Sakhalin II gas and oil project

Further Breaches of Equator Principles
May 2004 – March 2005

BANKTrack

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A briefing for financiers

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Introduction

In May 2004, 39 civil society groups, from 15 countries, warned commercial banks of extensive and systemic violations of the Equator Principles by the Shell-led Sakhalin II project – violations which should preclude financing of the project by banks that have adopted the Equator Principles.[1]

This update finds that, far from resolving those violations, events over the past ten months show a deteriorating situation, constituting further violations of the Equator Principles, and even more compelling reasons for Equator banks not to finance the project.

About the project

The Sakhalin II gas and oil project is located on Sakhalin Island in Russia's Far East, and is being developed by a consortium led by Shell. It will consist of three offshore platforms, offshore and onshore pipelines, an onshore processing facility, a liquefied natural gas (LNG) facility and oil and gas export terminal.

It will have severe environmental and social impacts, including threatening the critically endangered Western Gray Whale with extinction, undermining the livelihoods of indigenous peoples, damaging habitats of endangered bird and fish species, and polluting important fisheries. Experts have reported that the project design falls way short of industry best practice, and that its risk assessments are inadequate. As a result, the project risks causing a catastrophic oil spill, as well as major routine impacts.

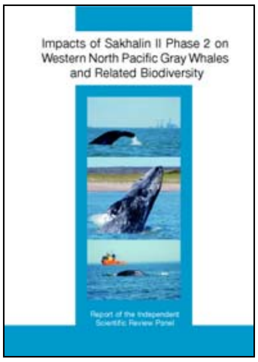
Local and international environmental organisations have demanded substantial design changes, and Russian groups have initiated lawsuits against the project.

With a capital cost of at least $12 billion, the project is expected to seek project financing later in 2005.

[1] PLATFORM et al report, 'Principal Objections', May 2004, and accompanying letter

Continuing threat to whales

In its May 2004 correspondence with banks, civil society groups highlighted the high risk that the Sakhalin II project will push the critically endangered Western Grey Whale into extinction. If the species does indeed become extinct as a result of this project, any financial institution that backs the project will be publicly seen as responsible.



In August 2004, Shell – under pressure from multilateral banks – appointed the World Conservation Union (IUCN) to convene an International Scientific Review Panel to examine the threats of the Sakhalin II project to the whales. The Panel's report, published in February 2005, concluded, "[E]xisting and planned large-scale offshore oil and gas activities pose potentially catastrophic threats to the population."[2]

Shell has announced that in response to the Panel's report, it has decided to re-route its offshore pipelines to avoid the whales' feeding area. Although this is a welcome first step in reducing the impacts on the whales, it is not considered sufficient. Indeed, Shell has shown no indication of complying with the other recommendations of the Panel.

Importantly, Shell has refused to move the location of the offshore platform (PA-B) for the Piltun-Astokhskoye field – despite the Panel's recommendation that "Clearly, from the perspective of gray whale conservation, the farther away the platform is from the foraging grounds the better."[3] The Panel also criticised Shell for not providing adequate information on the PA-B platform. Similarly, conservation organizations have demanded that Shell move the platform location a sufficiently safe distance away, suggesting a distance of 12 nautical miles using horizontal drilling.

The Panel also recommended, "The most precautionary approach would be to suspend present operations and delay further development of the oil and gas reserves in the vicinity of the gray whale feeding grounds off Sakhalin, and especially the critical nearshore feeding ground that is used preferentially by mothers and calves."[4] However, reports in the media suggest that Shell plans to ignore these warnings, and press ahead with

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[2] Independent Scientific Review Panel, 'Impacts of Sakhalin II Phase 2 on Western North Pacific Gray Whales and related biodiversity', February 2005, pp.3 (Executive Summary) and 94 (Overall conclusions)
[3] ibid, pp.6, 96
[4] ibid, pp.4, 94

the proposed PA-B Platform, without slowing the project down for fuller evaluation.[5]

The International Whaling Commission (IWC) also declared at its July Annual Meeting that measures be taken to protect the Western Gray Whale ''as a matter of absolute urgency."[6] The resolution, adopted by consensus, declares that there is compelling evidence that the population is in "serious danger of extinction," and that "the onset of oil and gas development programs is of particular concern with regard to the survival of this population". Sakhalin II is the largest of these projects to negatively impact and degrade the critical natural habitat of the Western Gray Whale.

