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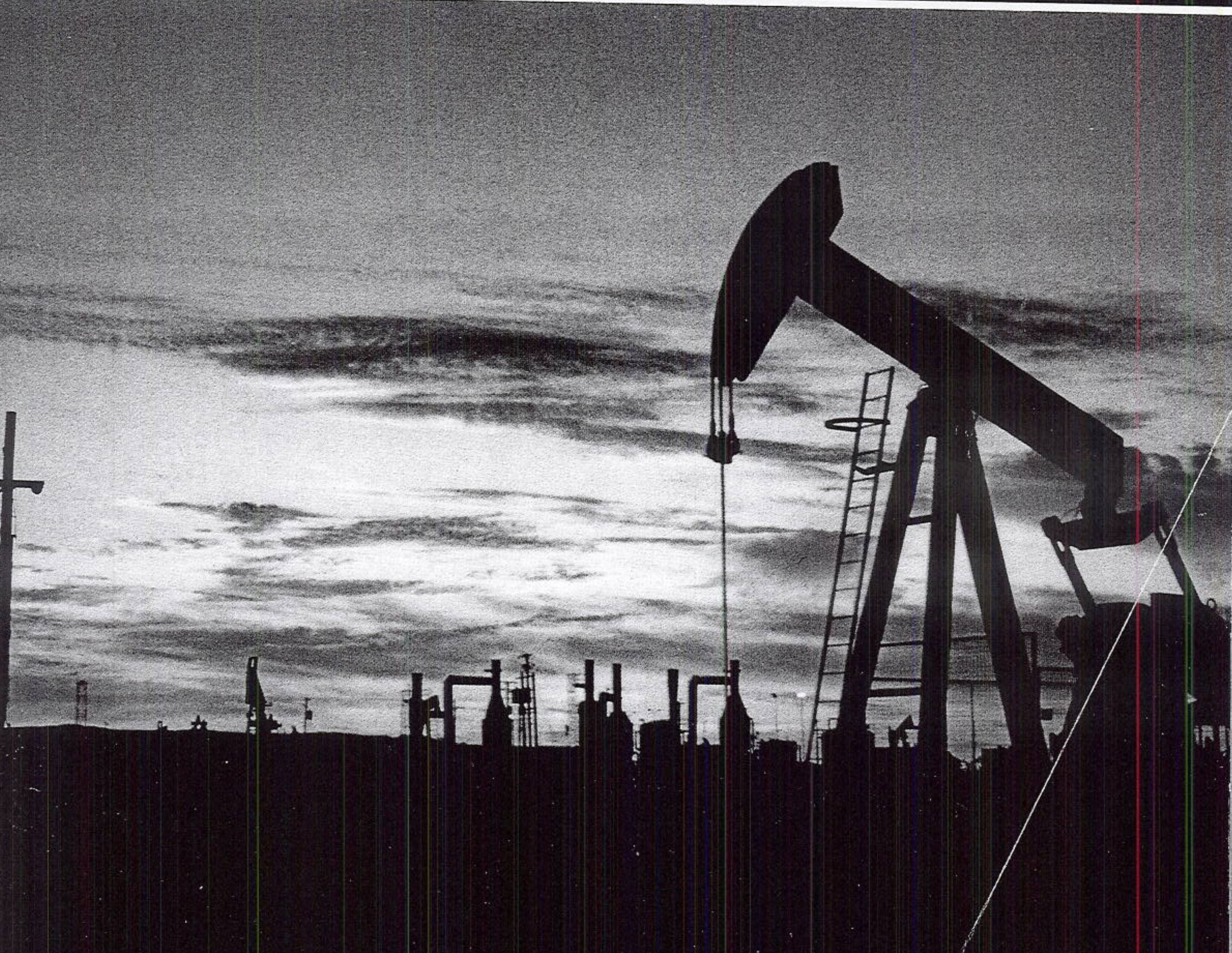

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Sakhalin tender results detailed

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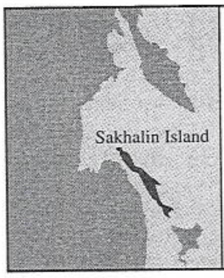


THE SAKHALIN TENDER

Given uncertainty over a final verdict for the Sakhalin Island tender announced in May 1991 (OGJ, Mar. 23, p. 128, and Mar. 30, p. 34), upon instructions from the Russian Federation government, a government committee (GC) was constituted and headed by V. Danilov-Danilyan, Russia's Minister for Ecology and Natural Resources, to synthesize the results of and select the winner of the tender.

