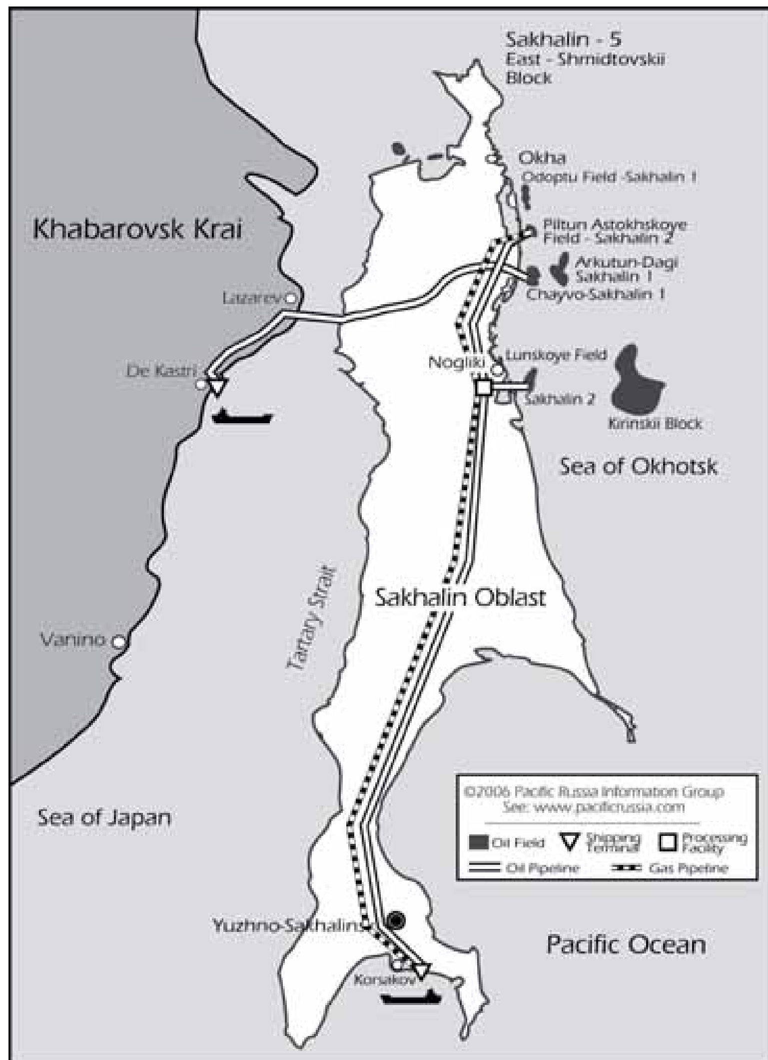
Russia seeks a greater role in energy projects

The recent actions on Sakhalin seem to be more than coincidence. Observers describe them as a "softening up" exercise to force the international oil companies (IOCs) to agree to greater Russian participation in their projects.

Foreign involvement in Sakhalin's offshore energy production began during the mid-1970s when Japan and the Soviet Union signed a compensation agreement to explore for oil and gas on Sakhalin's continental shelf. After initial success, the project fell foul of deteriorating East-West relations and the economic slump of the early 1980s, however, exploration continued and a number of oil and gas bearing structures were identified. Renewed commercial interest in the late 1980s led to an international tender being held in May 1991. Eventually two development licenses were awarded and Russia's first production-sharing agreements were signed, first with Sakhalin-II in June 1994 and then Sakhalin-I in 1995. As these projects evolved, their membership changed. Today the Sakhalin-II project is the only major energy project in Russia comprised entirely of non-Russian companies: Shell (UK-Netherlands), Mitsui and Mitsubishi (both Japanese). Participants in Sakhalin-I are: ExxonMobil (US), SODECO (Japan), ONGC Videsh (India), Rosneft and Sakhalinmorneftegaz (both Russian). Table 1 on p. 11 provides a complete breakdown of all of the Sakhalin projects and their current status, while Map 1 overleaf shows the major fields and infrastructure currently under development.

1990s PSAs made foreign investment possible

Russia in the early 1990s was a very unstable place and drilling for oil and gas in the Sakhalin shelf was considered a chancy proposition. To manage the risk inherent in these ventures, the foreign investors required the protection of PSAs that would set the legal and fiscal terms for the lifetime of the project and would guarantee a profitable return. The PSA is



Map 1: The Current Sakhalin Projects (reproduced with permission)

an internationally-binding legal agreement and each is customized to specific projects.

In July 1999 Sakhalin-II produced Russia's first offshore oil and by the end of the 2005 production season had exported over 11 million tons of crude oil. However, in the absence of an onshore pipeline, production is limited to a 6-month period each year as winter ice conditions prohibit offshore transshipment.