The Equator Principles (clause 3 and Exhibit II) require compliance with the IFC's Safeguard Policy on Natural Habitats, which rules out financing of projects that "involve the significant conversion or degradation of critical natural habitats". The summer feeding grounds of the Western Gray Whales are a critical natural habitat, which will be degraded by the plans for the Piltun-Astokhskoye B offshore platform and its associated undersea pipelines. The project thus remains in violation of the Equator Principles.

Indigenous peoples not considered

In January 2005, local indigenous peoples' groups began public protests against Sakhalin II.

The indigenous peoples on Sakhalin Island – who include the Nivkh, Uilta, Evenk and Nanai ethnic groups – practice a traditional subsistence economy based on fishing, hunting, reindeer herding and wild plant gathering, which will be badly damaged by the destruction of reindeer pastures and forests, and the decline of fish stocks. The groups state that they have

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[5] John Barry, Shell country chairman for Russia, said in an interview with Reuters, "The project is going ahead. I want to be unambiguous about that… What [the Panel's report] said was, the most precautionary approach would be to stop and gather further data. But it did say that if the project went ahead, mitigation measures were needed. That is important because the project is going ahead and there is no question of stopping it." ['Rare Whales Will Not Stop Shell's Sakhalin Gas', Reuters February 25, 2005, by Sujata Rao] See also Sakhalin Energy press release, 16 February 2005, 'Independent Scientific Report Offers Way Forward', in which CEO Ian Craig states "We … are confident that we can develop an acceptable way forward based on the application of a conservative risk management approach, as recommended by the Panel"

[6] IWC Resolution 2004-1 on Western north Pacific Gray Whale, available at http://www.iwcoffice.org/meetings/resolutions/resolution2004.htm

not been properly consulted[7] or informed of the details of the project, and that the project has not performed required studies of project impacts on indigenous peoples. These indigenous groups demand an independent cultural impact assessment and compensation fund for a Sakhalin indigenous peoples.[8]

The Equator Principles (clause 3 and Exhibit II) require compliance with the IFC's Safeguard Policy on Indigenous Peoples, which requires that projects involve the informed participation of indigenous peoples, and formulate an Indigenous Peoples Plan, to avoid negative social impacts. The Sakhalin II project is in violation of both of these requirements of this Policy, and hence in violation of the Equator Principles.

Botched oil spill response

On 8 September 2004, a Sakhalin II-contracted dredging vessel ran aground on rocks at Kholmsk, Sakhalin Island, spilling approximately 1,300 barrels of fuel oil along 5 kilometres of coast and leaving local residents ill. This Category 2 spill could have been much bigger, and the consortium's botched response showed environmental groups' criticism of Shell's ineffectual oil spill prevention and response plan to be well founded.

Spill response equipment for Sakhalin II was stored at the opposite end of Sakhalin island, many hundred kilometres away. Spill specialists did not even examine the spill until nine hours after the accident, and actual cleanup efforts began eighteen

[7] Indigenous peoples regard the consultations to date as contrived; and in any case consultations have been limited to reindeer herding, and have not addressed other issues such as impact on fisheries

[8] See eg letter of Russian Association of Indigenous Peoples of the North, Siberia and Far East (RAIPON) to EBRD, 21 January 2005, available at http://www.raipon.org/english/news/index.cfm?requestedItemId=1320

hours after the spill. It was 48 hours before booms were in place to contain the spill[9] – something that should have happened within a few hours.

The Equator Principles require that a project Environmental Assessment addresses "major hazards" (clause 3f) and "pollution prevention" (clause 3q). The Principles also require compliance with the December 2000 IFC guidelines on offshore oil and gas (clause 3 and Exhibit III), which in turn require "Plans for the *immediate* securing of sources of oil pollution and effective containment and collection of spilled/leaked oil" (page 4, emphasis added) and the preparation and use of an Oil Spill Response Plan (page 5). Shell did not have an effective mechanism in place before the start of activities that led to the spill, thus representing a further breach of the Equator Principles.

Damage to fish resources

On March 20, 2005, *The Observer* newspaper exposed severe violations of pipeline construction requirements for Sakhalin II.[10] *The Observer's* front page business section exposé included leaked pictures of reckless construction—pipeline right-of-ways slashing through forests and turning streams muddy brown—which show that the company's actions in the field betray its stated commitment to sustainable development. Fishing, the centuries-old economic base of the island for indigenous people, and now also for commercial and sport users, depends on clean spawning streams, which are now compromised by Shell's

[9] Sakhalin Independent, 24-31 September 2005, 'Head of Natural Resources Department: Kholmsk oil spill not environmental catastrophe'
[10] 'Trouble in the Pipeline', Nick Mathiason, The Observer, March 20, 2005;

construction. As *The Observer* also notes, the dangers from Shell’s plan to dump 2.3 million cubic metres of dredging waste into the rich fisheries of Aniva Bay will negatively impact crabs, shrimps, scallops, sea urchins and other fisheries resources.