Government committee scope

The GC was asked to consider proposals from foreign companies, verdict of the Tender Organizing Committee (TOC), and conclusions by the committees of experts created by the Sakhalin Region administration and the Examining Council under the Chairman of Russia's Government.

Most important, the GC was to make a definitive decision as to the foreign partner that would participate in conducting a feasibility study and later in developing oil and gas resources off Sakhalin Island.

In summarizing tender results, the GC was instructed to proceed from the need to relate interests of the Russian Federation to interests of the Sakhalin free economic zone. A top priority was given to delivery of Sakhalin offshore gas to the Sakhalin Region and Khabarovsk and Maritime Territories to meet their needs for fuel, electricity, and heat.

The GC's work included participation by independent foreign experts from a group of banks led by Lazard Frere and the legal firm Cleary, Gottlieb, Stein & Hamilton. Their opinions were taken into account in the process of deciding the tender winner, as well as in the process of formulating a set of requirements to be met by the foreign partner at the time of completing its feasibility study. The GC found the most urgent objective of the Sakhalin project is meeting the Far Eastern Region's needs for gas and oil and in promoting socioeconomic development in Sakhalin while at the same time adhering to the basic principles of the tender announced in May 1991.

Committee decisions

The GC decided it would be impractical to divide the tender zone into blocks and assign them to several bidders because that would call for drafting new proposals for each block. That would take more time to coordinate the various groups of companies and further delay development of the Sakhalin shelf.

At the same time, the GC deemed it inexpedient to extend to the tender winner exclusive rights for the entire zone in order to prevent possession of the most promising area of the Sakhalin shelf by a singe group of companies. It also decided against including Chaivo and Odoptu fields in the tender zone, pending respective decisions regarding the General Agreement of 1975 with Japan.

Aware of the need for early delivery of gas to the domestic market and of available information regarding prospective structures in the region, GC recommended extending to the tender winner exclusive rights to conduct a feasibility study for only two fields, Piltun-Astakhskoye and Lunskoye.

This is the last of three articles outlining the Sakhalin Island tender process

That's because, for a number of economic considerations, only that format would guarantee delivery of gas to Russia's Far East starting in 1995 and still generate enough foreign exchange to pay back the original investment.

In addition, GC decided the scope of the feasibility study should include further exploration in the tender zone as well as integrating development of the Sakhalin shelf with promoting socioeconomic development in the Sakhalin Region.

GC recommended the Russian government have the decisionmaking privilege covering development of other fields in and outside the tender zone, as well as recruitment of foreign partners.

MMM group chosen

On Jan. 27, 1992, GC ruled that the MMM group—Marathon Oil Co., McDermott International Inc., and Mitsui & Co. Ltd.—would be selected as a foreign partner to conduct a feasibility study to develop Piltun-Astokhskoye and Lunskoye fields and further exploration in the tender zone.

