

## COMMERCIAL UPDATE - SAKHALIN REGION, January 2004 (Russian Far East)

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This report contains the following items on oil and gas:

- On January 21 and 22<sup>nd</sup> the Authorized State Body for Sakhalin-1 and the Advisory Council for Sakhalin-2 meetings took place in Yuzhno-Sakhalinsk.
- Pipeline Construction starts.
- Scientists and ecologists to discuss gray whales problems again.
- Oil carries a price. (Rosneft-Sakhalinmorneftegas press-conference).
- Interview of Mr. Ramil' Valitov, Rosneft-Sakhalinmorneftegas General Director to *Region* Newspaper.
- Mikhailin Kasyanov's visit to Japan – December 2003.
- Oil and Gas complex Department Director Ms. Galina Davlova speaks on 2003 results.
- Saipem and Samsung Heavy Industries Co obtained 2 contracts from Sakhalin-2.
- Finnish companies to participate in Sakhalin-2.
- Urban construction Company constructing Olympia Housing Complex.

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The major topics were approvals of budgets for the current year. It is planned to invest about USD 3 billion for Sakhalin-2 and USD 1.4 billion for Sakhalin-1. In 2003 the total investment made up about USD 3 billion.

In April Sakhalin-1 is to submit its proposal on the gas component of the project. The Russian side announced at the Authorized Council meeting that the gas component should be promptly developed. The question was raised that Exxon Neftegas should discuss gas marketing issues more openly, as Galina Pavlova stated to the press. The decision was made to have the next meeting of the Advisory Council in April of this year and to discuss the issue of the future gas pipeline. There are three possible variants – Japanese markets, South Korea or China. According to Ms. Pavlova, Exxon Neftegas considers Japan as a priority, but the company did not obtain any specific proposals yet.

In 2003 Sakhalin-1 started an infrastructure upgrade in the north of the island, upgraded the Nogliki airport, drilled first wells at Chaivo, built the bridge from the drilling area to the place of the future Onshore Processing Facility, major contracts were awarded for drilling areas, vessels freight, office and dwelling complex construction. In 2004, ENL will proceed with these activities, the future pipeline route will be cleaned as well.

The budget for Sakhalin-1 for 2004 was approved in the amount of USD 1.367 billion. The Russian side again brought up the question on maximizing the Russian content, which at the moment makes 60-65% but the Regional Administration wants to raise this level. The question

will be raised again at the April meeting. At the moment the construction of industrial infrastructure is being approved by the State Expert Commission. Environmental approval is almost ready, but the feasibility study is to be approved at Gosstroy (Construction), the Ministry of Economic Development, the Ministry of Taxes, and the Ministry of Finance. Exxon Neftegas believes that the approvals can be obtained in two months. Other questions discussed were the upgrade of several landfills, infrastructure, and first of all – the road between Okha and Nogliki. At the moment there are some complaints about the Baltic Construction company activity and the Regional Administration demanded that the conditions and term of work are met. The Administration demanded also that ENL should partially change the contractor, and part of the construction contract was already given to JSC Dal'moststroj. More than USD 20 million is allocated for environmental studies (such as Gray whales, Steller's sea eagle, etc).

Seventeen questions were discussed at the Supervisory Board for Sakhalin-2. Major topics concerned the approval of the schedule and budget for 2004. The budget makes up more than USD 3 billion (2.8 billion plus more than 200 million for social projects and other outpayments) – this is the maximum annual scope for the project (to cover the cost of the LNG plant and pipeline), the figure will decrease in 2005. Other questions discussed include – Russian share of gas, Sakhalin gasification, increasing of Russian content, environmental and labor safety.