Also, in August 2004, the Shell-led Sakhalin Energy Company announced the prohibition of salmon fishing in waters bordering the construction site of its liquid natural gas plant (LNG) in Sakhalin Island's Aniva Bay. The decision to ban fishing in the area yesterday led local fishermen to protest by blocking the LNG factory road with cars loaded with fishing nets. Fishing constitutes the largest element of Sakhalin Island’s economy, and restricting the available waters for fishing will have major social impacts.

Again, this constitutes a violation of the Equator Principles requirements to address “sustainable development and use of renewable natural resources” (clause 3c) and land use (clause 3j), and to properly consult with project-affected groups (clause 5). Furthermore, it violates the Principles’ requirement (clause 3 and Exhibit II) to comply with IFC Safeguard Policy on Involuntary Resettlement, which states that in cases such as loss of fishing areas, “attempts must therefore be made to establish access to equivalent and culturally acceptable resources and earning opportunities” (clause 15).

Legal actions against the project

In January 2005, the Yuzhno-Sakhalinsk city court cancelled environmental approval for a temporary jetty being built to import equipment to build the project’s LNG plant. The court also ruled against two decisions of the Sakhalin Department of Natural Resources regarding the conducting of the state environmental assessment of the project and the Department's approval of the results.[11]

Meanwhile, a lawsuit about the impacts of Sakhalin II before Moscow's Presnensky court lists the Government of the Russian Federation and Ministry of Natural Resources of the Russian Federation as the defendant, and Shell's Sakhalin Energy Investment Company, Ltd. as a third party.[12]

The Equator Principles require that a project address "requirements under host country laws and regulations". The filing of these court cases indicates that Sakhalin II has not effectively demonstrated that it is "addressing" legal requirements, so this is another further breach of the Principles. In any case, adherence to the law, and respecting the legal institutions of the host country, should be considered minimum ethical standards for any project.

Economic assessment

As well as the social and environmental impacts outlined above, we would like to draw your attention to the enclosed economic analysis of the project carried out by leading energy economist Dr Ian Rutledge of SERIS.[13]

Dr Rutledge finds that "The terms of the Sakhalin II PSA [Production Sharing Agreement] are a major departure from standard PSA terms worldwide and are losing Russia considerable amounts income." In fact, so unfavourable are the terms to the Russian state that he describes the PSA as a "production *non*-sharing agreement". In February 2005, the Russian State Audit Chamber published a review of the economics of the project, finding that abuse by the consortium of the terms of the PSA had cost the Russian state $2.5 billion – an amount which the Audit Chamber called to be repaid.[14]

This is of clear concern from a development point of view; however we also believe it is not in investors' interests for a

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[11] The Moscow Times / Bloomberg, 20 January 2005, 'Shell suffers a setback in Sakhalin', by Eduard Gismatullin, available at http://www.themoscowtimes.com/stories/2005/01/20/048.html

[12] Claimants are number of citizens and civil society organizations from Moscow and Russian Far East. The claim has been made and sent on behalf of claimants by lawyers of the Moscow-based NGO Legal center Rodnik. See http://www.eca-watch.org/problems/russia/documents/BackgroundonSakhalinIILawsuit.doc

[13] Dr Ian Rutledge, 'The Sakhalin II PSA – A production 'non-sharing' agreement', November 2004, available at http://www.carbonweb.org/documents/SakhalinPSA.pdf

[14] see eg Associated Press, 10 February 2005, 'State Audit Chamber accuses Shell consortium of overspending'

project to be so unfavourable to the host country, as this can lead to instability of the contract, particularly given the considerable intervention by the federal government in the oil and gas sector and the controversy over PSAs in general in Russia.

Furthermore, despite the heavy weighting of the PSA terms in favour of SEIC, there are still questions over the project's viability for international finance, in light of the project cost over-runs announced during summer 2004 that are reported to have increased by 20%, from $10 billion to $12 billion.[15]

Dr Rutledge finds that if the oil price returned to $24/b – the value on which the project was apparently planned –the project's post-tax internal rate of return would fall to 13.1%. This is at the low end of most oil companies' threshold rates of return, and is subject to further downside should Shell continue to lose control of its costs. Given the cost over-runs, the project is only viable if the oil price continues to remain at a high level: a risky assumption.

[15] Shell/SEIC have still not disclosed a figure for the cost over-runs; but $12 billion has been widely reported in the media.

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