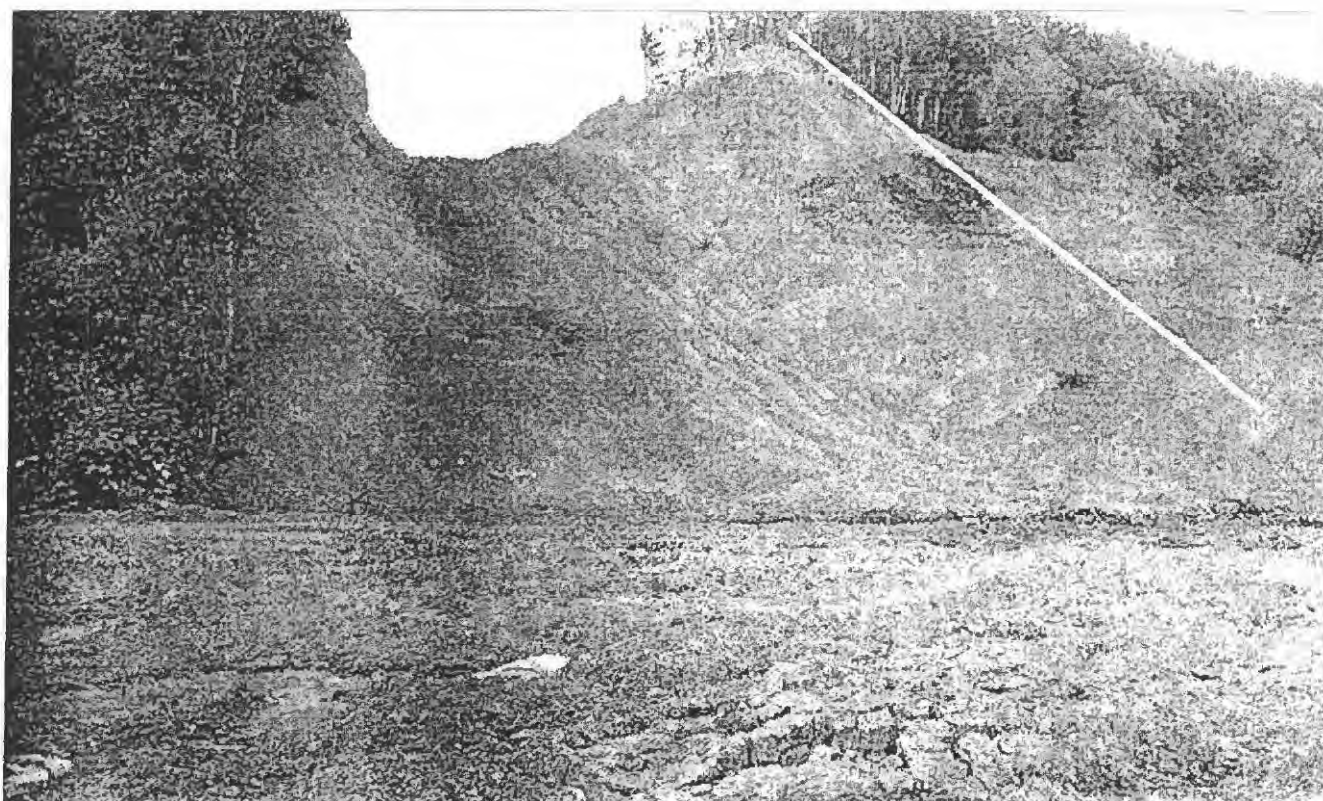




The Ai River (flows into the Sea of Okhotsk) is one of the large rivers in the south of Sakhalin Island; 504,3 KP. There is a salmon rearing station upstream from the pipeline route.

The pipeline construction works have been already completed here. However, in contrast to the left bank of the river, the right bank is lacking of bank protection. Ironically, this bank is much steeper than the far bank. Moreover, the river-bed makes a bend here, causing surfy current, thus the bank in this place is being washing out actively. Thereafter, the pollution by suspended solids occurs.



487,4 KP. The dumping of soil on the steep slope to adjacent forest area beyond the limits of the right-of-way (approximately marked with yellow line).

# The Sakhalin II PSA:



What's in it for Russia?



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**Sakhalin Energy**

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The Sakhalin II PSA:  
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# Introduction

Sakhalin II is the largest and most advanced single direct foreign investment in the Russian Federation. It was the first Production Sharing Agreement (PSA) to be signed – in 1994 – in Russia. In 1999, it delivered Russia's first offshore oil production. In 2007, it will deliver Russia's first liquefied natural gas (LNG).

This pioneering, \$12 billion investment project represents a huge undertaking and commitment by its shareholders, Shell, Mitsui and Mitsubishi, and more than ten years of work in one of the most isolated areas and difficult climates in the world.

Being the first is a great responsibility. Other investors, in the oil and gas sector and beyond, look to Sakhalin Energy as a bellwether for foreign investment in Russia.

The risks, the sums of money and the effort involved in developing Sakhalin II are enormous, but so are the benefits. This report describes those benefits.

The direct income to the Russian Federation<sup>1</sup> from the project will be up to \$45 billion. The additional financial benefits are worth billions more, such as the \$2.4 billion payable in taxes on project labour. Sakhalin II will also have a knock-on or multiplier effect, stimulating the development of new businesses and services.

The project will also meet Sakhalin's and the Khabarovsk Krai's energy needs from 2006, and open up strategic markets for Russian hydrocarbons in the Asia-Pacific region. We are creating thousands of jobs for Russian nationals, and awarding billions of dollars in contracts for Russian industry and businesses, not just while we build the project, but throughout the 40 plus years of operations.

Other major benefits include the improvements we are making to public infrastructure on Sakhalin Island – for example, roads, bridges, health and waste services – improving the quality of life for all. We are building capacity too – training people and transferring management and business skills and technology.

Pioneering oil and gas projects can transform the economies and societies in which they are developed. The UK North Sea was another remote environment with severe weather and no infrastructure when its oil and gas fields were first developed more than 30 years ago. The development of the Brent field made possible many other projects, and created jobs and revenue for the government of the UK. Sakhalin II is a catalyst for a similar transformation for the Sakhalin region: providing the bridge between the shifting sands of what might be to the solid bedrock of what is.

Sakhalin II has already delivered many benefits – jobs, training, contracts for Russian industry, improvements to infrastructure, contributions to the community. Many more will follow as we move forward into the intensive period of construction.

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<sup>1</sup> The Russian Federation is represented by the Government of the Russian Federation and the Administration of Sakhalin Oblast, "the Russian Party", both signatories to the 1994 PSA with Sakhalin Energy.





**Sakhalin Energy**

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The Sakhalin II PSA:  
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# **1 Key benefits**

**The main benefits we have identified are listed below:**

- Up to \$45 billion value to Russia from royalty, profit share of oil and gas, taxes and bonuses<sup>2</sup>;
- Investment of some \$12 billion in project construction;
- Close to \$6 billion spending on Russian labour and related taxes over the life of the project;
- \$300 million spent on improvements to Sakhalin infrastructure: roads, bridges, airports and ports, creating more than 3,000 short-term jobs;
- Approximately \$4 billion in contracts already awarded to Russian companies;
- Expenditure of \$15 billion, more than 70% of it with Russian companies, over the operational life of the project;
- \$12 million plus to be spent on improvements to public health and waste management;
- \$7 million plus spending on jobs training programmes;
- Employment for up to 12,000 people, almost all Russian nationals, in construction of the second phase of the project;
- Long-term jobs for more than 2,000 Russian nationals in operations;
- Sakhalin II gas can meet the region's energy needs from 2006;
- Sakhalin LNG is the first Russian gas to Asia – opening up strategic new markets;
- Creation of an oil and gas industry infrastructure that can be used by other offshore Sakhalin projects;
- Improvements in occupational safety and management of the environment;
- Transfer of technology and international management and business skills.





**Sakhalin Energy**

The Sakhalin II PSA:  
What's in it for Russia?

# **2 The Investment**

During the Soviet era, Russia built up one of the world's most successful oil and gas industries. In the mid 1980s, it was the biggest oil producer, and it is still the world's largest natural gas producer today.

In the early 1990s, Russian industry was de-nationalised and underwent radical restructuring. The oil companies that emerged are now powerful players on an international scale. But when the Sakhalin development was initiated, they mostly did not exist. Those that did were short of capital even to support their own production, let alone tackle new developments. The downturn in Russian oil output for this period is evidence of this crisis: production declined from 11.4 million barrels/day (570 million tonnes/year) in 1988 to 6.1 million barrels/day (305 million tonnes/year) in 1996.