Several environmental issues were discussed as well. The agreement was reached between the Russian side and ENL on using slide valves at the future pipeline to De-Kastri. The initial variant proposed by ENL envisaged manual valves, which led to numerous protests among environmentalists. ENL announced that automatic remote control valves will be installed at the pipeline. Another question discussed was future tanker transportation in Tatar Strait. Due to the difficult ice situation and active fishing in the Strait, the Russian side wants Exxon to take full responsibility for the possible oil spill during tanker transportation. ENL should send an official note to the Regional Administration, stating that the company certifies its responsibility, together with the tanker owners, for the possible oil spills, Ms. Pavlova said. (*Source- TIA Ostrova*)

*\* Pipeline Construction Starts.*

On January 23<sup>rd</sup> the ceremony for the first pipes welding took place in Sokol village. Weather conditions did not allow celebrations at the site – the ceremony took place in the Sakhincenter. The first kilometers will be installed by *JSC Svarichno-Montazhny Trest*. The USD 1.2 billion contract for the pipeline envisages construction of 800 kilometers long twin pipeline (for oil and gas). Starstroy (major contractor) employs 2 thousand specialists on the island and there is a need for another 3 thousand. The 1200 units of equipment were delivered to the island to work on the pipeline project. Starstroy will construct the pipeline in alliance with Russian LUKoil-Neftegasstroy and European companies Saipem SA and AMEC Spie Capag. Six Russian companies act as subcontractors. (*Source – Sakhalin Investment Promotion Agency, Yuzhno-Sakhalinsk & Sovetsky Sakhalin Newspapers*)

*\* Scientists and ecologists to discuss the gray whales problems again.*

The Institute for Marine Biology of the Russian Academy of Science held a roundtable on the gray whales problem. The Roundtable was organized by the public companies coalition *Zhivoye More* (Live Sea) – IsaR DV (Far Eastern Resource Center) and *Ecologicheskaya Vakhtha Sakhalina* (Environmental Watch of Sakhalin). The questions discussed were the current state of the western population of the whales, stages of the oil projects, present and potential threat to the whale population from oil and fishing business. Another goal was to work out recommendations for decreasing the risk of the industrial influence on the population and to discuss the five-year program for gray whales study proposed by Sakhalin Energy Investment Co.



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Okhotsk Sea – the Korean population of gray whales survived after the times of whaling in the XVIII-XIX centuries. It was believed for a long time that the population was fully destroyed. But in the late 70s the whales came back to the shores of Sakhalin. It is not clear where they stay during the winter (presumably near the shores of Japan or Korea). In spring they travel to the North-eastern Sakhalin bays, which are the only ones that have the proper forage conditions. Right now this population consists of about 100 whales and is considered to be the most scant in the world. (*Source – Деўта.RU, January 12, 2004*)

SEIC held consultations in Vladivostok concerning the gray whales problems. The consultations were related to the whales studies independent program; they attracted specialists from several Far Eastern scientific institutions and public organizations. The representative of the public organization Environmental Watch of Sakhalin Mr. Dmitrij Lisitsin said that Sakhalin Energy has studied the Okhotsk Sea population of gray whales already for 5 years, USD 3 million were used and, according to Mr. Lisitsin, no comprehensive study was completed. He said that the studies were isolated and not properly coordinated, and were probably deliberately not consolidated with one idea. Also, as Dmitry Lisitsin states, the company equates protection and studies; currently available data do not help to understand the situation and to take the right measures, the pipeline is to cross the southern part of the whale pasture and according to SEIC, “moderate” influence on the population is inevitable. Mr. Lisitsin states that SEIC does not propose any alternatives to that. He refers to the law, which states that the whale population cannot be exposed to any influence, even minimal. In total, SEIC plans to hold 4 consultations on gray whales studies - three of them already took place. The fourth one is scheduled to take place in the US. (*Source – Sakh.com, January 21, 2004*)

*\*Oil carries a price. (Rosneft-Sakhalinmorneftegas press-conference)*

On January 09, 2004 Rosneft-Sakhalinmorneftegas General Director Mr. Valitov held a press-conference on 2003 preliminary results. The year was quite successful for the company, 1652.8



thousand metric tons of oil were extracted (which is more than was forecasted, and higher than the level of 2002). Gas extraction met the plan. Rosneft-SMNG drilled 24.14 kilometers of wells, the number of production wells increased by 41. The forecasted profit of the company for 2003 is approximately USD 30 million, and all bad debts were paid. The average salary in the company is USD 650. SMNG spent about USD 3.7 million on social payments. At the same time, there are signs that the traditional onshore fields are depleted. Despite the fact that Rosneft-SMNG increased the associated gas utilization ratio that enabled, due to compression, extract additional 200 cubic meters of gas, in 2004 Rosneft-SMNG is planning to suspend the flares and to collect all the associated gas. The total amount of gas extracted is not increasing and there are no plans to increase the extraction. The only perspective trend is the shelf projects. A similar situation exists with oil - onshore fields are getting more complicated in terms of extraction and the cost of product is growing. In 2003 the extraction of one metric ton of oil was 11 cents

