TRANSNATIONAL INVESTMENT LAW AND ENVIRONMENTAL PROTECTION: RUSSIAN STATE INTERVENTION IN THE SAKHALIN II PROJECT – THE EMPIRE STRIKES BACK?

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1. INTRODUCTION

The overall legal framework governing transnational investment projects generally, and especially transnational petroleum development projects, is a conjunction between international investment law and several other fields of international law, notably human rights and environmental law. However, the specific legal instruments governing major petroleum development projects involving foreign investors are usually in the form of transnational investment agreements (TIAs) involving host state governments on the one hand, and privately-owned corporate entities operating within these states on the other.[1] These entities are usually (but not always) multinational or transnational companies (MNCs/TNCs). The term 'transnational' is used here to denote these TIAs because they are established by private non-state actors acting in concert with states, rather than between two (or more) states.[2] Previously, the applicable substantive law within these TIAs would be the principles of international investment law regulating the contractual relationship between the MNC/TNC and the host state in which the company is operating within. More recently, the applicable law within these TIAs is accepted as including several other fields of international law, notably human rights and environmental law. However, there is a general debate over the relationship between these different branches or fields of international law which are applicable to transnational investment projects, especially in the context of the resolution of transnational investment disputes before international arbitration bodies.[3] A specific aspect of this debate concerns both the provision and application of environmental principles and standards through the applicable TIA for the

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1. The relatively recent focus on the legal implications of these types of agreements, especially from the social and environmental perspectives, is at least in part indicated by the lack of a well-accepted generic legal term for these agreements. Within the growing literature on this subject, they are also known as 'host government agreements' (see Amnesty International, *Human Rights on the Line: The Baku-Tbilisi-Ceyhan Pipeline Project*, May 2003; and Amnesty International, *Contracting Out of Human Rights: Chad, Cameroon and the Oil Consortium Led by ExxonMobil* (2005)); 'international construction contracts' (see O. Perez, 'Using Private-Public Linkages to Regulate Environmental Conflicts: The Case of International Construction Contracts', 29 *Journal of Law & Society* (2002) p. 77; and O. Perez, *Ecological Sensitivity and Global Legal Pluralism: Rethinking the Trade and Environment Conflict* (Oxford, Hart 2004)); and 'privately financed infrastructure' (see D. Wallace, 'Private Capital and Infrastructure: Tragic Useful and Pleasant? Inevitable', in M.B. Likosky, ed., *Privatising Development: Transnational Law, Infrastructure and Human Rights* (Leiden, Martinus Nijhoff 2005) p. 131).

2. In this sense, the term 'transnational' is used here in the same way as when coined by Philip Jessup to describe the legal regulation of the full gamut of economic, cultural, social, and in this context – environmental – interaction between and across nations that transcend the formal diplomatic relations between legally and politically constituted states. Jessup defined the term 'transnational law' 'to include *all* law which regulates actions or events that transcend national frontiers [emphasis added]'. See P. Jessup, *Transnational Law* (New Haven, Yale University Press 1956) p. 2.

3. Aspects of this debate are examined in a recent volume of essays: M. Waibel, et al., *The Backlash Against Investment Arbitration* (Alphen aan den Rijn, Kluwer Law International 2010).

petroleum development project concerned. In a nutshell, the question is whether new (usually more stringent) host state domestic environmental laws and standards constitute a 'regulatory taking' under international investment protection law, or the legitimate implementation of applicable international environmental principles and standards as a consequence of the international legal obligations of the host state government. Prospects for the implementation of international human rights and environmental law standards within such projects depends on the balance in political and economic power between the host state and the MNC/TNCs involved in the project. This balance is usually weighted in favour of protection for the investing economic actors rather than the application of human rights and environmental standards. However, the enduring role of the host state as the sovereign regulatory power within the relevant territorial jurisdiction cannot be denied. Thus, disputes can arise within the host state-investor relationship when the state exercises its regulatory power on social and/or environmental protection issues in ways that are deemed to be detrimental to the investments made by the private economic actors involved. The general issues raised in this debate will be examined here within the specific context of the Sakhalin II Petroleum Development and Pipeline Project (hereinafter: Sakhalin II project) in the Russian Far East.

The focus of this contribution is on whether TIAs (such as that governing the Sakhalin II project) include environmental principles within these transnational investment projects and how far the host states can intervene in these projects on the basis of concerns over the implementation of environmental laws. A specific example of a TIA between a host state and MNC/TNC will be examined here, namely the Sakhalin II project located on the island of Sakhalin and its surrounding waters in the Far East region of the Russian Federation.[4] This case study of the Sakhalin II project will be conducted against the backdrop of the 2007 takeover by Gazprom, the Russian majority state-owned gas corporation, of the majority shareholding within the consortium that owns the operating company in this project, namely, Sakhalin Energy, or the Sakhalin Energy Investment Company (SEIC), to give its official title. The four shareholders (Shell, Mitsui, Mitsubishi, and now Gazprom) work together under a production-sharing agreement (PSA) to finance and manage the construction of the project's oil and gas extraction and transportation facilities and to share the income from sale of oil and liquefied natural gas (LNG) proportionally. The extracted hydrocarbons are processed for export as LNG to Japan, (South) Korea, and North America. On

4. The Sakhalin II and other TIA projects highlighted in this article were the focus of a United Kingdom (UK) Economic and Social Research Council (ESRC) funded research project entitled 'Project Finance, Human Rights and Sustainable Development', under its 'World Economy and Finance' Research Programme, which the author was involved with, in collaboration with the University of Essex Human Rights Centre (UK) and the Institute for International Environment and Development (IIED) (UK). The results of this research project are currently being completed for publication in S. Leader and D.M. Ong, eds. *Project Finance, Human Rights and Sustainable Development* (Cambridge, Cambridge University Press 2011, forthcoming).

29 March 2009, the first scheduled Russian LNG cargo was successfully loaded from the Sakhalin II LNG plant onto the LNG carrier Energy Frontier for delivery to two Sakhalin Energy customers, namely, Tokyo Gas and Tokyo Electric. By the end of 2010, Sakhalin Energy's LNG plant had reached its full production capacity, producing a 5 per cent share of the world LNG market.[5]

Utilizing the Sakhalin II project as a case study, we can surmise that the application of domestic environmental laws by the Russian federal government was arguably a political manoeuvre designed ultimately to leverage the participation of the Russian state-owned Gazprom company within the original consortium of shareholding partners (including Shell,[6] as the majority shareholder) that own the operating company, namely, Sakhalin Energy in this project. This new ownership structure for Sakhalin Energy raises questions as to the viability of the investment protection clauses provided within the TIA concerned, namely, the 1994 Production Sharing Agreement (PSA) between the Russian Federation and Sakhalin Energy.[7] Previously, the debate over these clauses highlighted their potentially impinging effects, especially on developing country host state governments, in respect of their sovereign autonomy over the application of domestic laws within their own territorial jurisdictions.[8] The Russian intervention within the Sakhalin II project, however, arguably turns this debate on its head and reasserts the preeminent sovereign position of the host state government within such transnational legal relationships. The case study presented here will examine the implications of this reassertion of host state sovereignty for future transnational legal relationships of this kind, especially in respect of the application of environmental law through such TIAs.

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5. Information accessed from Sakhalin Energy website at: <www.sakhalinenergy.ru/en/>.

6. The main Western MNC/TNC involved in the Sakhalin II project is the Royal Dutch Shell 'super major' petroleum company. However, its shareholding participation in this project has been more than halved by Russian federal government intervention, although it still acts as the operator for this project (see the discussion below). The names 'Shell', 'Shell Group' and 'Royal Dutch Shell', are used interchangeably in this article. Royal Dutch Shell plc is incorporated in England and Wales and has its headquarters in The Hague, the Netherlands. More information is available at: <www.shell.com>.

7. Full title: Agreement on the Development of the Piltun-Astokhskoe and Lunskoe Oil and Gas Fields on the Basis of Production Sharing between the Russian Federation and Sakhalin Energy Investment Company, Ltd., adopted on 22 June 1994.

8. For a discussion of the implications of the stabilization clause and dispute settlement provisions of the TIAs governing the Baku-Tbilisi-Ceyhan (BTC) Pipeline Project and the Chad-Cameroon Oil Development and Pipeline Project for the progressive application of evolving international environmental law rules and standards within these projects, see D.M. Ong, 'The Contribution of State-Multinational Corporation "Transnational" Investment Agreements to International Environmental Law', 17 *Yearbook of International Environmental Law* (2006) pp. 168-212.

2. APPLICABLE FIELDS OF LAW WITHIN TRANSNATIONAL INVESTMENT AGREEMENTS

Prior to this in-depth case study of the legal relationships between the host state (Russia) and the TNC/MNC oil company (Shell/Sakhalin Energy) concerned, several more general questions will be considered first. These are as follows: a) whether TIAs can be considered to be a subspecies or subset of international agreements generally; b) whether applicable international environmental principles are being implemented through these TIAs; and c) what role (if any) other non-state entities, notably, the private international financial institutions (IFIs) that assist in providing (private) project finance support for these projects are playing with regard to the application (or otherwise) of these environmental principles? Last but not least, the Sakhalin II project case study will examine whether the host state can still exercise discretionary and/or residual police powers to regulate environmental protection, even in the face of apparently significant contractual constraints imposed by the TIAs concerned. In this context, the enduring role of the host state to govern the overall economic, legal, social and natural environment within which these TIAs operate will be highlighted.

At this early juncture of our impending analysis, it is incumbent upon us to observe that the questions and issues raised above are arguably only part of significantly wider debates about the role of private non-state actors in international relations generally, and the types of legal relationships being entered into between these private entities and the states they deal with within the context of large infrastructure and services projects involving multiple partners. A further complication that should be noted is the fact that the present case study on the Sakhalin II project involves large-scale petroleum resource development and transportation, a subject-matter to which host state governments concerned tend to attach great importance from their perspective as the sovereign power within the territorial jurisdiction concerned. However, as the eminent UK oil and gas lawyer, Terence Daintith, has observed, it is questionable whether the legal relationship between the actors in most state-company relations in the petroleum industry can be adequately explained simply in terms of the state as the 'regulator' and the company as the 'regulatee'.[9] Instead, he postulates that conceiving of the host state-company relationship as an exchange or 'deal' offers a better understanding of the attitudes and behaviour of those involved. Nor does this alternative, arguably more contractually-oriented conception of the host state-oil company legal relationship necessarily diminish the sovereign character or governing role of the state in this context. As Daintith notes, '[C]ontractual forms may express unilateral orderings imposed by the State, or arrangements offered by the State

9. T. Daintith, 'State-Company Relations in Offshore Oil Exploitation: Regulatory and Contractual Analyses', in B. Barton, et al., eds., *Regulating Energy and Natural Resources* (Oxford, Oxford University Press 2006) p. 269.

on a "take it or leave it" basis.'[10] On the other hand, Daintith observes that with the exception of the USA, no other state has allowed petroleum resources to be subject to entirely private forms of property rights, resulting in total alienation of the resources by the private owner. Even in the USA, this legal position is problematic and elsewhere state ownership, or control over access to the resource, is the norm.[11] The regulation of access to, and production of, hydrocarbon resources thus bears the hallmarks of so-called 'command and control' regulation of essentially private sector-type economic activities. However, the abiding proprietary character of the state interest in oil and gas, even when this interest falls short of the assertion of full ownership over the resources, means that the governing legal regime essentially represents a new or different type of regulatory institution or at least, according to Daintith, is something best analysed with different tools.[12] In this sense, regulatory and relational contract discourses are similar because they treat law as only one among many mechanisms for inter-party ordering of their relationships.[13] Indeed, whether regulatory or contractual in form, these instrumentalities represent different ways of influencing behaviour that may not necessarily even have legal implications as such. What is certain is that denoting petroleum resources with a quasi-sacred status has acted as a justification for state interventions in previously agreed exploitation arrangements with private oil companies. As we shall see below, this is at least in part the motivation for the Russian Federation intervention in the Sakhalin II project that ultimately secured Gazprom's participation in the equity control of this petroleum development project.

