OIL AND GAS PROJECT UPDATE - Sakhalin Island, Fall 2003

Country: Sakhalin Island, Russia
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Summary:

The two largest projects currently underway in the Sakhalin Region are Sakhalin-1 and Sakhalin-2, operated by ExxonMobil and Royal Dutch/Shell respectively. Sakhalin-2 is in its second phase of development, while Sakhalin-1 is in its first. The Sakhalin-1 project encompasses transportation of hydrocarbons to Khabarovsk Krai and Sakhalin-2 is proceeding with construction of Russia's first LNG plant - said to be the largest in the world.

The island has always been rich in oil and gas, and though on-land fields now almost depleted, the offshore reserves have attracted a multitude of investment to the island. Forecasts for 2005 expect extraction of 12 million metric tons of oil in the Sakhalin region, and about 30 million metric tons of oil for 2006 – the vast majority this by the Sakhalin-1 and Sakhalin-2 projects. For 2002, the Sakhalin region extracted 3.2 million metric tons of oil; this is less than 1% of the total for Russia in 2002 – 378 million metric tons. The oil and gas consortia are planning to invest more than USD 200 million into infrastructure upgrades - for instance, Nogliki airport upgrades at an estimated cost of USD 40 million, and USD 13 million more will be necessary for additional roads and dead-end railroad tracks.

In the first nine months of 2003, 2.4 million tons of oil were produced on Sakhalin. Rosneft-Sakhalinmorneftegas produced 1.2 million tons, Sakhalin Energy one million tons; the rest was produced by Petrosakh. It is expected that the oil production on Sakhalin in 2003 will reach 3.2 million tonnes, 1.4 million of which will be produced by Sakhalin Energy.

Sakhalin Region investment in 2002 reached 23 billion rubles (USD 727,848,100). More than 20 billion rubles of this figure is foreign investment, 82% of which is oil and gas sector. More than USD 500 million of the latter percentage was invested into shelf development projects. Sakhalin region takes the second place in the RFE after Yakutia by investment figures available for 2002. Sakhalin takes the third place in RFE (After Yakutia and Primorye) by the volume of contracting. According to the Sakhalin Economic Committee, by 2003 results Sakhalin should shift to the second place due to increasing amount of work to be completed for Sakhalin-1 and 2. In 2003, more that USD 1 billion will be invested in Sakhalin-1 and 2 projects alone. About 30% of all tax revenue of Sakhalin region in 2002 came from the oil sector.

Additional Background:

To learn more about the international oil and gas projects on Sakhalin shelf, please refer to our previous reporting at the following links –

Chart of oil and gas projects –
http://www.bisnis.doc.gov/bisnis/isa/020702projectchart.htm

Map of oil and gas projects -
http://www.bisnis.doc.gov/bisnis/isa/020502projectblocks.htm

Each project overview is available in our 2002 update -
http://www.bisnis.doc.gov/bisnis/isa/0207OilGasSak.htm
http://www.bisnis.doc.gov/bisnis/bulletin/decjan03bull2.htm

Contracting procedure is described at –
http://www.bisnis.doc.gov/bisnis/isa/0301SakhalinVendors.htm

This report provides additional information on:

- Sakhalin-2
    - Phase-1 of the project
    - Phase-2 of the project
    - Potential Contracting activity to 2005
    - Phase-2 Contracting Strategy
    - New Zapadnyi Port on Sakhalin
    - Construction of LNG plant
- Sakhalin-1
    - Project overview
    - Phase-1 activities
- Sakhalin-3, Kirinsky Block
- Sakhalin-3, East-Odoptinsky and Ayashsky Blocks
- Sakhalin-3, Veninsky Block
- Sakhalin-4, 5
- Sakhalin-6
- September 2003 Conference
    - Oil and Gas Potential of Sakhalin - Look Into the Future
- 2003 Awarded Contracts
- Local Difficulties
- PSA (Production Sharing Agreement) information

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Sakhalin-2

Shell Sakhalin Holdings B.V, 55%; Mitsui Sakhalin Holdings B.V., 25% and Diamond Gas Sakhalin B.V., a Mitsubishi company, 20%.

Phase-1 of the project –

- First production in 1999
- Seasonal oil production: 6 months/year
- Output up to 90,000 barrels/day (11,000 metric tons/day)
- Close to 40 million barrels (5 million metric tons) produced by 2002
- Sakhalin Energy became an established exporter to Korea and China

Current activities –

- Arctic drilling /production platform in operation since 1999
- Full year drilling operations
- Construction of modifications during 2000 and 2002 in Russian yards
- Pressure-maintenance project to be implemented in late 2003

The first water injection at Astokh is scheduled for December 2003. Water-flood and power-generation modules (the main new core facility elements) will be fabricated at Amur Shipyard (RFE).

Sakhalin Energy consortium made a decision on Sakhalin-2 second phase commencement. In four years, the LNG plant in the south of Sakhalin will start full capacity LNG manufacturing. This projected output is said to be covering 10% of all Eastern Asia LNG needs, including China.

Sakhalin Energy signed an LNG sales agreement with Tokyo Gas, which is at the moment importing more than 7.5 million metric tons of LNG annually from 6 countries, 80% of gas is imported under cooperation with Shell. Tokyo Gas is going to purchase 1.1 million metric tons of LNG annually. The final agreement is to be signed by 2004, with gas deliveries to start in 2007. In 2003, the LNG plant construction will begin. With the plant's annual capacity of 9.6 million metric tons of gas, the company will have to search for additional buyers.

Currently it is being said that TEPCO is going to buy up to 1.5 million metric tons of liquefied gas on Sakhalin. It is expected that other Japanese companies will follow the example of TEPCO and as a result, Sakhalin-2 will be able to sell up to 3.9 million metric tons of LNG to Japan annually.

The Mitsubishi division at Long Beach signed a letter of intent to cooperate in an LNG terminal construction in California. According to the agreement, Mitsubishi will invest in the construction of USD 400 million-worth of the terminal, which should be able to receive 5 million metric tons of LNG annually. In order for the project to take place, it will need to be approved by the authorities.

It was announced in July that Tesoro Petroleum Corp., TX obtained 700,000 barrels of oil from Sakhalin. Tesoro Petroleum Corp., owner of one of two refineries on Oahu, has begun to buy oil from Sakhalin. Sakhalin Energy Investment Co. dispatched a tanker with 700,000 barrels of crude oil for refining at Tesoro facilities in Kenai, Alaska, and Anacortes, Washington. Until that time, SEIC had been selling mostly to Japan, South Korea, and China.

