

Sakhalin 2 – On Track to Phase II

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Thank you Mr. Chairman, Honorable Governor Farkhutdinov, other distinguished members of the Sakhalin Administration and Russian Federation, ladies and gentlemen. I would like to thank the organisers of this Sakhalin Oil & Gas Conference, IBC and Trade Partners UK for allowing me to speak today on behalf of Sakhalin Energy and its shareholders.

I would like to present a high level view of the status of the Sakhalin II project. In addition, I wish to address four topical and controversial issues that we have seen in the newspapers and on the internet recently about our project and PSAs in general. The first topic I call Russian Content, “the real truth”. Then I’ll share my view of a topic that provides great rivalry between the previous speaker, Mr. Duffin, representing the Sakhalin 1 project and myself called “Gas to Japan - LNG or pipeline”. Then I would like to address a topic that flared up in the Wall Street Journal this September in a slanderous article on the lack of Russian environmental standards for offshore Sakhalin development. And finally, for my last topic, you cannot pick up a Moscow newspaper these days without reading an article from someone describing how bad PSAs are for Russia and in addressing this, I will enlighten you with some facts on the Sakhalin 2 PSA and leave you to judge for yourself.

Firstly, as you probably all know, the Sakhalin II project has been producing oil from our Molikpaq platform and Vityaz complex since 1999. We are in our fourth ice free production season this year and have produced a total of 10.8 million barrels of sweet, high quality, 36 degree American Petroleum Institute gravity crude. Our crude has been sold by tender and tankered to markets in the Far East with Korean refiners being the keenest bidders thus far. The production from the Molikpaq is less this year than that of last year. This is because of the decline in reservoir pressure under primary production. This decline will continue slightly next year until we complete construction of a pressure maintenance water-flood project that will increase production in 2004 and beyond. In addition, I am proud to report that Molikpaq has operated for the past two years with a total of only 30 ml of oil spilled into the sea. That is about enough to fill a moderate sized sewing thimble, and is a “world class environmental performance achievement”.

The pressure maintenance project includes new wells and facilities to inject 140,000 barrels or 22,000 cubic meters of water per day into the Astokh reservoir. The total cost of the project is estimated at \$300 million and will

develop 260 million barrels or 35 million tonnes of secondary recovery reserves. A contract for \$9 million was awarded to the Amur Shipyard in Komsomolsk to construct the two main water-flood and power generation modules. The project fabrication and construction is progressing well and has now achieved a total of 1.3 million company and contractor man-hours without a lost workday accident. First water injection is scheduled for December of next year.

Our Phase II expansion is an \$8.5 billion integrated oil and gas development and export project. Phase II will include construction of a second platform in the Piltun-Astokh oil field plus conversion of the Molikpaq platform into year round production. A third platform will be constructed in the Lunskeye gas field together with an onshore processing facility for gas dehydration, condensate stabilization, power generation and compression. We will lay 800 kilometers of oil and gas transport pipelines to the south end of the Island and construct a two-train 9.6 million tonnes per annum Liquefied Natural Gas plant and an oil and LNG tanker export terminal in the deep waters of Aniva Bay where the ocean remains relatively ice free year round. We have made much progress on the project. The Russian Party approved our Plan of Development in June 2001 and later the full project budget in August of this year. We filed our TEO-C for construction in February this year and all final elements of the EIA were forwarded to the Ministry of Natural Resources along with all requisite agency pre-approvals on October first. EPC tenders have been issued for all major phases of the project, except for platform drilling. The bids are now just back and currently under evaluation.

It is always fun to look at some of the technical details and I want to mention our two new planned offshore platforms. Both are designed as integrated steel decks mated to concrete four leg, gravity based substructures that are anchored to the ocean floor. First, the Piltun B platform is designed for 70,000 bpd oil and 100 mmcf/d gas production. It will have 45 well slots with total topside facilities weighing about 23,000 tonnes. The Lunskeye-A platform is designed for 1,800 million cubic feet per day of natural gas and up to 30 well slots. Each of the seven initial gas wells will be capable of producing up to 300 mmcf/d each using Shell's latest high rate well completion technology. The Lunskeye field also has a small oil rim and we need the extra well slots for this potential development. The total topside weight for Lunskeye will be about 20,000 tonnes. Initially, we had designed these platforms for steel gravity based substructures, but we changed the design to concrete so that they could be built in Russia at Vostochny Port to help maximise Russian Content.