more expensive than in 2002, the goal will be to at least hold the price at the same level, one of the measures being to get rid of non-core and low profit assets. Some of them will be re-structured into the independent companies, some will be sold. The same destiny awaits the floating rigs – those constructed in the 70s cannot compete with the modern western analogs. (Source- Sovetski Sakhalin newspaper, January 13, 2004)

*\* Interview of Mr. Ramil' Valitov, Rosneft-Sakhalinmorneftegas General Director to Region Newspaper.*

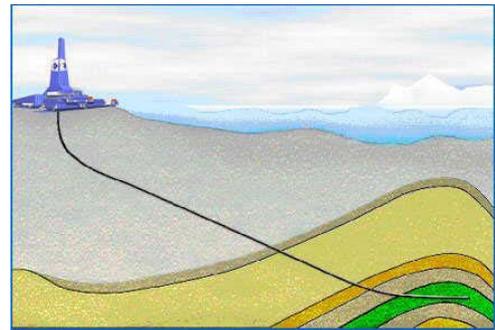
Mr. Valitov was appointed General Director of Rosneft-SMNG in May, 2003. Before that he was the Deputy General Director for 5 years, one of the major sectors of management for him was drilling, which normally takes 70% of any oil and gas company investment.



Mr. Valitov reported that the plans for 2004 are to extract 1 million 700 thousand metric tons of oil. In 2003 Rosneft-SMNG was celebrating its 75<sup>th</sup> anniversary. The long history of the company also has its drawbacks – the fields are mostly depleted, Sakhalin oil is viscous and is even rated as “difficult for recovery”. The wells are old, but the amount of hydrocarbons available for extraction is still

high, but the fields are quite drowned and the oil is to be extracted with water. The methods for such oil extraction are quite expensive; from maintaining formation pressure to steam injection and fireflooding. The latter was invented by local scientists and was first implemented in Russia by Rosneft; it makes it possible to extract oil from pocket zones. All this makes the extraction the most expensive in Russia (average price for Siberia oil is RUR 800-1200 per metric ton, on Sakhalin – RUR 2000-2300), while it is being sold practically at the same price. The major factors that help the company to be profitable are the development of new, perspective fields and upgrade of the extraction technologies. The first deviated well at Odoptu filed was drilled for 9 months – now the same process takes less than two months. The technology was taken over by Exxon Neftegas and ENL is now drilling horizontal wells with the Yastreb rig at Chaivo (Yastreb's equipment is more up-to-date and allows to drill wells up to 9.4 kilometers long (5.8 miles), while Rosneft-SMNG drilled only 7.4 kilometers well (4.6 miles).

Horizontal (directional) wells are drilled first vertically, then horizontally under the sea bottom until they reach the hydrocarbon-bearing formation. The maximum allowed mistake is 32.8 feet (10 meters). The well can be in use all-year-round compared to the offshore wells. Mr. Valitov pointed out that this type of well is more cost-effective and is ecologically safer. The first Sakhalin shelf oil came from the horizontal well drilled by Rosneft-SMNG in 1998 (Sakhalin Energy produced the first oil in summer of 1999). Unfortunately the horizontal wells only help to reach the fields that are located 10-11 kilometers (6-7 miles) from shore, and there still are perspective fields located 18 kilometers and farther from shore. At any rate, the directional drilling method can be used for a long time – there is still enough oil located close to the shore.



Speaking of gas extraction Mr. Valitov had to admit that it is dropping. The oil fields are being depleted as well. Gas fields, in comparison with oil, cannot be “washed out” of a depleted reservoir. An increase of gas extraction can be possible only at the expense of new fields. Mr. Valitov was speaking of Vostochny Osoy as the nearest perspective. The field is 5 kilometers deep (3 miles), there is no Russian-made equipment for such deep drilling available, and imported equipment is expensive and custom-made. Rosneft-SMNG is planning to shift equipment from Odoptu, after the project is over and drill at Osoy. The other two perspective gas fields are Ust'tomi-More and Mongi-More which will be thoroughly explored.