SEIC signed an agreement with the Kyushu Electric Power Company for LNG supplies for a period of 21 years. This is the third agreement for LNG deliveries concluded with Japanese customers. Kyushu Electric is the major power company of the Kyushu Island. Presumably since 2010 Kyushu will start receiving Sakhalin fuel.

Phase-2 of the project –

- Integrated oil and gas development
- Investment of over $9 billion
- Astokh field Molikpaq year-round production
- Two new offshore platforms (Piltun-B and Lunskoye-A)
- 800 km onshore oil and gas pipelines
- First LNG plant in Russia + export terminal
- Largest single LNG trains ever built (4.8 mtpa)
- First Russian gas to be shipped to Asia

Two new platforms to be installed –

Piltun – oil production 70,000 Bp/d; gas production 100 mmscf/d; 45 well slots, 4-leg concrete gravity base, topsides about 23,000 metric tons

Lunskoye – gas production – 1800 mmscf/d; 30 wells slots, 4 leg concrete gravity base; possible oil rim development; topsides – about 20,000 metric tons.
(both gravity base structures built in the Port of Vostochny, RFE)

Year-round oil production is anticipated in 4th quarter 2005- 1st quarter 2006, first gas production – 2nd half of 2006.

SEIC's started a USD 8.5 billion development phase in the second quarter of 2003 and announced that the necessary gas deliveries agreement was already set up with Japan. The pipeline will be laid from the north of the island to the LNG plant in the south.

Separate contracts for individual project components – awarded and to be awarded during 2003:

- Offshore platforms – gravity bases and topsides
- Offshore pipelines
- Onshore processing facility
- Onshore pipelines
- LNG plant
- Oil export terminal

Potential Contracting Activity in 2003-2005

SEIC is trying to achieve the maximum level of the Russian content during the lifetime of the project. A tenderer is considered a Russian enterprise if at least 50% of its equity is held directly or indirectly by Russian individuals or companies or by a Russian governmental authority.

- Vendor registration process – can be found on the SEIC website at: http://www.sakhalinenergy.com/contracting/con_registration.asp

- Standard procedure – registration form sent to SEIC, request for qualification, additional information requested from vendor, if successful – confirmation of registration received

- Registration form online - http://www.sakhalinenergy.com/contracting/con_registration_questionnaire.asp

More on vendor registration is available in our report at **http://www.bisnis.doc.gov/bisnis/isa/0301SakhalinVendors.htm**

Phase-2 Contracting Strategy (according to SEIC presentation materials)

SEIC Project Management			
Project /	***FEED*** /	***Detail Engr.*** /	***Procure Construct./Install***
Lunskoye topsides	AMEC	AMEC	PC tender
Piltun topsides	AMEC	AMEC	PC tender
Platform GBS	AMEC	EPC tender	
Onshore prod. facilities	Parsons	Parsons	PC tender
Onshore pipelines	Starstroj - Bouygues	EPC tender	
Offshore pipelines	Starstroj - Bouygues	EPC tender	
LNG Plant & OET	Fluor -Nipigaz	EPC tender	

Some experts believe that the scheme for Gasprom entering the Sakhalin project in exchange for a share in the huge oil and gas condensate field in the Yamalo-Nenetski Autonomous Area, gas reserves of which are estimated at about 735 billion cubic meters of gas, may be the only possible one at the current moment. The cost of possibly bartered resources is estimated at USD 1 billion. The plans were announced by Gasprom representative Mr. Alexander Ryazanov, he did not provide any specific detail but clearly specified that he was talking about the Sakhalin-2 project. As he told *Vedomosti* Newspaper, Gasprom is counting on 25% share in this project. Previous negotiations on purchasing the share did not lead to any positive result. Other sources state that the price proposed by Gasprom was different from that anticipated by Royal Dutch/Shell, which led to the alternative proposal on shares barter. According to *Vedomosti*, Gasprom concluded the strategic partnership agreement with Shell back in 1997. By this agreement, the British company obtained a 50% share in polar field, with extraction of up to 25 million metric tons of oil per year. In exchange, Shell had to purchase convertible bonds of Gasprom for the amount of USD 1 billion. The deal was not implemented, as well as the mutual plans of the two companies to participate in Rosneft privatization. Right now, certain sources state that Royal Dutch/Shell is ready to sell not more than 10% of shares in Sakhalin-2.

New Zapadnyi Port on Sakhalin

Pictures courtesy of Lynden International

A transportation vessel was brought the first shipment of pipes for the construction of Sakhalin-2 oil and gas pipelines. The vessel came from Vostochny port, where a lot of cargo for Sakhalin projects is still waiting to be shipped, as the crew said. Sakhalin Shelf Services turned the former bankrupt port into a supply base for Sakhalin-2. The port was dredged, one of several dockside cranes installed came from Germany (60 metric tons of cargo capacity, the largest on Sakhalin). The area of pipe storage field is 62190 square yards. Frame cranes, manufactured in Komsomolsk, with 20 and 40 metric tons of capacity, are exclusive; the reconstructed railway junction is to service 60 cars with pipes per day. The major hero of this occasion, Sakhalin Shelf Services company, is proud of the port reconstruction work that was completed in a short term and on time. Mr. Lukin, the representative of Starstroj said to the press that the scope of work to implement is significant – his company must process more than 500 thousand tons of cargo; the pipes arriving will be assembled into a pipeline by more than 1000 workers that came from Moscow region and Krasnodar Krai – the high-class welders and machine operators, where special expertise is necessary, are not available locally (the company is additionally recruiting Sakhalin specialists as well). He mentioned that the Sakhalin pipeline is currently the largest construction project in Russia. At the moment the camps are set up, pipes being transported, and the future pipeline route will be facilitated. The new port, able to serve vessels with significant draught (nine meters near the berth and ten at the ship channel - 29.5 to 33 feet correspondingly), has to process more than 400 thousand of the pipes just for Sakhalin-2, which is sufficient at least for 4

years of work. The port has created about 100 working places now and this figure will increase at least four times in the near future. Leonid Katsev estimates that the port will stay busy for a period of at least 40 years.