The rapidly developing international legal framework governing the protection of transnational investments within individual host states by non-state actors is being established mainly through a conjunction of international instruments such as the International Convention for the Settlement of Investment Disputes (ICSID), the Trade-Related Investment Measures (TRIMs) Agreement within the World Trade Organization (WTO) legal regime, and other relevant treaties such as the Energy Charter Treaty, as well as accumulated state practice in the form of Bilateral Investment Treaties (BITs). However, these international instruments do not directly apply specific legal standards to the host state and non-state actors (usually MNCs/TNCs) involved in transnational hydrocarbon projects. As Roberts has recently noted, 'Investment treaties typically involve a high level of obligation and delegation, because they establish legally binding commitments and delegate enforcement power to tribunals, but a *low level of precision*, because the commitments themselves are *broad and vague*… [emphasis added].'[14] Instead, these international investment treaties generally

10. Ibid., p. 268.
11. Ibid., pp. 270-271.
12. Ibid., pp. 271-272.
13. Ibid., p. 269.
14. A. Roberts, 'Power and Persuasion in Investment Treaty Interpretation: The Dual Role of States', 104 *AJIL* (2010) pp. 179-225 at p. 189.

confine themselves to establishing binding procedural standards for the efficient resolution of disputes arising from these host state-private investor relationships. These international investment treaties have therefore been subjected to increasing scrutiny by human rights and environmental non-governmental organizations (NGOs) for their perceived role in securing the export of industries that pollute or provide low working conditions into developing countries hungry for foreign investment in their economies. Environmental NGOs have argued that investment treaties should therefore contain exemptions to allow host states to legislate for higher environmental standards but as Sornarajah notes, 'Few investment treaties have responded to this concern.'[15] This is despite the fact that the concept of sustainable development as it has evolved within international law places more environmental duties upon states in the management of their natural resources under the principle of permanent sovereignty over these resources.[16] Moreover, the principle of integration arguably demands due regard for environmental protection considerations to be included by investors within transnational development projects that are currently subject to international investment law.[17]

One international instrument that does provide explicitly for the possibility that the introduction of domestic environmental measures may have implications for investments is the North American Trade Agreement (NAFTA), where Article 1114(1) reads as follows: 'Nothing in this chapter shall be construed to prevent a Party from adopting, maintaining, or enforcing any measure, otherwise consistent with this Chapter, that it considers appropriate to ensure that the investment activity in its territory is undertaken in a manner sensitive to environmental concerns.' However, the interpretation of this provision arguably leaves much to be desired. Writing in 2001, Hansen had already noted that arbitral tribunals paid scant attention to this provision.[18] Other writers, too, have expressed concern as to the preventative capability of this provision when compared with the other provisions under Chapter 11 of NAFTA allowing investor protection claims against host state environmental regulations.[19] More generally, Sornarajah concludes that 'The tendency of tribunals has been to read down the effect of rare environmental provisions that are to be found in investment treaties, thus

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15. M. Sornarajah, *The International Law on Foreign Investment*, 3rd edn. (Cambridge, Cambridge University Press 2010) p. 226.

16. N. Schrijver, *The Evolution of Sustainable Development in International Law: Inception, Meaning and Status*, Hague Academy of International Law Lectures (Leiden, Martinus Nijhoff 2008) p. 174.

17. Ibid., pp. 203-207 citing, *inter alia*, the Iron Rhine ('*IJzeren Rijn*') Railway Arbitration (*Belgium/The Netherlands*) Award of the Arbitral Tribunal, 24 May 2005, available at: <www.pca-cpa.org>.

18. P.I. Hansen, 'The Interplay between Trade and the Environment within NAFTA Framework', in F. Francioni, ed., *Environment, Human Rights and International Trade* (Oxford, Hart 2001) pp. 313-347 at p. 326.

19. See, for example, A. Cosbey, 'The Road to Hell? Investor Protections in NAFTA's Chapter 11', in L. Zarsky, ed., *International Investment for Sustainable Development: Balancing Rights and Rewards* (London, Earthscan 2005) pp. 150-171.

preserving the original basis of these treaties as investment protection treaties.'[20] Indeed, as Bernasconi-Osterwalder observes,

> 'Many investment treaties give the investor the possibility to challenge host state measures with international tribunals without prior exhaustion of local remedies. Foreign investors have increasingly availed themselves of this mechanism over the past decade, leading to a steep increase in investment arbitration, often involving environmental and public health protection, human rights and other public interest issues.'[21]

Moreover, as Kentin notes, it is the threat to utilize investor rights against host states before international arbitration tribunals as a deliberate corporate strategy to pressurize host governments against introducing or enforcing environmental regulations that has been criticized as being more detrimental to the autonomy of the host state to regulate private activities in the wider public interest.[22]

On the other hand, Tietje makes the point that '[a]rbitral tribunals will almost always strike an appropriate balance' between investor protection and state measures on behalf of the public interest.[23] Examining the arbitration awards related to environmental measures under the NAFTA Chapter 11 investor-state dispute settlement provision, he notes that there have been only two cases so far in which the State Parties were held liable for measures deemed to have impinged on investments made in their territories. In both the *Metalclad* v. *Mexico*[24] and *S.D. Meyers* v. *Canada*[25] cases, host state regulations based on environmental considerations were held to be in violation of investor rights.[26] In the *Metalclad* case, for example, the denial of construction permits by Mexican authorities effectively prohibited the operation of a Metalclad-owned hazardous waste landfill facility. The Tribunal found that the Mexican actions constituted an illegal expropriation, requiring compensation. As we shall see below, Sakhalin Energy found itself

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20. Sornarajah, *supra* n. 15, p. 226.

21. N. Bernasconi-Osterwalder, 'Transparency, Participation and Accountability in International Economic Dispute Settlement: A Sustainable Development Perspective', in H.C. Bugge and C. Voigt, eds., *Sustainable Development in International and National Law* (Groningen, Europa Law Publishing 2008) pp. 323-345 at p. 332.

22. E. Kentin, 'Sustainable Development in International Investment Dispute Settlement: ICSID and NAFTA Experience', in N. Schrijver and F. Weiss, eds., *International Law and Sustainable Development: Principles and Practice* (Leiden, Martinus Nijhoff 2004) pp. 309-338 at p. 318.

23. C. Tietje, 'Transitional Arrangements and Future European International Investment Policy', Speaking Notes to a Hearing on Foreign Direct Investment, before the Committee on International Trade, of the European Parliament, Brussels, 9 November 2010, available at: <www.europarl.europa.eu/document/activities/cont/201011/20101118ATT96254/20101118ATT96254EN.pdf>, at p. 2.

24. ICSID Case No. ARB(AF)/97/1, available at: <www.icsid.org>.

25. Award of NAFTA/UNCITRAL Arbitration Tribunal, 13 November 2000, available at: <www.naftalaw.org/>.

26. Bernasconi-Osterwalder, *supra* n. 21, pp. 332-333.

in a similar situation when threatened by the Russian environmental regulator. However, in the *Pope and Talbot Inc* v. *Canada* case,[27] domestic environmental measures were held not to constitute indirect expropriation or measures tantamount to expropriation as provided under NAFTA Article 1110 unless they were substantial enough to threaten to eliminate or discontinue the investor's business.[28] Moreover, the *Methanex* v. *USA* decision upheld a Californian prohibition on environmental grounds.[29] When held alongside more recent NAFTA-based arbitration awards pitting private investor protection against host state regulations such as *Glamis Gold* v. *USA*[30] and *Chemtura* v. *Canada*,[31] it would seem that such measures will not easily be deemed adverse to investment. In *Glamis Gold*, for example, a new Californian requirement to restore culturally-sensitive Native American landscapes following proposed gold mining activities was alleged, *inter alia*, to amount to expropriation but the Tribunal held that these measures did not cause sufficient economic impact to be regarded as an expropriation of Glamis' investment.[32] This seems to leave open the possibility that if a significant diminution of the investment had in fact occurred, then expropriation requiring compensation would have been found, even if the domestic measure is justifiable from a cultural/environmental perspective. In *Chemtura*, too, the Tribunal seemed to be of the view that should a 'substantial deprivation' of investment occur as a result of the domestic environmental measure adopted, then this could be held to amount to expropriation,[33] although this was not proven in the present case.[34] On the other hand, the Tribunal concluded that irrespective of the existence of a contractual deprivation (whether substantial or not), the measures challenged by the claimant (Chemtura) were in any event a valid exercise of the respondent's (Canada) police powers.[35]

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27. (Partial) Award of NAFTA/UNCITRAL Tribunal, 13 November 2000, 40 *ILM* (2001) pp. 1408-1492.

28. NAFTA Art. 1110: Expropriation and Compensation, *inter alia*, provides as follows:

'1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:

(a) for a public purpose;

(b) on a non-discriminatory basis;

(c) in accordance with due process of law and Article 1105(1); and

(d) on payment of compensation in accordance with paragraphs 2 through 6…'

29. Final Award of NAFTA/UNCITRAL Arbitration Tribunal, 7 August, 2005, available at: <www.naftalaw.org/>.

30. *Glamis Gold Ltd.* v. *USA*, ICSID NAFTA/UNCITRAL Award, 8 June 2009. For case notes see S.W. Schill and D.J. Bederman, 'Glamis Gold Ltd. v USA', 104 *AJIL* (2010) pp. 253-259; and J. Harrison, 'Investment Protection and the Environment: *Glamis Gold Ltd. v USA*', 22 *Journal of Environmental Law* (2010) pp. 505-507.

31. *Chemtura Corporation (formerly Crompton Corporation)* v. *Canada,* NAFTA/UNCITRAL Award, 2 August 2010.

32. *Glamis Gold* award, *supra* n. 30, p. 9, para. 17.

33. *Chemtura* award, *supra* n. 31, para. 249.

34. Ibid., para. 265.

35. Ibid., para. 266.

Thus, while it is arguably correct to describe international investment law as a well-balanced legal system, it is not necessarily the case that this legal system 'gives states far-reaching scope to determine their own regulations'.[36] Specifically, this view neglects the concerns previously expressed about the 'chilling effect' on government regulation when confronted by the threat of foreign investors to resort to international arbitration. As Sornarajah notes, 'The strategy of investors has been to negate environmental laws through stabilisation clauses in the contract which seek to freeze such controls as at the time of entry and exclude the application of later improvements to environmental standards to the investment.'[37] The asymmetrical legal relationship that this strategy begets is exacerbated by the fact that the rules protecting investments by foreign business entities within host states are also to be found in the accumulated state/investor practice within TIAs, as well as the interpretation of these TIA provisions by arbitral tribunals ruling on disputes arising between these parties. Significantly, the law-making role played by these tribunals is 'provoking strong expressions of concern' too, *inter alia*, because they 'are not paying sufficient heed to state regulatory interests'.[38] Moreover, being essentially a private contract between investor and a host state, a TIA can also be designed in such as a way that an alleged breach of contract on the part of the state can result in a duty to pay compensation, even if only MNCs usually have the economic clout to negotiate such contracts,[39] as Shell has done in the Sakhalin II PSA examined below.

Despite being arguably an unorthodox source of law, the 'transnational' rules established by these TIAs and applied by arbitral tribunals have not only transcended international law to influence the domestic legal systems of host countries but through this process have also elevated the legal status of the MNC/TNC non-state actors involved to the same level as that of host states, at least for the purposes of litigation within this context.[40] This type of state/non-state actor TIA arguably contributes to the development of international law by providing a means by which both international and 'transnational' law applies to disputes beyond the traditional relationship between states only, reaching into the legal relationship between states and these non-state actors. The space confines of this article, however, do not allow for an extended discussion of the full implications of these innovative legal developments and the burgeoning attendant literature on this particular issue.[41]

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36. Tietje, *supra* n. 23, p. 3.

37. Sornarajah, *supra* n. 15, p. 153.

38. Roberts, *supra* n. 14, p. 191, fn. 55, citing, *inter alia*, G. van Harten, *Investment Treaty Arbitration and Public Law* (Oxford, Oxford University Press 2007) pp. 152-175.

39. Tietje, *supra* n. 23, p. 2.

40. Nieuwenhuys, for example, has noted that while corporations are not legal persons under international law, transnational corporations do have limited legal personality in so far as they can appear before dispute resolution proceedings under the ICSID framework. See E. Nieuwenhuys, 'Global Development Through International Investment Law: Lessons Learned From the MAI', in Schrijver and Weiss, *supra* n. 22, pp. 295-307 at p. 296, fn. 5.

41. For an initial examination of these generic issues within TIAs, see Ong, *supra* n. 8.

Within this context, the type of transnational, rather than international, agreements that is most innovative are those agreed between transnational, non-state actors like the Equator Principles banks, which are altogether unconnected with states and therefore wholly within the private sector. The Equator Principles, which will be referred to in more detail below within the context of the Sakhalin II project,[42] are an example of such an *exclusively* transnational, non-state actor agreement. This is because the Equator Principles are truly 'transnational' in the sense that they have been adopted by private, non-state actors, namely commercial lending banks, that are nevertheless 'international' in their scope of operations.[43] The Equator Principles are a set of statements of social and environmental principles that have been agreed and adopted by an increasingly large group of like-minded commercial banks as applying to the 'project finance'-type lending activities of these banks.[44] The Equator Principles are directed towards constraining the behaviour of mainly private, non-state actors, usually in the form of business corporations – in this case, international commercial banks. In this respect, they indicate the implementation of well-accepted environmental principles, as opposed to making a separate contribution to the progressive development of international environmental law in and of themselves. One question that can be posed in relation to the legal status of the Equator Principles is as follows: given that non-state actors such as the Equator banks now have transnational legal relations with each other as well as with states, through which international law is applied, does this mean they are new subjects of international law themselves and, furthermore, that their agreements – both between themselves and between them and states – are new sources of international law? The general aspects of these questions have been previously discussed elsewhere by the present author.[45] This article will address the specific aspects of these issues within the context of the private funding from Equator banks for the Sakhalin II project (in section 4 below).

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42. For an initial assessment of the application of the Equator Principles to the Sakhalin II project, see M. Bradshaw, 'The "Greening"' of Global Project Financing: The Case of the Sakhalin-II Offshore Oil and Gas Project', 51 *The Canadian Geographer* (2007).

43. As of May 2009 there are nearly 70 participating institutions (Equator banks) in the Equator Principles. According to a recent report, up to three-quarters of all international financing deals in developing countries representing US$53 billion out of US$75 billion in loans, as well as around 85 per cent of cross-border project financing deals in emerging markets, complied with these Principles. See S. Bergius, *Environmental Standards Loom Ever Larger in Banks' Lending Services*, Environmental Data Services (ENDS) Report, December 2008, available at: <www.equator-principles.com/documents/ENDSReport12-08English.pdf>.

44. See A. Hardenbrook, 'The Equator Principles: The Private Financial Sector's Attempt at Environmental Responsibility', 40 *Vanderbilt Journal of Transnational Law* (2007).