The major phases of the project are divided into Front End Engineering Design (FEED), detailed engineering, procurement and construction. AMEC has provided the FEED work for both platform topsides and substructures. We are negotiating with AMEC to continue the detailed engineering with separate tenders having been issued for procurement, fabrication and installation of the topsides. Detailed engineering of the gravity based structures has been included

into the full EPC tender. Parsons has completed FEED for the onshore production facility and are planned for the detailed engineering with the procurement and construction being tendered. All onshore and offshore pipeline FEED work was done by the Russian consortium of Strastroi - Bouyges Offshore. The remaining work has been tendered as a full EPC contract. And finally, the LNG plant and OET was designed by Fluor Daniel - Nipigaz using a Shell Global Solutions patented process and the EPC work has been bid by two multi-national contractor consortia including Russian participation.

Now that you have heard some of the details of Phase II, let's look at the forward schedule. We expect the Russian Government to come through on approvals of the TEO-C and PSA legal stabilization measures, which I will discuss in more detail later in the presentation, by the first quarter of next year. Both of these actions are on the project schedule critical path so every day delayed by lack of Government action causes a one day delay in the start of new production. Once these approvals are cleared, the company will be prepared to declare a Lunskeye development date in the second quarter as defined in our PSA. With these approvals, we can then award all major EPC contracts and commence major construction. If all goes well, we would expect year round oil production flowing to Prigorodnoy late 2005 to early 2006. First gas production is expected in the second half of 2006 and first LNG deliveries will be timed based upon customer requirements that have yet to be determined.

Now let's turn our attention to the topical issues I said I wanted to address at the opening. I spoke about the misinformation being spread about Russian Content at last year's conference but the issue hasn't gone away so I will address it again. I believe Russian Content is being used as a convenient but weak argument from groups inside and outside the Russian Government to voice their real opposition to PSAs. Their arguments are often backed by incorrect definitions of RC, little or no factual evidence and intentionally misconstrued data. Frequently heard myths printed in government reports or newspapers about RC include: "Sakhalin Energy prefers foreign suppliers over Russian suppliers"; "Sakhalin Energy has a poor record on RC of only 23%"; Then, "Sakhalin Energy's tender process is not fair to Russian suppliers" and then the topper is "Sakhalin Energy loads costs onto affiliated shareholder contractors to maximize cost oil". You may have heard other myths, but these four are good enough to get the competitive juices flowing.

Under our PSA, RC is clearly defined. Sakhalin Energy is required to use best efforts to achieve a 70% RC in our procurement over the life of the project subject to price, quality and project timing requirements. RC is measured in terms of man-hours and volumes of materials and we have a measuring system in place to keep the score. Monetary value is not used as a measure to avoid discrepancies in valuing goods and services not found in Russia, but we track this as well. 50/50 JVs with foreign enterprises are encouraged and count as 100% RC. Where a qualified Russian enterprise satisfies the project's

requirements, it shall be given preference over a non-Russian tenderer. Sakhalin Energy is focused on activities to maximise RC and our record shows it. Since the project's inception more than 80% of the man-hours and almost 70% of the volumes of materials have qualified as RC. So ladies and gentlemen, and particularly members of the Russian press, write it down, you heard it here today, remember it later, Sakhalin Energy is within the requirements of our PSA. Our RC Manager, Mr. Alexey Okhotnikov will present more details of our program to maximise RC later in this conference and we have a handout called "[RC, Facts and Figures](#)" available for your reading. We fully support the RC terms in our PSA and we expect to achieve the 70% requirement over the project life.

Now let me address these other myths one by one. First, regarding unfair tendering practices, in 2001, 80% of Sakhalin Energy contracts were competitively tendered and about 50% of the contracts were won by Russian suppliers. Although our PSA specifies use of international oil and gas standards, we have tailored our project specifications to not disadvantage Russian suppliers by using Russian design institutes as expert consultants. The Russian party has the right to audit our tender process through the Joint Procurement Committee. Although that right to audit has been exercised on several occasions, not once has Sakhalin Energy's tender process been found to be unfair. That's one. As for favouring foreign suppliers, Sakhalin Energy has awarded over 4000 contracts to Russian companies worth over \$800 m. In addition, our vendor assessment program has qualified 51 new Russian suppliers in 2002. Even our company's annual bonus system is partially driven by maximising RC. Scratch the second myth. Regarding loading cost onto affiliates to maximise cost oil, the Sakhalin Energy three party shareholder agreement strictly regulates charges to affiliates. And no one in Sakhalin Energy is incentivised to spend one extra dollar on this project; quite the contrary. Why would we spend an extra dollar only to get it back under the cost oil formula ten years later when the present value had eroded to about 25 cents? Companies don't make profits by maximising cost; it simply doesn't work that way. That's three myths down. And of course the fourth myth we have already answered. We are above our 70 % RC threshold as defined in the PSA and even in monetary value terms (not a requirement of our PSA) we have exceeded 53% for the project to date. In summary, no one will deny that areas of Russian industry desperately need revitalisation. But it is time that the Russian Government recognises the realities of the basic problems in the manufacturing and supply sector and attacks those problems rather than continuing to attack the foreign investor and PSAs which just may be a part, but not all, of the solution.