In May 2003 Shell and its partners committed to an investment of almost $10 billion to allow year-round export of oil and LNG. Phase 2 includes the installation of two offshore platforms, twin 800 km oil and gas pipelines down the length of Sakhalin Island and an LNG plant and oil export terminal. Together these elements represent the largest integrated oil and gas development project in the world today, all taking place in a harsh environment, with seismic risks and little economic infrastructure.

When the two Sakhalin projects hit anticipated peak oil production at the end of the decade, they will account for about 7 percent of demand in the Asia-Pacific region. Sakhalin-II's LNG output is already sold out, with the majority of exports planned to Japan, South Korea, the US and Mexico. Sakhalin-II will account for about 8 percent of Japan's total LNG consumption and Sakhalin Energy is now considering adding a third bloc to its LNG plant, which could boost capacity to 16 million tons a year. Given their size, these globally significant projects will make a major contribution to energy security in the Asia-Pacific region (APR) and bolster Russia's economic position in this part of the world, promoting a key foreign policy goal of the Kremlin. At a recent meeting of the Valdai Discussion Club, President Putin stated: "We plan to increase the share of our energy exports to Asia to around 30 percent (it is currently 3 percent) of our total energy exports over the next 10–15 years."

Foreign investors face cost overruns

With projects this ambitious, it is not surprising that there have been problems. First and foremost, both projects have been plagued by delays and cost overruns. In July 2005 Shell announced that the cost of phase 2 had doubled from $10 billion to $20 billion and pushed back the first exports of LNG from mid-2007 to third-quarter 2008. ExxonMobil recently announced that the total cost of its project has increased from $12.8 billion to $17 billion.

The reasons for these cost overruns are both internal and external to the projects. Undoubtedly it is proving more difficult and costly to develop the projects than company managers first envisaged. One major new cost is minimizing the environmental impact of the facilities. There are also external inflationary pressures, such as the cost of labor and raw materials, and the weakness of the dollar.

The nature of the Sakhalin-II PSA means that increased costs and delays extend into the future the point at which the Russian government will start to receive revenue from the production of oil and gas.

The international companies will first recover the funds that they invested into the project. The Russian government audited the project this summer and has yet to approve the increased costs the companies have claimed. In fact, more than one Kremlin advisor has suggested that the government will not accept the cost increases and the PSA projects should work to their original budgets and on the basis of the normal tax and royalty regime. However, industry experts maintain that the high cost of offshore development is not economically viable under the current tax regime.