45. D.M. Ong, 'From "International" to "Transnational" Environmental Law? A Legal Assessment of the Contribution of the "Equator Principles" to International Environmental Law', 79 *Nordic JIL* (2010) pp. 35-74.

3. APPLICATION OF ENVIRONMENTAL LAW WITHIN TRANSNATIONAL INVESTMENT AGREEMENTS

Unlike the home and host states, as well as international organizations (also known as inter-governmental organizations (IGOs)), the non-state actors involved within TIA projects such as multinational corporations, private international banks and domestic state and corporate entities are not formally regarded as being bound by public international law generally. Indeed, as Higgins notes, early writers on this subject suggest that the proper legal domain for such an international contract for the exploitation of natural resources is national law, rather than international law, at least in part because international law had hitherto relatively little to say on transnational contracts.[46] As noted earlier, however, it is increasingly clear that this previous legal lacuna has been eroded within the past few decades, at least in terms of the recognition of the investing entities' rights with respect to the host state for the protection of their investments. On the other hand, albeit more recently and to a far lesser degree, internationally accepted principles and standards in human rights, labour, health and safety, and environmental protection are also beginning to impact on both the host states and their transnational investors within the context of these projects. As Ritchie notes from the perspective of the international transfer of good environmental practice alone, 'For a major international development (project), especially one that is coastal or marine, the list of statues, law, protocols and conventions seems endless. It is also increasingly layered.'[47]

Given that international law now recognizes the rights of investing entities within host states, the question then arises as to whether and to what extent international law also places duties upon these entities in respect of their activities both within individual host states and indeed on a worldwide, global basis. Within this context, serious shortcomings have been identified in the current international investment regime, which expands the rights of MNC/TNCs without ensuring that these entities have commensurate responsibilities towards the social and environmental common good.[48] As Bekhechi points out, '[I]nvestment codes and laws

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46. R. Higgins, *Problems and Process: International Law and How We Use It* (Oxford, Oxford University Press 1994) pp. 139-140, citing F.A. Mann, 'State Contracts and State responsibility', 54 *AJIL* (1960) p. 572 and C.F. Amerasinghe, 'State Breaches of Contracts with Aliens and International Law', 58 *AJIL* (1964) p. 881.

47. W. Ritchie, 'The Concept of the International Transfer of Good Practice as an Environmental Policy Component in Major Offshore Oil and Gas Developments: A Perspective from Environmental Science', in M.H. Nordquist, J.N. Moore and A.S. Skaridov, eds., *International Energy Policy, The Arctic and The Law of the Sea* (Leiden, Martinus Nijhoff 2005) pp. 101-123 at p. 103.

48. See, for example, L. Cotula, *Investment Contracts and Sustainable Devlopment: How to Make Contracts for Fairer and More Sustainable Natural Resource Investments*, Natural Resource Issues No. 20 (London, IIED 2010) and Zarsky, ed., *supra* n. 19.

rarely refer to environmental protection as an objective of investments.'[49] Indeed, the underlying uncertainty as to the overall scope of the applicable international legal regime for energy investment projects is not necessarily helpful even to the MNC/TNCs involved, whose rights are ostensibly protected by this regime. As Waelde observed, '[F]or a foreign investor, predictability of investment conditions is essential. … The investor will therefore look towards environmental regulation (policy and politics) as an added complication.'[50] Indeed, environmental regulation by the host state is increasingly seen as an uncertain risk factor that needs to be rendered either more certain or else curbed altogether, with the latter by far the most favoured option. Waelde and Kolo have noted that the question of environmental regulation of foreign investment and the limits on such national regulation by international law is now a highly controversial issue.[51]

While the precise content of the environmental principles designed to achieve the ultimate objective of 'sustainable development' continues to generate debate,[52] their general application to all anthropocentric activities throughout the globe is now undeniable. These environmental principles are meant to govern state behaviour in their daily interaction with other states in the international arena, where these interactions can result in adverse environmental change. They are arguably also applicable to private transnational actors. As Bekhechi notes, '[A]lthough the pace of environmental protection-related legislation is slower than the implementation of new privatization and foreign investment policies and laws, it is shaping new trends that will certainly impact the business environment in the future.' Transnational investment projects such as the Sakhalin II project examined below clearly require the application of internationally accepted environmental principles and standards. The most significant of these environmental principles can be summarized as follows: 1) the environmental integration principle, entailing the inclusion of environmental considerations within socio-economic development activities; 2) the preventive and precautionary principles, providing that such activities do not cause significant environmental harm or damage; 3) the polluter-pays principle, requiring that the polluter should pay

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49. M.A. Bekhechi, 'International Investment and Environmental Protection: Notes on the Environmental Conditions of Investments in the Oil and Mining Sectors', in International Bureau of the Permanent Court of Arbitration, ed., *International Investments and Environmental Protection: The Role of Dispute Settlement Mechanisms: Papers emanating from the Second PCA International Law Seminar, 17 May 2000* (The Hague, Kluwer Law International 2001) pp. 73-90 at p. 74, fn. 3.

50. T.W. Waelde, 'Sustainable Development and the 1994 Energy Charter Treaty: Between Pseudo-Action and the Management of Environmental Investment Risk', in F. Weiss, E. Denters and P. de Waart, eds., *International Economic Law with a Human Face* (The Hague, Kluwer Law International 1998) pp. 223-270 at p. 227.

51. T. Waelde and A. Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law', 50 *ICLQ* (2001) pp. 811-848 at p. 811.

52. See, for example, essays charting the progressive (or otherwise) implementation of sustainable development within global, regional and domestic legal and policy contexts, in Bugge and Voigt, eds., *supra* n. 21.

for the environmentally damaging impacts of its activities; 4) the environmental impact assessment (EIA) principle, providing that the environmental impact of proposed socio-economic activities is fully accounted for; and 5) the principle of public participation on environmental issues in decision-making processes relating to such socio-economic development activities.

However, the question arises as to how these international environmental principles and standards will be applied by the home state of the MNC/TNC to transnational investment projects undertaken by an MNC/TNC within a foreign jurisdiction. According to Sornarajah, '[h]ome states of multinational corporations have the power of control over these corporations to ensure that they conduct themselves in accordance with the standards in the international law on the environment', arguing for (home) state responsibility for the failure to do so.[53] Within the context of TIAs between these MNC/TNCs and their host states, the legal implications of the attempted application of these environmental principles by the host state upon the operating MNC/TNC is uncertain. As Brower and Hellbeck observe, environmentalists would hold that when a state restricts the foreign investor's activities in order to comply with the state's international environmental obligations reflecting these environmental principles, this possibility can and should simply be factored into the costs of any investment vehicle by the MNC/TNCs concerned.[54] On the other hand, foreign investors would take the view that '[A]ny attempt to lower the traditional customary standards of investment protection, *i.e.,* prompt, adequate and effective compensation, based on the nature of the particular public purpose for which the taking was effected, would increase the risk (and therefore ultimately the cost) of investing abroad, if not altogether foreclosing foreign investment.'[55] Moreover, this customary law compensation standard, now also enshrined in many BITs, does not appear to differentiate between various public purposes of expropriations, apparently considering all of these to be worthy of compensation for the foreign investor.[56]

Here it is possible to discern a gap between the perceptions of what may be loosely termed the 'environmental', as opposed to the 'investor', interest groups. Thus, environmental interest groups view improvements in domestic environmental regulation as not merely to be expected but in fact required by progressive developments in international environmental law. On the other hand, foreign investor interest groups would insist that the higher environmental standards embodied in such regulation impinges on the investor's rights in respect of an adequate return on the investment. Therefore, according to the foreign investor, these actions by the host state could amount to so-called 'regulatory taking',

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53. Sornarajah, *supra* n. 15, p. 153.

54. C.N. Brower and E.R. Hellbeck, 'The Implications of National and International Environmental Obligations for Foreign Investment Protection, Including Valuation: A Report from the Front Lines', in International Bureau of the Permanent Court of Arbitration, ed., *supra* n. 49, pp. 19-28 at p. 21.

55. Ibid.

56. Ibid., at p. 22.

which is in turn a form of expropriation for public purposes, thus requiring compensation for the investor that is impinged upon in such a manner. Perry describes the foreign investor view succinctly, when she notes that 'MNEs [multinational enterprises] may be uniformly keen on the existence and enforcement of secure property rights, but their preferences regarding the existence and enforcement of strong environmental law may vary.'[57]

Clearly neither of the two 'environmental' and 'investor' perspectives portrayed above is wholly correct. As Waelde and Kolo note presciently,

> '[T]he question is rather to identify the threshold of unexpected regulatory change and of its impact on the investor's legitimate expectation which require that the investor be paid compensation. … [Moreover, i]t is not, … a question of prohibiting regulatory change, often a legitimate way of evolving the regulatory regime in tune with new knowledge, new standards and the demands of public opinion, but rather to determine when the society, rather than the individual company, should pay for it.'[58]

Among the legal criteria that Waelde and Kolo suggest should be taken into account in determining such a threshold is the requirement of non-discrimination as between foreign and domestic enterprises and the reasonableness of the proposed new or improved environmental standards being applied.[59] The non-discrimination principle would certainly be fulfilled should any new and improved domestic environmental regulation seek to apply the environmental principles discussed above, as they are both eminently reasonable and non-discriminatory in their wording. On the other hand, von Moltke cautions that non-discrimination in itself can be inimical to environmental protection, when the host state is forced to apply the former standard at the expense of the latter.[60] Yet, it is also clear from the specific terms incorporated in the TIA examined below, namely, the 1994 PSA between Russia and Sakhalin Energy, that such new environmental regulation can all too easily be claimed to fall foul of the foreign investors' rights within this agreement. It is this discrepancy between the doctrinal writing that is at least in part based on adjudicated case law, and the actual contractual terminology employed within the 1994 Russia-Sakhalin Energy PSA, which will be the focus of the following section (4).

Given the uncertainty in the application of the relevant environmental principles between states themselves, it is clearly difficult to suggest that these principles are also considered to be applicable to the activities of MNC/TNCs within host states and moreover arguably accepted as applicable by the MNCs/

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57. A.J. Perry, 'Multinational Enterprises, International Economic Organisations and Convergence among Legal Systems', 2 *Non-State Actors and International Law* (now *International Community L Rev.*) (2002) pp. 23-39 at p. 39.

58. Waelde and Kolo, *supra* n. 51, pp. 824-825.

59. Ibid., p. 827.

60. K. von Moltke, 'The Environment and the Principle of Non-Discrimination in Investment Regimes: International and Domestic Institutions', in Zarsky, ed., *supra* n. 19, pp. 172-196 at p. 175.

TNCs themselves. At least one reason for this acceptance can be attributed to the fact that such corporations do have to take potential developments in the governing legal frameworks for their investments very seriously and, where possible, plan ahead for their eventual application. Within this context, it should be noted that it is not necessarily the prospect of stricter environmental (or indeed, other types of) regulation that raises concerns for the investing companies but in fact the uncertainty surrounding the timing of their application or implementation. As Verhoosel notes, '[S]tricter environmental standards are not likely to deter MNEs from investment, but uncertainty regarding changes in the regulatory framework are.'[61] According to Peter on the other hand, the growing interest in environmental issues is increasingly being relied upon by host states as grounds for the renegotiation of TIAs with MNCs/TNCs.[62] However, greater scrutiny of the legal instruments providing for individual projects, as undertaken below, reveals a rather mixed picture as to the potential for the actual *in situ* application of improved environmental standards within the territories of such host states in the face of intransigence from the investing MNCs/TNCs.

Returning to the general requirement for the application of international environmental principles and standards, it is arguable that these can be understood here in exactly the same way as it is understood that the applicable financial principles and standards underpinning all contractual and other legal relationships between the parties to these TIAs and related agreements will be the accepted international financial industry practice for these types of arrangements. In other words, since no foreign direct investment by private financial institutions, or any credit guarantee arrangements involving inter-governmental (or other types of international) financial institutions would have taken place at all without the full compliance by the participating entities to international investment banking/finance standards;[63] it can therefore be equally argued that the regulation of the impacts of the infrastructure projects that are the objects of such investment on the local community and its surrounding natural environment should also be expected to conform to applicable international environmental principles and standards. In this respect, Braithwaite and Drahos conclude that, at least within the international banking sector, '[T]he international reality which is emerging through the work of the Basle Committee, BIS and the EC is that of internation-

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61. G. Verhoosel, 'Foreign Direct Investment and Legal Constraints on Domestic Environmental Policies: Striking a "Reasonable" Balance between Stability and Change', 29 *Law and Policy in International Business* (now *Georgetown University Journal of International Law and Business*) (1998) p. 451, cited in Waelde and Kolo, *supra* n. 51, p. 819, fn. 38. This point is also confirmed when it is observed that despite the apparently higher environmental, labour, health and safety, hygiene, and other standards operating in developed economies, they are nonetheless among the highest receivers of inward foreign direct investment as a whole.

62. W. Peter, *Arbitration and Renegotiation of International Investment Agreements*, 2nd edn. (The Hague, Kluwer Law International 1995) p. 14.