Exploration and appraisal by the Soviet oil industry in the 1980s indicated the Sea of Okhotsk contained a huge resource. However, the domestic oil industry had no experience of deepwater offshore production. The lack of offshore industry infrastructure, Sakhalin's remoteness, harsh climate, high seismicity and environmental sensitivities presented further challenges: the cost of development would run to billions of dollars. The capital strength of the international oil and gas industry, and its success in managing other offshore developments in similar environments, led the Russian authorities to open up the development of the Sakhalin shelf to foreign investors.

Meanwhile, huge changes were taking place in Russia. After the dissolution of the USSR, state support for industry decreased dramatically, and the economy went into recession. The Sakhalin region was particularly hard hit – on the periphery of the Russian Federation in one of the most remote, inaccessible and environmentally harsh regions of this vast country.

Sakhalin had developed rapidly after 1945, bolstered by government subsidies for industries that set up in the region. People were offered incentives to migrate to the island from the Russian mainland. These state subsidies and incentives were reduced in the 1990s and in some cases eliminated. Some military facilities closed. Production of coal and oil, once the mainstay of the region's economy, slumped. As unemployment grew and living standards fell, people started to leave Sakhalin. Over a decade, almost a quarter of the island's population moved away in search of better prospects: population dropped from close to 700,000 to below 550,000.

The changes in Russia's political and economic systems affected every important public service on Sakhalin in the 1990s, including healthcare, drinking water distribution and waste management. This resulted in a deterioration of Sakhalin's infrastructure and institutions at all levels: staffing, equipment, materials and maintenance.

In the decade after the dissolution of the USSR, health and education services shrank, roads and bridges collapsed, and there were cuts in transport services. Waste management and water supply systems deteriorated, posing a threat to the natural environment and public health.

In recent years, the situation has stabilised and improved. Labour is becoming more market-driven. Municipal social services have improved. The authorities have also supported outward migration. And the effects of the benefits from oil and gas developments offshore Sakhalin, including Sakhalin II, are reflected in increased budget revenues from tax and in improvements in employment and productivity figures.

This is the context – social and political upheaval, environmental degradation and an economic decline which is only now reversing – in which Sakhalin Energy has been developing one of the most ambitious oil and gas projects the world has ever seen.

## The Sakhalin II PSA

The project provides for the development of the Piltun-Astokhskoye and Lunskeye oil and gas fields offshore Sakhalin Island. The PSA defines the conditions for this development, by replacing the existing tax and royalty regime with a special contract-based mechanism which remains unchanged for the entire life of the project. This is broadly how it works:

Sakhalin Energy develops the fields and produces hydrocarbons at its own cost.

Out of the gross value of the production, the company owes a fixed proportion – 6% – to the Russian Party: this is royalty.

The remaining revenues are used to recover the company's costs associated with the development.

Once costs have been recovered, revenues are divided between the Russian Party and the company in

proportions agreed in the PSA, which also provides for an increase in the Russian Party's share from 10% up to 70%, depending on the project's profitability. The company's profit share is also subject to a profit tax fixed at 32% for the life of the project.

Why a PSA and not a development under a conventional fiscal and legal regime? In the early 1990s, there was insufficient legislation to regulate offshore oil and gas development and investment, and Russia's tax regime was fast-changing and unpredictable. For large-scale investments of this kind spanning many years, a stable fiscal and legal regime is essential for the investor.

The extent to which PSAs are used all over the world demonstrates that they have become an established framework for co-operation between government and industry. They have been successfully used in over 70 countries over almost 40 years<sup>3</sup>. PSAs are beneficial for both the investor, who has the opportunity to work in a stable legal and tax environment, and the state, as many capital-intensive oil and gas projects with long payback periods may remain undeveloped in a standard tax environment. The experience of Sakhalin bears this out: even today, a decade after the Sakhalin II PSA was signed, none of the Sakhalin shelf licences without a PSA has progressed very far. And other major foreign investments in the Russian oil sector have focused more on mergers and acquisitions than new field development.

Foreign direct investment in the oil and gas sector is beneficial to Russia: international oil companies have the technology, experience and access to global capital markets that allow them to take on challenging, multi-billion dollar projects such as the development of the Sakhalin shelf. Over the past decade, the newly privatised Russian oil companies have developed rapidly, but capital remains an issue: foreign banks' attitude to Russia is still one of extreme caution. Other factors are the introduction of competition, transparency in governance, and the opportunity for Russian contractors to access world markets. Foreign direct investment provides all of these, and is an important means of fulfilling Russia's strategic objective to develop fuel supplies to the Far East and generate new business for Russian manufacturers, as well as integrating the Russian Federation into the world economy.

## The Sakhalin II Project

The Sakhalin II project is an integrated oil and gas development. It involves the development of two fields: Piltun-Astokhskoye and Lunkoye. Together they contain recoverable reserves of over 1 billion barrels (150 million tonnes) of crude oil and more than 17 trillion cubic feet (500 billion cubic meters) of natural gas.

Sakhalin II is the most advanced of the Sakhalin shelf projects. Phase 1 focused on oil development and went into production in 1999. Output is currently limited to the ice-free "summer" period – about 180 days.

Phase 2 of Sakhalin II is an integrated development requiring investment of roughly \$10 billion. There will be two new offshore production platforms. These and the existing platform will be linked to an onshore processing facility by pipelines. The oil and gas will be transported via 800 km onshore pipelines to Prigorodnoye, in the south of Sakhalin Island, the site of a new liquefied natural gas (LNG) plant and oil and LNG export terminals. The LNG and oil will be exported to markets in the Asia-Pacific region and beyond. Some natural gas will be made available for local and regional markets.

Sakhalin Energy has already invested more than \$4 billion in the development of the Sakhalin II project. The total capital investment in the entire Sakhalin II project (phases 1 and 2) will be about \$12 billion. We expect to invest \$15 billion in operating the project, which will run for more than 40 years.

<sup>3</sup> *Petroleum Review*, Institute of Petroleum, London, February 2000.