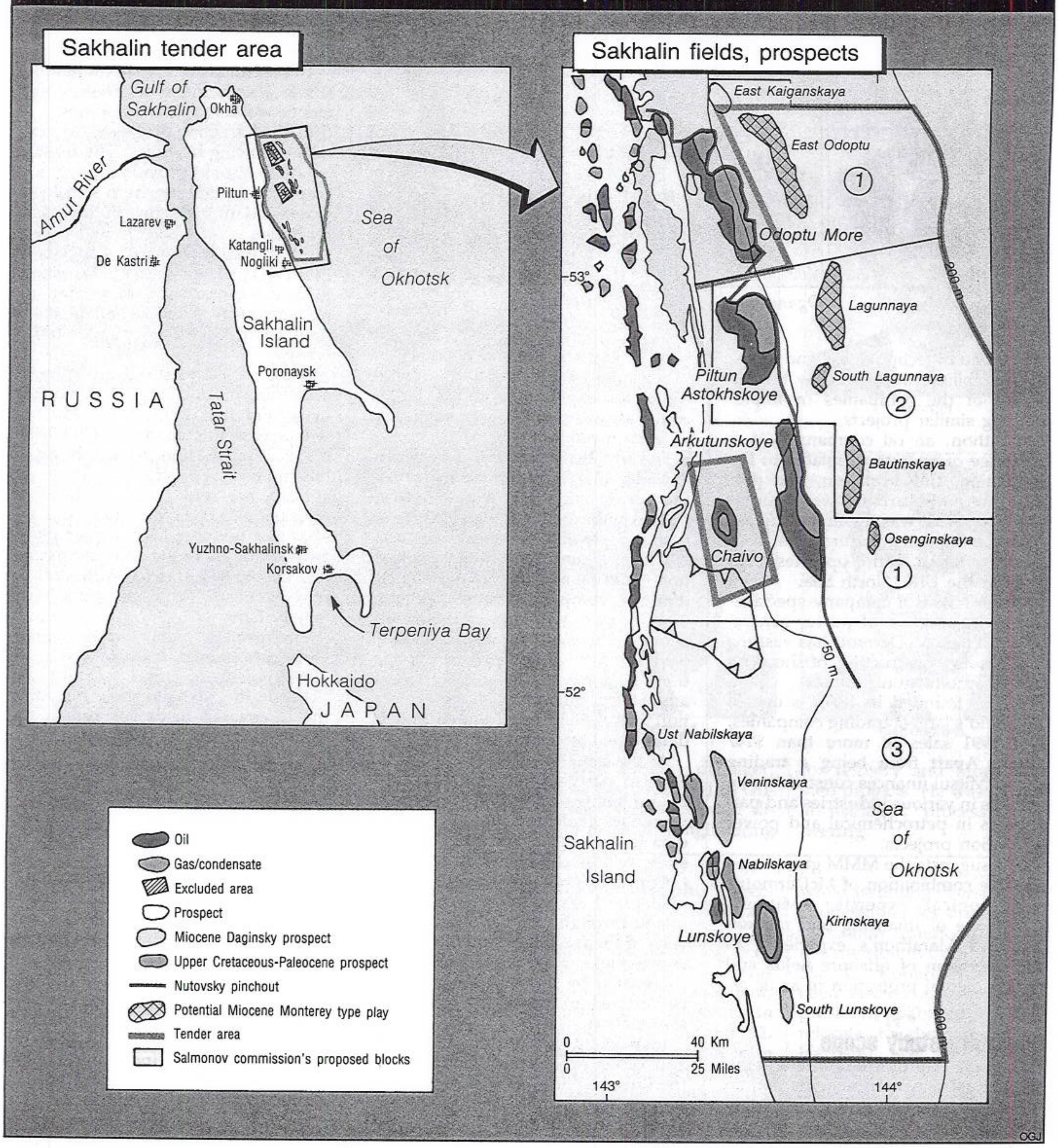
The MMM group was selected because it had met most of the requirements of the Russian government, has considerable expertise in developing offshore fields in arctic conditions, and possessed enough capital to mount the project. In effect, the GC reconfirmed decisions on the tender winner by TOC, the groups of experts under the Sakhalin Executive Committee, and in part the Salmanov Commission.

In selecting only one winner, GC complied with requirements stipulated by the tender announced in May 1991. It also deemed it improper for the government to arbitrarily put foreign companies together into a new consortium that could be pronounced a winner because that would have run counter to tender stipulations and world practices.

Because no applicable Russian legislation exists, GC deferred a decision on the organizational format of the project pending commencement of the feasibility study. It also decided to put off formulating specific proposals on allocation of profits between the federal budget of the Russian Federation and the local budget of the Sakhalin Region.

GC regarded Mobil Corp.'s proposal of possible participation in the MMM group as meriting continued consideration. It also recommended that the MMM group and the Russian party consider enlisting participation of Japan's Sakhalin Oil Development Co. (Sodeco) in the project on the premise project implementation would make development of Chaivo and Odoptu more financially attractive.

WHERE SAKHALIN ISLAND PROPOSED FIELD DEVELOPMENTS, PROSPECTS ARE



The committee urged the tender winner and Sakahlinmorneftegaz to begin at the earliest possible date to conduct a feasibility study with the assistance of the Sakhalin Region administration.

The legal, managerial, and financial structure supporting development of Piltun-Astokhskoye and Lunskoye fields will be determined from a number of variables covered by the feasibility study.

In pursuit of the Jan. 27 protocol of intent between the government of the Russian federation and the MMM group, the foreign partner recognized as valid the Russian party's requirement that a joint feasibility study be mounted by the foreign party, Sakhalinmorneftegaz, and the Sakhalin Region administration for development and further exploration in the tender zone.

However, V. Fedorov, Sakhalin Region governor and GC vice-chairman, refused to sign the committee resolution in what can be construed as a move to reserve the privilege to present his ill-founded and frequently changing views in the media.

The tender winner

The MMM group's three companies came together to work on the Sakhalin project as early as 1990.

That became a fortunate and effi-

Konoplyanik

Oganesyan

Retiunin

cient blend of technological and financial possibilities supported by the expertise of the companies in implementing similar projects.