63. See, for example, Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards (Basel II), adopted November 2005, available at: <www.bis.org/publ/bcbs118.pdf>.

ally-coordinated standard-setting for international banking.'[64] Significantly, they find that these standards represent best practice even though they take the form of guidelines only rather than positive law. Yet they are in the main adhered to, because, '[N]o regulator wants to face the uncertainties of globalized banking without best practice standards.'[65]

Much in the same manner, within the exploration, exploitation and pipeline transportation aspects of the international petroleum industry, it has been noted that developments in environmental regulation over the past 30 years have introduced a new element into petroleum transactions, with the biggest development for the industry being the change in investment conditions, and the most significant change of all being the introduction of environmental controls in law, policy and contracts.[66] A further development in the environmental regulation within this sector is the increasing use of cross-references to the international standards established by the relevant industries in order to complement the treaty obligations of States Parties.[67] This development has the effect of strengthening, or 'hardening', previously 'soft', non-binding international industry standards or guidelines, by explicitly bringing them within the scope of the States Parties' international obligations under the relevant treaty instruments. In this way, 'soft' law itself moves from its traditionally aspirational role as 'an indicator of where the international community envisions the law developing',[68] eventually becoming legally-binding obligations at the international level, to be implemented and enforced at the domestic level. Thus, industry experts now advise companies to seriously monitor 'soft' law developments as current 'soft' law is quite likely to become the 'hard' law of the future.[69]

Moreover, these international industry standards have the merit of being applicable wherever the industry operates throughout the world, thus generating a leveraging, or 'ratcheting-up' effect on otherwise lower domestic environmental standards within developing countries and economies in transition. As

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64. J. Braithwaite and P. Drahos, *Global Business Regulation* (Cambridge, Cambridge University Press 2000) p. 141.

65. Ibid.

66. Zhiguo Gao, 'Environmental Regulation of Oil and Gas in the Twentieth Century and Beyond: An Introduction and Overview', in Gao, ed., *Environmental Regulation of Oil and Gas* (London, Kluwer Law International 1998) pp. 3-55 at p. 43.

67. Ibid., pp. 24-25.

68. G.W. Pring and S. Noé, 'The Emerging International Law of Public Participation Affecting Global Mining, Energy, and Resources Development', in D. Zillman, A. Lucas and G.W. Pring, eds., *Human Rights in Natural Resource Development: Public Participation in the Sustainable Development of Mining and Energy Resources* (Oxford, Oxford University Press 2002) pp. 11-76 at p. 72, fn. 502, citing P. Sharma, 'Restoring Participatory Democracy: Why the United States Should Listen to Citizen Voices While Engaging in International Environmental Lawmaking', Comment, 12 *Emory ILR* (1998) p. 1215 at p. 1226.

69. Pring and Noé, *supra* n. 68, p. 72, fn. 503, citing W. Prince and D. Nelson, 'Developing an Environmental Model: Piecing Together the Growing Diversity of International Standards and Agendas Affecting Mining Companies', 7 *Colorado Journal of International Environmental Law & Policy* (1996) p. 247 at p. 316.

Braithwaite and Drahos note in relation to the application of the best available technology (BAT) standard by environmental regulation, '[G]lobalization of BAT is a ratcheting-up mechanism for environmental standards, just as fixed-outcome standards are a prescription for guaranteed environmental decline.'[70] This increasingly prevalent preference for a 'continuous improvement' business model rather than a strict 'rule compliance' approach in global corporate strategies will be shown to have been undermined and indeed arguably reversed by the effect of the 'applicable law' and other related clauses within the Russia-Sakhalin Energy PSA examined below. It is also arguably at variance with the Equator Principles accepted by the private international financial institutions (namely, Bank of Tokyo-Mitsubishi, Mizuho Bank, Sumitomo-Mitsui Bank, and BNP Paribas) providing project finance loans to the consortium owning Sakhalin Energy. In the revised 2006 Statement of these Principles, the so-called Equator Principles Financial Institutions (EPFIs) undertake that they 'will only provide loans to projects that conform with the following ten Principles'. A summary of each Equator Principle is provided here:

Principle 1: review and categorization
This provides that when a project is proposed for financing, the EPFI will, as part of its internal social and environmental review and due diligence, categorize this project based on the magnitude of the potential impacts and risks in accordance with the environmental and/or social screening criteria of the International Finance Corporation (IFC). Category A projects are those with potentially significant adverse social or environmental impacts that are diverse, irreversible or unprecedented. Category B projects that have potentially limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures, and category C projects have minimal or no social or environmental impacts.

Principle 2: social and environmental assessment (SEA)
This is a key requirement that the Equator Principles banks are required to oblige upon the would-be borrowing companies. The borrower has to conduct a SEA process to the EPFI's satisfaction. An illustrative list of the potential social and environmental issues to be addressed in the SEA documentation is provided in Exhibit II, also annexed to the Equator Principles themselves. This list is fairly comprehensive in scope but there is no suggestion that it is exhaustive in any way.

Principle 3: applicable social and environmental standards
Once the SEA has raised the social and environmental issues that need to be addressed, the next question that arises is the standard of protection that needs to be applied to these issues. Here, a distinction is made on the one hand between

70. Braithwaite and Drahos, *supra* n. 64, p. 270.

projects located in non-OECD (Organisation for Economic Co-operation and Development) and non-High-Income OECD countries,[71] and on the other hand, projects within the High-Income OECD countries. In the former group of countries, the SEA will reference standards laid down in the applicable IFC Performance Standards (attached in Exhibit III to the present Principles) as well as the applicable Industry Specific Environmental, Health and Safety (EHS) Guidelines (attached to Exhibit IV). The SEA for projects within these countries will establish to a participating EPFI's satisfaction the project's overall compliance with, or justified deviation from, the respective (IFC) Performance Standards and EHS Guidelines. The danger here will be that these standards are not taken as the minimum requirements but as the maximum level of performance expected of the borrowing company, beyond which it would be unreasonable to expect them to exceed.

Principle 4: action plan and management system
For the non-OECD countries and non-High-Income OECD countries, the borrower has to prepare an Action Plan (AP) which addresses the relevant findings of the SEA exercise and draws on the conclusions of the assessment. The AP will describe and prioritize between the mitigation measures, corrective actions, and monitoring measures necessary to manage the impacts and risks identified in the SEA. The AP may therefore range from a brief description of routine mitigation measures to a series of documents (e.g., resettlement action plan, indigenous peoples plan, emergency preparedness and response plan, decommissioning plan, etc.).

Principle 5: consultation and disclosure
For category A and B projects located in non-OECD, or non-High-Income OECD countries, the host government, borrowing company or third party expert must consult with so-called project 'affected communities' in a structured and culturally appropriate manner.[72] For projects with significant adverse impacts on affected communities, the process will ensure their free, prior and informed 'consultation' and facilitate their informed participation as a means to establish, to the satisfaction of the EPFI, whether a project has adequately incorporated affected communities' concerns. 'Consultation' in this context should be 'free' (free of external manipulation, interference or coercion, and intimidation), 'prior' (timely disclosure of information) and 'informed' (relevant, understandable and accessible information), and apply to the entire project process and not to the early stages of the project alone.

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71. As defined by the World Bank Development Indicators database. These categories will presumably include all developing and less-developed countries (LDCs).

72. 'Affected communities' in this context are defined as 'communities of local population within the project's area of influence who are likely to be adversely affected by the project'. See fn 4 to Principle 5 of the Equator Principles, available at: <www.equator-principles.com/documents/Equator_Principles.pdf>.

Principle 6: grievance mechanism
For all category A projects and category B projects 'as appropriate' that are located in non-OECD or non-High-Income countries, the borrower is enjoined to establish a grievance mechanism; the existence of which the borrower has to inform the affected communities. However, the grievance mechanism to be established is subject to the following qualifiers: 1) this mechanism is scaled to the level of risk and adverse impacts of the project; and 2) it is part of the management system.

Principle 7: independent review
For all category A projects, and again category B projects 'as appropriate', an independent social 'or' environmental expert 'not directly associated' with the borrower will review the SEA required under Principle 2, the AP required under Principle 4, and the consultation process document required under Principle 5, to assess the borrower's compliance with the Equator Principles, and thereby assist with the fulfilment of the EPFI's due diligence requirements.

Principle 8: covenants
The borrowers are required to enter into detailed covenants for the project concerned. These covenants extend to the following areas:

1) compliance with all relevant host country social and environmental laws, regulations and permits in all material respects;
2) compliance with the AP during the construction and operation of a project in all material respects;
3) provision of periodic reports in a format agreed with the EPFIs, although the frequency of these reports is proportionate to the severity of impacts, or as required by law, as long as these are at least on an annual basis. Moreover, these reports need to fulfil any formal documentation requirements of the AP and show compliance with the relevant social and environmental laws, regulations and permits;
4) decommission the facilities, where applicable and appropriate, in accordance with an agreed decommissioning plan.

Principle 9: independent monitoring and reporting
To ensure continuous monitoring and reporting throughout the life of the loan, the EPFIs will require the appointment of an independent environmental and/or social expert for all category A projects, and again for category B projects only 'as appropriate', or require the borrower to retain qualified and experienced external experts to verify its monitoring information which should be shared with EPFIs. While the thrust of this Principle is clear in the first part of this statement, the alternative and arguably much weaker option given to the borrower to fulfil its requirements in the second part of this Principle 9 is clearly open to abuse.

Principle 10: EPFI reporting
Finally, each EPFI commits to publicly available reports, on at least an annual basis, about its Equator Principles implementation processes and experience, subject to confidentiality considerations. This last phrase arguably provides much scope for hindering transparency, in that it is not limited only to matters of commercial confidentiality and therefore may be relied upon by the Equator banks to include all manner of sensitive information.

So, how successful have the Equator Principles been in securing the application of the relevant social and environmental principles by Equator lending banks and their borrowing companies? This question can be approached from both the institutional and empirical perspectives. At the former, institutional level, a study by an international law firm conducted in 2005, prior to the revision of the Equator Principles in 2006, reported that several Equator banks have entered into structured dialogues with stakeholders and NGOs about the social and environmental aspects of their lending. This study concludes positively on the way the Equator Principles have influenced financial markets generally and redefined bank lending considerations.[73] At the latter, empirical level, however, other reports have still found instances of Equator bank funding of unsustainable projects.[74] As Richardson concludes, the overall evidence so far is patchy, and points to the need for more comprehensive solutions for promoting socially and environmentally responsible financing generally, beyond the private finance sector.[75]

4. TRANSNATIONAL INVESTMENT PROTECTION AND ENVIRONMENTAL REGULATION IN THE SAKHALIN II PROJECT

We can now begin our examination of the major oil and gas infrastructure project showcased in this article, namely, the Sakhalin II project on Sakhalin Island in the Russian Far East. There are in fact at least five oil and gas projects at different stages of development within Sakhalin Island and its surrounding waters off the North Pacific coastline, in the Russian Far East region.[76] As Dean and Barry note, '[T]he Sakhalin oil and gas projects, which have grown into one of the larg-

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73. Freshfields Bruckhaus Deringer, *Banking on Responsibility* (July 2005), cited in B.J. Richardson, 'Financing Sustainability: The New Transnational Governance of Socially Responsible Investment', 17 *Yearbook of International Environmental Law* (2008) pp. 73-110 at pp. 89-92.

74. See J. Monahan, 'Principles in Question', *The Banker*, 7 March 2005; and R. Bulleid, 'Putting Principles into Practice', *Environmental Finance*, June 2004, both cited in Richardson, *supra* n. 73, p. 92.

75. Richardson, *supra* n. 73, p. 94.

76. For example, the Sakhalin I Project is operated by ENL, a consortium including ExxonMobil, Rosneft, Sakhalin Oil and Gas Development Co. Ltd. (SODECO), ONGC Videsh Ltd., Sakhalinmorneftegas-Shelf, and RN-Astra.

est direct investments into the Russian economy, involve the participation of a large number of Russian and foreign energy companies…'[77] The TIA that brings together the relevant fields of international law in the Sakhalin II project is the 1994 PSA signed between the Russian Federation and Sakhalin Energy (formally known as the Sakhalin Energy Investment Company or SEIC),[78] wholly owned by the consortium of corporate shareholders headed by Shell. This PSA provides for all the relevant issues involved, namely, investor protection, host state regulatory framework, and international industry standards applicable to this project. More pertinently, Grigoryev observes that 'The Sakhalin projects are perhaps the best example of how foreign investment projects can be successful and at the same time how political capriciousness can damage investors' morale.'[79]

The Sakhalin II project was initially developed by a consortium of Shell, Matsushita and Mitsui and, *inter alia*, involved the building and operation of extensive oil and natural gas production and pipeline transit infrastructure, including the development of Russia's first LNG facility, on the southern tip of the Sakhalin Island, near the town of Prigorodnoye. The Sakhalin II project is the largest integrated oil and gas project in the world according to its sponsor, Sakhalin Energy. Altogether, Sakhalin II boasts 4.5 billion barrels of reserves. Shell expected to be producing 185,000 barrels a day of oil plus condensates from gas and 467 billion cubic feet per year of gas by 2008.[80] At a cost of over US$25 billion, this project includes three large offshore platforms, 165 kilometers of subsea pipelines to shore, 800 kilometers of onshore pipeline, one of the world's largest LNG plants, and oil and gas export terminals. Oil and gas from beneath three platforms off the island's northeast coast is pumped onshore by pipeline and sent 500 miles south to the tip of the island. There the oil is loaded into tankers and the gas super-cooled in giant LNG plants, to be shipped to energy-hungry Japan and South Korea, and probably to China. Some gas will also pass through a terminal in Baja California, Mexico, and on to the west coast of the US. This project has confirmed Sakhalin's stature as a major new energy province and transformed Russia into a key supplier to Asia, and especially the burgeoning East Asian markets. While Russia is now the main oil and gas supplier to Europe,[81] the mid to

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77. R.N. Dean and M.P. Barry, 'A Conflict of Interest for Russia: Offshore Oil vs. the Problems of Environmental Regulation', in Nordquist, Moore and Skaridov, eds., *supra* n. 47, pp. 213-46 at p. 215.

