

Shell shakedown

Fortune's Abraham Lustgarten reports how the world's second-largest oil company lost control of its \$22 billion project on Russia's Sakhalin Island.

By Abraham Lustgarten, Fortune
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(Fortune Magazine) -- Word that control of the world's largest integrated oil and gas project had been wrested from Royal Dutch Shell trickled down to the company's staff on Russia's Sakhalin Island in December the same way it reached everyone else: via the newswires.

Outside Shell's six-story steel-and-glass compound in Yuzhno-Sakhalinsk, a town of 175,000, snow swirled in subzero wind past drab rows of communist-era cinderblock apartments. Inside, Jim Niven, the company's gregarious head of external affairs, was halfway through an upbeat presentation on the vast potential held in this claw-shaped island dangling from the Siberian Arctic - an estimated 45 billion barrels of oil and gas - when he was interrupted by a nervous colleague, paper in hand.

The news was stunning, even if rumors had been flying: [Shell \(Charts\)](#) was halving its ownership in the \$22 billion project, cutting its stake from 55% to 27.5%, and Gazprom, the Russian gas giant, was stepping in, buying Shell's share plus half the stakes owned by Japanese partners Mitsui and Mitsubishi, for just \$7.5 billion - the equivalent, says a Shell spokesman, of "paying to enter on the ground floor, as if they were a shareholder at the beginning." The foreign companies also agreed to absorb \$3.6 billion of the project's mounting cost overruns.

Shell's top executives, who were in Moscow at the time, weren't negotiating from a position of strength. Not in Vladimir Putin's Russia, where strong-arm tactics have been used to reassert government control of the country's vast natural resources. Last summer the Russian Ministry of Natural Resources suddenly backed Sakhalin Island environmentalists, revoking permits and delaying work on twin 400-mile pipelines that connect to a monstrous LNG terminal and an oil-export facility. The threat of a \$50 billion lawsuit meant Shell stood to lose everything.

"A guy says, 'Give me half of what is in your pocket, or I shoot you and kill you,'" says Oppenheimer oil analyst Fadel Gheit. "You give him half and say, 'Thank God I am alive to live another day.' They could have lost all of it."

That December night Yuzhno was abuzz with the news. In the Chameleon bar, where Russian bands hammer out Western rock riffs and twentysomethings pass the hose of a hookah pipe, phones started to vibrate and text messages were thumbed out. The talk was exultant, nationalistic. The feeling was that Shell had it coming.

"I'm not proud of how it was done," said one Russian oil worker. "Russia has lost a lot of reputation on this. But I am happy. Shell - they just don't understand how this place works."

Risks on the frontier

That Shell and its partners were victims of an unscrupulous campaign by the Russians to win leverage at the negotiating table is certainly true. The company's loss of its controlling interest in what chief executive Jeroen van der Veer called a "key part of Shell's upstream strategy," amounting to an estimated 5 percent of its global reserves, is largely a story about the high risks of frontier international energy projects. But it is also a tale of how Shell misplayed a strong hand and, after 12 years of work, lost untold billions of dollars in future earnings.

It starts with a production-sharing agreement that most observers agree was inherently unfair to Russia - a deal signed in 1996, when oil was \$22 a barrel and Russia was on its knees, that gave the Shell-controlled Sakhalin Energy Investment Corp. the right to recoup all its costs plus a 17.5% rate of return before Russia would get a 10% share of the hydrocarbons coming out of the ground.

Then there was the cost of the second phase of the project, which ballooned from \$10 billion in 1997 to \$20 billion in 2005, fueling a perception that the company was profligate while Russians picked up the tab. The chapters in between include a calamitous safety record, a failure to meet local expectations for new roads and schools, a fuel spill in Sakhalin's third-largest city, and environmental concerns that caused anger and resentment toward Shell's leadership, earning it a reputation for stubbornness and for consistently misreading political realities.

Gallery: Scenes from Sakhalin

"Shell is always resisting," says Tom Madderom, a veteran Sakhalin contractor who has worked on the Shell project but is now employed at another site, run by Exxon Neftegas, on the northern tip of the island. "Instead of accommodating, they come out with lawyers and try to prove their case. You can run a project in Russia and have a win-win deal - even a project of this size. But it takes engaging with these people, and Sakhalin Energy hasn't been real good at it."

Take, for instance, the ire the company has drawn in Korsakov, a small weather-beaten port city on the island's southern coast, near Sakhalin Energy's Prigorodnoye LNG plant. Residents say the company led them to believe that housing for 6,000 construction workers would be located in the town, where it could later be reused by the community, which sorely needs it. Many people in Korsakov earn less than \$300 a month - a sharp contrast to the wealth of Sakhalin Energy employees, many of whom, especially those who come from other countries, make more than \$1,000 a day.

But when construction began, Sakhalin Energy built its housing for workers next to the plant itself, inside a one-kilometer safety zone, where it will be illegal for people to live once operations begin. "People here could use this place for their well-being, and it will be demolished," says Elena Lopukhina, director of a Korsakov advocacy group and an assistant to a regional government official, who says that is just one of the emotional issues in the community that have swayed people against Sakhalin Energy. "The company did everything that was good for them and not good for us."

Executives at Sakhalin Energy say the production-sharing agreement would have prohibited such a promise, and they maintain that these sorts of complaints are based on unrealistic hopes. "When big projects come along, expectations are always running higher than reality," says Niven. "But clearly there are also opportunities."

Local government revenue, he says, has increased fivefold, and unemployment is just over 1%. Sakhalin Energy has



PHOTO: MICHAEL CHRISTOPHER BROWN
Shell-controlled Sakhalin Energy's LNG plant

Scenes from Sakhalin



Here's a virtual tour of the world's largest integrated oil and gas project and the community that surrounds it. (See [the gallery.](#))

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View

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View

contributed more than \$300 million so far to roads and infrastructure. And while it's too early to offer a verdict, he believes Sakhalin is on the cusp of a four-decade period of economic development. There are at least nine major oil and gas projects planned on the island, involving many of the world's largest oil companies. Shell's problem is that its project, known as Sakhalin II, is the largest of them all - and therefore the biggest target.

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