Mr. Valitov also answered questions concerning the company subdivisions that are involved with construction, oil products sales and transportation. He pointed out that the company will continue with these types of activities as well since they are considered to be profitable and convenient. They help not only to provide all the necessary logistics for the parent company but also to obtain sub-contracts from the Sakhalin-1 and 2 operators. Rosneft-SMNG supplies Exxon and several construction companies with fuel from the Komsomolsk refinery, taking the leading place for fuel supplies in the region. Rosneft-SMNG has 17 fuel stations on the road from Okha to Korsakov.

Rosneft-SMNG promotes urban construction, being the major employer for such districts as Okha and Nogliki, where the company also performs its social tasks - construction of housing, hospitals and schools. In 2003, two apartment houses were constructed for 84 families. A new hospital is being built in Nogliki.

Mr. Valitov commented on competition of his business with Sakhalin 1 and 2. The disadvantages are that Rosneft-SMNG has lower salary figures, so the company is losing staff to work for foreign investors, and the PSA conditions, which enable the investors to get compensated with hydrocarbons extracted. Mr. Valitov pointed out that any expenses, even unnecessary, are to be compensated and the higher they are the later the actual production sharing starts (when the Russian side can get their part of hydrocarbons). On the other hand he stated that it is not a right position to criticize the PSA as unprofitable for Russia – which became a “fashionable trend” recently when one wants to look as a patriot; this is the view of the situation as of today only. Back in 1994 when the PSA was signed Russia did not have money to invest and the PSA was the only way to attract large investment, which led to the present level of development. Mr. Valitov remembered the last election campaign when almost every candidate promised to implement his plans using oil-related money, since it is obvious that the oil industry is the only possible source of income. Forestry is in stagnation, as well as pulp and paper industry; the coal industry is hardly making profits, and fishing industry is also in difficult situation – the good thing is it gives jobs to more than 20,000 people. There are no more leading industries on the island. Mr. Valitov’s persuasion is that if not for the shelf projects, there would have been no such perspectives for Sakhalin as at the moment. Another story is that PSA regime needs to be revised and corrected, because the situation is now different. The foreign investor is here and is not going to leave, and if the Russian side, using civilized methods, will be able to change the PSA by signing additional agreements, this should be accepted as normal.

Mr. Valitov answered the questions of environmental claims. He admitted that the harm is really high and it cannot be totally eliminated – it can be only minimized. In 2003 the company did a lot in this respect. The complete set of equipment and neutralizing sorbents was stocked. A special vessel is regularly on duty at Chikhachev Bay oil terminal to track safe oil transfer to tankers. At the moment the company is liquidating the well-known oil spill near Katangli. The oxidized oil was accumulated at the lake bottom for decades, the lake is separated from the sea by a dam only. In 2004 this lake will disappear. Rosneft-SMNG found the way to pump out the residual oil, 6 thousand metric tons in total. This was the major difficulty – now the lake is being covered with soil – the major channel will be left, with oil “traps” (filters). At other sites the company is upgrading their treatment systems and is switching from an open to closed collector system, in order to eliminate oil contact with environment. (*Source – Region newspaper*)

*\* Mikhailin Kasyanov's visit to Japan – December 2003.*

During the visit Mr. Kasyanov discussed Sakhalin-1 and 2 development. The Japanese share in the projects is 30% and 40% correspondingly and USD 8 billion is to be invested. Liquefied gas



<http://vff-s.narod.ru/sh/22>

and fuel which is exported to Japan is due to decreased dependence of this country on Middle Eastern fuel. As it was noted by Kasyanov, Sakhalin-2 already entered its intensive implementation stage with about USD 250 million of investment a month. According to the Japanese side, Sakhalin-2 implementation will double the trade turnover between Russia and Japan.