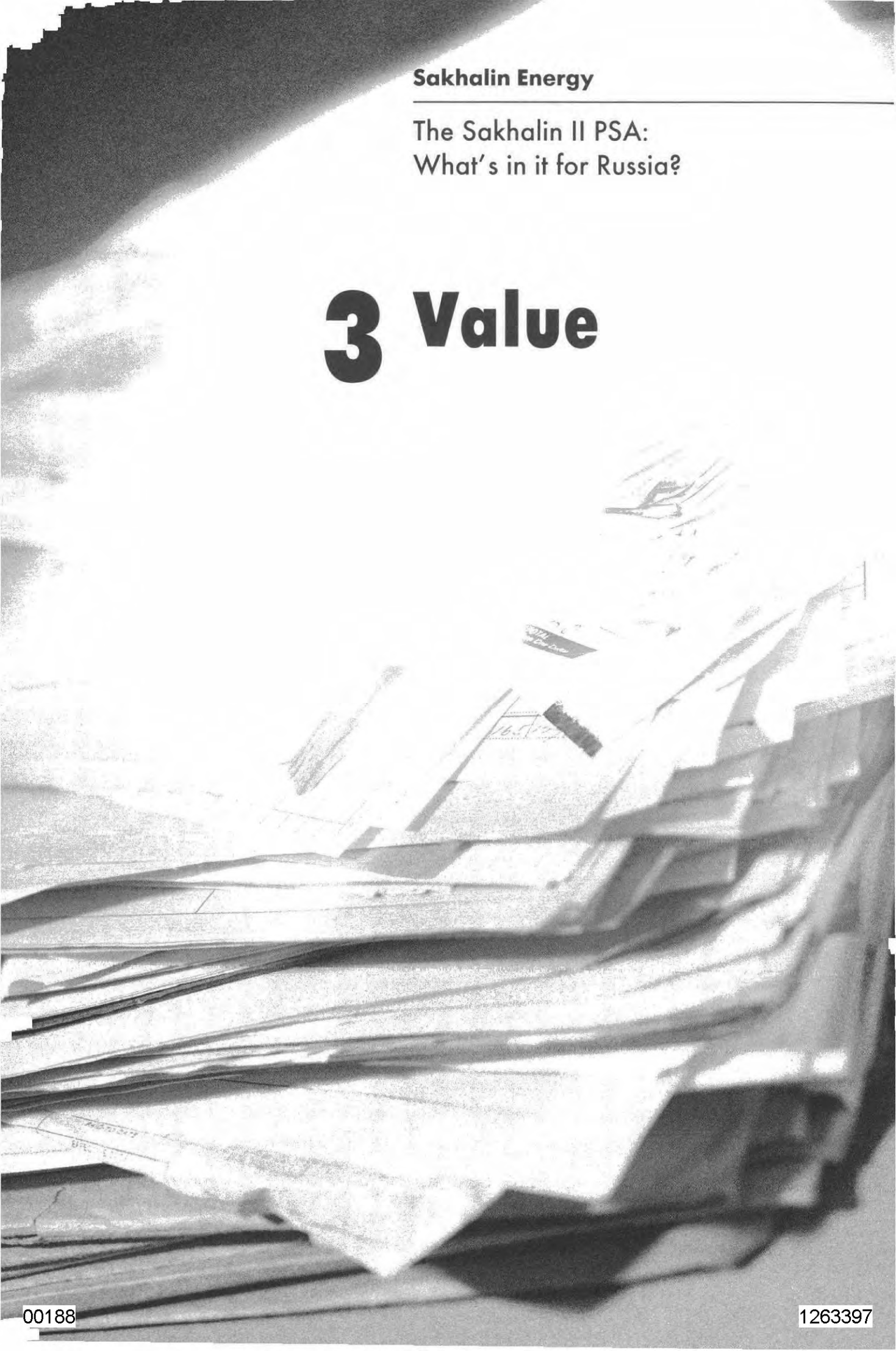


**Sakhalin Energy**

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The Sakhalin II PSA:  
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# 3 Value



Oil and gas produced under the Sakhalin II PSA will generate some \$45 billion of value for the Russian Federation. This is a huge sum, which deserves detailed explanation.

Sakhalin Energy makes a number of payments to the Russian Party in accordance with the PSA. These are shown in the table below.

**Royalties** – an agreed percentage of the produced hydrocarbons under the PSA. This is set at 6%.

**Russian Share of Profit Hydrocarbons** – initially 10% of the produced hydrocarbons after project costs are recovered, increasing to 70% as the project's profits go up.

**Bonuses** – payments to the Russian Party to ~~\$1.2~~ three pre-agreed milestones in the development of the project: the commencement date of the entire project (1996), the development of the Piltun-Astokhskoye field (1997) and the development of the Lunskeye field (2003). They have been paid in full.

**Reimbursement of prior exploration expenses** – these are payments made to the Russian Party to compensate the expenses incurred by Russian enterprises for the cost of exploring and appraising the fields in the Sakhalin II licence area. \$68 million had been paid by the end of 2003.

**Sakhalin Development Fund** – pre-agreed payments totalling \$100 million made between 1997 and 2001 to the Sakhalin Oblast's development fund for the region.

**Taxes** – Sakhalin Energy pays a number of taxes to the Russian Federation. Profit tax is agreed in the PSA and will be payable once project costs (capital expenditure and annual operating costs) have been recuperated. It is fixed at 32% for the life of the project<sup>4</sup>. In addition, Sakhalin Energy pays income tax and social security taxes on staff earnings.

We have already paid more than \$330 million to the Russian Federation since the Sakhalin II project went into development in 1997. A breakdown of this sum is shown below.

**Figure 1: Payments to the Russian Federation**

Payments by Sakhalin Energy to the Russian Party through 2003

US millions	1996	1997	1998	1999	2000	2001	2002	2003	Total
Sakhalin Development Fund		20	20	20	20	20			100
Bonus	15	10	5					20	50
Prior Russia exploration expense				4	16	16	16	16	68
Royalty				1.5	21.5	21.7	17.3	17.8	79.8
Taxes (on labour)	0.8	1.6	1.9	5.5	4.9	5.8	4.8	6.9	32.2
<b>Total</b>	<b>15.8</b>	<b>31.6</b>	<b>26.9</b>	<b>31.0</b>	<b>62.4</b>	<b>63.5</b>	<b>38.1</b>	<b>60.7</b>	<b>330</b>

**Sakhalin Development Fund:** The \$100 million Sakhalin Energy contributed to the Sakhalin Oblast's *Sakhalin Development Fund* has been spent on improvements to the infrastructure of the Sakhalin region, including the power sector as well as health, education and other social services.

Sakhalin Energy's contributions to budget and extra-budgetary funds, particularly in the Sakhalin region, are also significant. The Sakhalin annual regional budget is about \$200 million. Sakhalin Energy's contributions in recent years have accounted for nearly 10% of revenues to the budget.

As well as contributing directly to budget revenues, Sakhalin Energy is also a major contributor to the improving economic performance of the Sakhalin region.

<sup>3</sup> The Russian word *Oblast* can be translated as region. It is also a political entity corresponding approximately to «state» in the U.S.

<sup>4</sup> Profit tax was at 32% when the PSA was signed in 1994. It is currently 24%.

Future payments

**Royalty:** Sakhalin Energy's royalty obligations to the Russian Party will increase significantly from 2006 when production from the second phase of the project comes on stream.

**Prior Russian exploration expenses:** Sakhalin Energy will continue to pay \$4 million quarterly until \$80 million has been paid. Further payments may be made, depending on the level of profitability of the project in the future.

**Taxes:** The remainder of the revenue from oil and gas sales (after royalty)) will be used to recover Sakhalin Energy's operating and investment costs(the latter is approximately \$12 billion). The precise timing depends on prevailing international oil and gas prices, project costs and the volume of Sakhalin Energy's oil and gas production. Sakhalin Energy expects to recover costs between 2010 and 2015, based on an average oil price of about \$20 per barrel (\$146/tonne), and depending on final investment costs.

After investment costs have been recovered, Sakhalin Energy's annual operational costs will be much less than its income. The difference between these two – "profit production" – is split between the Russian Party and Sakhalin Energy. The Russian Party's share of the profits is 10%, 50% or 70%, depending on the rate of return Sakhalin Energy makes on its investment (which in turn depends on prevailing international crude oil and gas prices). The remaining profit is paid to Sakhalin Energy, which pays a 32% tax on its profits. This is also the ceiling for all taxes.

The table below shows the revenue due to the Russian Party with oil prices at \$20 and \$24 per barrel (\$146/tonne and \$175/tonne)<sup>5</sup>.

Figure 2: Projected revenue to the Russian Party

International oil price	Profit tax	Royalty*	Profit hydrocarbons*	Total PSA	Tax revenues from Sakhalin Energy staff and contractors	Total revenues
\$20/barrel	21.9	7.7	6.1	35.7	2.4	38.1
\$24/barrel	26.4	9.0	7.4	42.8	2.4	45.2

\* for gas valued at international price.

Clearly, revenues depend on international oil and gas prices, as can be seen from the two examples above. A second factor is the price of Russian domestic gas. Domestic gas prices are expected to rise steadily in future years to international levels.

The PSA obliges the Russian Party to take royalties and profits in the form of gas if sufficient gas is available. Otherwise it will receive its entitlements in oil or cash. It is expected to take some \$15 billion of value in gas: this is discussed in detail in section 7, *Energy*.

The project will generate other income for the Russian Federation. For example, income tax payable on workers' earnings over the life of the project is estimated at \$2.4 billion plus. Other tax benefits will also accrue from taxes payable by Sakhalin Energy's Russian suppliers.

Sakhalin Energy will contribute roughly \$85 per tonne of oil equivalent to the Russian Federation in revenues, assuming total revenue of \$45 billion (as explained above). Russian oil and gas companies operating under the normal tax regime contribute between \$35-45/tonne of oil equivalent in a relatively high oil-price environment<sup>6</sup>.

<sup>5</sup> Oil prices have generally been between \$25 and \$30 per barrel (\$163/tonne and \$219/tonne) for the past five years.  
<sup>6</sup> Institute for Financial Research (Russia), based on data for 2001, when international oil prices ranged between \$20 and \$30/barrel (\$140/ tonne and \$219/tonne).





**Sakhalin Energy**

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The Sakhalin II PSA:  
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# **4 Russian suppliers**

One of the measures of success of any major investment project is the opportunity it provides for contracts for national industry and business. In the case of Sakhalin II, Russian contractual content plays a significant role in the project, and will create the possibility for Russian industry to develop and expand internationally.

In the PSA, Sakhalin Energy is required to use its best efforts to achieve a level of Russian Content equivalent to 70% over the life of the Sakhalin II project<sup>7</sup>. Russian Content is defined and measured as volume and weight of equipment, and man-hours worked, rather than dollars spent. Why measure in this way and not in currency? This is because when the PSA was signed, the Russian economy was changing fast. Volume of materials and man-hours represented a more enduring measure of Russian Content than either roubles or other currencies, and this was recognised in the PSA.

