

Out in the Cold

Royal Dutch Shell and Arctic Drilling

Introduction

The Arctic Ocean is the last frontier for international oil companies, with rapid reductions in ice cover (due to climate change from the combustion of fossil fuels) making the exploitation of newly discovered offshore resources possible, at least theoretically. Royal Dutch Shell's (Shell) proposed drilling programme in Alaska this year is seen as leading the charge into Arctic exploration by major oil companies.

As with many frontier oil projects, questions remain about the medium- and long-term economic viability of Arctic projects, which are dependent on high oil prices and fiscal subsidies. Arctic projects also present new and unique challenges for the oil industry, not least when it comes to responding to and dealing with an oil spill.

In addition to these general risks, particular Arctic-conditions projects present their own issues. Accordingly, it is necessary to analyse specific projects and specific territories to understand the precise risks of Arctic projects for a particular company.

This briefing accompanies a new report published by Platform, Greenpeace and FairPensions focused on Shell's Russian and Alaskan Arctic-conditions projects. The report: *Out in the Cold: Investor Risk in Shell's Arctic Exploration* is available at: www.fairpensions.org.uk/arcticshell

Shell's Arctic Plans

Arctic offshore exploration is a priority for Shell: its Alaskan project alone accounted for about one-seventh of Shell's total exploration spending in 2011¹ while further lease purchases were made in Greenland and Canada in 2010-11, and negotiations continued for a strategic Arctic partnership with Russian state-controlled major Gazprom. More bidding is expected soon for concessions in Arctic Norway, Greenland and the US.²

Shell plans to begin a drilling programme in the Beaufort and Chukchi seas, north of Alaska this summer. Shell is also a partner in Sakhalin-2 in Russia, Shell's headline offshore Arctic-conditions project.

Investor Risks

- Questions about the commercial viability of some proposed Arctic projects.
- Inadequate spill response plans: Shell has not yet tested the well capping system to be used in Arctic conditions and has stated to a UK parliamentary committee that it has no plans to do so.
- Lack of disclosure on the financial impact of a worst-case scenario oil spill.
- Lack of transparency in Russian operations and potential exposure to poor safety and environmental practices of partners.
- Funding challenges.

Commercial viability of the Arctic projects

High extraction costs challenge the feasibility of Arctic extraction projects in the medium-term. Furthermore, commercially recoverable reserves may not be as bountiful as the oft-quoted US Geological figures suggest. The feasibility of particular extraction projects will depend on political will and availability of tax breaks as well as the oil/gas ratio. Bernstein Research excludes any Arctic oil and gas production from its supply predictions for the next decade, noting that *'development costs will be at the high side of the industry range'* and *'development times are likely to disappoint.'*³

Inadequate spill response plans

- Shell's worst-case discharge estimate has quadrupled from 5,500 barrels a day in its 2009 Chukchi Sea oil spill response plan to 25,000 barrels a day in its 2011 plan but there has not been a corresponding increase in spill response resources.
- Shell provides no oil spill modelling for a spill at the end of the drilling season.
- Shell has admitted it has no plans to test its well containment equipment in icy conditions despite its oil spill response plan acknowledging ice may be present at the drill site.

The Deepwater Horizon disaster revealed deepwater exploration's inherently risky nature and its inadequate regulation, risk assessment and risk management. But the oil industry's push into Arctic offshore exploration with regulatory and investor community support suggests that the correct lessons have not yet been learned from the tragedy.

Arctic projects present new and unique challenges for the oil industry. The US government's Bureau of Ocean Energy Management, Regulation and Enforcement estimated a one in five chance of a major spill occurring over the lifetime of activity in just one block of leases in the Beaufort Sea.⁵ Across all Arctic waters current technology is ill equipped to deal adequately with a major spill. Limited access will mean oil companies will not have the long months that were available to those tackling the Deepwater Horizon disaster to find a solution to any major spill. The infrastructure to mount a large-scale response is not in place.

Shell is awaiting approval from the US Interior Department's approval of their oil response plan. This approval is conditional on the company's well containment plans in the event of a well blow-out. However to date the well containment equipment has not been tested leaving only two months to thoroughly test the equipment before drilling in the Arctic begins. Worryingly, Shell confirmed recently to a UK parliamentary inquiry that it has no intention of testing the capping system in icy conditions.⁶ *This is despite Shell's Chukchi oil spill response plan stating: "the range of open water is variable from year to year and ice could be present at the drill site."*⁷

No analyses have been published quantifying the specific oil spill response impediments in Shell's lease areas in the Chukchi and Beaufort seas. A study commissioned by WWF found that it would not be possible to respond to an oil spill in the Canadian Beaufort Sea for seven to eight months of the year.⁹ Such a 'response gap' analysis needs to be carried out and published to be able to accurately assess the threat that spills pose to Shell's operations.