RAO EES (United Energy System of Russia) representatives discussed the possibility of an energy bridge construction between Sakhalin and Hokkaido. The next step is to work out the feasibility study and to negotiate power export contracts in Japan. (Source - *Независимая газета*, December 16, 2003)

*\* Oil and Gas complex Department Director Ms. Galina Davlova speaks on 2003 results.*

The Regional Department for Oil and Gas consists of 16 people. The Department coordinates the work of all oil and gas, geological survey companies in the territory and carries out certain amount of foreign economic activities. The Department works not only with the local subcontractors, but with the companies coming from other regions of Russia.

At the moment the major extracting companies in the region are Sakhalinmorneftegas (SMNG) and Sakhalin Energy (SEIC).

The major producer of gas is again SMNG, major customers of this gas are mainly in the Khabarovsk Krai. The annual extraction plans for the region were met.

In 2003 about USD 3 billion was invested into Sakhalin-1 and 2. At the moment it is obvious that the expenditures are much higher than profits. About USD 20 billion is to be invested into Sakhalin infrastructure. The LNG plant, the first of this kind in Russia, was highly appreciated by President Putin. The airport in Nogliki was upgraded in 2003.

The Regional Administration is discussing the possibility of Sakhalin 4, 5 and 6 development. Sakhalin-5 geological survey licenses are available for all 4 blocks, licensing is available for Sakhalin-6 and partially for Sakhalin-4. Sakhalin-3 is still waiting for some positive changes.



*Picture by WINNE*

- All is set for major construction.

Thousands of units of heavy equipment were delivered to the region, more than 10 thousand specialists were attracted. In July 2003, Sakhalin-2 obtained positive conclusion from the State Environmental Expertise. At the end of 2003, the expert examination in Gosstroy had to be finished for all the industrial objects. For Sakhalin-1 the State Environmental Expertise is still underway and it is planned that in February Exxon Neftegas may have the approval for the construction to start.

May 2003 - when it was announced that Piltun-Astokh and Lun'skoye fields will be developed, with the investment of USD 10 billion - became a landmark date. Sakhalin-1 approved the long-term comprehensive plan of facilitation and the installation of the Yastreb onshore rig. The first deviated well, more than 11 kilometers long (about 7 miles) was drilled.

- Infrastructure – pluses and minuses.

The region considers it very important that more than USD 250 million is invested into the associated infrastructure upgrade – roads, bridges, culverts, Nogliki airport. Transit roads in villages were also paved, which was a pleasant surprise for many local Administrators. Subcontractors received a letter from Sergey Belozerkikh stating that if the problem sectors of roads would not be upgraded by spring, no cargo will be allowed to move at these areas. Unfortunately, to a large extent, this is the fault of Russian subcontractors (Galina Pavlova mentioned Baltic construction company). The Kholmsk Fishing port was upgraded and is transporting pipes, ready for welding. More camps are being constructed for temporary workers. Different companies are facilitating their sites in different ways. Starstroy (having the USD 1 billion contract for pipeline construction), for instance, did excellent facilitation work. These camps received many favorable reports from the local district authorities. In the Korsakov district, on the other hand, temporary settlements receive negative comments. Certain contractors, mainly Russian, bring in workers and hastily construct huts, to complete the work at any price. The Regional Construction Department had a serious meeting concerning such cases and camp construction was taken under strict control. The great deal of work was done at the railway – dead-ends upgraded, temporary modules constructed, new traffic lights installed. Sakhalin communications people will install fiber-optic lines on the island. The service sphere is improving, but there still are not enough offices, hotels and even show-rooms. Many companies are offering their services for such construction, a large Indian company recently expressed interest. There is also a topic that is not very much discussed but is of top interest especially to the inhabitants of northern Sakhalin – the upgrade of the so-called waste grounds. Sakhalin Energy allocated USD 3 million for this work. The regional administration made a decision that the Sakhalin part of hydrocarbons (which partially substitutes taxes) should be first of all used for gasification of Power Plant #1 in order to mitigate the ecological problems of Yuzhno-Sakhalinsk. In 2007 it will be possible to supply gas to the local power system. Sakhalin University established the Oil and Gas Faculty. At the moment the operator companies employ about 700 Russian specialists. Exxon Neftegas is training another 100 people to work at its sites. At the moment Russian companies have contracts for about USD 5 billion, which makes 50% of

total. (Abstracts from the article published in *Gubernskije Vedomosti* newspaper, December 10, 2003)

Has the development of the shelf projects really become that “locomotive” that helps the Sakhalin economy to move forward? Was Governor Farkhutdinov’s policy progressive or are opponents of foreign investment right? The existing specter of accusation is wide – from “selling Russia” to statements that the oil and gas from Sakhalin is not needed by Asia Pacific countries and that there is no positive influence on the local economy so far.