78. An unofficially translated copy of this agreement is on file with the author.

79. Y. Grigoryev, 'The Russian Gas Industry, Its Legal Structure, and its Influence on World Markets', 28 *Energy LJ* (2007) pp. 125-145 at p. 128.

80. 'Sakhalin Island: Journey to Extreme Oil', *Business Week*, 15 May 2006, available at: <www.businessweek.com/magazine/content/06_20/b3984008.htm>.

81. According to European Commission figures, see J. Perovic and R.W. Orttung, 'Russia's Role for Global Energy Security', in A. Wenger, R.W. Orttung and J. Perovic, eds., *Energy and the Transformation of International Relations: Towards a New Producer-Consumer Framework* (Oxford, Oxford University Press 2009) pp. 117-157 at p. 117, fn. 2 citing European Commission, *The European Union and Russia: Close Neighbours, Global Players, Strategic Partners, Euro-*

long-term Russian National Energy Strategy envisages that the share of Russian oil exported to Asia will rise to 30 per cent, from its current 3 per cent and that 15 per cent of Russian gas exports will go to Asia by 2020.[82]

On the other hand, the Sakhalin II project is well-known among the Sakhalin Island projects both for its environmental standards violations and for the Russian federal government's pressure on Royal Dutch Shell to transfer the controlling share of the project company (Sakhalin Energy) to the Russian state-owned Gazprom corporation. Indeed, the Sakhalin II project has been implicated in several issues involving severe environmental impacts and risks, namely,

1) Eight hundred kilometers of the project's onshore pipelines have created severe erosion that has damaged hundreds of wild salmon rivers and tributaries and threatens future damage from poorly designed crossing of manifold geohazards, including 22 active earthquake fault crossings and landslide-prone areas;
2) LNG terminal dredging and the dumping of dredging wastes damaged the fisheries-rich Aniva Bay. Associated construction activities disrupted local fishermen's and fishing companies' activities, adversely affecting the quality and quantity of fish caught, leading fishermen to bring a claim to the Independent Recourse Mechanism of the European Bank for Reconstruction and Development (EBRD) in 2005. After a massive die-off of herring in 1999 at Piltun Bay, independent lab tests conducted by environmental groups showed herring contained pollutants of the kind used in Sakhalin II drilling;
3) The project's offshore platforms and subsea pipelines threaten the critically endangered western North Pacific (Asian) gray whale population. Sakhalin Energy has failed to follow many of the recommendations of the Western Gray Whale Advisory Panel (WGWAP), violating a condition of several public and private lenders;
4) The project poses long-term risks of oil spills amidst treacherous weather and ice despite the fact that the oil industry, including Sakhalin Energy, has no successful experience of responding to oil spills in ice conditions.[83]

In April 1994, Royal-Dutch Shell plc, Mitsui and Co. Ltd. and Mitsubishi Corporation established Sakhalin Energy to develop the Piltun-Astokhskoye oil field and the Lunskoye gas field in the northeastern shelf of the Sakhalin Island. In June 1994, Sakhalin Energy and the government of the Russian Federation,

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pean Commission External Relations, Brussels, October 2007, available at: <http://ec.europa.eu/external_relations/russia/docs/russia_brochure07_en.pdf>, at p. 13.

82. See Perovic and Orttung, *supra* n. 81, p. 118, fn. 4 citing the official Russian Energy Strategy for 2020, approved as decree no. 1234-r by the Russian federal government on 28 August 2003, available at: <www.minprom.gov.ru/docs/strateg/1/>.

83. Information obtained from the 'Pacific Environment' NGO website, available at: <www.pacificenvironment.org/article.php?id=2875>.

along with the Sakhalin Oblast administration, signed the PSA for the Sakhalin II project. This PSA is the governing TIA for this project. According to Dean and Barry, the Sakhalin projects were the first in Russia to employ PSAs.[84] Indeed, the Sakhalin II project was the first PSA to go into operation in Russia. Phase I of the Sakhalin II project was launched in 1996 and consisted of an offshore oil platform that began production in 1999. In 2003, the much larger Phase 2 of the Sakhalin II project was launched, involving another offshore oil and associated gas platform, a further gas platform, offshore and onshore pipelines, an onshore processing facility, a LNG facility and an oil export terminal. Phase 2 of this project therefore aimed to both expand oil production and add gas production from offshore Sakhalin deposits, but concerns were once again expressed about the risks of this phase of the project, *inter alia*, to the western North Pacific gray whale. A report assessing these risks was produced by an Independent Scientific Review Panel (ISRP) convened by the World Conservation Union (IUCN) at the request of Sakhalin Energy. The ISRP eventually evolved into the WGWAP. The Panel was asked to evaluate the science around the conservation of the western gray whale and related biodiversity. However, it was not asked to develop prescriptive recommendations, but rather to provide evidence-based analysis and conclusions about the relevant issues. Nevertheless, both the ISRP and now the WGWAP have been compelled to include several criticisms on the Sakhalin II project impacts on the western gray whales within their reports.[85] This has led to continuing civil society criticism that the Sakhalin II project still violates Russian law in several instances, for example, in respect of pipeline construction standards; and also that the project continues to represent a serious threat to the environment, including rare and endangered species such as the western gray whale, as well as to the fisheries resources of Sakhalin and Hokkaido.

Throughout the life of the Sakhalin II project, Sakhalin Energy has sought both public financial backing of taxpayer-supported banks like the US Export-Import Bank and EBRD, and project finance from private banks like Credit Suisse First Boston to expand this project, but environmental violations forced the western public IFIs to deny funding for the massive project. In 2001, the then shareholders of Sakhalin Energy – Shell (55 per cent), Mitsui (25 per cent) and Mitsubishi (20 per cent) – asked the EBRD to partially finance Sakhalin II. Much collaborative work was undertaken with Sakhalin Energy to ensure the project could meet the expectations – especially environmental standards – of EBRD financing, but the Bank had not taken any decision on whether to make the investment when Gazprom took over the majority shareholding within the consortium of companies that own Sakhalin Energy. The EBRD initially declared that the project met sufficient requirements for the Bank to seek the views of the public and con-

84. Dean and Barry, *supra* n. 77, p. 215. The Sakhalin I project involving Exxon-Mobil was also the subject of a PSA.

85. See, for example, *Impacts of Sakhalin II Phase 2 on Western North Pacific Gray Whales and Related Biodiversity*, Report of Independent Scientific Review Panel, December 2004, available at: <http://cmsdata.iucn.org/downloads/isrp_report_with_covers_high_res.pdf>.

ducted an intensive consultation process in Russia, Japan and London. Pending the decision on whether to finance, the EBRD had continued to monitor construction and encouraged the adoption of long-term safeguards, especially related to environmental and social aspects of the project. The EBRD saw its potential role in the Sakhalin II project as a financial partner to encourage the highest standards of environmental protection in the design and construction phases of the project, which includes offshore drilling and underwater pipelines to Sakhalin Island. Through its engagement in the development of the project, the EBRD had helped to introduce commitments to the consultation, transparency and treatment of indigenous people. The EBRD had worked with Sakhalin Energy on many enhancements during the construction phase: Sakhalin Energy rerouted pipelines to accommodate the rare western gray whale that feeds in the region; a panel of recognized whale experts was established to monitor and advise on operations; significant improvements were introduced to the strategy for on-land pipeline construction, especially the environmentally sensitive crossings of some 1000 rivers; and Sakhalin Energy adopted a standard-setting plan for treatment of indigenous peoples as well as transparency and consultation. However, chronic violations of public and private bank environmental policies contributed to the eventual withdrawal of the EBRD from its consideration to finance the project. In August 2007, after Gazprom joined the consortium, the EBRD announced that it 'will not resume negotiations on financing the Sakhalin II project'.[86]

This also led Sakhalin Energy to abandon its attempt to receive other public financing from the US Export-Import Bank and UK Export Credit Guarantee Department. Alone among the many potential public IFIs, only the Japan Bank for International Cooperation (JBIC) – the Japan government's official export credit agency, has so far decided to fund the Sakhalin II project. The initial Sakhalin II Phase 1 financing agreement was signed in 1998 between JBIC (then the Export-Import Bank of Japan) and four other private finance lending institutions, namely, the Bank of Tokyo-Mitsubishi UFJ (Japan), Mizuho Corporate Bank Ltd. (Japan), Sumitomo Mitsui Bank Corp (Japan), and BNP Paribas (France). The Sakhalin II project thus became the first to secure a project finance loan in the oil and gas industry in the Russian Federation. According to the Sakhalin Energy's 2008 Annual Report, the JBIC's involvement and support for this project over the years has encouraged Sakhalin Energy to set world-class standards for social and environmental performance and transparency in both the construction and production phases of the project.[87] However, the negative response to these project finance arrangements can be gauged from the statements of environmental NGOs and other civil society interest groups against the decision of the JBIC and four private banks to provide approximately US$5.3 billion dollars in financing for the problematic Sakhalin II project. According to these

86. Information accessed from the 'Sakhalin Environment Watch' NGO website at: <www.sakhalin.environment.ru/en/>.

87. Sakhalin Energy, 2008 Annual Report, available at: <www.sakhalinenergy.com/en/documents/Sakhalin_Energy_2008_Engl_New.pdf>.

groups, the JBIC have violated their own environmental policies and standards by agreeing to finance the Sakhalin II project.[88] These concerns had previously been expressed in a formal letter by these civil society interest organizations to the JBIC when this Japanese public IFI was actively considering its decision to finance the Sakhalin II project, which stated that their intervention was, *inter alia*, based on documentation demonstrating that the principal design of the project and its primary technical decisions did not comply with JBIC Guidelines for Confirmation of Environmental and Social Considerations (JBIC Environmental Guidelines). Specifically, JBIC Guidelines which required the project to comply with the environmental laws and standards of the (Russian) host national and local governments were not being followed and the company continued to violate Russian environmental legislation and requirements. Moreover, Sakhalin Energy's failure to release its oil spill response plan is arguably a direct violation of Russian citizens' legal and constitutional rights to environmental information,[89] as well as international rights and norms guaranteeing peoples' rights to access to information. Most importantly, according to an open letter to the JBIC published by a consortium of NGOs, Sakhalin Energy's failures to properly design and construct a project that meets international social and environmental standards greatly increases the likelihood of major accidents in the future that could lead to significant pollution of both Sakhalin and Japan's shorelines and fisheries resources.[90] Nevertheless, in 2008, the JBIC, three private Japanese banks and three European private banks provided a further estimated US$5 billion in financing for Phase 2 of the Sakhalin II project.[91]

The Sakhalin II project is therefore yet another clear indication of the distance that remains to be travelled before effective (Russian) domestic implementation of environmental principles and standards can be achieved. In 2002, it was noted that, '[A]fter the collapse of the USSR, many democratic principles were adopted in the Newly Independent States (NIS), including access to information and public participation in environmental and natural resource usage decision-making. … Unfortunately, little has been done to transform legal provisions into

88. See, for example, remarks attributed to Naomi Kanzaki, Development Finance and Environment Program Director, Friends of the Earth, Japan, available at: <www.foejapan.org/>.

89. Art. 42 of the 1993 Constitution of the Russian Federation asserts a right, *inter alia*, to a favourable environment and reliable information as to its state. However, Espinosa has cautioned against the likelihood of these rights being realized under existing environmental laws regulating the Russian offshore oil and gas industry, see D.K. Espinosa, 'Comment: Environmental Regulation of Russia's Offshore Oil & Gas Industry and its Implications for the International Petroleum Market, 6 *Pacific Rim Law & Policy Journal* (1997) pp. 647-681 at p. 666.

90. Letter from 14 Environmental and Social Interest NGOs to Koji Tanami, Governor, Japan Bank for International Cooperation, re: 'Review of Environmental and Social Standards of Sakhalin-2 and NGO Concerns about Project Financing', 11 October 2007, available at: <www.foejapan.org/>.

91. Information available at: <http://pacificenvironment.org/article.php?id=2875>.

actual practice.'[92] Several years on from that comment, the Russian environmental situation remains parlous today. The Russian Federation, in whose territorial jurisdiction the Sakhalin II project resides, has promulgated several pieces of legislation on environmental protection, such as the 1991 Law on Environmental Protection. Even if it is assumed that this general environmental legislation purports to implement at least some of the applicable international environmental principles described above, it is the specific implementation of these principles and the equally well-accepted international industry standards that are in question here. In this regard, the 1996 Russian Law on Production-Sharing Agreements is also highly relevant, providing environmental obligations for petroleum investors by requiring certain issues to be addressed within every PSA. However, Espinosa is critical of these provisions and further implementing regulations made under the auspices of the PSA law, describing them as vague and therefore providing investors with no guidance as to their responsibilities and potential liability, nor specific standards by which to measure compliance.[93] Moreover, concerns have been expressed that '[T]hese ambiguities leave much room for arbitrary decisions by low-paid bureaucrats.'[94] These concerns may be pertinent to the following discussion of the implications of Russian state actions on the basis of environmental violations by Sakhalin Energy in the present project.

