

Progress of the Sakhalin-II PSA Against the Odds: Reality Behind the Myths

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The Sakhalin II PSA Project has been in the spotlight since its inception in 1994. Due to its complex nature, challenges and ambitions it was the project most talked about both in Russia and internationally. What is very characteristic is that even at today's forum, the appraisals of the project range from "Fantastic opportunity for Sakhalin Island and Russia as a whole" to "unclear benefits for Russia".

It is unfortunate that, at present, there are still doubts and sometimes a lack of understanding of the PSA projects and how they benefit Russia. This is due in part to certain myths that have been created and are currently circulating in the media. The four most common are:

- ! the Sakhalin II PSA does not benefit Russia;
- ! the PSA is not needed and such projects should be developed under Russia's standart fiscal system;
- ! investors do not care how much the project costs because the PSA allows it to recover all the costs;
- ! the PSA allows for discrimination against Russian industries and for the provision of most contracts to foreign companies.

Despite the above-mentioned criticism, the Sakhalin II PSA project has strong support from top-level officials in the Russian Federation and is backed by both the Federal Government and the Sakhalin Oblast Administration. For purposes of illustration, I would like to quote by Mr. Vladimir Putin, President of Russia, from the International PSA Practitioners' Conference in Yuzhno-Sakhalinsk: "We regard the PSA as one of the most important tools for attracting investments to the national economy, especially to its mineral development industry."

Hence, the main thrust of this talk is to clarify the primary features of the Sakhalin II project and

to restore reality, which has been distorted by the above-mentioned myths. The article will consist of the four parts:

- ! brief description of the project;
- ! myths and reality in relation to the Sakhalin II PSA project;
- ! benefits, which the project brings to Russian Federation; and
- ! project development and recent achievements.

1. A few words on the project

Sakhalin II is being carried out in accordance with the terms of a Production Sharing Agreement (PSA) between the Russian Federation and Sakhalin Energy Investment Company, Ltd. (SEIC). The current shareholders of the company are Shell Sakhalin Holdings B.V. (Shell), which has a 55% share in the project, Mitsui Sakhalin Holdings B.V. (Mitsui) which have a 25% share and Diamond Gas Sakhalin, a Mitsubishi company, with a 20% share.

Sakhalin II is the first PSA in Russia and the first to go into production. It also represents the largest single foreign direct investment project in Russia, requiring an investment \$10 billion US.

The project is comprised more than by the development of two fields: Piltun-Astokhskiye, primarily an oil field with associated gas, and Lunskiye, predominantly a gas field with associated condensate and an oil rim. Together the fields contain recoverable hydrocarbon volumes of more than 1 billion barrels (150 million tonnes) of crude oil and more than 500 billion cubic meters (18 trillion cubic feet) of natural gas. The combined oil reserves equate to more than one year of crude oil exports from Russia at the level of around 2.5 million barrels per day while the gas reserves repre-

sent nearly five years of Russian gas exports to Europe, or enough to meet current global LNG demand for four years.

The project is being implemented in 2 Phases.

Phase 1 has been successfully producing oil from the Vityaz Complex since July of 1999. The Vityaz Complex is built around the Molikpaq offshore production platform. Oil is transported from Molikpaq to a floating offloading unit, where it is transferred to shuttle tankers for sale to customers. Current production is seasonal due to winter sea ice. Average production for Phase 1 is at the rate of more than 70,000 bbl/day.

Phase 2 is thought to be the biggest single integrated oil and gas project ever undertaken. It includes installation of two additional platforms. All the platforms, including Molikpaq, will be linked to the shore by pipelines. The oil and gas will then be transported via 800 km off onshore pipelines to the south of Sakhalin island where Russia's first liquefied natural gas (LNG) plant is being constructed, which will have an annual capacity of 9.6 million tonnes (mtpa). Then, via LNG and crude oil export terminals, hydrocarbons will be shipped to customers all year round, as the Aniva bay where the terminals will be located is ice free.

2. Reality vs. Myth

First myth: the Sakhalin II PSA does not benefit Russia.

In reality: If there was no Sakhalin II PSA, it is highly unlikely that the project would have been developed, and the Russian Federation would earn nothing.

Second myth: The PSA regime is not needed and such projects should be developed under Russia's standart fiscal system.

In reality: Given the political and economic environment of the early 1990s, the Sakhalin II project shareholders simply would not have risked investing in such a large project without the stability of a PSA. An expensive, large and complex project in such a challenging frontier environment would have constituted a substantial risk without a known and fixed set of legal and fiscal conditions.