- To Be or Not To Be?

The Regional Administration was far from illusions from the very beginning. 6% of extracted hydrocarbons is probably not enough, 12% is a more desirable figure. Unfortunately, investment money is what was always difficult to raise in Russia. The foreign investors also knew that. It was necessary to compromise and provide advantages in order for the Sakhalin projects to happen – the choice was either to start the development or to leave everything as is. Igor Farkhutdinov knew that the extraction is just half a deal – the serious work is not to be done on finding the buyers and staying in these markets.

- Time and Money

In 2001 the social sphere of the region started to be upgraded - schools and hospitals were re-equipped, additional funds were available for public utilities upgrade. The funds were available from the non-budget fund of the region, formed partially from the oil industry money.

- Break-through

2003 became the projects turning point. The construction began and the scope cannot be compared to any other construction projects in the region. Demand for workers is exceeding availability.

- Perspective

The contracts for LNG sales were signed. The last London conference *Oil and Gas of Sakhalin* again proved the perspectives for Sakhalin gas to enter the Asia-Pacific market.

- Errors Correction

The oil and gas projects were not implemented smoothly. Galina Pavlova talked about these difficulties at the London conference. For the Russian side the problems arise in the form of - Russian content, legal background development, enforcement of the environmental side of the projects. The positive trend of increasing employment at the cost of shelf projects, on the other hand, led to deficiency of specialists in forestry and public utilities maintenance in some districts. (Abstracts from *Hauu ocmposa* newspaper article by Igor Matveyev, December 12, 2003)

*\* Saipem and Samsung Heavy Industries Co obtained 2 contracts from Sakhalin-2.*

Italian company Saipem SpA and South Korean Samsung Heavy industries were awarded 2 contracts for the construction of a marine pipeline and platform installation for Sakhalin-2. The total amount of the contracts is USD 343 million. The first contract, with Saipem, is to be implemented by 2005. The contract includes engineering, development, construction and installation of twin pipeline from oil Piltun-Astokh to gas Lun' fields, as well as from the offshore platforms to the shore. The work will be carried out with two crane ships in two stages – in the summer of 2004 and 2005. The second contract, awarded to Samsung Heavy Industries includes transportation and installation of 2 drilling platforms, the first one to be installed in summer of 2005, and the second, the heaviest one – up to 28 thousand metric tons is to be installed in summer of 2006. In 2004 SEIC is planning to invest USD 2.8 billion in 2004 compared to 1.8 billion already invested in 2003. The total amount of investment for Sakhalin-2 made up USD 4.4 billion, the total investment during the lifetime of this project is supposed to reach the figure of USD 10 billion. (*Source – Sakh.com, January 20, 2004*)

*\* Finnish companies to participate in Sakhalin-2.*

Finnish mass media sources announced that the private export agency Exportum started collecting applications from Finnish companies who want to participate in tenders for Sakhalin-2. Large companies – Masa Yards and QuattroGemini were already awarded contracts for Sakhalin-2. (*Source – Rosbalt Agency, Sakhalin Investment Promotion Agency, January 22, 2004*).

*\* Urban construction Company constructing Olympia Housing Complex.*

The Turkish construction company is constructing the complex for Exxon Neftegas Limited in 2003-2005. The complex will have 77 residential units, a community center, support services buildings, sports fields and facilities, paved roads and infrastructure. The total scope of work of the company is for 22,000 square meters (5.5 acres). The permanent residential complex (the residential units are designed to have 2 and 4 rooms) will also have open-air sports facilities of 23,000 square meters. The total facilitated area is 27,000 square meters.

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