Now let's look at the second topical issue. Why is Sakhalin Energy pursuing LNG shipments to Japan and other Asian markets rather than backing a gas pipeline to Japan like Sakhalin 1? First, we believe there is sufficient Asian gas demand growth to justify our new plant, but you have to look at more than just Japan to make the project economics work. Gas demand growth in Japan has been sluggish over the past five years and the future demand looks marginally better.

Our view is that a sub-sea gas pipeline to Japan is extremely expensive and faces tremendous schedule and political uncertainties. There is no domestic gas distribution system in Japan to connect to and any pipeline faces major right-of-way issues and dealing with independent fishermen and farmers. These factors coupled with sluggish demand growth in one single market simply cannot justify the 8-12 bcma throughput required to make this pipeline economic. By using the speed and flexibility of LNG we see the potential for tapping into, not only Japan, but Korea, China, Taiwan and the North American West Coast for a minimum sustained 5% per annum gas demand growth over the next decade. Due to our proximity to the Asian markets, we will have the lowest shipping costs of any of our competitors, bar none. LNG makes effective use of existing customer import terminal facilities that do not need expansion. Selling to multiple markets will help the fast buildup of gas production volumes for project economics. We are currently engaged in discussions with multiple Japanese customers and we will participate in the current Taiwan LNG tender. We continue to believe that sufficient volumes will be committed to support the project schedule previously discussed.

But make no mistake about it, Sakhalin Energy is placing big bets by investing into new island facilities infrastructure, and we expect those big bets to pay big dividends long into the future. We believe the Sakhalin II pipelines will become an important new "Corridor to the Marketplace" for future offshore Sakhalin reserves from many projects to follow Sakhalin II. With additional pumping stations and tanks, our 24" oil pipeline and oil export terminal at Prigorodnoye can be expanded to over 400,000 bpd (20 mmtpa) of oil export capacity or roughly twice our initially planned usage. Our new 48" gas export pipeline can be expanded up to 3.5 bcfd (37 bcma) with additional compression and dehydration which is again about twice our current nominated usage. We have the space and the reserves to support additional LNG expansion trains at Prigorodnoye and should the market demand grow, we will be ready to supply it. And lastly, I never say never! Some day in the future, perhaps 12-15 years from now, a sub-sea gas pipeline may be justified and built to Japan and Sakhalin Energy may even be interested in participating at that time. But if a pipeline is ever built, it only makes sense to begin from the south end of Sakhalin Island at the terminal point of our current proposed pipeline in Prigorodnoye. For now, the key message for Sakhalin gas exports to Japan is "LNG first followed by pipeline later, if feasible."

Now let's move to the third issue, that of environmental standards in Russia. I and many of my industry colleagues were concerned to read the September article in the Wall Street Journal, written by Mr. Jim Carlton, that accused international energy companies of focusing upon Sakhalin for new energy developments and taking advantage of lax environmental standards in Russia compared to those in other areas of the world. This was a preposterous claim and many arguments evinced in the article were factually incorrect and, in our opinion, discredited an otherwise fine business newspaper such as the Wall

Street Journal. Nothing could be further from the truth. First of all, we must recognize the basic principles of Sustainable Development – as adopted by Sakhalin Energy and backed by our shareholders, Shell, Mitsui and Mitsubishi. “We are committed to policies and practices to protect the natural environment of Sakhalin Island while minimizing disturbances to the way of life of its people”.