Construction of an LNG plant in Prigorodnoye started

About 1000 people are working during the day-shift, 200 people are working nights (12 hour shifts). In all, 290 units of different equipment (bulldozers, dump-trucks, tractors and other) are used for this construction. Chief contractor is CTSD Limited (Chiyoda Engineering and Toyo Engineering), with the major Russian subcontractor Transstroy (Transstroy has in turn subcontracted 14 companies from other parts of Russia). The road, temporary moorage, oil tanks foundations, water wells and water pipe, and mancamp for 400 people (which will be expanded into a 6 thousand people camp) are currently under construction. Dredging work is also underway (the bay will be dredged up to 9.6 meters deep – 31.5 feet). In 2004 the work will start on the LNG shipment moorage construction and the plant base concreting. The plant will include two technological lines (total output of 9.6 million tons per year – fires train to be put into operation July 2007, second – February 2008), two gas storage tanks (total capacity - 200 thousand cubic meters of gas) and the shipping system (mooring lines for tankers). The shipping terminal will be able to serve the largest LNG tanker available in the world. In the first stage two oil tanks will be situated at the plant – a third will be constructed later. In the future the third train for the LNG could be constructed as well as the third oil tanker.

The assembly of oil and gas pipes for the trans-island line pipe will start in November, as the representative of Starstroj Company reported to the press. The pipeline is considered to be the longest in Russia (800 kilometers – almost 500 miles); the pipes have to cross more than 1100 natural obstacles - rivers, marshes, and tectonic faults; every 30 meters will be equipped with gate valves. The diameter of the oil pipe is 618 mm (24.3 inches), and the gas pipeline – 1220 mm (48 inches). The three-year project is divided into 4 sections, assembly work will be carried out simultaneously (Nogliki-Tymovsk; Tymovsk-Smirnykh; Poronajski-Makarovski districts; Dolinsk-Aniva district). Five thousand people and 1 thousand units of machinery will be utilized for construction (equipment is being delivered to Sakhalin); 11 mancamps and 6 pipe-welding stations are under construction for this project.

Sakhalin-1

Consortium of 5 companies; Exxon Neftegas ltd. 30% and which was named as the operator, the Russian companies Rosneft-Astra 8.5% and SMNG-Shelf 11.5%, both affiliates of Rosneft, the Indian national oil company ONGC Videsh, 20%, and SODECO, 30% (a consortium of 13 Japanese companies).

The Sakhalin-1 project is the most significant investment ExxonMobil is involved with in Russia, with anticipated capital investment for all of its phases amounting to over USD 12 billion. Potential recoverable resources - 2.3 billion barrels oil; 17.3 tcf gas (307 million tons of oil, 485 billion m^3 gas)

Exxon Neftegas, LTD officially started drilling on July 12, 2003 at Chaivo. This is the first well in the program of extended reach drilling, planned by ExxonMobil. Three onshore sites on Chayvo and Odoptu will have 34 wells drilled during the 1st stage of the project. The length of extended reach wells of such type may reach 11 kilometers (about 7 miles). The south-western part of the field, situated too far from the shore line, will be developed from the Orlan offshore rig – the project involves the drilling of 14 wells, and is scheduled to start in 2005. Chaivo field is being developed – the onshore processing facility for oil and gas separation and oil processing complex (250 thousand barrels per day) are under construction.

On August 11, 2003 journalists were invited to Chaivo field for the presentation of the new Yastreb rig. Yastreb is considered to be the largest on-shore rig of such type in the world, and some elements of the rig are unique. As part of a test drilling program, the rig drilled the first injection well (1.6 miles deep) and two production wellsare being drilled. Horizontal reach of the well will be almost 6.2 miles long. In total, 10 production wells are planned to be drilled, and in 2005 Chaivo field will produce 250 thousand barrels of oil per day.

The exploration phase of Sakhalin-1 has been completed. The three fields - Chayvo, Odoptu and Arkutun-Dagi - have the potential to recover 307 million tons of oil and 485 billion cubic meters of gas.

Phase 1 - oil development

- Chayvo production late 2005
- Odoptu - 2007
- Pipeline to De-Kastri terminal
- Tanker export

Phase II - gas export

- Export of Chayvo gas via pipeline
- Japan is the primary target market triggered by securing long-term gas sales contracts

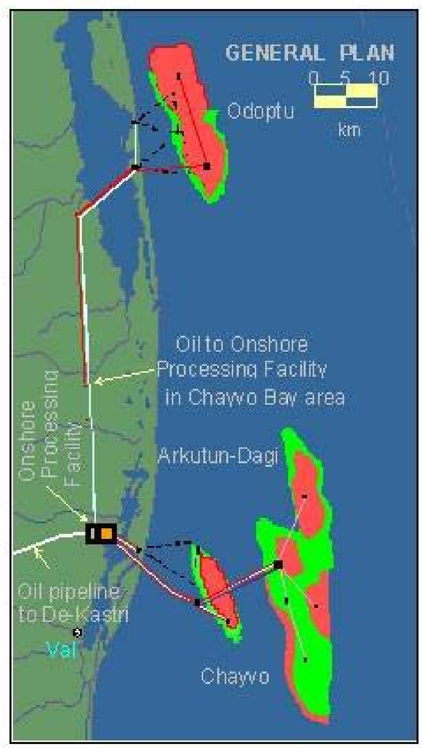
Phase III - Arkutun Dagi development

- Oil development to maintain production plateau

Phase IV - late life gas development

- Arkutun Dagi and Odoptu gas production

Phase 4 will enable gas production to continue to beyond the year 2050.



By ExxonNeftegas, LTD.

<u>Phase-1 activities:</u>
a) Shore-based Extended Reach Drilling (ERD) spudding, 2003; 34 wells from 3 sites; up to 11 km (6.8 miles) reach

b) Orlan platform drilling spudding 2005–13 wells from gravity-based drilling structure; water depth 14 m (46 feet);

By ExxonNeftegas, LTD.

c) Onshore Processing Facilities (OPFs) produce pipeline quality crude (Chayvo OPF starting up late 2005 at 250 kb/d, Odoptu OPF starting up 2007 at 90kb/d, local gas sales targeted at 150 MSCFD)

d) Export system will move oil to world markets (oil pipeline from Chayvo to DeKastri, terminal with single-point mooring (SPM) facilities at DeKastri on Russian Mainland).

Bidding process – see more details at **http://www.bisnis.doc.gov/bisnis/isa/0301SakhalinVendors.htm**

Step 1 - Initial Review

1) List of vendors and subcontractors is compiled from a variety of sources.
2) Evaluated by ENL & Consortium members, Sakhalin Oblast Department of Petroleum Industry, Government entities of the RF, EPC Contractors.
Registration form online - http://www.sakhalin1.ru/en/russian/registration/mn_vendorRegistrationPopup.html

Contractor and vendor database for the Sakhalin I Project includes over 3,000 companies.