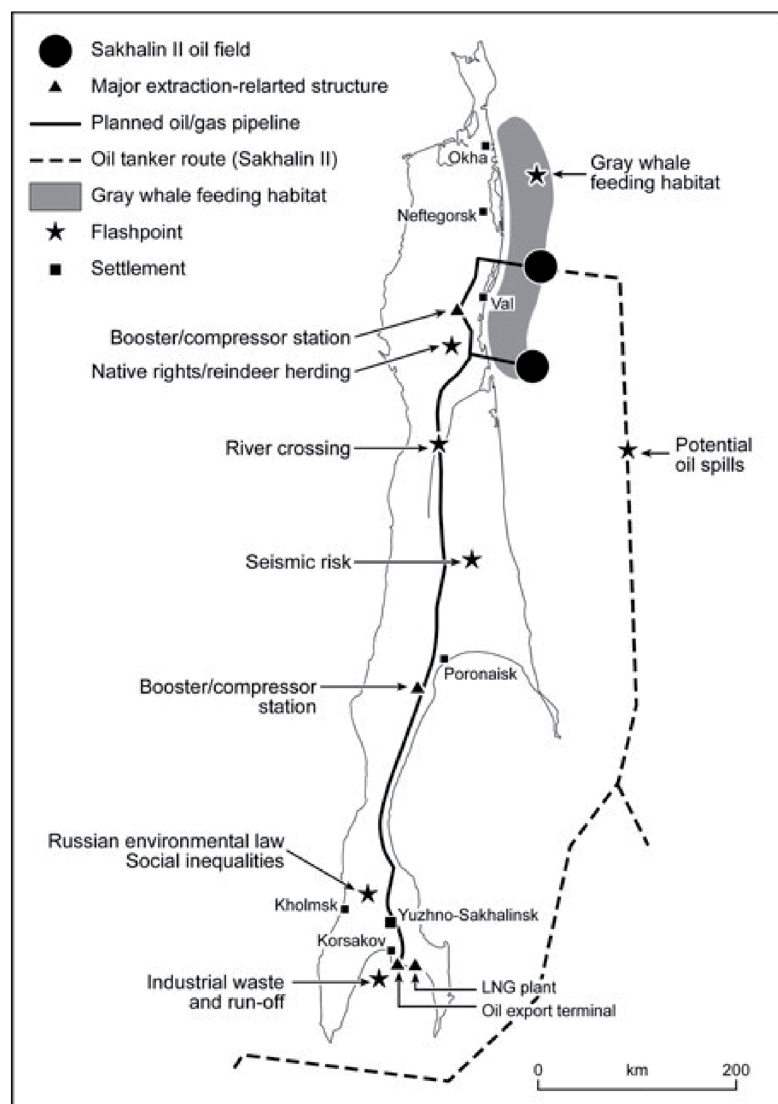
Environmental concerns slow project

The environmental concerns now raised by Moscow are genuine and are not new. In 2003 the European Bank for Reconstruction and Development (EBRD) declared the Sakhalin-II Phase-2 Environmental Impact Statement "unfit for purpose" and began negotiating with Sakhalin Energy to address the areas of concern. Upon completing this process, in December 2005, it announced the amended EIA "fit for the purpose of public consultation" and entered into a 120-day public consultation process that ended in April 2006. Since then it has delayed a final decision and has now stated that any decision must wait until the current difficulties with the Russian government are resolved.

For an EBRD loan to be granted, the project must be compliant with Russian legislation and have the support of the host government. A coalition of environmental NGOs (ENGOs) has 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 impact of construction activity at the LNG plant on the ecology of Aniva Bay, the impact of this activity on the indigenous peoples and finally, the fact that the PSA is not a good deal for Russia (see Map 2 for a summary of the environmental problems).

Now there is a strange alignment of interests, as all of the issues raised by the ENGOs have become part of the Ministry of Natural Resources' criticism of the project. In their defense, Sakhalin Energy representatives point to the fact they have re-routed one of their pipelines, funded research into the ecology of the whale population, and created an independent advisory panel to monitor the impact of the project on the whales. On the matter of river crossings, they admit that there have been problems, in part because the contractors have not worked to international standard; but a revised river crossing strategy is in place and subject to independent review. In relation to the indigenous peoples, they are implementing an Action Plan designed to take their interests into account. Thus, Sakhalin Energy would maintain, with justification, that it is 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. Clearly, funding

Map 2: Environmental and Social Flashpoints for Sakhalin-II (Source: Author)



by the EBRD would provide a seal of approval and recognition that the project was being developed to international standards, but that endorsement is now in doubt.

Russia wants more money, faster

The principle source of the Russian government's grievance over Sakhalin-II is the fact that the cost increases will delay the time when Russia starts to receive a share of the production. Russian policy makers have decided that the current arrangement does not serve Russian interests and should be renegotiated.

However, the rapid negative reactions of governments in Japan, Europe and the US to protest the potential suspension of the project, ostensibly on environmental grounds, suggests that renegotiating the PSA would bring widespread foreign condemnation. Foreign investors are already suspicious of Russian intentions following the Yukos affair, in which the Russian state bankrupted Russia's largest and most transparent oil company and transferred its assets to a state-owned firm.

Another way to insure an increased Russian share of the profits would be to bring a Russian company into the project—Sakhalin-I already has Russian partners and is delivering profit oil and gas under the terms of its PSA. In July 2005 Shell and Gazprom announced that they were negotiating an asset swap that would give Gazprom 25 percent of Sakhalin-II in return for Shell acquiring 50 percent of the Zapolyarnoye field in West Siberia. Gazprom has plenty of reason to join Sakhalin-II: it will gain much needed experience with LNG, plus add reserves and income. The foreign partners would then have inside access in dealing with the Russian authorities. Unfortunately, the cost overruns were then made public and the two parties have been unable to agree final terms. The swap is no straightforward matter: 25 percent of Sakhalin-II is relatively easy to value since the project is almost 80 percent complete and has sold all its LNG. The Zapolyarnoye field, by contrast, is technically challenging and undeveloped, therefore any value assigned to it is based on potential rather than tangible assets. Discussions continue and form a critical backdrop to recent events. To avoid foreign criticism, and to abide by agreements reached at the recent G8 summit in St. Petersburg, any agreement on Gazprom's entry into the Sakhalin-II project must be transparent and commercially viable for Shell and its partners.

Figure 1: Construction work at the LNG Site (Source: Author).

Many commentators describe the timing of Russia's sudden concerns about environmental issues as a cynical move to improve the terms for Gazprom. Speaking at the recent Sakhalin Oil and Gas Conference, Russia's Foreign Minister Sergei Lavrov denied such accusations. However, Russian Ambassador to Japan Alexander Losyukov had suggested earlier that the entry of a Russian company (Gazprom) would assist in the rapid completion of the project, and former Deputy Minster of Fuel and Energy Valery Garipov suggested at the conference that when Gazprom joined the project, the problems would go away.

