

Kremlin makes life difficult on Sakhalin

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Published: Nov 22, 2006

A few hundred metres from Royal Dutch Shell's ultra-modern liquefied natural gas plant on Sakhalin, a cemetery of rusting ships testifies to the Russian island's enduring contradictions. So does the sign on a drab apartment block opposite the new headquarters for its venture there: it warns against parking underneath for fear of falling masonry from the crumbling facade.

Everything about Sakhalin is extreme. Perched north of Japan, which ruled part of the island until 1945, it is Russia's eastern frontier. Though rich in wildlife and boasting some of the biggest oil and gas reserves in the world, the former penal colony remains one of the poorest and most neglected parts of the country. In the 1990s a quarter of its population left.

Yet for all its singularity, Sakhalin is in many ways a microcosm of Russia. Its problems mirror those of the country as a whole: the perils of an oil-dependent economy, regional inequality, media manipulation and energy nationalism. The last of these has turned the island into a battleground between the Kremlin and the world's largest oil and gas companies.

At stake is the Shell-led \$20bn (£10.5bn, €15.5bn) oil and gas project known as Sakhalin-2. The outcome of the stand-off will determine not only the future of Sakhalin's oil and gas reserves but also, more broadly, the rights of foreign investors in Russia.

Sakhalin-2 is one of the most ambitious energy projects ever undertaken. It involves drilling for oil and gas 16km out into the Pacific Ocean, transporting it in 800km-long pipelines along the island, which is frequently shaken by earthquakes, before turning the gas into liquid at a giant LNG plant - the first of its kind in Russia.

Until recently it has been trumpeted as the largest foreign direct investment in Russia and an example of energy co-operation with the west. But for the past four months the Russian government has painted the venture as an environmental disaster and an economic rip-off.

Shortly after July's summit of the Group of Eight industrial nations in St Petersburg, where Russia declared itself a guarantor of energy security, Oleg Mitvol, a low-ranking but high-profile official from the state environmental agency, threatened to cancel an environmental permit for Sakhalin-2 for alleged violations of ecology law. Menacing statements from prosecutors and from the ministry of natural resources followed.

International leaders expressed dismay. Japan, whose companies are part of the consortium and which has pre-paid deliveries of LNG from Sakhalin warned that relations would suffer. Russia responded with tougher rhetoric and launched an investigation.

Yet senior ministers readily concede that the crackdown on Sakhalin Energy - the holding company that is 55 per cent owned by Shell - was "detonated " by matters that had little to do with the environment. German Gref, minister of trade and economic development, has described the main factor as rising costs. Last year Sakhalin Energy announced that these would be double the \$10bn it estimated in 2001.

The overrun will have a direct effect on Russia's state finances because the production-sharing agreement, the legal basis of the project, allows foreign companies fully to recoup their outlay and receive a real rate of return of 17.5 per cent before they have to share revenues with Russia. Rising costs would delay the moment Russia saw any money from the project. President Vladimir Putin is said to have been enraged: not only did Russia give Shell an advantageous deal but now it had to bear the burden of the price increase.

Even worse was the timing of the announcement. Shell had just agreed to swap assets with Gazprom, giving Russia's gas giant a 25 per cent stake in Sakhalin-2 in return for 50 per cent of Gazprom's Siberian field. Gazprom felt tricked by the cost announcement and called the deal off last year. Analysts say the government had a point and Shell should have anticipated trouble.

Shell says it can explain both the timing and size of the cost increases. Ian Craig, chief executive of Sakhalin Energy, says these are mainly driven by market forces out of its control. "The cost of Russian labour has gone up 20 per cent a year, " he says. So have steel and fuel prices.

Gazprom's staff costs, by comparison, almost tripled from 2001 to 2005 and materials and maintenance bills have risen more than 60 per cent. Last month the state auditor said the bulk of the Sakhalin-2 increases were justified. Meanwhile, as costs have gone up, so has the price of oil. Russia stands to receive at least \$50bn from the project. "You can't have the benefit of \$60 oil and not bear any of the cost increase associated with it, " says Mr Craig.

As for the timing, Sakhalin Energy maintains that while Shell was aware of an ongoing financial review, it did not have the result when it agreed the asset swap with Gazprom. In the past few months Shell has restarted talks with Gazprom. "It has always been our intention and wish to have a Russian partner in the project, " says Christopher Finlayson, head of Shell in Russia.

But some observers say the problems faced by Sakhalin-2 have deeper roots. High oil prices have transformed Russia from near-bankruptcy into an assertive - some say arrogant - state that resents large projects on its soil being led by foreign companies. Production-sharing agreements - usually struck between oil companies and unpredictable countries - are now viewed as an embarrassment by the Kremlin.