ENL and EPC Contractors undertake assessments related to potential vendor capabilities and qualifications including :

- Health, Safety and Environmental policies
- Experience operating in Russia (for foreign companies)
- Experience with this product or service, references
- Capacity and capability, workload
- Certification to ISO
- Financial status
- Caliber of Management
- Russian Content (for foreign companies)

Sakhalin-3, Kirinsky Block

Pegastar Neftegas - ExxonMobil – 33.3%; ChevronTexaco – 33.3%; Rosneft – 16 2/3 %; Rosneft-SMNG– 16 2/3 %;

Resources
Oil- 70 million tons
Gas- 730 billion cubic meters

Status- In 1993 Mobil and Texaco, as winners of international tender, were awarded the right for exploration and development of hydrocarbons of Kirinsky block. Joint operator PegaStar Neftegas LLC was established in 1997- NK “Rosneft” and SMNG were included in the project in 1998. In 1999, the Law of List was enacted. PSA negotiations have been suspended since 2000 because of changes in the authority distribution scheme among Federal executives. A PSA Feasibility Study in accordance with current Russian law has been prepared.

Current Plan - Further work planning, considering changes to the Russian legislation regarding PSA.

Sakhalin-3, East-Odoptinsky and Ayashsky Blocks

ExxonMobil – 66 2/3%, Rosneft – 16 2/3 %; Rosneft-SMNG– 16 2/3 %

Resources

E. Odoptinskiy Block:
Oil - 70 million tons
Gas - 30 billion cubic meters

Ayashskiy Block:
Oil - 97 million tons
Gas - 37 billion cubic meters

Status - In 1993 ExxonMobil, as a winner of the international tender, was awarded the right for exploration and development of hydrocarbons of Ayashskiy and East-Odoptinsky blocks. NK “Rosneft” and SMNG were included into the project in 1998. A feasibility study was prepared in 1999. In January 2000 the draft law concerning East-Odoptinsky and Ayashsky blocks inclusion into the Federal Law of List was submitted to the Federal Duma.

The major investor is ready to invest up to USD 9 billion over the 20-year period, as Russian *Expert Magazine* reports.

Current Plans -Further work planning, considering changes in the Russian legislation regarding PSA

Sakhalin-3 - Veninsky Block

Rosneft 75%-1 and Sakhalin Oil Company – 25%+1

Resources
Oil - 57 million tons
Gas - 316 billion cubic meters

Status– Seismic survey has been performed, 2 exploration wells drilled.

In April 2003 NK Rosneft obtained the licence for surveying of Veninsky Block of the Sakhalin 3 Project. It has been agreed that the Sakhalin Oblast Administration will take part in the Project, represented by the Regional *State Unitary Enterprise Sakhalin Oil Company*. Licence agreement is provided for 3D seismic surveying (360 sq.km - 140 sq.miles) and drilling of four exploratory wells.

Current Plans a) Establishment of the Management Company for the Project;
b) Ensuring of the Licence agreement accomplishment.

Sakhalin-4, 5

Rosneft – 25.5 %; Rosneft-SMNG– 25.5 %; BP – 49% (Alliance)

Resources – Sakhalin 4
Oil - 110 million tons
Gas - 440 billion cubic meters

Status –Sakhalin-4- The Astrakhanov offshore structure was included in Federal Law of List; SMNG is the holder of the Astrakhanov offshore structure exploration license. In 2000, NK "Rosneft" and SMNG financed and drilled the first exploration well. In 2001, Sakhalin-4 was included into the Alliance Agreement between BP, NK "Rosneft" and SMNG. A feasibility study of the Astrakhanov offshore structure (based upon 3D seismic data and first exploration well results) was completed.

Current plans: To determine new perspective fields with in the Sakhalin-4 block territory and to develop exploration strategy

Project Resources –Sakhalin-5
Oil - 783 million tons
Gas - 432 billion cubic meters

Status – Sakhalin-5 In 1998 BP, NK "Rosneft" and SMNG completed the Alliance Agreement, and seismic works were done: in 2000 - 2D seismic (about 3,100 miles), in 2002 – 3D seismic (888 sq miles); On July 2, 2002 NK "Rosneft" was awarded the Kaygansko-Vasukanskiy block exploration license. The rest of Sakhalin-5 block is being studied to find new perspective fields.

Current plans - 2002 seismic data processing and interpretation; work out the project corporate structure; planning further exploration within the licensed area; first exploration well drilling in 2004; determining new perspective fields within the Sakhalin-5 block and work out the strategy for further activities.

In the summer of 2002 the seismic survey was carried out in 25% of the Sakhalin-5 block area, with preliminary results being optimistic. The first exploration well is to be drilled in the summer of 2004. Current financing of the seismic survey is done solely by BP. In 2002 the financing figure reached about USD 20 million, almost the same amount was set aside for the 2003 survey. It is also planned that USD 100 million will be spent on the survey in 2004. The total figure to be spent on geologic survey is around USD 250 million, but this amount may increase to USD 300-400 if the results are promising. The preliminary data on Sakhalin-5 show 700-800 million metric tons of oil and 400-500 billion cubic meters of gas.

This summer, BP, Rosneft and Rosneft-Sakhalinmorneftegas started a geotechnical survey at the Kaigansko-Vasjukanski block of Sakhalin-5. The amount of the survey contract, up to USD 3 million, is the largest contract awarded by the Alliance for 2003. The company is going to carry out an ecological survey and environmental impact assessment, which is contracted to the Environmental Company of Sakhalin. All planned surveys were finished in August; in a year the Alliance plans to drill the first appraisal well.

At the end of April 2003 it was announced to the Commission for Natural Monopolies of the Russian Council of the Federation that Alfa-Access/Renova and BP are combining assets, including SIDANCO, TNK service stations and the retail system of BP in Moscow, shareholding in JSC Russia Petroleum and the share in Sakhalin projects. The Chairman of the Council of the Federation called this deal a unique one for Russia in terms of its financial volume.