The Sakhalin II project was accused of inflicting large-scale damage on Sakhalin's ecosystem, including illegal deforestation, the dumping of toxic waste, and soil erosion. These environmental violations led to major Russian government actions in 2006 to require Sakhalin Energy to improve its behaviour and, ultimately, to a change in the majority shareholder of the project. At around this time, both the Eastern Siberia and the (Russian) Far East regions became higher priority regions for Gazprom in its long-term strategy perspective for the future development of Russian energy supplies to its booming East Asian neighbour economies, notably, China, Japan and Korea. This increasing Gazprom interest coincided with the rising concerns of the Russian natural resources/environmental ministry/agency, Rosprirodnadzor,[95] over the environmental impacts of the Sakhalin Island-based projects.

The company came under the scrutiny of federal authorities in September 2006 when Rosprirodnadzor conducted an investigation, and it concluded that the operating company was in breach of environmental laws, and revoked Sakhalin Energy's environmental licence for the Sakhalin II project. Rosprirodnadzor followed up this action with a suspension of its water permits.[96] Analysts

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92. S. Kravchenko, 'New Laws on Public Participation in the Newly Independent States', in Zillman, et al., eds., *supra* n. 68, pp. 467-503 at p. 467.

93. Espinosa, *supra* n. 89, p. 673.

94. Ibid., p. 679.

95. The (unofficially translated) full title of this Russian government agency is the Federal Service for the Supervision of Natural Resource Use.

96. T.F. Krysiek, 'Agreements From Another Era: Production Sharing Agreements in Putin's Russia, 2000-2007', Oxford Institute for Energy Studies, Working Paper No. 34, November 2007,

however linked the probe with Shell's decision to double the project costs to US$22 billion, thereby putting off the date on which the Russian government will receive its share of the profits. This is due to the unusually generous PSA terms for the recovery of Shell's project development costs (which include a 17.5 per cent real rate of return on its investment) in cost oil, before having to provide the Russian (state) with its share of profit oil production.[97] Following on from the inquiry of the Russian Federal Service for the Oversight of Natural Resources into alleged violations in implementing the Shell-led Sakhalin II project, Russia's natural resources minister, Yury Trutnev, held that they were punishable under at least five statutes of Russia's Criminal Code, and also accused regional regulators of failing to perform their oversight duties properly to ensure compliance with environmental legislation. The Sakhalin II project operator, Sakhalin Energy, admitted damaging the ecosystem of the eponymous island. Following a meeting with Trutnev, the Sakhalin Energy CEO, Ian Craig, announced that they had agreed to draw up a joint plan of action to rectify the environmental damage inflicted by the project. Craig also expressed Sakhalin Energy's willingness to compensate for the damage, although he expressed doubt that the Ministry's preliminary estimates, putting it at 10 billion rubles (US$371.33 million), were accurate.[98] On the other hand, the environmental and social conditions associated with the Sakhalin II project have apparently neither improved nor come into compliance with Russian law, and both the Russian federal and provincial (Sakhalin) government agencies are reportedly continuing with their inspections.

Following the 2006 audits by Rosprirodnadzor which identified a number of environmental problems, Sakhalin Energy compiled an environmental AP in 2007. The environmental AP has a special focus on river crossings, erosion control and land reinstatement. However, as noted above, the PSA allowed Shell to recoup all its expenses before sharing any of its profits with the Russian state, and was therefore hugely unpopular with the Russian government. Moreover, as the *Economist* news magazine notes, these PSA-type TIAs were also 'designed to insulate big investors from legal and taxation changes, but are now seen [by Russian officials] as anachronistic relics of a humiliating era'.[99] Looking back, analysts have described the privatization of Russia's oil sector during the 1990s as an effort to emulate the US petroleum development policy, where private companies run the industry within a contractual, rather than regulatory legal regime, as Daintith has noted above. While the prevailing European trend during this

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available at: <www.oxfordenergy.org/pdfs/WPM34.pdf>, at pp. 20-21.

97. I. Rutledge, *The Sakhalin II PSA – A Production 'Non-Sharing' Agreement: Analysis of Revenue Distribution*, Sheffield Energy & Resources Information Services (SERIS) Report, November 2004, p. 17, available at: <www.seris.co.uk/>.

98. 'Minister Orders Report on Sakhalin II Eco-damage, Operator Admits Guilt', 25 October 2006, on Rianovosti, Russian news website, available at: <http://en.rian.ru/russia/20061025/55127992.html>.

99. See 'Russian Energy: Hardball: Would the Kremlin Really Renege on Russia's Biggest Foreign Investments?', *The Economist* (UK), 16 September 2006, p. 86.

period was also one of privatization of state-owned or state-controlled oil companies, this was not the case for most petroleum producing countries and it is the latter trend towards increasing control over oil and gas suppliers by nationally owned or controlled oil companies (NOCs) that has prevailed to the extent that these NOCs now control approximately 80 per cent of global oil and gas reserves.[100]

Under Putin's presidency, the Russian federal administration slowly turned away from the *laissez-faire* approach of the Yeltsin era and instead embarked on a policy of reasserting the state's role within the economic control and regulation of the Russian oil and gas industry, especially for political and strategic purposes. Thus, during Putin's second presidential term (2004-2008) the Kremlin exercised its extensive powers to rectify what were considered to be the 'mistakes' of the privatization period in the 1990s, by re-establishing state control over the larger 'strategic' oil and gas fields. Putin himself called the present Sakhalin II PSA a 'colonial agreement', which did not serve Russia's national interests.[101] Dixon, for example, has examined the impact of this new interventionist approach with regard to previously privately-owned Russian oil companies such as Yukos and TNK-BP.[102] The latter (TNK-BP) consortium is particularly apt for the present case study on Sakhalin II, as it also involves the participation of a major Western oil company, namely, British Petroleum (BP). Indeed, a recent report that Rosprirodnadzor was recommending the withdrawal of the TNK-BP licence to develop the Kovykta gas condensate field fuelled speculation that similar tactics were being adopted in this case as with the Sakhalin II project.[103] On the other hand, as Tompson cautions in his analysis,

> 'It would be a mistake to see this expansion of the state as proceeding according to some well defined plan – different groups appear to be pursuing different agendas, often in rivalry with one another. However, the process is neither random nor chaotic: there is clearly a coherent *approach* towards resource sectors, which merit special consideration, and the general context is favourable towards state expansion in general. The once bankrupt Russian state now has both the cash and the coercive capacity to acquire what it wants, and private owners are unpopular and widely regarded by the public as illegitimate, which makes them particularly vulnerable to official pressure. Moreover, the authorities in Russia, anxious to pursue ambitious development goals very rapidly, appear increasingly impatient of indirect methods of economic governance, such as regulation, and wary of the uncertainties involved in reliance on market-based solutions. For politicians in a hurry, direct intervention offers a degree of (apparent) control and certainty about outcomes that reliance on

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100. Perovic and Orttung, *supra* n. 81, p. 123, fn. 14.

101. Ibid., p. 123 citing an interview with President Putin in *The Times* (UK), 4 June 2007, available at: <www.timesonline.co.uk/>.

102. S. Dixon, *Organisational Transformation in the Russian Oil Industry* (Cheltenham, Edward Elgar 2008) p. 82 (epilogue to Yukos case study) and p. 209 (postscript).

103. See C. Belton, 'Threat to TNK-BP Gas Licence', *Financial Times* (UK), 18 February 2010, p. 17.

> markets cannot. All this, then, makes for an environment in which a number of state actors have the means, the motive and the opportunity to extend the state's control over important industrial and financial assets [emphasis in the original].'[104]

It is also significant to note that this new interventionist approach has been taken despite the fact that the privatization of the Russian petroleum industry had increased output by the end of the 1990s. Whereas, according to Perovic and Orttung, the growing presence of both the Russian federal government and Russian state-owned or controlled companies within the industry of late is actually resulting in a reduction of oil and gas output.[105] The Kremlin was able to utilize a number of tools to achieve its goals in this respect, including its 'tight control over the regulatory environment, the taxation regime, transportation monopolies (through state-owned pipeline company – Transneft) as well as licenses and the operating environment'.[106] On the other hand, increasing Russian state intervention on the ownership and regulatory fronts has perhaps predictably had a detrimental effect on foreign investment within the petroleum sector, especially in the remote regions such as eastern Siberia and Sakhalin Island. While Russia's key state-owned and controlled companies have gained control over many private projects and companies, they urgently need access to private capital and sophisticated technology in the hands of the oil MNC/TNCs to fully realize the oil and gas potential of these remote areas. At the same time, these MNC/TNCs are increasingly reluctant to invest in risky and expensive projects without the required tax incentives and contractual protection for their investment.[107]

Within this context, it should perhaps come as no surprise to find that the Russian Federation's proposed solution to the continuing environmental concerns in the Sakhalin II project was to pressure Shell into giving up its majority share in the project to the Russian majority state-owned Gazprom company. This implicit nationalization policy in favour of Gazprom is officially denied by the Russian government.[108] However, this move is in line with the Russian Federation's evolving state policy on the gas infrastructure development in Russia's (Far) East region, as stipulated in the Development Program for the Integrated Gas Production, Transportation and Supply System with due regard to possible exports to China and Asia-Pacific markets approved by the government of the

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104. W. Tompson, 'Back to the Future? Thoughts on the Political Economy of Expanding State Ownership in Russia', in P. Vahtra and K. Liuhto, eds., *Changes in Economic Power and Strategic Government Policies in Russia* (London, Routledge 2007), available at: <http://eprints.bbk.ac.uk/509/>, at p. 4.

105. Perovic and Orttung, *supra* n. 81, p. 123.

106. Ibid., p. 124.

107. Ibid., p. 125.

108. Oleg Mitvol, the Deputy Head of Rosprirodnadzor, has rejected claims that the Kremlin used the alleged environmental violations to pressurize the Sakhalin consortium partner companies to accept Gazprom participation in the project. See T. Parfitt and T. Macalister, 'Russia Denies Ulterior Motives over Sakhalin', *The Guardian* (UK), 27 September 2006, p. 25.

Russian Federation on 15 June 2007.[109] Gazprom was then appointed a coordinator of the Program's execution. The Program defines the priority order of the regional gas reserves development aimed at achieving the settled goals. Industrial gas production in Eastern Siberia and the (Russian) Far East was to begin with the fields that had already been prepared for utilization on the Sakhalin Shelf (Sakhalin I and Sakhalin II projects). These Russian government and Gazprom moves to increase the Russian state-owned company's involvement were initially resisted by Shell. However, the pressure on Shell increased with the delays (and eventual refusal) by the EBRD to approve financing support for the Shell-led consortium's investment in the project, which was at least in part due to the alleged environmental violations being investigated by Rosprirodnadzor. This setback in relation to the public financing support aspect of the project resulted in negotiations between the Shell-led consortium and Gazprom. In earlier negotiations over this issue, Gazprom would have received a 25 per cent stake in Sakhalin in exchange for giving Shell a 50 per cent hold on Zapolyarnoye, a smaller field in western Siberia. However, these negotiations came to a quick end when Shell more than doubled Sakhalin's estimated costs from US$10 billion to US$22 billion, and Gazprom withdrew its offer. Finally, after months of further negotiations, the original consortium of (private) shareholders, namely Shell and its partners, agreed to dilute their shares by half and sold a majority share of this project to the Russian state-controlled company, Gazprom. OAO Gazprom, Royal Dutch Shell plc, Mitsui & Co., Ltd. and Mitsubishi Corporation then signed a Protocol on 21 December 2006 allowing Gazprom to join the consortium owning Sakhalin Energy as the main shareholder. Under the terms of the Protocol, Gazprom acquired a 50 per cent stake plus one share in Sakhalin Energy for a total cash purchase price of US$7.45 billion.[110] With Gazprom gaining control of Sakhalin, the upside for Shell may be not only a proportionate payment of this cash price but also a stake in the Zapolyarnoye field, although this is unconfirmed.

In April 2007, the shareholders of Sakhalin Energy, including Gazprom, signed the PSA that was previously applicable between the original consortium and the Russian state. As from 18 April 2007, Sakhalin Energy is still the operator of the Sakhalin II project and consists of the following shareholder companies, with their percentage of shareholdings as follows: OAO Gazprom, 50 per cent, plus one share; Shell Sakhalin Holdings B.V., parent company Royal Dutch Shell plc, the Netherlands, 27.5 per cent minus one share; Mitsui Sakhalin Holdings B.V., parent company Mitsui and Co. Ltd., Japan, 12.5 per cent; Diamond Gas Sakhalin B.V., parent company Mitsubishi Corporation, Japan, 10 per cent.[111]

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109. By Order No. 340 of the (Russian) Ministry of Industry and Energy as of 3 September 2007.

110. Information accessible from the Sakhalin Energy website at: <www.sakhalinenergy.com/en/media.asp?p=media_page&itmID=198>.

111. Information accessible from the Gazprom website at: <www.gazprom.com/production/projects/deposits/sakhalin2/>.

Although the Russian state-owned Gazprom is now the majority stakeholder in this project, Shell continues to be the main operator and all the high-ranking positions in the SEIC consortium are still held by Shell personnel. Thus, the Russian government's threats against the project due to alleged environmental violations have at least indirectly resulted in Shell reducing its investment stake in this project. The effect of this change in shareholders within the consortium owning Sakhalin Energy has worried wider stakeholder groups and interests, with the suspicion that the Russian (federal) environmental agency, Rosprirodnadzor's crackdown on Sakhalin Energy's ecological abuses may end now that Gazprom has taken control of this project. Oleg Mitvol, the deputy head of the agency, claims there will no be favourites when it comes to environmental violations.[112] That remains to be seen, although it was recently reported that in early August 2009 the (local) Sakhalin Rosprirodnadzor had inspected the Sakhalin II project pipeline and identified a number of violations, resulting in an injunction requiring Sakhalin Energy to address these violations, which had still not been resolved by the time of the next public environmental inspections, two months later.[113] Neither did Shell threaten to invoke the stabilization clause under Section 24 of the 1994 PSA with Russia for the Sakhalin II project. Suspicion that Shell had been either warned or bought off this possible course of action, or both, is heightened by the news that Shell is being retained by Sakhalin Energy as the actual operator of Phase 2 of the Sakhalin II project, albeit on a service contract basis.