Shell is not the only foreign company facing problems in Russia. TNK-BP, the Anglo-Russian oil venture, has been threatened with licence withdrawals and a fresh investigation is set to be launched into Sakhalin-1, a production-sharing project operated by ExxonMobil. "It looks as though the Russian government decided to take on all foreign projects, " says one oil executive.

Sakhalin-2, however, stands out. It is the largest energy project in Russia, it has no Russian partners and it defies Gazprom's monopoly on gas exports. All these make it an attractive target for a state eager to claw back control.

Three years ago, the Kremlin chose Yukos, then the country's biggest and most ambitious oil company, as its target. It used questionable back-tax claims to bring it down and seize its assets. The production-sharing agreement shields Shell from tax claims, but not from environmental probes.

As a quoted company, Shell has been under enormous pressure from international environmental campaigners and image-conscious western creditors. The European Bank for Reconstruction and Development branded Sakhalin-2 unfit for purpose, citing concern over its impact on the environment.

The company was forced to spend \$300m rerouting its offshore pipeline in order to avoid a feeding ground of the world's only population of grey whales. Ironically, the Russian government was against the change of route. "Regarding whales, we always had more problems with the ministry of natural resources than with the company itself," says Dmitry Lisitsyn of Sakhalin Watch, the main independent environmental group on the island.

The Kremlin has always treated environmental campaigners such as Mr Lisitsyn as at best a nuisance, at worst a front for foreign intelligence services. The sudden change of heart coincided with the crackdown on Shell.

Armed with photographs produced by Sakhalin Watch and flanked by reputable environmentalists and diplomats, Mr Mitvol chartered a jet and flew to Sakhalin to show the extent of the damage. Stumbling on a dead fish at one of the rivers, Mr Mitvol rejoiced at finding an evidence of Shell's "barbaric" behaviour. One environmentalist accompanying him, who tried to explain that the fish's death was a result of its natural two-year cycle, says the official took him aside and urged him to keep quiet.

In fact, the salmon catch in Sakhalin this year was higher than expected. But the dead fish has become a regular feature of state television broadcasts about Sakhalin-2. "We know we are being used, but we feel we can use them too for the common good," says another environmental campaigner.

Mr Lisitsyn argues that Shell deserves criticism but his rhetoric is calmer than that of the government. His biggest concern is the possibility of a spill, from a pipeline cut across seismically active areas or a tanker passing through dangerous waters. Another worry is the rivers that swarm with salmon: if the streams became muddy as a result of work on the pipeline, the fish would not enter.

The company admits that not all its river crossings were perfect and admits to cutting down more trees on some steep hills than it was permitted. "You can find violations - temporary spoil heaps, encroachments, some river crossing - but those are fixable problems," says Mr Craig.

Mr Craig agrees that building a pipeline under the sea would have been easier. But Russia has neither the equipment nor expertise for such a complex project and Sakhalin Energy was obliged to use 70 per cent Russian "content ". As a result, Russian companies have been awarded \$5.3bn worth of contracts, but this has not won Sakhalin Energy any love from the local population. Instead, the televised campaign against it stoked up nationalism and resentment.

Members of a local activist group in Korsakov, a fishing town near the LNG plant, say that on top of environmental damage, the project has brought migrants and social problems. "Our 18-year-old girls give birth to mixed-race babies, " complains one member, unabashed. The project was meant to transform the island but so far it has just driven up property prices, says Elena Lopukhina, the group's leader. "It is only good for those who want to sell up and leave. "

But Alina, a 29-year-old who works at the LNG plant, disagrees. Ten years ago she left for the mainland. "In 1993 there was a 1km-long queue for bread here, " she recalls. Now she has a family in Sakhalin, draws a salary that allows her to holiday in Spain and is studying for a degree in marketing and management, hoping to replace foreign staff of Sakhalin Energy when they go. "It is a different culture here. I don't think I will ever be able to work for a Russian company again, " she says.

Sakhalin's acute contradictions remain. The 6,000 workers constructing the LNG plant have better living conditions in their temporary camp than the residents of Korsakov, the local town, where running water is a luxury.

Behind this inequality is the Kremlin. An agreement signed by then president Boris Yeltsin with the regional government allocated the island 60 per cent of rent and half the future proceeds from the Russian portion of oil and gas sales. Mr Putin scrapped that arrangement and last year Sakhalin was left just 5 per cent of the rent.

The signs of wealth generated by the island are best observed in ostentatiously prosperous Moscow - where London-price restaurants serve salmon and crab that are often poached from the waters of Sakhalin.

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