BP increased the estimates for explored fields of its JV with TNK (TNK-BP Holding) from 3.2 billion barrels to 4.1 billion, according to the standards of the Federal Commission on Capital Market and Securities. The output increase for the united company will make 12-13% in 2003, 7% in 2004, and 5% the following years. TNK-BP also estimates investment of USD 850 million in 2003 and is planning to increase investment to USD 1 billion in a year. In August BP merged its Russian assets with TNK oil company, getting 50% in TNK-BP. The deal led to establishing of the third largest Russian oil company and became the largest one-time investment in Russia – BP paid USD 7 billion for the shares to TNK shareholders – Alpha-Group and Access Renova.

Sakhalin-6

Project Resources
Oil - 146 million tons
Gas - 359 billion cubic meters

Status In 2002 NK Rosneft filed application with the Russian Federation MNR for a geological survey license within the Eastern Pogranichny Block of the Okhotsk Sea shelf. The Russian Federation MNR have prepared the draft license agreement, which is now being revised for the approval in the Sakhalin Oblast Administration. The draft license agreement is provided for the 2D seismic exploration (800 km), 3D seismic exploration (120 sq km) and 2 exploratory wells drilling.

Current plans - To obtain the license for the geological survey in the Eastern Pogranichny Block area; to ensure the fulfilment of the license agreement; drilling of the first exploratory well in 2004.

September 2003 Conference – Oil and Gas Potential of Sakhalin - Look Into the Future

Picture by kapital.zrpress.ru

The Sakhalin Regional Administration approved the oil and gas complex development program, according to which it is planned to increase the regional oil output 5-6 times in 2006 compared to current level. Sakhalin-1 and 2 will contribute 20 million metric tons per year by that date. Thanks to these projects, regional gas output should also increase.

It is planned that during the period of active industrial infrastructure construction in 2004-2005 the number of Russian workers involved may reach 20 thousand people.

According to Rosneft-Sakhalinmorneftegas, the non-explored perspective Sakhalin shelf resources are estimated at 1.9 billion metric tons of oil and 4.3 trillion cubic meters of gas. Speaking of Sakhalin-3 and Sakhalin-5, there are good chances to find unique fields of oil with resources of about 300 million metric tons of oil and 1 trillion cubic meters of gas. Not all the resources are depleted at the on-land fields of Northern Sakhalin. A major resource is reservoir traps at the shore shallow areas which are suitable for deviational drilling. While these fields are smaller in resource, they are more profitable in terms of development. Tweleve perspective oil and gas structures with forecasted resources of about 240 million metric tons were found at the shallow shelf area. Taking into account current prices and the exploratory success ratio of 0.5 (average for Sakhalin shelf) the expected economic effect from the deviational drilling can be as high as USD 4.8 billion. It is possible to create a large production complex which can annually produce 50-70 million metric tons of oil and 100-125 billion cubic meters of gas, which can not only cover the internal regional needs but also be a good basis for export, according to Rosneft-Sakhalinmorneftegas.

2003 Awarded Contracts

According to the Russian Ministry for Economic Development, Sakhalin-1 signed 247 contracts as of March 2003, totaling USD 1.34 billion. 145 contracts for USD 759.7 million, or 56%, were signed with Russian and Russia-registered companies.) By year-end 2003, Sakhalin-1 reported that the overall total of contracts assigned to Russian companies reached $2.3 billion. In 2002, Sakhalin-2 signed 2779 contracts, of which 1066 with companies registered in Russia. The total amount of these contracts is USD 326 million – 185 million of which is Russia-based contracts. Below we list awards that were announced in the local media sources.

About 1.5 thousand workers came to Sakhalin in the first half of 2003. These employees work for the Sakhalin-1 and Sakhalin-2 related projects. According to the Sakhalin Construction Department, in January- February of 2003, 528 people from other Russian regions had already came and got registered with the local tax inspectorate. They work for the Baltic Construction Company, Dalmoststroy and Transstroy. 148 units of heavy construction equipment were delivered to the island. Currently about 9.5 thousand people are already involved in the construction of new infrastructure; about 9 thousand of them are Sakhaliners.

The Regional Construction Department concludes special cooperation and mutual support agreements on behalf of the Regional Administration with the Russian companies that arrive from outside the region to subcontract oil companies on the infrastructure development. In order to create conditions for work of these companies and their employees, the Regional Administration authorized the Construction Department to sign agreements with the companies, sending workforce to Sakhalin to work under Sakhalin-1 and Sakhalin-2. According to the Department, some steps on regulating such companies' activities were already taken. Speaking of concrete contracts, the agreement was signed with Baltiiskaya Stroitelnaya Kompaniya (Baltic Construction Company), which sent 14 construction organizations to the island. The goal that the Regional Administration is trying to reach is that all incoming companies register locally and pay local taxes.

* *Lukoil-Neftegasstroj awarded large Sakhalin-1 project contract.* The large pipeline contract envisages design, licensing, overland transportation, logistics, construction and installation of pipelines. According to the top management of LNGS this is one of the largest contracts ever awarded to a Russian company on this project. It is planned to transfer some of the activities to subcontractors.

The company will start construction of the on-land part of the line pipe. At the end of 2002, Japanese company Nippon Steel and Lukoil-Neftegasstroy (LNGS) were jointly awarded the contract for design and construction of the pipeline for the first stage of Sakhalin-1. The pipeline will be laid across the Sakhalin Island to Khabarovsk Krai Territory (De-Kastri oil terminal), crossing the Tatar Straight underwater. Nippon Steel will be in charge of the underwater part of this project. The total amount of this contract is estimated at USD 300 million. The LNGS representative did not exclude the possibility that the company may be involved in local dwelling construction in the future. LNGS is participating in almost every tender available for industrial infrastructure development for Sakhalin-1(including De-Kastri terminal) and Sakhalin-2 (including the LNG plant project).

* *Objedinennaya Metallurgicheskaya Kompanija was awarded a tender for pipes supply under Sakhalin-1 project.* The company will supply 3.7 thousand metric tons of pipes for the project. Pile pipes, API 5L standard, will be used to build onshore and offshore structures. This is the third tender awarded to the company for Sakhalin-1, the first pipes delivery was carried out in May-June 2002. The pipes will be also supplied for the Chaivo - De-Kastri line pipe (105.6 miles long). The second delivery of pile pipes took place in the second quarter of 2003.

* *Tender for accommodations modules was awarded to the Sphera construction company at the beginning of 2003*. Sphera built the Zima village, module houses and warehouses in Nogliki, Poronaisk and other villages.