Along with the shareholding restructuring process within Sakhalin Energy, new project finance-based arrangements were also put into place. In Tokyo, on 16 June 2008, Sakhalin Energy, the JBIC and an international consortium of commercial banks signed a US$5.3 billion agreement to finance Phase 2 of the Sakhalin II project. As noted above, project financing is frequently used in the world's oil and gas industry for the development of major infrastructure assets. Repayment of the debt comes from the cash flow generated by the financed asset. By signing this financing agreement, Sakhalin Energy set a new record for Russia in terms of the amount raised and established new benchmarks for future Russian and international oil and gas developments. Japan's leading financial institution, JBIC, gave strong support to Sakhalin Energy, providing US$3.7 billion. The consortium of commercial banks contributed an additional US$1.6 billion. Previously, Sakhalin Energy had funded the cash needs for Phase 2 of the project from shareholder financing and oil revenues. The project finance loan will be used primarily to replace shareholder finance for the Phase 2 final construction stage and start-up costs, on a 45:55 debt to equity ratio, that is to say, project finance

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112. See 'Shell and Partners Cede Control of Sakhalin II to Gazprom', Bank Information Center, 12 December 2006, available at: <www.bicusa.org/en/Article.3046.aspx>.

113. See 'Sakhalin-II Has Pumped Oil and Gas for a Year without Proper Approval for the Main Pipelines', Sakhalin Environment Watch, Press Release, 20 October 2009, available at Friends of the Earth (Japan) NGO website: <www.foejapan.org/en/aid/jbic02/sakhalin/091020.html>.

will be relied upon to fund 45 per cent of the overall Sakhalin II project initiation costs. Direct lenders to Phase 2 of the Sakhalin II project include the JBIC, Bank of Tokyo-Mitsubishi, Mizuho Corporate Bank, Sumitomo Mitsui Banking Corp, Credit Suisse, BNP Paribas and Standard Chartered – together providing US$5.3 billion in project finance.[114] According to Reuters, ABN-AMRO, Morgan Stanley and Societe Generale provided an additional US$4.5 billion for Gazprom's 2007-2008 majority shareholding acquisition of the Sakhalin II project.

On 11 June 2008, seventeen civil society groups sent the banks involved a further fourteen-page letter citing a litany of these examples of violations and stressing that financing by JBIC and other banks for Sakhalin II conflicts with decisions against financing by the broader international banking community, as follows: 'Sakhalin II never achieved environmental clearances from the European Bank for Reconstruction and Development, UK Export Credit Guarantee Department and the US Export-Import Bank. The project's fundamental environmental and social shortcomings contributed to the ultimate unwillingness of these public banks to finance the project.'[115] The NGOs' letter further noted:

> '… [W]e have informed JBIC on many occasions that Sakhalin II has committed fundamental and irreversible violations of "JBIC Guidelines for Confirmation of Environmental and Social Considerations," international commitments, as well as Russian law. Given the project's many irreparable policy breaches and Sakhalin Energy's chronic unwillingness to correct repairable damage, financing by JBIC will eviscerate your Bank's environmental and social credibility, increase risks to the Japanese government, and damage the larger international effort to maintain ecological safeguards through the OECD Common Approaches[116] and the Equator Principles.'[117]

Apart from the furore raised by international and local civil society groups surrounding the provision of funding from a public IFI in the form of the JBIC, it should be noted that a number of private IFIs have also provided project finance for the Sakhalin II project, in the amounts as follows:

1) Bank of Tokyo-Mitsubishi UFJ, corporate loan: US$358 million, as well as participation in a loan of US$1.6 billion provided by a consortium of private IFIs, namely, Bank of Tokyo-Mitsubishi UFJ, Mizuho Corporate Bank, Sumitomo Mitsui Banking Corp, and BNP Paribas, in addition to a US$3.7 billion loan provided by JBIC;
2) BNP Paribas, corporate loan: US$125 million, as well as participation in the US$1.6 billion provided by the private IFI consortium;

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114. 'Sakhalin II: Whale Wars, Project Finance', posted: 29 July 2008, accessible from Pacific Environment website, at: <http://pacificenvironment.org/article.php?id=2877>.

115. Text of letter accessible from Friends of the Earth (FoE), Japan website at: <www.foejapan.org/aid/jbic02/sakhalin/pdf/20080611JBIC%20letter.pdf>.

116. OECD Recommendation on Common Approaches on the Environment and Officially Supported Export Credits, accessible from the OECD website at: <www.oecd.org/>.

117. NGOs' letter, *supra* n. 115.

3) Credit Suisse, corporate loan: US$100 million, as well as participation in the US$1.6 billion loan; Mizuho, corporate loan: US$358 million, as well as participation in the private IFI consortium loan;
4) Royal Bank of Scotland and 5) Société Générale, joint corporate loan: US$2 billion to finance Gazprom from an international banking syndicate, of which ABN-Amro Bank (the Netherlands) was the lead arranger. This part of ABN-Amro is now part of Royal Bank of Scotland and Société Générale;
6) Standard Chartered, corporate loan: US$300 million, as well as participation in the private IFI consortium loan of US$1.6 billion;
7) Sumitomo Mitsui Banking Corporation, corporate loan: US$358 million, as well as participation in the private IFI consortium loan.

All of these private IFIs have accepted the Equator Principles in the following order: RBS (4 June 2003), Credit Suisse (4 June 2003), Standard Chartered (8 October 2003), Mizuho (27 October 2003), Bank of Tokyo-Mitsubishi UFJ (22 December 2005), Sumitomo Mitsui Banking Corporation (27 December 2005) and Société Générale (3 September 2007). Finally, BNP Paribas adopted the Equator Principles on 24 October 2008 and is currently not yet obliged to meet the reporting standards required of EPFIs.[118] The individual decisions in favour of the project finance provision for the Sakhalin II project made by these private IFIs, all of which are also EPFIs, do not appear to have paid sufficient heed to the environmental and social concerns raised by the increasingly large group of international and local (Russian and Sakhalin) civil society interest organizations working on Sakhalin issues. NGO concerns have focused on the apparent lack of application of the Equator Principles by these private IFIs that had previously agreed to adopt them in their project finance lending decisions. Indeed, in anticipation of the Sakhalin II project consortium efforts to obtain project financing, this civil society group organized themselves as a single body called 'PLATFORM' to collaborate on this issue. The conclusion of their jointly-drafted report is that Sakhalin Energy had failed to fulfil the required criteria for compliance with the Equator Principles to allow the EPFIs to provide project finance for Phase 2 of the project.[119]

Specifically, the following deficiencies in relation to the Equator Principles were highlighted: First, the environmental aspect of the environmental, social, and health impact statement required by Equator Principles 2 and 3 is not adequately addressed. For example, major elements of the biological diversity baseline facts (such as information about endangered species) and the geophysical baseline (such as seismic behaviour at pipeline crossings) are not assessed in the required EIA statement. Second, mitigation measures related to assessed biodiversity impacts, such as those affecting the western gray whale migration,

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118. Information accessed from the Bank Information Centre website, at: <www.bic.org/>.

119. PLATFORM, *Principal Objections: Analysis of the Sakhalin II Oil and Gas Project's Compliance with the Equator Principles on Responsible Lending*, May 2004, available at: <www.platformlondon.org/carbonweb/documents/Sakh-EP-analysis.pdf>.

feeding and breeding habits, had not been implemented. Third, despite reports of environmental action plans being implemented (see above), no environmental management plan has been published *prior to* project finance consideration as required by Equator Principle 4. Fourth, in relation to Equator Principle 5 on consultation with project-affected groups, the criticism is that the consultation mechanism was inadequate and not subject to an independent expert review, as required for category A projects, such as Sakhalin II. As noted above, in February 2009, the first Russian LNG plant was launched on Sakhalin Island under Phase 2 of the Sakhalin II project. However, this was followed by a critical report by the WGWAP. The 5th WGWAP Report suggested that the unexpectedly low numbers of already endangered species of western (North Pacific) gray whales observed offshore Sakhalin in the summer of 2008 could have been related to the significant oil industry activity being undertaken in the vicinity of the known habitat of these whales. A further example of the continuing environmental sensitivities associated with the Sakhalin II project may be discerned from Sakhalin Energy's decision to postpone a 4D (four-dimensional) seismic survey at the 6th meeting of the WGWAP on 24 April 2009.[120]

Throughout this controversy, it is notable that none of the stakeholders involved, whether the primary parties to the contractual arrangements and the legal framework regulating this relationship, or the secondary parties involved, including the public and private IFIs funding this venture, as well as the social and environmental NGO interest groups concerned, have alluded to the central legal document governing the Sakhalin II project, namely, the 1994 PSA. Prior to undertaking an assessment of the applicable TIA, the dual British-Dutch nationality base of the principal oil MNC/TNC involved in this project, namely, Shell, should also be examined in terms of the provisions for investment protection within the applicable BITs between these two countries and the host state, namely, the Russian Federation. The relevant provisions are, respectively, Articles 2 and 5 of the 1989 UK-USSR Agreement for the Promotion and Reciprocal Protection of Investments, and Article 6 of the Netherlands-USSR Agreement on Encouragement and Reciprocal Protection of Investments.[121] They include, *inter alia*, investor protection from unreasonable, discriminatory measures that may impair the management, maintenance, use, enjoyment or disposal of investments;[122] or measures having effect equivalent to nationalization,[123] or measures having similar effects.[124] These potentially far-reaching BITs provisions for the protection of foreign investments are facilitated by a provision under Article 8(1) of the UK-USSR Agreement allowing either party to an investor-state dispute to refer it to international arbitration, whereas the Netherlands-USSR Agreement only

120. In accordance with Recommendation WGWAP-6/02, accessible from IUCN website at: <http://cmsdata.iucn.org/downloads/wgwap_6_recommendations_and_responses.pdf>.

121. Both texts available at the UNCTAD website: <www.unctad.org/>.

122. Art. 2(2) of the UK-USSR Agreement.

123. Art. 5 of the UK-USSR Agreement.

124. Art. 6 of the Netherlands-USSR Agreement.

allows an investor-state dispute to be referred to international arbitration by the investor under Article 9(2), without having to secure the consent of the host state.

However, as mentioned above, the PSA between the Russian Federation and Sakhalin Energy is still the Transitional Investment Agreement (TIA) which applies to the project, albeit with the addition of the new majority corporate shareholder in the form of Gazprom. A short analysis of the relevant agreement follows, paying particular attention to the balance within the legal relationship established between investor protection and host (Russian) state regulatory autonomy on environmental issues. To begin with, Section 24(a) of this 1994 PSA provides that the Sakhalin project shall be carried out 'in accordance with' the laws, by-laws, and other acts of (Russian federal and Sakhalin Oblast provincial) government bodies 'that have been officially brought into effect' on Russian territory and are publicly available. However, Section 24(b) then commits all the Russian (federal and provincial) government bodies involved to ensure that the necessary decisions for the implementation of the PSA are approved and that their (Russian government) obligations under this agreement will be met, including the rights and exemptions (for Sakhalin Energy) specified in Appendix E. This last clause is significant from an environmental protection perspective, as within Supplement 7 of Appendix E of the PSA, entitled 'General Issues', paragraph 4 provides that 'After proper treatment and processing, drilling agents, cuttings, and liquid produced in the wells may be dumped into water from the offshore platforms and shall not be considered as waste or sewage prohibited for dumping into sea.'

This clear exemption from the otherwise applicable definition of waste or sewage to be prohibited from dumping into the sea under Russian laws is especially pertinent when we consider that Section 25 of the PSA then provides that the 'Company' (SEIC or Sakhalin Energy) is regulated by Russian Federation and Sakhalin Oblast legislation, *inter alia*, on environmental protection and shall take measures in accordance with the PSA and 'Standards Generally Accepted in the International Oil and Gas Industry'. On the face of it, this commitment on the part of Sakhalin Energy to both the host country's environmental legislation as well as international petroleum industry standards appears to be insufficient to ensure adequate environmental protection when such clear exemptions are written into the PSA. Neither does the undertaking by Sakhalin Energy in Section 24(e) of the PSA to 'take every reasonable measures to restrict pollution and prevent damage', *inter alia*, to air, water, flora and fauna, overcome the specific exemptions located elsewhere in this legal document. Moreover, within the Section 30(a) provision of the PSA on the 'Applicable Law and Regulators', the so-called 'Operations' of the Sakhalin project, defined generally under Section 1 (Definitions; Interpretation) as including all operations and activities stipulated by the agreement, are reiterated as being subject to Russian (federal and provincial) laws and government acts, including any exemptions mentioned therein. Although this is stated to be 'without limitations' to the actual 'Applicable Law' of the agreement, namely the State of New York (USA) legislation, it would be difficult in the extreme to envisage how the New York State laws and standards

on, *inter alia*, environmental protection, could be held to apply to the Sakhalin II project, pre-empting the applicable Russian laws and standards on this issue.