The PSA also states that Sakhalin Energy must show preference to Russian enterprises when awarding contracts, provided that they are duly qualified and meet the basic criteria for a competitive bidding process as described in the PSA. If a Russian company bidding for a contract with Sakhalin Energy offers competitive pricing, and is able to meet quality and delivery requirements, then it will win the contract in preference to a foreign bidder<sup>8</sup>.

The important enabling role that can be played by joint ventures is also acknowledged in the PSA. Joint ventures between Russian and foreign companies can help Russian enterprises to learn how to do business in an international environment, acquaint them with international management skills, and transfer technologies. For this reason, joint ventures with 50% or more Russian equity are considered 100% Russian Content according to the definition in the PSA. Indeed, Sakhalin Energy's experience has been that joint ventures have enabled Russian enterprises to meet our pricing, quality and timing requirements better than they would have done if they had operated alone.

Sakhalin Energy reports regularly to the Russian Party on our performance in Russian Content and also Russian Industry Utilisation (RIU), in line with the PSA. RIU is Russian expenditure – actual dollars spent – not Russian Content as defined in the PSA. The figures in the section below are for Russian Industry Utilisation.

Sakhalin Energy has made tremendous efforts to promote the involvement of Russian companies. We cooperate closely with the relevant government agencies and employ a dedicated team of specialists to maximise Russian Content.

We share and discuss our contracting plans with the Russian Party, which supplies us with details of potential Russian contractors and nominates potential contractors to participate in pre-qualification. We announce planned tenders worth more than \$5 million in the Russian national and regional press.

Sakhalin Energy's Russian Content department provides a crucial link with potential or actual Russian contractors. A key aspect of its work has been to encourage the development of joint ventures between Russian and foreign companies, to maximise technology and skills transfer and promote financial security.

<sup>7</sup> The 70% target is to be achieved not each and every year, but over the life of the project: more than 40 years. This is because the nature of the project, particularly its technical aspects, limits Russian participation in the earlier stages of development and construction. In the operational stage of the project, however, the Russian Content that can be realistically achieved is significantly higher.

<sup>8</sup> There is one area in which Sakhalin Energy would consider a lower quality bid from a Russian enterprise: if it is equal in all other respects with a foreign bidder but its health, safety and environment standards and systems need improvement, Sakhalin Energy will help bring the Russian company's HSE performance up to standard.

### Sakhalin Energy's Russian Content team

- informs and educate Russian industry about the scope and requirements of the Sakhalin II project: for example, they have held several seminars in Moscow, Yuzhno-Sakhalinsk and elsewhere and visited a number of potential suppliers;
- works with engineering contractors to ensure that they make specific provisions for Russian equipment in their designs;
- maintains and develops a database of potential Russian vendors that is easily accessible to all Sakhalin Energy staff and contractors, to make it easier to identify potential Russian contractors;
- exchanges information about potential contractors with the operators of other Sakhalin PSAs and other Shell projects in the Russian Federation, with a view to promoting local content;
- supports the efforts of Russian companies to obtain licences to manufacture equipment and materials to internationally recognised standards;
- encourages the development of joint ventures between Russian and foreign companies, for example the Sakhalin-based companies, Sakhalin Shelf Services and Sakhalin Support Services..

### «Designing in» Russian industry

Sakhalin Energy has paid special attention to Russian designs and norms to promote the involvement of Russian companies. For example, the support structures for the two new offshore platform decks have been designed as concrete gravity base substructures, to provide greater opportunities for Russian participation. We also stipulated that the dry dock used for construction of these gravity structures should be in Russia, to create business opportunities and jobs for local people. The result is that the port of Vostochny near Vladivostok will be used to build these two structures and will lead to Russian industry involvement of 80% in man-hours and 50% in monetary terms. The dry dock created to build the concrete structures may also provide Vostochny with a strategic position for future field developments on the Sakhalin shelf or internationally.

The development of phase 1 of the Sakhalin II project has already shown how Russian contractors can contribute to success. In building and installing phase 1, Sakhalin Energy entered into about 4,000 contracts totalling over \$800 million for goods and services with Russian enterprises. One of the best known examples of Russian Content is a \$45 million contract awarded to the Amur Shipbuilding Plant in Komsomolsk-on-Amur in the Russian Far East, which included manufacturing of the steel "spacer" structure for the Molikpaq offshore platform. This raised the height of the platform, which had previously been used in shallower water in the Beaufort Sea in Alaska, for the deeper waters of the Sea of Okhotsk. The second contract included manufacture of waterflood and power generation module for the Molikpaq platform.

Most major contracts for the second phase of the project were awarded in 2003, with a combined value of \$6.3 billion. Russian companies have won a number of major contracts in key project areas including upgrades to Sakhalin Island infrastructure, and manufacturing and construction work for the project facilities.

Approximately \$2.7 billion of the \$6.3 billion in contracts for the second phase of the project that had been awarded by the end of 2003, and about 70% of associated labour, is Russian sourced. This is a great achievement, considering the technical aspects of the project. Much of the technology we use – for example LNG technology – has never been manufactured in Russia. Indeed, Russia's major oil and gas companies also source significant amounts of equipment abroad as a matter of course<sup>9</sup>. Despite these constraints, we expect that the total value of phase 2 contracts to Russian enterprises will be in excess of \$3.4 billion (RIU) out of a total contract value of more than \$9 billion.

The tax value of Russian contracts to the Russian Federation is considerable. Based on a contract value of \$3.4 billion, the tax value will be more than \$200 million<sup>10</sup>. The Russian tax value of employment is discussed in the following chapter.

<sup>9</sup> High-pressure pumps, pipework, fittings and valves are typically imported, as are compressors. Most large diameter gas transport pipelines are usually sourced abroad.

<sup>10</sup> The average tax burden in the Russian construction industry is calculated to be 6% of the gross sales price.



## Looking ahead

The main benefits to Russian contractors will be realised during the operational life of the Sakhalin II project.

The major contracts in this period are for drilling services, training, marine operations and asset management. We will also need support services worth up to \$150 million per annum (approximately \$6 billion over the life of the project), such as fuel supply, healthcare and catering, and contractors will provide the bulk of these. Sakhalin Energy will aim to work with Russian equipment and service providers wherever possible. Non-Russian contractors will be expected to use Russian labour wherever they can, and to obtain tax registration in Russia.

We estimate that Russian contracts will amount to substantially more than 70% of the \$15 billion that we expect to invest in operating the Sakhalin II project over its lifespan of more than 40 years.

## Learning

The development of Russian Content in the Sakhalin II project has been a learning process for all concerned. It has been tremendously successful, considering the pioneering nature of the investment, the technology and equipment needed and the tight schedule of the project.

Russian companies have demonstrated an excellent technical skills base and sophisticated technical standards and methods. Many are clearly keen to participate in the project and use it as a platform to expand into international markets. Russian bidders have successfully competed against international tenderers, with notable achievements in two key areas: service provision and construction.

The tailored approach for major contracts secured a great deal more Russian Content and Russian Industry Utilisation than true free-market competition to supply pre-engineered items: Sakhalin Energy made estimates of high, but realistically achievable Russian Content and included it in invitations to bid. A key factor in the bidding documentation was the development of detailed scopes of work that could be understood by Russian vendors.

It is clear that Russian design skills are essential for successful Russian projects. A thorough understanding of Russian design standards and norms and the Russian working environment, particularly the approvals regime, is invaluable in complex projects such as Sakhalin II, and we gained this knowledge through close cooperation with Russian Design Institutes such as the Krylov and Rubin institutes in St Petersburg, VNIPmorneftegaz in Moscow and NIPIgaspererabotka in Krasnodar. In turn, the Russian engineers became familiar with non-Russian industry standards such as those set by the International Standards Organisation and the American Petroleum Institute, opening up the way for Russian enterprises to compete more effectively in international markets.

## Communication and partnership

The results underscored the importance of good communication. Real success has been achieved where partners have been willing to share and apply new ideas and adapt methodologies, and where they have taken the time to harmonise working practices. The most successful Russian bidders were commercially responsive, took time to communicate and build relationships, and had ambitions to export their goods and services to international markets. Relationships were enhanced when foreign contractors made real efforts to optimise communications and developed strong personal ties. In these cases, Russian companies and their foreign counterparts were able to achieve a common understanding of technical and business concepts and issues. Success has been greatest where relationships have developed into formal partnerships, in the form of joint ventures.