* *Local physicians work with the international companies at the new Fairweather clinic.* Last year the JV Island Aid was created at the local regional hospital with Fairweather company, specializing on oil industry servicing (http://www.fairweather.com/). The main goal for the creation of this new company is to provide first aid services to the local and foreign workers during the pipeline construction. The company provided the necessary additional language and professional training for medical specialists hired in the RFE. Island Aid opened first aid sites at the camps, and some support will be provided by the nearest district hospitals. A

special waiting hospital was organized for those expatriates who have to be transferred to Japan, which can be necessary when flying conditions are poor and/or impossible.

* *Negotiations between Smith International and FEMCO.* The Dutch company conducted negotiations with Sakhalin Far Eastern Marine Company. More than 5 years these two companies work together as subcontractors for Sakhalin-2 project. Two vessels of Smith Int'l provide year-round emergency guard services on Piltun-Astikhskoye field and other operations for the Molikpaq platform. FEMCO possesses unique expertise on ice-class oil industry supply vessel operations. The two companies discussed further upgrades in the process of vessels operation, possible future cooperation in diving support and terminal management for Sakhalin-1 and 2 projects. *(March, 2003)*

* *Far East Shipping Company to provide services for Orlan drilling platform .* The amount of the 5-year contract between ExxonMobil and FESCO for icebreaker services is estimated at USD 60 million. FESCO is considered to be the third largest shipping company in Russia - an owner of 77 vessels, total deadweight of which is about 1 million metric tons. FESCO's profit in 2001 made up USD 30 million. This year the company ordered an ice-class supply vessel to be constructed. Starting in the third quarter of 2005 the vessel will be chartered by ExxonMobil for a period of 5 years with possible contract renewal for another 4 years. Some sources announced that in the final stage of this particular tender 4 companies remained – Tide Water, FEMCO, PRISCO and FESCO. FESCO was chosen as "the most experienced in this specific field."

* *PRISCO and Sovcomflot will use 5 ice-class tankers of Aframax type for crude oil transportation for Sakhalin-1.* Crude oil will be shipped from the De-Kastri terminal in Khabarovsk Krai to the ports of Japan, South Korea and other Far Eastern markets. Depending on the future extraction dynamics the amount of the two shipping contracts is estimated at USD 400-600 million.

* Sakhalin Energy announcement on gas supplies to Tokyo Gas can be found at - http://www.sakhalinenergy.com/news/nws_releases_20030512.pdf

* *Amur Shipyard manufactures two Molikpaq modules.* The plant manufactured 2 modules for the platform, which were transferred to the port of Korsakov. The contract, which was signed 2 years ago, encompassed manufacturing of water flood facilities that will increase reservoir pressure and the amount of oil produced. The barge with the modules headed from Korsakov to the Piltun-Astokh field to deliver the modules to the production complex Vityaz where they will be installed (*June, 2003)*

* *On 25th June 2003, BETS B.V. signed Construction Contract No. H-00259 with Sakhalin Energy Investment Company Ltd. for the construction of the Onshore Processing Facilities.* The contract was signed for treating gas and unstable condensate from the Lunskoye field for subsequent transportation to the LNG Plant in the south of Sakhalin Island. The project is located approx. 40 km to the south of Nogliki and 40 km to the east of Nysh; 7 km away from the Okhotsk sea beach. Project duration: May 2003 – December 2006. *(www.betsbv.com)*

** Sakhalinskije Aviatrassy (SAT) signs an additional agreement with Sakhalin Energy and ExxonMobil.*
SAT signed a third agreement for the DASH-8 type Canadian plane to be used for servicing both projects. The latter will likely be used for regular services both inside the region and abroad. SAT is the first Russian carrier to use the equipment of this type. (*July , 2003)*

** Aker Kvaerner and Quattrogemini Ltd. sign a contract with Sakhalin Energy.* The contracts were signed for design, construction, technical assistance, logistics, management and servicing for the two rig foundations - Concrete Gravity Substructures (CGS). The design for the structures takes into account severe conditions for oil extraction which are typical for northern Sakhalin and Canada. The amount of the contracts is about USD 250 million. Quattrogemini will be responsible for the construction of the CGSs in Vostochny port, Primorski Region, where it will have to build the casting basin and all related infrastructure (temporary office space, batch plant, roads, equipment, etc.). It is expected that about USD 120 million will go to Russian subcontractors. Kvaerner (Norway office) will provide design services. *(July, 2003)*

** Hitachi Ltd won a JPY 6 billion order for four gas turbine generators and four compressors.* Hitachi said it will supply to Sakhalin Energy Investment Co by the end of June 2004 the four H-25 gas turbine generators, with an output of 26.9 megawatts each, and the four compressors for use at an oil and gas purification plant. *(July, 2003)*

** ExxonNeftegas awards contract for Sakhalin office construction.* As a result of a competitive tender process, a contract is being awarded to Bouyguesstroy (Russian subsidiary of Bouygues Batiment) teamed with the local company Transstroy Sakhalin for office construction. The new ENL office, located at the intersection of Sakhalinskaya St. and Mira Avenue, will provide a centralized workplace for more than 300 ENL employees. The facilities will include one five-story office building, a parking garage, gate house, and landscaping that will retain as much of the existing wooded setting on the site as possible. *(August 2003)*

** Chayvo drilling site's bridge construction completed.* The longest Sakhalin bridge (850 meters at present) has been constructed from Chayvo Bay as part of Sakhalin-1; this bridge will assist with the delivery of equipment for construction of the on-shore production complex. The bridge also will help shorten the existing road between Nogliki and Chayvo from 170 km. to about 100 km. The bridge consists of two components: a temporary bridge that will be

Picture courtesy of Exxon Neftegas, LTD

demolished after the end of construction and a permanent bridge. Dalmostostroy Company built the temporary bridge two weeks ahead of schedule and has now started construction of the permanent bridge, which is planned to be completed in early December 2003. *(August 2003)*

* *Nogliki airport new runway now in operation.* The runway's total length will be 1850 meters and 35 meters in width. The airport is being reconstructed as part of the Sakhalin-1 and Sakhalin-2 projects. Total cost of the project is $24 million. The contract for airport reconstruction was awarded to ZAO TransstroySakhalin and OAO Sakhalinmorneftemontazh. As part of the construction, TransstroySakhalin bought a special mobile asphalt plant that is currently located at the airport site. According to TIA Ostrova, the company installed runway lights purchased in Germany. Sakhalinmorneftemontazh constructed the airport building and the control tower. The airport building consists of three sections: passenger services, airport administration, and a section for oil and gas company representatives with a conference hall. Plans are to complete the reconstruction by early 2004. The airport area will increase from 78 to 125 hectares.