The arrival of Oleg Mitvol, the Deputy Head of Russia's Inspectorate for the Use of Natural Resources (*Rosprirodnadzor*), on Sakhalin on the second day of the conference on a chartered aircraft packed with press and NGO representatives only served to add confusion and a degree of farce as he proceeded to make unfounded statements about the scale of the environmental damage caused by Sakhalin-II. Meanwhile, back in Moscow, Minister Trutnev was involved in a damage limitation exercise, making it clear that

Figure 2: Lunskoye-A Production Platform, installed summer 2006 (Source: Sakhalin Energy Investment Company)

the SEER would not be revoked and that the project would continue while further inspections are carried out. But there have already been over 200 inspections this year alone. A range of issues has been identified (some 90 in total) and Sakhalin Energy is working through them now. The new review will be completed by late October and Minister Trutnev has announced that he will visit Sakhalin at that time to see the results first hand. Meanwhile, there is a momentary cease-fire and no doubt battle will recommence at the end of October.

Expanded state control will be counter-productive

While it is accepted that foreign oil companies should abide by Russian legislation, those familiar with the state of Russia's natural environment and with its track record of environmental degradation and resource utilization will find it hard to believe that the Russian government's recent statements represent a new environmental consciousness on its part. The current effort to use "administrative leverage" against international oil companies is part of a wider, long-term process that has increased state control over Russia's oil industry and affirmed Gazprom's gas export monopoly.

Ultimately expanding state control over Russia's energy sector may 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 and new fields need to be developed. The Sakhalin projects represent the future of Russian oil and gas production, both in the Sea of Okhotsk and the Arctic. These projects are best developed by Russia's state-owned giants like Gazprom and Rosneft in partnership with the IOCs, although Gazprom's recent decision to reject foreign partners in its development of the Shtokhman field suggests that it prefers to go it alone.

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 be commercially viable, transparent and backed by the rule of law. The battle for Sakhalin, which is far from over, suggests that these conditions currently do not pertain in Russia. While the IOCs will fight hard to keep the value they have created, for the moment at least they will have to reassess their view on Russia.

The net consequence of this conflict will be delays in the development of Russia's frontier production, which will reduce the country's near-term oil and gas revenues and its ability to contribute to global energy security. In such circumstances, it is more than a little ironic that Russia put energy security at the top of the G8 agenda in 2006.

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Table 1: The current status of the Sakhalin projects (as of 1st September 2006)

Project	Fields/Blocks	Participants	Recoverable Reserves	Project Status
Sakhalin-1	Chayvo, Odoptu, Arktun-Dagi (oil & gas)	Operator: Exxon Neftegaz Ltd (US) 30% SODECO Ltd. (Japan) 30% ONGC Videsh Ltd. (India) 20% SMNG-Shelf (Russia) 11.5% Rosneft-Astra (Russia) 8.5%	307 mln t of oil 485 bcm of gas	PSA Phase 1: early oil. First oil in October 2005. First exports October 2006
Sakhalin-2	Piltun-Astokhskoye (oil), Lunskoye (gas)	Operator: Sakhalin Energy Investment Co. Royal Dutch Shell (Netherlands/UK) 55% Mitsui (Japan) 25% Mitsubishi (Japan) 20%	600 mln t of oil 700 bcm of gas	PSA Phase 1: early oil in 1999 Phase 2: Gas/LNG in 2007-08
Sakhalin-3	Krinskii	Operator: Pegastar ExxonMobil (US) 33.3% ChevronTexaco (US) 33.3% Rosneft (Russia) 33.3%	453 mln t of oil 700 bcm of gas	Exploration project suspended due to loss of exploration rights
	Vostochno Odoptinski, Ayashski,	ExxonMobil (US) 66.6% Rosneft (Russia) 33.3%	167 mln t of oil 67 bcm of gas	Project idle and now suspended due to loss of exploration rights
	Veninski	Rosneft (Russia) 51% Sakhalin Oil Company (Russia) 24% Sinopec (China) 24%	51 mln t of oil 578 bcm of gas	First drilling season summer 2006
Sakhalin-4	Astrakhanovskii offshore structure	Rosneft (Russia) 51% BP (UK) 49%	89 bcm of gas	Project stopped by Rosneft
Sakhalin-5	Vostochno-Shmidtovski and Kaigan/Vasyukan (and Zapadno-Shmidtovskii)	Rosneft (Russia) 51% BP (UK) 49% Joint Venture Company Elvary Neftegas being created to develop the project	600 mln t of oil 600 bcm of gas	Exploration First well drilled in summer 2004, second in 2005 and two planned for 2006.
Sakhalin-5	Lopukhovski	Gazpromneft (Russia)100%	130 mln t of oil 5 bcm of gas	Sibneft acquired block from TNK-BP. Gazpromneft was created in late 2005 when Gazprom purchased Sibneft
Sakhalin-6	Progranichnii	Urals Energy	200 mln t of oil	Acquired when Urals Energy purchased Alfa Echo.

Source: table based on oil and gas industry press and oil company websites and press releases.