## Constraints

A relatively low number of Russian companies came through the tender process successfully, and a number of factors came into play here.

Contacting Russian companies was not always easy, owing to sometimes unreliable communications in Russia. The language barrier also played a role. The majority of our documentation is in English, the working language of the international oil and gas industry. Schedule and cost considerations ruled out the possibility of translating

the many volumes of bidding documentation into Russian. We ensured that Russian speakers communicated with Russian companies, but despite this, many Russian companies did not respond to invitations to bid, or else they responded late and with insufficient information. Also, they frequently did not respond to requests for clarification.

Another factor limiting Russian participation is the fundamental differences that remain between the Russian and international oil and gas industries. Chief among these is the significant in-house engineering design capability that most Russian oil and gas enterprises still retain. In contrast, international companies generally outsource design, and rely on complete, turn-key engineering and procurement packages. In Russia, manufacturers tend to supply component parts rather than complete packages: there is very limited capability for turn-key packages, and a related shortage of project management skills.

Where design capacity exists, it is often difficult to integrate into standard international design processes, which use computer-aided design (CAD). CAD makes it possible to design several features simultaneously, so it is faster than conventional design techniques. It is also less labour intensive and therefore cheaper. In Russia, however, the relative costs of labour and computer technology differ, and conventional design techniques are more common.

Pricing was also an issue in procurement. Russian companies often submitted high bids – in some cases twice as high or even higher than the lowest bid received. There may be several reasons for this. Due to market conditions in Russia, many vendors may not know their true cost of production, or may not be aware of international market conditions. Another factor is the high cost of transport: most Russian equipment manufacturers are in European Russia, a long way from Sakhalin Island.

The fact that more than a third of contract value to date has been awarded to Russian enterprises is a remarkable achievement when considered in this context. A comparison with the UK North Sea in the 1970s, for example, reveals that UK industry was challenged to supply the new offshore infrastructure. "British industry has been notoriously slow to respond to the opportunities provided by North Sea activity<sup>11</sup>," wrote one commentator. Much of the design of the early UK North Sea infrastructure was imported: of the 26 offshore platforms ordered by the end of 1974, 12 came from outside the UK.

British industry has gone on to supply many successful North Sea oil and gas developments, creating hundreds of thousands of jobs and generating billions of dollars for the British economy. UK industry is a world leader in offshore oil and gas, and exports to new developments around the world (including Sakhalin).

The success of the Russian oil and gas industry in the 20th century and now in the 21st suggests that with time, Russian industry will also export successfully to international markets and play a role in new industry developments around the world.

Given adequate time, and support from Russian industry, the Sakhalin II project will benefit from the use of Russian goods and services. The use of high quality, timely and competitively priced local labour, materials and equipment can eliminate the extra time and costs associated with long-distance shipping and customs formalities. In this way, Russian Content can improve efficiency and thus the economics of the project.

<sup>11</sup> Adrian Hamilton, *North Sea Impact*, International Institute for Economic Research, 1978.



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# 5 Employment and training



The creation of jobs is one of the most important, tangible benefits that investment can bring. It takes on special importance in an area of high unemployment or in a difficult period for the economy.

Sakhalin Energy aims to maximise the proportion of Russian nationals employed on the project. This is a commitment under the PSA, and is recognised as good, responsible business practice around the world. This commitment extends to our contractors and sub-contractors, who employ most of the workforce involved in project construction, and a large part of the operations workforce.

We have made significant efforts to employ Russian nationals and the numbers in service have more than doubled since end 1997. In January 2004, Sakhalin Energy was employing more than 650 Russian staff out of a total of about 1,200 staff. Of the Russian staff, nearly 500 (76%) are Sakhalin residents.

The number of people we employ directly is a small proportion of the overall project workforce, however. Our contractors are expected to maximise job opportunities for Russian nationals, too. The development of our predominantly Russian workforce is shown in the table below.

**Figure 3: Project labour utilisation**

Sakhalin-II project labour utilisation (including contractor labour)

	1996	1997	1998	1999	2000	2001	2002	2003
Russian man-hours (thousand)	381	1,326	1,370	812	1,137	1,490	2,900	11,202
Total man-hours (thousand)	498	1,832	1,856	952	1,420	2,505	3,752	14,997
Average Russian labour (individuals employed)	212	736	761	451	632	828	1,612	6,223
Average non-Russian (individuals employed)	65	282	270	78	157	563	473	2,108
Total (persons)	277	1,018	1,031	529	789	1,391	2,085	8,331

The big increase in the number of people employed in 2003 shows the first effects of the phase 2 project on labour figures.

The infrastructure upgrade project has led to the creation of more than 3,000 short- to mid-term jobs, and is described fully in the following section, Infrastructure. Construction of the phase 2 project began in 2003 and will be completed in 2008. Sakhalin Energy is creating thousands of short-term jobs and several hundred long-term jobs as a result. Temporary construction jobs range from several weeks' duration up to three years. We expect that some 5,000-8,000 people will be employed during the four-year construction period, and as many as 12,000 at the peak of construction in 2006-2007.

The majority of construction workers will be hired from Sakhalin and the Russian mainland. Most jobs will be on construction of the LNG plant at Prigorodnoye in south Sakhalin, and the 800-kilometre onshore oil and gas pipelines. The types of skilled workers required include welders, crane operators, carpenters, electricians and metalwork assemblers.

Throughout the extensive public consultation we have held on Sakhalin Island for the phase 2 project since 2001, people's desire for jobs has been mentioned to us more than any other issue. We are working closely with the Sakhalin employment authorities and our own contractors to ensure that Sakhalin people and businesses benefit from employment opportunities. We give priority to people in project-related communities when we are hiring workers, provided that they are suitably qualified.

It is estimated that there are about 6,000 people on the island with the qualifications for available jobs (including those in small to medium companies). About half of these people already hold jobs, leaving a potential labour pool of about 3,000. This means that a large part of the workforce will need to be brought in from outside Sakhalin, mostly from the Russian mainland.

Most of the construction work for the phase 2 project is carried out by contractor companies. Contractors bidding for work on the project have had to demonstrate their commitment to Russian jobs and business development by making detailed plans for Russian Content. Last year, some of the main project contractors ran a roadshow around Sakhalin Island. This helped people to find out what jobs were available and where, and at the same time it made our contractors aware of potential training opportunities.

Sakhalin Energy has created a special community liaison organisation is also helping to match people with jobs during the construction phase. Sakhalin Energy has 15 community liaison officers working in communities all over Sakhalin. They act as the "eyes and ears" of the company and contractors in the community throughout construction and operations. Most people who are seeking jobs, especially in the north (an area of high unemployment) are finding employment of one type or another in relation to the project.

Job creation is extending beyond Sakhalin to the mainland in the Russian Far East, where jobs are also much needed. For example, in Vostochny (Primorsky Krai) a Russian-Japanese consortium has built a new, technologically advanced pipe coating plant. The investment, which includes both the construction of the coating yard and coating of linepipe, has a total value of \$50 million. The plant will be used for coating Sakhalin-II oil and gas line pipes and provides work for about 250 people. Vostochny will also be the location for the development of a new dry dock, including facilities such as workshops, where the bases for the Piltun-Astokhskiye and Lunskiye platforms will be constructed (see previous section). The on-site construction work force will be about 1,200, almost all Russian nationals.

### Long-term employment opportunities

As well as the many skilled and unskilled jobs available in the construction phase of the project, there will be job opportunities in the operations and maintenance phase. Up to 1,500 new jobs will be created by Sakhalin Energy for the operational phase of the project. Contractors will employ about 900 more people. Our estimate of Russian labour for the operations phase indicates an overwhelmingly (90%) Russian workforce.

Each job in the oil and gas industry helps to create new jobs in other industries and in the service sector. Our estimates do not include the significant secondary employment which will be created as a result of increased demand for goods and services increasing job creation in both the construction and operational phases of the project.

The monetary benefit of employment should also be considered. Sakhalin Energy and its contractors will pay some \$4.6 billion in Russian labour costs for the Sakhalin II project as a whole, the majority (close to \$4 billion) in the operations phase. The tax value of these to the Russian Federation is estimated to be about \$1.3 billion, giving a combined total value of close to \$6 billion for Russian project labour. Non-Russian project labour will generate a further \$1.1 billion in tax revenues for the Russian Federation.

### Russianisation

Sakhalin Energy is also making considerable investments in training Russian nationals.

The nature of the project means that some positions have been filled by secondees from Sakhalin Energy's shareholders who have the necessary technical, commercial, financial or other expertise. They are now passing on the knowledge they have gained from decades of experience in projects around the world to the Russian citizens who will succeed them on the Sakhalin II project.

