Growing energy conflicts across Eurasia:

Gazprom wrests control of Sakhalin-2 gas project from Shell

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The state-owned Russian energy conglomerate Gazprom has taken majority control of the multibillion-dollar Sakhalin-2 oil and gas project, previously majority-owned by the Anglo-Dutch firm Royal Dutch Shell. Months of negotiations, threats of legal action and government pressure from Russia, Japan, Britain and Holland ended on December 21 with Shell acquiescing to Gazprom's offer of $4.1 billion for half of its previous 55 percent stake in the venture.

Gazprom agreed to pay a total of $7.45 billion for a controlling stake in Sakhalin Energy, which also included buying out about half the shares of Shell's partners in the project, Japanese companies Mitsui and Mitsubishi.

The deal was signed by Russia's President Vladimir Putin and top executives from Royal Dutch Shell and Gazprom.

Sakhalin-2 is a combined oil and gas extraction, production and distribution network involving investment of more than US$20 billion. It is based on the undersea hydrocarbon fields near the Russian Pacific island of Sakhalin, estimated to hold 1.2 billion barrels of oil and 500 billion cubic metres of natural gas. Due to come online in 2008, it will be the world's largest source of liquefied natural gas, producing an estimated 9.6 million tonnes of LPG annually.

Shell and its Japanese partners first gained the rights to exploit the Sakhalin fields from the Russian government in 1994. At the time, the Kremlin was desperate for foreign capital investment in the Russian energy sector. Consequently, the government of then-president Boris Yeltsin agreed to a deal whereby the Shell-led consortium would only start to pay for exploitation rights after the full capital costs of the venture had been recouped.

This deal became increasingly offensive to the Putin government as Sakhalin Energy's capital costs rocketed, meaning that the foreign investors would not have begun to pay tax to the Russian exchequer for an even longer period, and then at a lower rate.

The current high price of oil and gas on the world market has allowed the Russian state and Gazprom to demand more favourable terms. Last year, Russia's environmental watchdog RosPrirodNadzor initiated a raft of inspections, complaints and threats of legal action, culminating in a warning on December 12 that it was considering suing the Shell-led consortium for $30 billion for damage the project had caused to the environment.

The environmental claims were widely believed to be politically driven by the Russian government to provide an additional bargaining chip in its effort to secure Gazprom's control of the project.

Vladimir Milov, Russia's former deputy energy minister, commented to the press in early December, "In the current situation Shell will not be able to defend its economic interests in a civilised process with the Russian authorities, so they will be obliged to give up control if they want to save at least some adequate part of the project."

Although there are very real environmental concerns associated with Sakhalin-2, it is expected that RosPrirodNadzor will now drop most if not all of its previous complaints relating to the venture.

Shell had hoped to exchange half its share in the Sakhalin Energy in exchange for a 50 percent stake of Gazprom's Zaployarnoye gas field in Siberia, the world's fifth-largest deposit of natural gas. However, Gazprom is seeking to limit foreign ownership of oil and gas deposits inside Russia.

While Gazprom's cash buy-out of Sakhalin-2 has been generally viewed by the market to be reasonable short-term compensation for the Shell-led consortium, some commentators have suggested that it is a significant strategic blow for Shell's longer term interests. The LEX column in Britain's Financial Times stated:

"With low gearing and few attractive investment projects, cash is the last thing any of the oil majors need, but Gazprom took off the table the more attractive option of an asset swap."

Gazprom's policy of aggressively taking control of Russia's massive proven and unproven hydrocarbon resources limits the basis for the future growth of the major American and European energy companies in the strategically vital region. President Putin has made clear that Russia wants the state to retain a majority stake in strategic resources, opening up the possibility that several other energy deals signed in the 1990s on terms now deemed unfavorable to the Kremlin will be renegotiated.

The LEX column, from December 22, went on to warn that "Russian resource nationalism" is of great concern to Western oil companies, pointing out that the London-based energy giant BP has approximately a third of its unproven reserves in Russia.

Russia supplies one third of western Europe's natural gas, with energy analysts expecting this figure to rise over the next decade. Japan is expected to be one of the principal customers for Sakhalin Energy's LPG.

In addition to dominating the extraction of oil and gas in Russia, Gazprom is seeking to consolidate its control of the distribution network across the former Soviet Union. It is also attempting to break into energy retailing in western Europe through a series of purchases of or tie-ins with European energy suppliers.

Gazprom recently signed a deal with the French state-owned gas supplier Gaz de France. Gazprom provides almost a quarter of France's gas supply and the new deal, which lasts until 2030, will see this figure rise. As part of the agreement, Gaz de France has permitted its Russian partner to directly retail 1.5 billion cubic metres of natural gas per year to French business customers.

Alexei Miller, Gazprom chief executive, said the Gaz de France deal was “a shining example of a successful implementation of Gazprom’s strategy to get access to end-consumers in Europe and increase the efficiency of Russia’s natural gas exports.”

Additionally, Gazprom has secured new, more favorable supply and distribution deals in Hungary, Italy, Greece and Bulgaria. Sixty-five percent of Russian gas goes to the European Union (EU).