* SakhalinMorNefteMontazh Alaska Projects Awarded Civil Construction Work Contract for Sakhalin-1. Press-release available at the web-site http://www.sakhalin1.ru/en/index.htm (Under *Contracting* section)
http://www.sakhalin1.ru/ru/whatsnew/press/sub_05222003_SMNMAK.html

* *Aviation company Vostok was awarded Sakhalin-1 contract.* The company from Khabarovsk will provide marine offshore-equipped helicopters with crews, maintenance and spare parts, services. Two helicopters are currently used for Sakhalin-1, two more will be purchased at Kazan Helicopter Plant.

* *Chioyda and Tokyo Engineering were awarded the initial contract for the LNG plant construction*. The contract for USD 2.6 billion was awarded by Sakhalin Energy, Sakhalin-2 consortium. Chioyda and Tokyo Engineering, together with Russian partners (KhinEnergo Group and Gaspererabotka Institute) will start the construction this summer. (http://www.chiyoda-corp.com/index_e.html)

* *Nippon Steel to Build Exxon Mobil's Sakhalin Pipeline.* Nippon Steel Corp., Japan's biggest steelmaker, will start building a 220-kilometer oil pipeline for Exxon Mobil Corp.'s Sakhalin-1 oil and gas project next fall. Full story -
http://quote.bloomberg.com/apps/news?pid=10000101&sid=a3hy7MAfy4ZI&refer=japan

* *Fugro company, Netherlands (http://www.fugro.nl/), obtained Sakhalin-2 contract* for pipeline pre-construction survey. Full story -
http://www.fugro.nl/news/newsdetails.asp?item=188

* *Sumitomo Corporation created a JV with Kriljon-Service.* Japanese Sumitomo Corporation signed a contract with Sakhalin Energy for a telecommunications system supply (amount of contract – about USD 60 million). To work on this project Sumitomo established a JV which will act as a general contractor. The whole team includes the Sumitomo Corporation (Japan), Kriljon-Service (Russia), ABB AS (Norway) and Fujikura (Japan). Sumitomo/Kriljon, as the head entity for this project will be responsible for management, services and necessary

maintenance for the project. ABB is responsible for project management at the design stage, quality control and environmental impact control, engineering, supply, installation and startup. Fujikura is responsible for engineering, supply and fiber-optic cable laying. The ABB share in the Sakhalin-2 telecommunication system project is estimated at more than USD 30 million, for the development and supply of telecom systems for oil & gas platforms, an 800-kilometers pipeline, equipment for 2 bays and infrastructure upgrade. It is planned to engage both Russian and Norwegian engineers. (October 2003)

Local Difficulties for Sakhalin Shelf Projects

Governmental approvals: It is typical for Russia that obtaining approvals takes a long time. Final endorsements and approvals are made by Federal level officials, and foreign contractors are not always familiar with Russian standards.

Severe natural conditions: Uneven terrain and insignificant infrastructure is characteristic for Sakhalin. Winters are long with extremely low air temperatures with a long ice-covered period and frequent storms in the ice-free season. High seismic activity and ecological sensitivity of the region are also major factors.

Workforce Availability: This remote island territory has only a small population and modest industrial capacity. There are limited local contractors with scant technical capabilities and few highly qualified personnel. In addition, there is alack of office space, warehouses and similar facilities for new contractors. Incoming contractors require a high level of logistical support, mobilization, and demobilization expenses.

PSA remains with no changes for Sakhalin-1 and 2:

In February 2003 official discussions started in Moscow about Production Sharing Agreements (PSA) in Russia. Prime-Minister Kasyanov held several meetings on PSA and related legislation changes for currently established PSAs on Sakhalin. Another question under discussion was the antimonopoly legislation for the pipelines. According to the existing rules, all pipelines are considered to be State property and the State can regulate tariffs to the local market and provide outside manufacturers access to the pipelines. This legislation was adopted after the initial Sakhalin PSAs were signed and can influence investor activities, which theoretically cannot happen according to the PSA. Sakhalin Energy *(Sakhalin-2)* was waiting for these changes to be able to make a decision on further investment stage (USD 10 billion). The officials analyzed existing possibilities of outside manufacturers appearance on the island and the transportation schemes and as a result, considered it inappropriate to place Sakhalin-1 and 2 pipelines apart from the existing antimonopoly legislation. It was decided that the terms already stipulated in Production Sharing Agreements are sufficient enough to provide the necessary flexibility and protection of investors' rights.

There have been some publications in the central Russian press about Sakhalin PSAs, with rather subjective opinions and did not represent facts properly to Russian readers.

There will be no new fields specially announced for the PSA regime in the future. Potential counterparts of PSA projects operators oppose the PSA idea (Russian pipe and machinery manufacturers want to see more contracts being concluded with Russian companies). Yukos and Sibneft, who joined the opposition later, think that the companies under a PSA can be more attractive for investors.

Russian officials, together with the representatives of oil companies discussed changes to the chapter of the Russian Tax Code on PSA taxation before it was sent for Duma approval in the second reading. It was stated that the PSA regime should be applied "as an exceptional measure when relevant". The field licenses should be auctioned first on common conditions. If the license is not purchased and the State decides that the field should still be developed, a PSA can be signed. The licenses for the majority of 27 PSA list-included fields already have their owners, so the license, to be auctioned, should be first recalled from its owner which usually takes years, not speaking of the possibility of further PSA negotiations (out of 375 million metric tons of oil extracted in 2002, 73 were extracted in the fields that can be potentially developed under a PSA, but these are developed under common conditions). The Government did not state clearly what could be considered "exceptional measures". Some opinions exist that the investment is flowing into Russian oil sector without any special conditions created. These discussions increased after the BP and TNK deal announcement.

The Head of Rosneft, Mr. Bogdanchikov thinks that the opponents for the PSA in Russia acquired the most productive fields when these were distributed. The fields have low extraction costs and provide competitive advantages that these companies are trying to keep for another 15-20 years. It is clear that investment in a new region, with the necessity to develop infrastructure, will always make it uncompetitive compared to already developed territories. Mr. Bogdanchikov has an opinion that the "euphoria'" from Russian oil extraction increase will soon come to an end, because none of the newly available oil & gas provinces have been developed since the mid-eighties. Sakhalin development started only due to the PSA and foreign investors. Russian private business in the oil industry did not prove its ability to develop new petroleum and gas areas; the activities are carried out thanks to the assets that were "inherited" for free, Mr. Bogdanchikov said to the press.