Marathon, an oil company with a full range of operations related to the production, transportation, and processing of hydrocarbons, was incorporated in 1887. It was the first company to export liquefied natural gas from Alaska to Japan, and it operates giant fields in the U.K. North Sea.

McDermott is a company specializing in construction of power generation facilities. McDermott has vast experience in constructing offshore oil and gas production facilities.

Mitsui, founded in 1876, is one of the world's largest trading companies, with 1991 sales of more than $147 billion. Apart from being a trading house, Mitsui finances construction of facilities in various industries and participates in petrochemical and power generation projects.

This suggests the MMM group is an effective combination of McDermott's technological expertise, Mitsui's knowledge of financing and marketing, and Marathon's experience in safe operation of offshore fields and environmental protection of arctic areas.

Feasibility study scope

The Jan. 27 protocol of intent delineates the basic requirements for an agreement to perform a feasibility study.

The feasibility study will be drafted in conjunction with specialists from the Russian party and take note of the Nov. 30, 1991, commentary from the State Examining Board of the Russian Federation. The study will cover only Piltun-Astokhskoye and Lunskoye fields.

Delivery of gas to the domestic market is scheduled to begin in 1995.

The feasibility study will make provisions for additional surveying and exploration in the tender zone. This, however, does not mean that the MMM group will be granted exclusive rights for exploration in the tender zone, as was erroneously suggested by certain publications.

The feasibility study is expected to consider an optimum program for further prospecting and exploration on the Sakhalin shelf and to determine its cost and possible sources of finance.

The program of additional exploration could be mounted mainly by the domestic company because Sakhalinmorneftegaz owns state of the art offshore drilling rigs for test drilling as well as other equipment for exploration. That means, in effect, that the approaches and methods of exploration will remain open ended and be determined by the Russian party later.

At the same time, acceptance of the Russian party's terms will guarantee the ice free season of 1992 can be used to update geological and engineering data in the region and the feasibility study will be completed on schedule.

Conditions of the project's legal and managerial structure will be determined through negotiations using results of the feasibility study. Sakhalinmorneftegaz and other participants designated by the Russian party will be entitled to participate in project formulation.

Investment for geological surveys and other exploration conducted by the Russian party, as well as type and format of its compensation, will be assessed in foreign exchange at free market prices.

The final amount of royalties, estimated at 15%, and other financial terms and conditions such as bonuses, investment into social infrastructure, taxes, production sharing, and profit allocation, will be determined from governing Russian legislation and results of the feasibility study.

Contracts for construction and installation will be put up for bid to qualified contractors with participation by Russian contractors encouraged. The feasibility study should analyze potential effects of the project on the region's environment and focus on special programs to reduce risk of environmental pollution.

The feasibility study should emphasize local sourcing of materials, equipment, workers, and know-how, including all training programs, to maximize financing in rubles. The feasibility study should provide for a special emphasis on investment in social programs and infrastructure in the Sakhalin Region.

Combined recoverable deposits in Piltun-Astokhskoye and Lunskoye fields are estimated at more than 100 million tons (730 million bbl) of oil and more than 400 billion cu m (14 tcf) of gas.

If the project proceeds according to schedule, production will commence in second half 1995. Oil production will peak at 10 million tons (200,000 b/d), gas production as much as 16 billion cu m (1.5 bcfd).

Plans are under way to build in Sakhalin a 15,000 b/d refinery and a 4-6 million ton/year LNG export plant. Delivery of gas to the domestic market will be 480-863 MMcfd, with start-up of deliveries to the Khabarovsk Territory in 1996.

The project, when implemented, will create an infrastructure vital to the development of other oil and gas fields on the Sakhalin shelf, including the discovered fields covered in the General Agreement with Japan.

Project economics

Capital investment in the project, minus further exploration, is estimated at $8-9.2 billion, depending on the scenario.

The economic analysis of the project as a whole indicates that if world standards were applied to this project, its economic viability cannot be questioned.

The tentative economics of the project can be broken down as:

- Sales of product at a stable oil price of $20/bbl totaling $45.5 billion.
- Project costs, including capital outlays, operating costs, and cost of capital totaling $15-19 billion.
- Profit to the Russian party, at current domestic prices, of $16-23 billion.
- Profit to the foreign party of $9-16 billion.

The project will be financed predominantly by the export-import banks of Japan and the U.S. through dedicated credits.

Participation of Japan and the U.S. in project implementation will offer economic benefits to Russia and create a healthier political climate in Asia and the Pacific region. ▪