Third myth: SEIC does not care how much the project costs because the PSA allows it to recover all the costs.

In reality: There is no cost at all to the Russian Federation for the development of the Sakhalin II PSA project. The shareholders put up all the money during development, take the risk and do not get any money back until hydrocarbons are produced and revenue is earned.

Additionally there is a clear rationale: one dollar spent today has a higher value than it will have in the future due to impacts such as inflation. The present net value of the costs SEIC will recover will be worth considerably less than they are today. SEIC's shareholders feel the impact more than the government does – for every dollar of increase in costs, the shareholders share is 79 cents.

Fourth myth: The PSA allows for discrimination against Russian industries and for the provision of most contracts to foreign companies.

In reality: This project contains facilities such as offshore oil and gas production platforms and LNG plants that are new to Russia. Consequently, Russian industry does not have the capability to manufacture these to the standards required. This is, however, a major opportunity for the Russian industry to learn and develop capabilities in technology and this is occurring. It is also simply not true to say that Russian industry is excluded.

3. Benefits to Russia

While the challenges, investments and effort to develop the Sakhalin II project are substantial for both Russia and the project shareholders, there are also benefits.

The benefits of the project to Russia fall into the following four categories.

a) Revenues:

! Direct income to the Russian federation will be as much as \$45 billion US over the life of the project, made up of royalty payments, shared profit from the oil and gas, taxes and bonuses payable under the PSA.

! Payments to Russian contractors and companies as part of the project construction already amount to \$4 billion US.

! Over the operational life of the Sakhalin II project, expenditure will be more than \$15 billion US, with more than 70% of this directed to Russian companies.

b) Jobs and training:

! Up to 12,000 people will be employed during the construction of the Phase 2 project, a large portion will be Russians;

! Spending on Russian personnel and income taxes over the life of the project will be close to \$6 billion US;

! 2400 permanent jobs are being created, up to 1500 are permanent jobs with Sakhalin Energy and 900 with contractors. SEIC will recruit islanders to those positions wherever possible;

! Sakhalin has started an apprenticeship program to develop employees for the future. This scheme is focused entirely on people from Sakhalin and the target will be to employ 2 apprentices for every 1 direct-hire from the Russian Federation;

! In Korsakov, several million dollars are being spent to train people for roles in the operation and maintenance of the LNG plant and associated oil export facilities;

! In 2008, following start-up, the target is for 35% of employees to be Russian-Nationals, rising to 60% by 2011 and 85% by 2018;

! There will be a transfer of technology, international management and business skills; and

! The project will bring an improvement in occupational safety and management of the environment.

c) Infrastructure:

\$300 million US has already been spent upgrading the infrastructure of Sakhalin Island. More than \$12 million US were spent on improvements for public health and waste management. SEIC is also supporting the development of an oil and gas industry infrastructure for other offshore projects.

Some of the specific accomplishments include:

! 116 km of roads on Sakhalin Island were constructed/upgraded;

! 45 new bridges and 170 culverts for river crossings were constructed;

! Nogliki Airport was upgraded with a new asphalted runway and terminal buildings;

! The merchant port of Kholmsk was upgraded.

The island's 600,000 inhabitants are already benefiting from improved bridges, roads, road drainage systems, telecommunications, hospitals, airport, railroads and ports as a result of the project.

d) Energy supply:

Sakhalin LNG will be the first Russian gas to Asia and North America, opening up new strategic markets for Russia. Additionally, natural gas produced by the Sakhalin II project will be able to contribute to energy demands of the Russia's Far-East regions.

4. Recent Project milestones

! SEIC has awarded contracts to two Japanese-Russian ship-owning consortiums for the long-term charter of three new-built LNG ships;

! SEIC entered into a pioneering deal to supply LNG to North America, which represents the first ever sale of Russian natural gas to American markets;

! SEIC continues construction of concrete gravity base structures;

! Total long-term sales of the Sakhalin II LNG exceed 5 mtpa out of 9.6 mtpa, which constitutes the total project capacity;

! All major construction contracts were tendered and most were awarded;

! Russian TEOC approvals were obtained;

! Phase II of the project was officially announced.

The Sakhalin II PSA Project moves forward. According to the expert estimates Phase II is more than 40 per cent complete. In this important stage of implementing the project SEIC is eager to demonstrate that the project already brings benefits to Russia and Sakhalin Island. I hope this presentation has exposed some of the myths currently in circulation with regards to our Project. □