ExxonMobil was arguing that depriving the investors of their right to sign the PSA is equal to depriving them of their property. The company was concerned that the continental shelf field would be removed from the list of non-auctioned on general conditions. The Sakhalin-3 Kirinski block (ExxonMobil, Rosneft, ChevronTexaco) is in the unique position – it gained the right for a PSA as a result of an international tender and significant funds were invested in 3D seismic survey and a feasibility study. The Russian Government did not make changes to the PSA fields status of Sakhalin-3, Prirazlomnoye and Shtokmanovskoye (Rosneft, Gasprom), Central and Yalamo-Samurski perspective Caspian fields (Lukoil). In order not to put all the field names in draft law, the officials made an amendment which excluded "the fields, situated on continental shelf and/or within the special economic zones, as well as the fields, which are PSA-developed by international agreements." The Russian Duma Budget Committee, on the other hand, wanted to make no exception for investors and recommended that the State Duma reject the amendment. Rosneft President Mr. Bogdanchikov asked the Speaker, Mr. Seleznyov, not to consider the Governmental changes to the basic PSA law. According to Mr. Bogdanchikov, these amendments "change the concept of the law (referring to the Chapter of the Tax Code on PSA) because they establish totally different rules for PSA-developed field selection." He thinks they should be approved as a separate law.

Lukoil and TNK, whose fields were also at risk of being auctioned, did not publish any comments on the PSA. But there were signs that TNK was also troubled by this problem – it has "not only Samotlor, but also Uvat an Kovykta fields, and all these projects are developed". The Head of Yukos Press Service Ms. Shadrin noted that no difference for single investors should be made. Projects underway should work, but all other fields have to be auctioned, Ms. Shadrin said.

The Chairman of the State Duma Committee on Natural Resources and Management Mr. Alexander Belyakov stated that the new governmental amendments to the Tax Code would de facto cancel the PSA regime in Russia, making it unattractive. According to him, it will break the investment attractiveness of Russia because the investors need stable legislation first of all. He referred to the opinion of former USSR Minister of Geology Mr. Kozlovski, saying that the explored and available sources of energy in Russia will last for only 15-20 years. Around USD 100 billion has to be invested into the industry in the next years for oil field development reproduction. "Half of this amount can be invested by Russian companies, but the rest should be collected from foreign investors", - Mr. Belyakov said.

The governmental amendments to the second reading of the draft law change the PSA conclusion procedure in principle. In order to switch to the PSA regime, the subsoil user has to reject the license, wait until the auction on it fails due to no interest, and then win the auction for the right to sign the PSA with the government (not relevant to five fields – Sakhalin-3 block, Prirazlomnoje and Shtokmanovskoje, Central and Uyalam-Samurski fields on Caspian sea).

Shell lost the hope to work on the fields in the Khanty-Mansiiski Area and agreed to develop the fields under common conditions. In 1993 Shell was awarded a tender to be a partner of the Russian company Evikhon in order to develop the Salymski group of fields under PSA conditions. At the end of 1999 the PSA project was submitted to the Government, was soon reported out and never refined. After some shareholder changes and new plans for field development it was decided that the development would be carried under common conditions, which is more realistic than waiting for a PSA. Shell did not give up the hope for a PSA completely but will work on common conditions in order to show its interest in the project. Almost nothing was done on the project since 1993 and in case of further inactivity it could be auctioned again.

On May 14th 2003, the Duma approved in the second reading the changes to the Tax Code and the basic PSA law. It finally left only five currently PSA-related fields in the list – Sakhalin-3 (ExxonMobil, Rosneft, ChevronTexaco), Prirazlomnoye and Shtokmanovskoje, Central and Yalamo-Samurski fields. The new PSAs will have to involve Russian materials and labor force under penalty of being transferred to the common regime of field development. The new amendment leaves no chances to buy imported equipment through Russian firms, which formally helped follow the PSA Russian content rule. Not less than 70% of equipment should be purchased from Russian manufacturers –"equipment, technique and materials are considered Russian if they are manufactured from joints and spares not less than for 50%, in money terms, manufactured in Russia". The PSA operator would have to submit annual reports proving not less than 70% of purchases and 80% of staff is of Russian origin.

The amendments do not influence three already running projects – Sakhalin-1 (ExxonNeftegas – 30%, ONGC Videsh Limited – 20%, RN Astra – 8.5%, SMNG-Shelf – 11.5%, SODECO – 30%) , Sakhalin-2 (Shell Sakhalin Holdings B.V - 55%; Mitsui Sakhalin Holdings B.V. - 25%, Diamond Gas Sakhalin B.V., a Mitsubishi company - 20%) and Kharyaginski field (Lukoil – 20%, Totalfinaelf – 40%, Norsk Hydro- 30%, Nenetskaya Nerftyanaya Kompaniya (Nenetsk Oil Co.) – 10%), which "grandfathered" the PSA – signed before this Russian PSA law was approved. The candidates to play by new rules are the five fields mentioned above. Some opinions exist that there will be hardly any new PSAs signed in the near future due to this more rigorous legislation.

President Putin signed the law changing the PSA regime taxation method. The new law is comprised of a special taxation regime when the payment of total amount of taxes and fees is substituted by production sharing. The difference between the existing order is that the taxable base (of oil and gas production under PSA) is defined not as the cost but as a quantity of extracted natural resources. The taxation rate is defined not as the percentage but as the fixed amount – RUR 340 per one metric ton.

The possibility of limiting the maximum level of commercial extraction is also envisaged, if reaching such a limit, the rate may be applied with the index 1.0 instead of 0.5 for the whole period of PSA validity. Limitations were set on the maximum level of compensational products of the total amount manufactured – not more than 75%, in case if continental shelf extraction- not more than 90%) and the investor's share in manufactured product (not more than 68%) in case of direct production sharing.

According to Mr. Khristenko, the Russian State Committee considers the level of Russian content being not satisfactory. A year ago some measures were taken in order to increase the content of local companies participation in existing PSA's, but for the past 5 years the percentage of the local companies reached the level of 44% (depending on a year, the figure varied from 25% to 60%). The State Committee considers this level not satisfactory, as well as the methods that are being used to determine the level of Russian

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conduct their own due diligence before entering into business ventures or other commercial arrangements. The Department of Commerce can assist companies in these endeavors.