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The Time Has Come to Renegotiate PSAs

By Konstantin Sonin

Two leading financial newspapers, the Financial Times and The Economist, wrote last week that the "environmental attack" on Shell, the main stakeholder in the Sakhalin-2 project, had been brought about by Russia's desire to bring foreigners to the negotiating table. This was a logical conclusion.

Both newspapers also wrote that the government's response was misguided, but here they missed the mark. Of course, both the method of initiating negotiations -- using the Prosecutor General's Office -- and the decision to have Gazprom manage the state's (future) share in the project are bad news. But the government's intention is correct. The time has come to renegotiate its production sharing agreements.

Transferring part of the Sakhalin-2 project to Gazprom is obviously a mistake. The project needs investment, and Gazprom is already struggling to fund such long-standing projects -- in the Yamal-Nenets autonomous district, for example. Figures from the Institute for Energy Policy show that extraction -- excluding newly acquired deposits -- has been falling for some years.

If the idea is to provide political oversight of Sakhalin-2, it is unclear what Gazprom has done to demonstrate its reliability in defending the interests of the state.

Why the production sharing agreements should be renegotiated is a more complex question. The idea behind the agreements is that they provide investors with additional security against political risks. This explains why they have been implemented so widely, from Mobutu Sese Soku's Zaire to Iraq in the post-Saddam Hussein era.

In 1996, the government decided that the large investment it needed could only be protected by signing a production sharing agreement. Ten years later, however, Russia does not need to offer such guarantees to investors. British Petroleum, which controls half of the British-Russian joint venture TNK-BP, has a greater interest in seeing Russia observe international intellectual property law than companies that are protected by production sharing agreements.

The point is not that BP is in some way better or more conscientious than Royal Dutch Shell. Both companies aim to generate maximum profits, and their main operation has long been managing political risks in petro-states. Yet a foreign company that enjoys no particular advantages will become a stakeholder -- you could even call it a hostage -- in the country where it is doing business, whereas a company with special advantages will not.

The European Bank for Reconstruction and Development – a co-investor in Sakhalin-2 whose mandate for the project includes not just maximum profits but promoting the development of market institutions -- made a mistake by supporting production sharing agreements. The best way to correct this would be to assist in the reconfiguration of the Sakhalin-2 consortium as a company working by the same rules and laws as other Russian companies.

Shell, meanwhile, should revisit its motives for entering into the agreement in the first place. Treating Russia as a volatile third world country with nuclear weapons is not a good basis for doing business. Production sharing agreements shelter investors from many political risks, such as military coups and major changes in domestic policy. But Shell failed to take into account another sort of political risk: that the country might recover from the economic shocks of the 1990s much more quickly than expected. Maybe they will have better luck next time, in another country.

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