“*In addition to the potential financial impact of an oil spill, high extraction costs, doubts over the amount of commercially recoverable reserves, and a precedent of cost overruns and delays combine to raise questions about the commercial viability of some proposed Arctic projects.*”

“*Out in the Cold: Investors Risk in Shell's Arctic Exploration*”⁴

“*There is nothing up there to operate from at present...no way we could deploy several thousand people as we did in the Deepwater Horizon spill.*”

Admiral Robert Papp Jr⁸

Lack of disclosure on the financial impact of a worst-case scenario oil spill

The potential environmental and financial impact of any potential major oil spill has not yet even been assessed. Shell and other companies acknowledge the ineffectiveness of existing technology to deal with such a spill but have chosen to focus on the supposed low probability of it happening rather than prepare for its inevitable high impact. In the wake of Deepwater Horizon, this approach seems unwise.

Earlier this year, executives from Shell gave evidence to the Commons' Environmental Audit Committee. Caroline Lucas MP put the following question to Peter Velez, head of Shell's emergency response operations in Alaska: *"I don't doubt that you have very good measures in place, but what I am saying is that accidents will always happen. BP wasn't expecting the Macondo to happen, it happened. So when accidents happen, can I just be really, really clear that you are telling me that Shell does not have any estimate financially of how much that will cost you?"* Peter Velez answered stating *"We do not apply a figure to it because our responsibility, as a responsible operator, is to protect the environment and to clean it up, and we are going to do whatever it takes regardless of the cost to clean it up."* His colleague Robert Blaauw confirmed that Shell considered the likelihood of any spill extremely small. Zac Goldsmith MP described the failure by shell to cost the risk as being *"hugely irresponsible financially."*¹⁰

Lack of transparency in Russian projects and potential exposure to poor safety and environmental practices of partners

The Sakhalin-2 project (where Shell reportedly has effective operational control, with a 27.5% stake¹¹) has neither disclosed oil spill response plans or certain key financial information. In 2006, Shell and its partners ceded the majority stake in Sakhalin Energy Investment Company in a deal which was described by commentators as having been made *'under duress'*¹² and a result of *'caving into government pressure'*.¹³

The Russian government has begun receiving revenues from Sakhalin-2¹⁴ which under the contract terms should happen once all of the investors' costs have been recovered. Yet at the time of ceding the majority stake to Gazprom, Shell and its partners reportedly agreed to absorb \$3.6bn of a cost overrun¹⁵. It appears that Shell has yet to make any disclosure on the issue of cost recovery, which highlights the risk of a lack of transparency at Russian projects.

With the return to power of Vladimir Putin investors should seek assurance from Shell on its plans to ensure that its current and any future Russian projects will not be subject to such unpredictable and damaging political, and resulting financial, pressure.

Shell and Gazprom signed a *'protocol on strategic global cooperation'* in November 2010¹⁶. Depending on the shape of the eventual partnership it may expose Shell to risks associated with Gazprom's poor record on safety, environment and transparency. The details of the *'protocol on strategic global co-operation'* have not been disclosed.

On 18th December 2011 the Kolskaya rig (commissioned by Gazflot, a direct Gazprom subsidiary) capsized and sank on its way back from dilling in the Okhotsk Sea, killing 53 of the 67 crew.¹⁷

The rig continued drilling outside the approved operations season¹⁸ and without having passed the necessary environmental and safety assessments.

Funding challenges

The social and environmental responsibility guidelines of international financial institutions and banks bound by the Equator Principles have proven to be a barrier for project funding on risky projects such as Sakhalin-2¹⁹. Many of the funders of Shell's Russian Arctic-conditions project - Sakhalin-2 are facing pressure to refuse funding for extensions to that project.²⁰

In addition the major German project finance provider West LB announced in April 2012 that it will not provide project finance for oil developments in the Arctic saying that "*the risks and costs are simply too high*".²¹ West LB also said that other banks had contacted them and are interested in their policy and approach.

Questions for Shell

- Will the company carry out an analysis of the environmental and financial worst-case scenario and make it available publicly?
- Has the company carried out a spill response gap analysis of its prospects in the Beaufort and Chukchi seas? If so, will the company make it available publicly? Without such an analysis it is not possible to accurately assess the risk posed to Shell by an oil spill in its Arctic operations.
- Will the company test its spill response technology (particularly well containment devices) in Arctic conditions, and make detailed disclosure of the conditions and results of these tests.
- What steps is Shell taking to ensure adequate funding for proposed developments at Sakhalin-2?
- How does Shell plan to finance extraction infrastructure in the event of a find in Alaska?
- In working on future projects with Gazprom, is Shell expecting to retain operational and sub-contracting control at Sakhalin-2 and future projects?
- If not, how will Shell ensure the application of its global health and safety and environmental policies by Gazprom and its subsidiaries?
- What steps is Shell taking to reduce the possibility of further intervention by the Russian government in Sakhalin-2 and possible future projects?

Conclusion

Arctic oil and gas exploration poses significant risks to a pristine environment, but it also poses significant risks to investors. The financial impact of the Deepwater Horizon spill on BP plc demonstrates the company-wide impact of failings at a single operation. Investors should consider whether potential failing at Shell's Arctic-conditions projects, which are driven by its Exploration & Production division, pose a significant risk to the overall financial health of the Shell group.

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