We have made considerable progress in identifying and recruiting talented Russians who can develop into management positions: this is the cornerstone of our Russianisation strategy. More and more Russian nationals are now being promoted to positions of responsibility. We are also recruiting new Russian staff. We seek out new talent from Russia's universities, as well as technical and commercial professionals across the Russian Federation. We have also carried out a review of salary competitiveness in order to ensure that we remain an attractive employer.

We are helping our contractors to Russianise their workforce in the operations phase of the project, too. For example, we have supplied them with information about workers who were formerly skilled but are now unemployed, in order to retrain them for work on the project.

### Training

We are setting up several major training programmes for the operations phase, so as to involve as many local people as we can.

We are running two apprenticeship schemes that will involve 300 people in all. Apprentices will receive training for up to two years, in many cases on the job itself, sometimes involving work placements or overseas assignments. Apprenticeships are open to experienced Russian nationals, graduates and new apprentices in a wide age range.

We are also investing more than \$7 million in a training programme in the Korsakov region to train local people for jobs in the operations and maintenance of the LNG plant and associated oil and gas export facilities.

We invest, too, in the development of current staff and new recruits through training programmes. We sponsor technical and other professional skills training, as well as generic business skills training and English language tuition. All Russian employees are given the opportunity to take part in these programmes and several hundred have already done so.

### Capacity building in HSE management

The international oil and gas industry has pioneered achievements in the field of health, safety and environment (HSE) over the past twenty years. Sakhalin Energy is committed to playing a leading role in promoting best practice in HSE. The responsibility to protect the safety of people and the environment where we work is one that we take very seriously.

We devote considerable resources to training in this area. In 2004, we will be spending more than \$200,000 on environmental training programmes, and \$300,000 on safety training.

We place special emphasis on the importance of training for safety awareness: good practice in HSE is based on accident prevention. Our record to date shows that these investments are worthwhile: our safety record is among the best in the world. In both 2002 and 2003 Sakhalin Energy recorded only one lost time incident per million man-hours, a work-related injury that results in time off work.

We have also successfully carried out five seasons of offshore oil production with one of the best records in the world. We have produced nearly 50 million barrels of oil (6.7 million tonnes), and have only accidentally spilled about two barrels: a ratio of about 3:100,000,000. In the last two years we have spilled less than 100 millilitres of oil – less than a cupful. We do not know of any oil operation anywhere in the world with a better record.

A related area is the investment that we make in environmental survey work. Surveying is essential to understanding the environment in which we work and the effect that we may have on it. Sakhalin Energy has spent more than \$15 million on baseline environmental survey work since 1997 for the siting, approval and development work of the Sakhalin II project. Our research over the past ten years has in many cases contributed significantly to the body of information about certain species of flora and fauna. We share our data with the Russian authorities, enabling them to draw on this extensive knowledge, and invite specialist researchers to peer review our survey data.

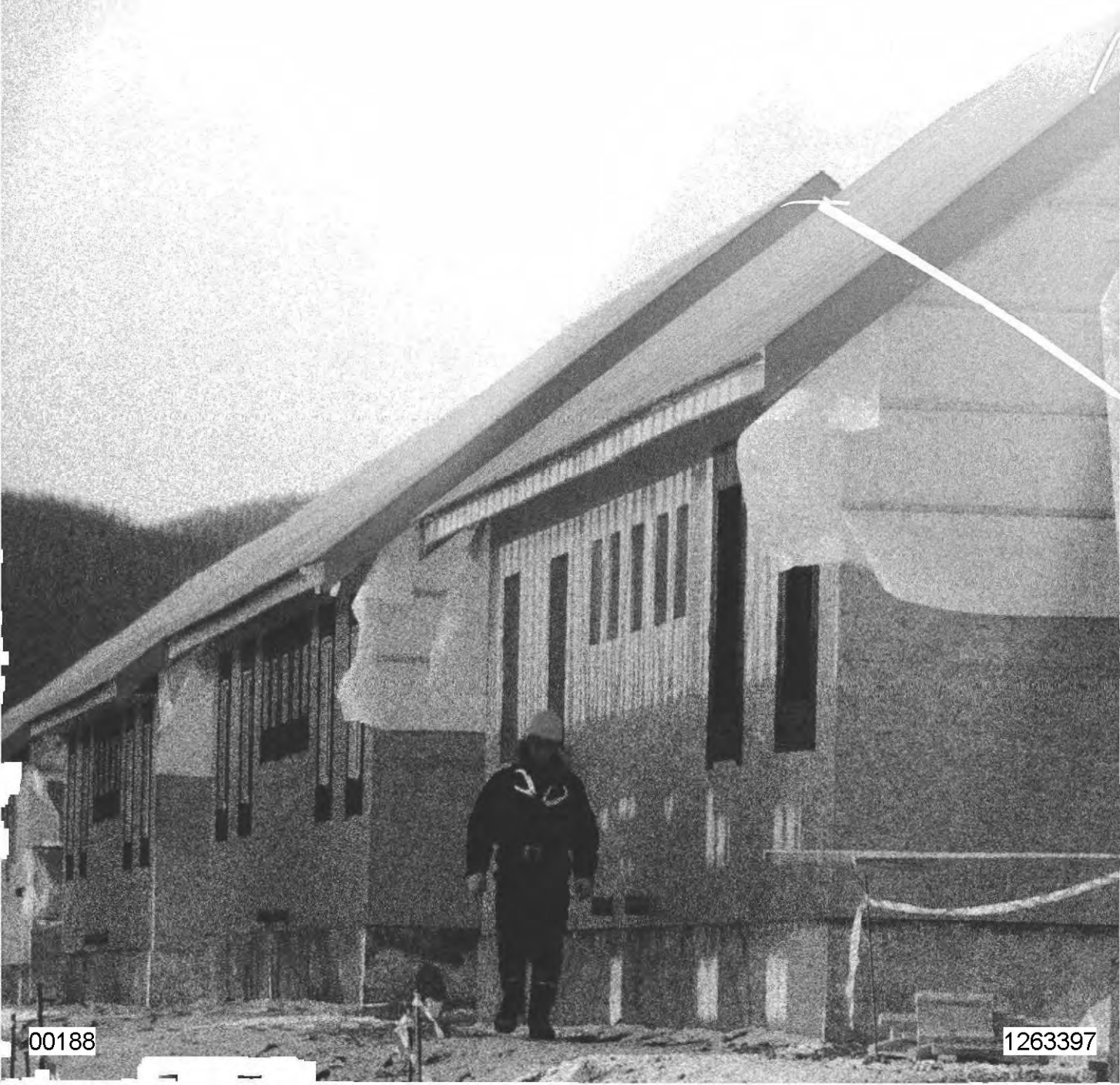


**Sakhalin Energy**

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# 6 Infrastructure



From 2002, Sakhalin Energy has been carrying out upgrades to the infrastructure of Sakhalin Island costing more than \$300 million. These upgrades have created jobs for several thousand Russians: about 1,450 from Sakhalin Island itself, and 1,700 from the Russian mainland.

The majority of upgrades will benefit Sakhalin people as well as the project, and can contribute to the socio-economic development of the island.

### Public infrastructure

Sakhalin Island's roads and bridges, as well as other parts of its infrastructure, needed urgent improvement to enable construction of the second phase of the project. These upgrades will also provide lasting benefits to the island's communities.

Sakhalin Island's infrastructure was in a state of near collapse in many areas at the end of the 1990s. The island's roads and bridges had fallen into disrepair, making many areas impassable even in early summer. This posed a safety risk and a barrier to communication, particularly in the north of the island.

In consultation with the Sakhalin authorities, Sakhalin Energy developed a comprehensive upgrade programme, which we funded and project managed. We are building 45 new bridges and bridge approaches and repairing 11 others. We are building, repairing and upgrading more than 100 kilometres of roads and asphaltting up to 20 kilometres of road in Sakhalin communities. More than 150 culverts are being repaired or reconstructed. The infrastructure upgrade project also involves repairs to the island's drainage system, and improvements to ports and airports, including refurbishment of the derelict fishing port of Kholmsk, upgrading of the northern port of Kaigon, and an upgrade of the airport at Nogliki.

### Health infrastructure

Health services on Sakhalin Island, and other related services, including the provision of waste management, deteriorated significantly in the 1990s.