These general commitments by Sakhalin Energy to observe the applicable Russian and local environmental rules, as well as international petroleum industry standards, are also undermined by their static nature. Under Section 24(d), the Russian 'Party' undertakes to 'work diligently' to keep the Sakhalin project exempt from any amending Russian federal or provincial legislation and official government acts, including any changes in their interpretation and application procedure, after 31 December 1993. Additionally, under Section 24(f) of the PSA, the Russian Party undertakes to compensate the Company for *any* damage sustained due to 'unfavourable' changes to the Russian Federation and other laws applicable to the project's activities. This includes changes in the interpretation or application procedure by Russian federal and provincial government bodies, as well as Russian 'judicial authorities', thereby significantly expanding the potential scope for compensation claims beyond the initial exemption from (Russian) federal and provincial legislative amendments and the interpretation and application thereof. This compensation undertaking was applicable from 31 December 1993, that is to say, nearly six months prior to the PSA itself being adopted on 22 June 1994.

Thus, both the 'applicable domestic law' provision under Section 24(d) and the compensation provision under Section 24(f) in effect 'freeze' the legal obligations to which the Company is bound to those laws and standards applicable up to 31 December 1993. The implications of the Russian undertaking to compensate for any damage suffered by Sakhalin Energy due to 'unfavourable changes' in the applicable laws (including changes in their interpretation and application) beyond 31 December 1993, is that it arguably prevents these laws from being improved upon, if such improvement could be deemed to constitute an 'unfavourable change' causing damage to the Company. At the very least, it certainly acts as a disincentive for both the Russian Federation and the regional/local Sakhalin government/legislature from amending or introducing more progressive environmental laws based on positive developments in the evolution of international environmental principles and/or international standards for the petroleum extraction industry. For example, Sakhalin Energy could interpret the imposition of new and/or amended environmental standards applicable to its activities that are more stringent to that which obtained previously as constituting an 'unfavourable change'. This would then allow the Company to claim compensation from the Russian Federation, even if the new or amended environmental laws are designed to apply more progressive interpretations of international environmental principles and standards. It also remains to be seen whether the Company is constrained in improving its compliance in line with the progressive evolution of the applicable international standards for the industry concerned; given that any new, improved industry standards could be construed as a 'change in interpretation' of the previously applicable international standard that the Company had pledged to have regard to and therefore also entitle it to compensation under Section 24(f) of the 1994 PSA.

An opportunity to test the apparent protection of Sakhalin Energy's interests under these legal provisions arose when the Russian federal agencies began to conduct more stringent environmental investigations against Sakhalin Energy operations at around the same time as Gazprom indicated its interest in becoming involved in the Sakhalin II project. As Cameron notes, when a host state contemplates the application of new or more stringent environmental standards, it is important for the state to 'avoid any impression of arbitrariness and to provide the investor with as much certainty as possible at an early stage'.[125] Given the twin benefits accruing to Sakhalin Energy in terms of the law 'freeze' and compensation clauses dating back to 31 December 1993, it would have been possible for the company to contemplate suing the Russian government for its ostensibly pre-emptive and arguably discriminatory actions. As previously noted, discriminatory regulatory behaviour on the part of the host state, even for plausibly legitimate reasons of environmental protection, can be subject to legal claims by the private investor involved, under the terms of the TIA in question. However, despite the Russian federal government's apparent wish to engineer the Gazprom involvement within the Sakhalin II project, there was little sign that Sakhalin Energy (and its (then) main shareholder and (still) operator – Shell) was prepared to refer to these PSA clauses in its initial dispute with the Russian Federal environmental agency over alleged environmental violations. This would have entailed resorting to arbitration in Stockholm, Sweden in compliance with the UN Commission on International Trade Law (UNCITRAL) Arbitration Rules, and for which the Russian Federation has relinquished its sovereign immunity, under Section 30(c) of the PSA. Media speculation has suggested that an informal agreement was reached between the Russian authorities and Shell, whereby Sakhalin Energy declined the opportunity to rely on the dispute settlement provisions under Section 30(b) of the 1994 PSA, in return for Shell being allowed to continue as the main operator of the Sakhalin II project, and retain good working relationships in both other and future Russian oil and gas field developments. Notwithstanding the unsubstantiated claims on this issue, the lack of any legal challenge on the part of the operating company in this respect does at least point to the significant role of the host state (Russia) in this dispute, being able to overcome perceived contractual limitations on its actions by asserting its underlying sovereignty through its regulatory enforcement actions, ostensibly on behalf of environmental protection. However, as Perovic and Orttung have presciently observed, 'Contract sanctity is an important issue and the breaking of the Sakhalin-2 Project PSA with Shell has created uncertainty for all future investors, with no guarantee that large investments in new greenfield developments will be secure.'[126]

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125. P.D. Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford, Oxford University Press 2010) p. 384, para. 8.52.

126. Perovic and Orttung, *supra* n. 81, p. 125.

The question then arises as to whether the Russian state can afford, from a reputational, and perhaps more importantly, a financial perspective, to risk a downturn in future investment from oil MNC/TNCs in particular. Partlett offers the following views on these issues:

> 'Since the oil boom, Russia has reduced the value it places on its reputation. In fact, it has seen its position in the hydrocarbon investment game transformed. From a debtor country with a rapidly disintegrating hydrocarbon infrastructure, it has been transformed into a hydrocarbon superpower. This new position has allowed it to incur reputational costs in return for short term payoffs. Russia needs fewer reputational incentives to encourage IOC [International Oil Company] investment. First, because of Russia's large proven resource base, IOCs are willing to invest in Russia even if they regard it as risky because the potential payoffs of working in Russia are so substantial. According to the U.S. Department of Energy, Russia has the world's largest natural gas reserves and the eighth largest oil reserves. Second, Russian-owned Gazprom has emerged as a massive asset for investing and developing Russian resources; thus, the Russian state has less need for future IOC cooperation. Third, Russia no longer needs IOC support to secure international political assistance; on the contrary, Putin's rise to power coupled with soaring resource rents have allowed Russia to assert its independence on the world stage.'[127]

On the other hand, as Partlett goes on to note:

> 'Despite Russia's reduced need for IOC involvement, it still requires future IOC investment because it does not have the resources to develop its large but difficult-to-extract hydrocarbon reserves. … [R]eliance on Gazprom can only go so far: Gazprom cannot underwrite the massive future investment that Russia will need. … From a political standpoint, Russia also needs future cooperation with IOCs based in key export markets…. Thus, although the value that Russia places on its reputation has dropped since the 1990s, Russia cannot ignore its reputation.'[128]

Finally, the latest news from 30 November 2010 is that Gazprom and Shell have signed a protocol on strategic global cooperation. The Gazprom-Shell agreement establishes basic guidelines for the companies' broader collaboration. Amongst the opportunities the companies will consider are: a) further development of bilateral cooperation in exploration and production of hydrocarbons in western Siberia and the far east of Russia; b) cooperation in the downstream oil products business in Russia and Europe, as well as Gazprom participation in Shell upstream projects outside of Russia. Shell and Gazprom will set up joint working

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127. W. Partlett, 'Enforcing Oil and Gas Contracts Without Courts: Reputational Constraints on Resource Nationalism in Russia and Azerbaijan', *Demokratizatsiya: Journal of Post-Soviet Democratization* (Winter, 2010) pp. 74-93 at p. 81.

128. Ibid., pp. 81-82.

groups to further develop these opportunities.[129] News of this agreement between these two transnational actors was accompanied by statements by Alexey Miller, Chairman of the Gazprom Management Committee, confirming Gazprom's policy of pursuing mutually beneficial development through strategic partnerships with the world's largest energy companies, and Peter Voser, Chief Executive Officer of Royal Dutch Shell plc, noting that this agreement underscores the strong partnership the two companies have built in recent years, with Russia being an important area for new energy development for Shell.[130] Not insignificantly, the Sakhalin Energy press release also notes in passing that Shell and Gazprom have been partners since 2007 in the Sakhalin II project, and that Shell and Gazprom Neft are jointly developing a group of Salym oil fields in western Siberia. The adoption of this agreement will confirm the perception among many commentators of this saga that a deal was brokered during the takeover by Gazprom of Shell and other consortium partner shares in Sakhalin Energy to ensure that Shell in particular did go down the route of resorting to international arbitration for investment protection, in return for future opportunities to participate in the Russian hydrocarbon development sector.

A further recent development involving yet another 'super major' oil company, namely, the BP-Rosneft exchange of shareholdings and co-operation commitments over a number of oil and gas fields in the Russian Arctic sector announced on 14 January 2011,[131] appears to confirm this new Russian (state) approach to the ownership, as well as management and development of its vast hydrocarbon resources. Much of this is to be found in inhospitable locations within its vast hinterlands, thus presenting difficult conditions both for its extraction and transmission to where it is needed. Rosneft and BP have agreed to explore and develop three licence blocks – EPNZ 1,2,3 – on the Russian Arctic continental shelf. These licences were awarded to Rosneft in 2010 and cover approximately 125,000 square kilometres in a highly prospective area of the South Kara Sea.[132] This historic agreement also creates the first major equity-linked partnership between a national and international oil company. Following the completion of this agreement, Rosneft will hold 5 per cent of BP's ordinary voting shares in exchange for approximately 9.5 per cent of Rosneft's shares. The aggregate value of the shares in BP to be issued to Rosneft is approximately US$7.8 billion (as at the close of trading in London on 14 January 2011). The share swap component

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129. Information available at: <www.shell.com/home/content/investor/news_and_library/2010_media_releases/gazprom_shell_cooperation_30112010.html>.

130. Ibid.

131. Information available at: <www.bp.com/>.

132. Rosneft is Russia's leading oil producing company. It produces oil in all key regions of Russia, producing some 2.4 million barrels of oil equivalent (boe) per day, and has reserves of 15.146 billion boe. These reserve figures have been estimated by Rosneft on an SEC (life of field) basis. Rosneft reported (pre-tax) profits for the year end 31 December 2009 of US$8,519 million and gross assets (as at 30 September 2010) of US$87,984 million. More information is available at: <www.rosneft.com/>.

of the BP-Rosneft alliance creates strategic alignment to pursue joint projects and demonstrates mutual confidence in the growth potential of both companies.[133]

5. CONCLUSIONS: THE HOST STATE ROLE WITHIN TRANSNATIONAL PETROLEUM INVESTMENT PROJECTS – A POSITIVE OR NEGATIVE INFLUENCE FOR ENVIRONMENTAL PROTECTION?

In this concluding section, we can return to the question posed at the beginning of this article, namely, whether the continuing role of the host state within TIAs (such as the 1994 PSA governing the Sakhalin II project) in terms of the assertion of their overarching regulatory power is a positive or negative influence in ensuring environmental protection. The Sakhalin II project case study suggests that the application of environmental principles and standards within transnational investment projects is more than simply a function of their provision (or otherwise) within the contractual relationship for such projects. Clearly, when stabilization clauses and resort to international arbitration for dispute settlement between the parties are common features within TIAs, as in the present case, expectations for the progressive improvement of environmental standards by the host state should be lowered. This is because these types of provisions within a TIA arguably privilege the protection of the MNC/TNC's investment in the project, at the expense of the host state's regulatory autonomy to ensure environmental protection from the project's activities.

On the other hand, since the legal status and nature of these TIAs (especially within the petroleum industry) cannot be fully captured by resorting simply to contractual or regulatory legal discourses alone, the resulting hybrid between private (contractual) law and public (regulatory) administration within the TIA depends for its effectiveness on the relative strengths of its protagonists, namely, the host state government and the MNC/TNCs concerned. In other words, the prospects for the application of environmental law within such transnational investment projects depends on the balance in political and economic power between the host state and the oil MNC/TNCs involved in the project. In the usual situation where the oil MNC/TNC has the advantage over the developing country government that is keen on receiving foreign direct investment, then the contractual aspects of the governing TIA will act as a deterrent against improved environmental regulation by the host state. Whereas in the present Sakhalin II project, the Russian host state managed to turn the tables on the oil MNC/TNC consortium, including the so-called 'super major' Shell corporation, such that Sakhalin Energy (in which Shell had a majority shareholding) did not attempt to rely on the stabilization clause within the applicable PSA (TIA) in the face of stringent and arguably discriminatory treatment by the Russian environmental

133. Ibid.

authorities. Russia was able to take advantage of the fact that the MNC/TNCs concerned were keen to continue their involvement within the Russian petroleum industry despite the setback occasioned upon them in the Sakhalin II project. Thus, Russia was able to exercise its regulatory role within the applicable TIA, namely, the 1994 PSA, rather than be held to the contractual element of this PSA by the MNC/TNC consortium that owned Sakhalin Energy. The Russian reliance on its strong political position, ostensibly to ensure full corporate compliance with the environmental standards alluded to within the 1994 PSA is laudable but can only be vouchsafed by ensuring that the Sakhalin II project's hitherto poor environmental record is redressed. Moreover, this does not necessarily augur well for the effective application of environmental principles and standards within TIAs generally, especially when we consider that in most cases the balance of political/economic power between the TIA parties will rest with the (economic) private corporations involved, rather than with the (political) host state authorities. It is also pertinent to note that the other applicable transnational agreement in this context, namely, the Equator Principles, was allegedly set aside by the private IFIs charged with applying these Principles when they make their project finance loan decisions on the Sakhalin II project. It is therefore possible to conclude that the potential for TIAs such as the Sakhalin II PSA to ensure that relevant environmental principles and standards are applied within the projects that they regulate is highly dependent on the strength of the political position of the host state involved and this is likely to be uncertain in the face of the corresponding economic strength of the MNC/TNC parties to such TIAs.