Our commitments include working closely with Russian Federal and regional agencies whose Health, Safety and Environment (HSE) standards are amongst the most stringent in the world. For instance, even though our PSA allows us the right to dispose of all excess drilling mud and cuttings into the sea, we choose not to. In addition, the Ministry of Natural Resources has severely restricted discharges through the issuance of our water use license for Molikpaq. We have proactively modified our drilling equipment to allow for cuttings re-injection into the subsurface reservoirs. The water use license we have is as strict as any I have ever seen in the world regarding discharge requirements and limits specific chemical components of any waste making variance extremely difficult. In addition, water quality monitoring under the guidance of the MNR in the ocean surrounding Molikpaq over the past four years have clearly shown absolutely no negative effects on water quality, fish or mammal life including the critically endangered Gray Whales. Sakhalin Energy also relies upon the worldwide experience of our shareholders and international codes and practices. We design and operate to World Bank environmental guidelines as required by our project lenders.

In addition to the commitments already mentioned, Sakhalin Energy will implement the following plan of action. We have put in place an international standard HSE management system to reduce all associated risks to as low as reasonably practical. We have conducted Social Impact, Health Risk, Quantitative Risk and Environmental Impact Assessments for review by Russian Federation and regional experts. The EIA is available for public inspection. We have an extensive program for public environmental consultation with interested groups including non governmental organisations (NGOs). Most of these plans are described in our TEO-C submission and in the end, our environmental operations are subject to external audit as again, required by the Russian Government and our project lenders. Bottom line is that we did not come to Sakhalin to cut any corners on HSE. The reputation of our company and its shareholders demands excellence in all aspects of HSE performance and we plan to deliver.

The last issue I will address is the continuous talk around Moscow that the Sakhalin II PSA is not beneficial to Russia. The Sakhalin II project is a US\$10 billion project, fully funded with foreign capital. Over the life of the project, we forecast the Russian Government will receive US\$ 49 billion in revenues from bonuses, taxes and domestic gas shares based upon a \$20/barrel oil benchmark price. To date, Sakhalin Energy has already paid the Russian Government over US\$ 275 million in cash for Phase I. We forecast that Russian industry will be

awarded contracts of over US\$ 20 billion subject to competitive bidding. To date, we have awarded over 4000 contracts to Russian companies worth over US\$ 800 million. Sakhalin Energy today directly employs about 400 Russian nationals and that number is expected to grow to over 1000 when Phase II is fully operational. We plan to upgrade the island's infrastructure including roads, bridges, ports and Nogliki airport worth \$250 million. These upgrades will benefit the public long after construction ends. Sakhalin II gas will provide an abundant long term domestic gas supply to the island and far east Russian mainland. And, of course, don't forget the multiplier effect that this large investment and employment can have to the local and national economies. And all these benefits accrue to the Russian Government and Russian economy without their investment of one ruble. I hardly see why this PSA is not beneficial to Russia.

But these benefits will not accrue to the Russian Government until and unless we secure legal stabilization of our "grandfathered" PSA. There are a number of current and proposed Russian laws that directly conflict with investor rights guaranteed in our PSA. First, the Anti-Monopoly law gives the government the right to force third party allocation into oil and gas facilities such as pipelines at government determined tariffs Vs. arm length commercial arrangements as provided in our PSA. The Gas Supply law allows the government to force a private gas pipeline company to sell gas to third parties at government determined prices. The current Draft Trunk Pipeline Law under consideration by the Duma would bar foreign ownership of oil and gas export pipelines. And finally, passage of the PSA Chapter of the Tax Code is necessary to clarify and anchor means for reimbursement of VAT to the investor as provided in the PSA. These laws must be amended or passed to guarantee our PSA rights. Let me be perfectly clear. We are not asking for anything new. There are no hand-outs expected from the Russian Government for the foreign investor. All we ask for is that the Russian Government deliver on terms already committed in our grandfathered PSA by clearly eliminating conflicts in other laws on the books. We are betting a huge investment into this venture and we wish no veiled "legal" surprises waiting around the corner after the bets are placed. The lack of PSA legal stabilization erodes investor confidence and could make the project unfinanceable. There is a plan, currently being worked on in the Duma, that could resolve these matters in the coming months, but bottom line is that if the laws are not amended, the Phase II project will not proceed on schedule.

This brings me to summarize what I have said today. The Sakhalin II, Phase II project is the only project in Russia able to deliver gas to the target Far East Asian markets in the near future. This will be the final link in establishing Russia as a global energy supplier by opening up the entire Asia-Pacific region for crude and LNG exports. All parts of the Phase II project within the company's control are progressing to a Lunskoye field development date declaration in the second quarter of next year. However, there are specific actions required by the Russian Government as clearly spelled in the PSA to allow the project to move forward. Thank you for the opportunity to speak today.