We are upgrading hospitals in Nogliki, Poronaysk and the region's main hospital in Yuzhno-Sakhalinsk, at a cost of nearly \$8 million. This year alone we will spend more than \$4.5 million on health upgrades. We also have a cooperation agreement with the Sakhalin regional health authorities under which we will tackle some regional health issues in partnership with the Oblast. These include tuberculosis and blood-borne diseases such as hepatitis and HIV.

### Environmental infrastructure

Waste management is a serious problem on Sakhalin Island, and a risk to public health. There have been radical cuts in services over the last ten years. A number of open refuse tips, some of them close to recreational facilities such as beaches, pose a real health hazard to Sakhalin's residents. The legacy of Sakhalin's industrial decline is an additional blight on the landscape and a threat to the environment. Industrial facilities have been closed and left standing. Old or broken industrial equipment has often simply been abandoned and left to rust.

Operation of the phase 2 project will also generate some waste of its own, although most will be recycled and the leftover amounts will be very small. In order to deal with our own waste during construction, and to help tackle the regional waste problem, Sakhalin Energy has reached an agreement with the Sakhalin authorities to invest 120 million roubles (\$4 million) in improvements to waste management. We will upgrade three existing waste landfills at Korsakov, Smirnykh and Nogliki. We will also assist the Oblast authorities in waste management planning. Building a completely new waste landfill for the project would require about the same investment, but by using this money to upgrade existing sites and improve public services, the Sakhalin community is better served.

Sakhalin has a number of other legacy issues including unexploded ordnance. Sakhalin Energy set up and funded a major search for unexploded ordnance, which has provided work for nearly 600 Russians, almost all of them from Sakhalin. It addressed a major threat to life, making Sakhalin a safer place. This initiative is described in detail in the companion report Sakhalin Energy and Society, as is the search for war dead, which we also sponsored.

## Oil and gas industry infrastructure

Sakhalin Island's oil and gas infrastructure is ageing and largely obsolete – the relics of a once dynamic onshore oil industry. The little that remains lacks sufficient capacity to support the development of large offshore oil and gas projects such as Sakhalin II. And our project is one of many new developments that will require pipelines and processing facilities.

The industry infrastructure we are building will meet our own needs and facilitate the development of other offshore projects. Our processing facility in the north of the island can be used to process oil and gas from other developments. Our 800 kilometre oil and gas pipelines can be adapted to transport gas for other operators, too. And our LNG plant at Prigorodnoye can also be expanded, to process gas produced by other operators, and the nearby terminals used to export the additional oil and LNG.

This sort of pioneering development is rare, but there are precedents. The development by Shell of the Brent oil and gas field in the UK North Sea in the 1970s is a comparable undertaking. Like Sakhalin, the North Sea was a frontier development area at the time the first oil and gas projects were undertaken. With the development of Brent, Shell also created an integrated offshore oil and gas gathering and processing system that was the largest in the world, used by many other fields whose development it enabled.

In the 30 years since Brent, a development which sparked the development of a vital new oil province, an achievement that Sakhalin can equal and maybe even surpass.





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# 7 Energy

The Sakhalin II project will produce and market energy resources in the Asia-Pacific region and beyond, generating revenue for the Russian Party and for Sakhalin Energy's shareholders. There will also be gas supplies for the Sakhalin region and the Russian Far East.

Russia has been exporting oil and gas to markets in the west for more than 50 years. It has an unbroken performance record over half a century, and has built up a reputation as one of the world's most reliable exporters of hydrocarbons as well as one of the biggest.

The east is a new market for Russian hydrocarbons. Sakhalin Energy is building on Russia's half century of achievement by moving oil to markets in Asia. We have exported nearly 7,000,000 tonnes (about 50 million barrels) of crude oil to Korea, Japan, China, Taiwan, the Philippines and the USA since 1999. With the development of the second phase of the project we will be exporting more oil and, for the first time, Russian gas in the form of LNG.

Sakhalin and the Russian Far East have faced acute energy supply problems in the last ten years. The shortage of clean, secure energy sources has led to widespread power outages. In winter, this crisis has claimed lives.

Existing energy resources cannot meet the region's needs. But Sakhalin gas will. Gas from the Sakhalin II project will meet Sakhalin's energy requirements by the end of this decade. Gas will mean more, reliable, diverse, cleaner<sup>12</sup> energy for Sakhalin and the Russian Far East, which currently relies on polluting brown coal-fired power generation in many areas.

The Sakhalin II PSA provides for gas supplies to the Sakhalin region. The Russian authorities will take their royalties and share of the profit hydrocarbons from the project in the form of gas. About 15% of the gas we will produce is expected to be delivered to the Russian Party. There may also be additional, commercial gas deliveries from Sakhalin Energy to Russian customers on the mainland.

There will be two firm gas delivery points, one in the south of Sakhalin Island near Yuzhno-Sakhalinsk and one in the north, near Boatasyn, where a terminal can also be used for gas deliveries to the Russian mainland via the existing Sakhalinmorneftegaz (SMNG) pipeline. The southern point will be for gas deliveries in the area of the island where energy demand is highest due to greater levels of population and industry. The northern point will allow gas deliveries via existing gas pipelines, which is operated and owned by SMNG. There may also be additional gas supplies to Korsakov, Poronaisk, and Vakhursev.

How the situation develops, and how quickly, depends now on the federal authorities and the authorities of Sakhalin and the Russian Far East, who are reviewing their energy needs.

<sup>12</sup> The region will experience environmental benefits associated with the shift to gas-fired generation from coal. Natural gas produces 50% of the amount of carbon dioxide of coal in power generation. Other emissions are also lower using gas.

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# **8 The Multiplier Effect**



In order to assess the broader effects of the Sakhalin II project on Russia's economy and society, Sakhalin Energy has commissioned an independent study of the project's benefits for the Russian Federation as a whole, and also specifically for the Russian Far East. A working group led by Professor Alexander Arbatov, deputy chairman of the Council for Production Studies (Совет по изучению производительных сил, or SOPS), a think tank governed by the Ministry of Economic Development and Trade and the Russian Academy of Sciences, has been working on this study in 2004.

The SOPS group is calculating the likely effects of the project on Russian Gross Domestic Product (GDP), and forecasting the number of jobs that will be created as a result of the project. In each case, they forecast a multiplier factor. This shows the factor by which an indicator – such as budget revenues, GDP or employment – can be expected to increase as a result of both the direct and indirect effects of the project.

The multiplier factor is calculated by taking the project's Russian expenditure (Russian contracts, sub-contracts and associated labour, taxes and other direct payments to the Russian Party such as duties and fees) and using an economic model to forecast the effect of this expenditure on the Russian economy. There are three main underlying assumptions:

1. The profit of Russian contractors will be spent on further domestic capital investment;
2. Wages of Russian staff will generate national consumer market demand;
3. Government income redistributed in the budget will generate both further domestic capital investment and consumer demand.

In other words, expenditure in Russia generates additional activity in the Russian economy.

The preliminary findings are impressive. The SOPS report indicates that the positive socio-economic effects of the Sakhalin II project will be significant for the Russian Federation. Over the 49-year life of the project SOPS forecasts that it will bring about a significant increase in Russian GDP. SOPS' forecast also suggests that the aggregate revenues to the Russian Federation as a result of this multiplier effect will significantly exceed the direct tax and other revenues from the project.

SOPS' analysis suggests that the project will act as a catalyst for the further development of the Russian oil and gas industry and growth in a number of other sectors. Some of these – such as machine building, steel and construction – have obvious links oil and gas sector. But the SOPS study also indicates that, particularly in the operational phase, the positive effects of the project will extend beyond those sectors of the economy that traditionally support the oil and gas industry, to contribute to growth in a number of other sectors including financial services, transport and communications, agriculture, food and municipal services such as housing.

SOPS anticipates that a large number of jobs will be created as a result of this growth, many of them during the construction period but even more during the project's 40 plus years of operations. During operations, it is expected that the project will have a "knock-on" effect on job creation in service sectors such as health, education and housing.

SOPS' forecast also indicates that the Sakhalin II project will significantly boost the economy of the Russian Far East. They are carrying out detailed studies for the Khabarovsk and Primorsk regions as well as for the Sakhalin Oblast, which is expected to experience the most significant project-related growth in the Far East region. Related to this economic growth, SOPS forecasts a significant improvement in employment levels in the Russian Far East.