Industry insiders have warned, however, that Gazprom’s rapid expansion is based on current high energy prices and could be unsustainable. There are serious concerns that this extension of Gazprom’s interests is resulting in chronic underinvestment in its core oil and gas extraction and distribution network. Vladimir Milov, who also heads the Institute of Energy Policy in Moscow, argues that Gazprom faces a supply shortage as soon as 2010, as production fails to grow sufficiently to meet increasing consumption.

In January 2006, Gazprom cut off its supply to Ukraine in an effort to force Kiev to pay a higher price for Russian gas, which has been supplied to the former Soviet republics for a below-market price for decades. The shock-waves of Russia’s actions were keenly felt across the European Union, which receives much of its natural gas supply via Ukraine.

Germany’s Die Zeit warned at the time: “Gazprom has not only turned its attentions towards Eastern Europe. With an intelligent, farsighted expansion strategy, the Russian state company is establishing direct access to Western European markets. The long-term goal here is also price control of the Ukrainian kind, when gas reserves are exhausted in the North Sea.”

Gazprom has continued its aggressive strategy of ramping up gas prices for its neighbours, to maximise profits at a time of high prices but also to improve its control over the supply network to the EU. Belarus—an ally of the Kremlin whose autocratic president Alexander Lukashenko is strongly dependent on Moscow for political and economic support—was forced by Gazprom to significantly increase the amount it pays for gas, from US$47 to US$100 per thousand cubic metres. The Russian company is also demanding a 50 percent stake in Belarus’s distribution network, through which 20 percent of the EU’s gas is piped.

The Kremlin also uses gas as a weapon in its immediate geopolitical struggles. Gazprom has forced an increase in the price paid by the former Soviet republic of Georgia from US$110 per thousand cubic metres to US$235. Since the American sponsored so-called “Rose Revolution” brought an anti-Russian regime into power in Tbilisi in 2003, Georgia has been the focus of threats and destabilisations by the Putin government. In addition to the sharp hike in the price of gas supplied to Georgia, the Kremlin had amassed troops near the border and provided aid to pro-Russian separatists opposed to Tbilisi’s rule.

Polish ire has been raised by the relationship of Gazprom and the Kremlin with the EU. Currently, much of Europe’s supply of oil and gas is piped through Poland. This will be reduced by the opening of the Baltic Sea pipeline, which circumvents Poland and deprives it of transit fees and political influence in European energy policy. The pipeline is a joint enterprise between Gazprom and German company BASF and has been hysterically condemned by Radoslaw Sikorski, the Polish defence minister, who compared the plan to the 1939 Nazi-Soviet pact.

The EU is struggling to respond to Gazprom’s—and therefore Russia’s—growing power and influence without disrupting the many lucrative bilateral energy deals that European companies have with Gazprom. For example, there is a proposal currently being considered by the EU to prevent gas producers from owning pipelines, which would compel Gazprom to sell its stake in the Baltic pipeline. There are also calls from Poland, some German politicians and sections of the European energy industry to require Russia to sign up to EU trading standards before Gazprom can expand further into the European market. However, these calls are likely to be blocked by such powerful interests as Gaz de France and BASF.

The European powers and Russia find themselves in the contradictory position of growing interdependence and rivalry. Lacking sufficient energy resources of its own and home to some of the world’s largest energy companies, Europe sees Russian oil and gas as a vital geopolitical asset and source of profits. For the Russian elite, expansion in Europe is necessary to secure and advance their political and economic interests.

Tensions between the EU and Moscow are becoming increasingly evident. Jose Manuel Barroso, president of the European Commission and the EU’s chief bureaucrat, has attacked Russia for, “the use of energy resources as an instrument of political coercion.”

European commentators and editorialists have expressed growing concern about the “energy security” of Europe in the face of a more powerful Russia that is blocking foreign domination of energy resources and aggressively pressuring its neighbours. Writing earlier this year in the British Guardian, Ian Traynor commented that Europe had to break its dependence on Russian energy:

“The Russian gas titan, fabled state-within-a-state, monopoly supplier of a quarter of the EU’s gas and rising, has the EU quaking. Like a junkie desperately seeking methadone or some other heroin substitute, the EU is starting to try to kick the Gazprom habit.”

British Conservative Party defence spokesman Liam Fox has recently called for an “energy pact” to counter “Russian nationalism and a willingness to use natural resources as a political weapon.” He urged NATO and the EU to “come together as a consortium of energy consumers to bring their collective weight to bear.”

Meanwhile, Russia is straining against European protectionism. Hans-Joachim Gornig, head of Gazprom’s operations in Germany, criticised Berlin’s attempts to limit the Russian company’s expansion, stating that “As long as the government is not clear about what it wants, [investments in Germany] will remain off our agenda.”

Such rivalries over key Eurasian energy deposits and transit routes will find even sharper expression as the imperialist adventures of the United States—with the European powers in its wake—further destabilise the Middle East and Central Asia. The largely American-organised coups in Ukraine and Georgia, and the current sponsorship of dissidents in Belarus by Washington and the EU are aimed at gaining advantage in the struggle over the resource-rich region, a struggle that will inevitably assume more violent and destabilising forms.