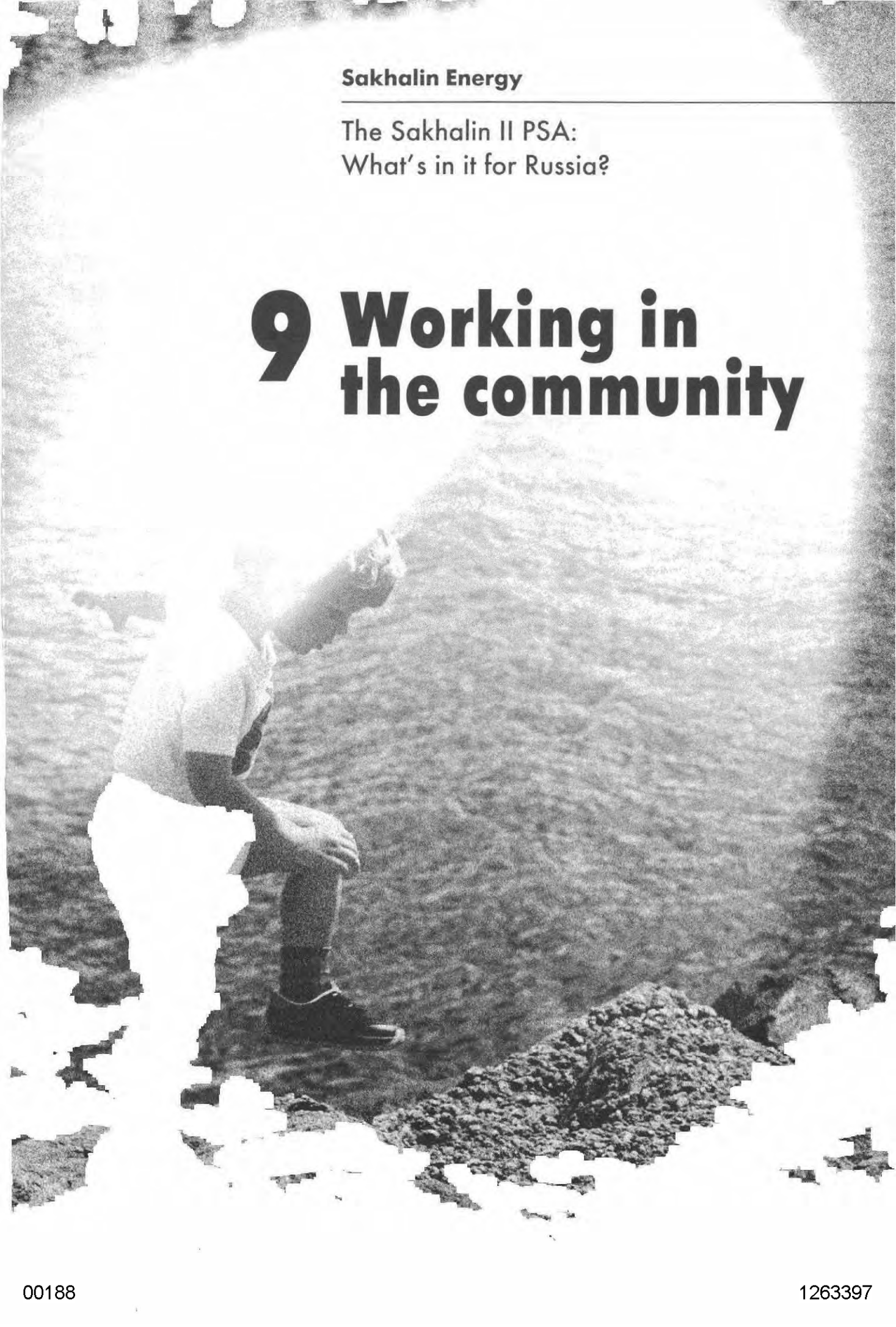
The SOPS report also provides an independent evaluation of a range of other benefits expected to arise from the project. These include substantial improvements in infrastructure, living standards, gains from the transfer of technology and management skills, improvements in occupational safety and the provision of healthcare.

**Sakhalin Energy**

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# **9 Working in the community**



Sakhalin Energy goes beyond the project to identify areas where we can have a positive impact through contributing to economic development and social well-being, through a range of community programmes. This is part of the responsibility of being a good neighbour but it is more than that: major international corporations are expected not only to act responsibly, but to make a positive contribution to society. Sakhalin Energy's community activities widen the overall project benefits to include Sakhalin communities that may not otherwise directly gain from project-related development. These initiatives are discussed more fully in the companion report, Sakhalin Energy and Society.

We contribute several hundred thousand dollars each year in voluntary (i.e. not cost-recoverable) donations to support projects that contribute to the environmental, economic and social development of the island. The areas where we have been most active are education, conservation and environment, native arts, culture and sports, which are the main recreational activity on Sakhalin Island. We also make some charitable donations.

We sometimes provide direct financial or other support to development projects or organisations. More often, however, we work in partnership with community based, non-governmental and governmental organisations, drawing on their local knowledge. We encourage community groups to come to us with their ideas and apply for funding.

With the onset of construction of the phase 2 project in late 2003, Sakhalin Energy's presence on Sakhalin Island is becoming more tangible. We want our presence to be felt beyond the building work and all it involves, and we are stepping up spending on our community programmes.

Our contractors are required to set aside a portion of their contract budgets to community needs. This fund amounts to several million dollars. We are working in partnership with aid organisations and regional non-governmental organisations to identify suitable projects to sponsor. The target areas will be health, environment and social programmes.

The fund is a key to extending the range of benefits that the Sakhalin II project will deliver to Sakhalin and to Russia to include as many people as possible.



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# **10 Conclusion**

The Russian Federation as a whole and the Sakhalin region in particular will gain directly from the Sakhalin II project in a variety of ways, ranging from the billions of dollars invested in Russian jobs and contracts to supplies of cleaner energy and a safer, healthier and more prosperous environment.

Sakhalin II brings with it the promise of a better future – for the people of the Russian Far East and beyond – to European Russia in the west, and the Asia-Pacific region in the east. Russian people will benefit from the opportunities for jobs and contracts that Sakhalin Energy is creating, and from the catalytic effect our \$12 billion investment will have on other sectors of the economy. And the customers for Sakhalin LNG in the Asia-Pacific region will look to Russia, as Europe has done for many decades, as a source of energy to fuel their further economic development. Sakhalin Energy is the bridge between the two, forging a bond linking the vast territory of the Russian Federation with the dynamic economies of Asia. That bond will be strengthened by the development of other large-scale energy projects in the Russian Far East, facilitated by the pioneering work of Sakhalin II.

The success of the Sakhalin II project will influence the speed and the volume of other foreign investments in the Russian economy, especially those in the oil and gas sector and, above all, those offshore Sakhalin. Where we succeed, others will follow. Some developments, including Sakhalin I, are already going ahead. And there are others at various stages of development.

Developed responsibly, the vast resources that lie in the Sea of Okhotsk will contribute to the stability and prosperity of the Russian Federation, and will create for Sakhalin a new and pivotal role. What is now the edge of the world will become the heart of a new energy province that will bring prosperity far beyond its borders.



# The Sakhalin II PSA: What's in it for Russia?

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Dinsdag 19 september, 9.00u

Bijgaande verklaring is zojuist uitgegeven door Sakhalin Energy Investment Company Ltd (SEIC). Shell is 55% aandeelhouder van SEIC en heeft op dit moment niets aan deze verklaring toe te voegen.

## QUOTE

Sakhalin II is the world's largest integrated oil and gas project, and with \$20 bln of inward investment it is the biggest foreign direct investment in Russia. The lifetime economic benefits to the Russian Federation from this project will total over \$50 bln assuming oil prices in the mid-30s.

We are confident the 2003 SEER conclusion does not violate any applicable law and indeed, has been the basis for successful execution of the project to date. Although there have been various environmental challenges on this project these have been tackled and largely overcome. Specific issues referred to by RPN and MNR are not material. All concerns are being addressed expeditiously in co-operation with the relevant authorities and do not constitute any legal grounds for nullification.

We are confident there are no valid grounds to revoke the order 600, which approved the SEER conclusion for Sakhalin II Phase 2 in 2003, and thus, to invalidate the SEER conclusion, which has been successfully defended in the Russian court, as recently as August 29, 2006.

Annulment of the order 600 could be damaging for the project and for Russia and lead to delays in project development. Extra costs would fall under the cost recovery mechanism of the PSA.

We have no doubts that the Government of the Russian Federation will honor its obligations under the PSA, and thereby, ensure that Russia meets its commitments to provide energy securely to its customers. We will continue to work with the Russian authorities to resolve the issue and thereby, maintain confidence of international customers in Japan, Korea and North America, where Sakhalin gas is contracted for supply in 2008.

## UNQUOTE