

Report of the Auditing Chamber of Russian Federation

Results of the audit for use of state-owned resources on a compensatory basis by subjects of enterprise activity, regarding payment of taxes, collections, and other payments in the federal budget,

as well as insurance payments to the federal unrestricted fund for execution of the Production-Sharing Agreement for the Sakhalin-1 and Sakhalin-2 projects, and

completion of the statements of the Auditing Chamber accepted by the Board of the Auditing Chamber of the Russian Federation on April 17, 1998 by results of the thematic audit of the tax payment and collection organization in the budget at the execution of the Production-Sharing Agreements according to the Federal law "On Production-Sharing Agreements" in the enterprises and organizations of the Sakhalin area.

Basis of audit: the Decision of the State Duma of the Federal Assembly of the Russian Federation dated May 20, 1999, №3994-P GD and the 1999 work plan of the Auditing Chamber of the Russian Federation (Item 3.69).

Purpose of the audit:

1. Audit of issues related to the realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, regarding:

- activity of the Government of the Russian Federation, agencies of the government of the Russian Federation and the Sakhalin Area Administration to protect the interests of the Russian Federation;

- activity of regional governmental entities of the Russian Federation in the Sakhalin area and Department of Natural Resource Development on the continental shelf of Sakhalin Area Administration in the regulation of resource use;

- execution by the resource users of the conditions under the Sakhalin-1 and Sakhalin-2 Agreements and the Russian Federation legislation on the development of resource sites, extraction, gathering, and shipping of oil and gas;

- legality and rationality of procedures in the choice of legal entities among which orders for services, manufacturing of equipment, and primary processing of minerals are distributed;

- correctness and timeliness of receipts to the Russian side of bonuses and other payments in the execution of the specified Agreements.

2. Audit of performance of Auditing Chamber of the Russian Federation statements, accepted by the Board of the Accounting Chamber of the Russian Federation on April 17, 1998 regarding the results of thematic audit of the organization of tax and payment collection in the budget at the execution the Production-Sharing Agreements according to the Federal law “On Production-Sharing Agreements” by the enterprises, the organizations of the Sakhalin area, as well as the accuracy of calculation, completeness, and timeliness of payment of taxes and other payments in the federal budget by Open Society Rosneft-Sakhalinmorneftegas.

3. Audit of correctness and timeliness of calculations and payments by resource users of insurance payments to the state unappropriated fund in execution of the Production-Sharing Agreements at Sakhalin-1 and Sakhalin-2.

4. Audit of legality, expediency, and efficiency of use by resource users of public funds and federal property while executing the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

Audit Subjects: Ministries, departments, enterprises, and organizations conducting projects, carrying out financial operations, and monitoring of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

The audit is lead according to the program authorized by the Board of the Accounting Chamber of the Russian Federation on July 9, 1999 (Report № 23 (174)).

The list of the documents used in the Audit, is submitted in Appendix 1.

List of Completed Certificates:

1. Certificate of Execution of Audit of the Production-Sharing Agreement of the Sakhalin-1 project. Co-Chairmen of the authorized federal entity acquainted with the Certificate: Governor of the Sakhalin area I.P. Farkhutdinov and Deputy Minister of Fuel and Power of the Russian Federation of V.Z. Garipov.

2. Certificate of Execution of Audit of the Production-Sharing Agreement of the Sakhalin-2 project. The Deputy Minister of Fuel and Power of the Russian Federation, V.Z. Garipov, and First Vice-Governor of the Sakhalin Area, V.I. Shapoval, are acquainted with the Certificate.

3. Certificate of Audit of legality, rationality choices of procedure for selecting legal entities among which orders for services, equipment manufacturing, means and materials necessary for geological studies, extraction and primary processing of minerals under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements. The Deputy Minister of Fuel and Power of the Russian Federation of V.Z. Garipov, the Department Chief for the Development of Raw Mineral Resources on the Sakhalin Area at the Sakhalin Area Administration, and member of the Supervisory Council and authorized federal entity,

G.N. Pavlov, and the Governor of the Sakhalin Area, I.P. Farkhutdinov, are acquainted with the Certificate

4. Certificate of Audit of the legality, expediency, and efficiency of resource users use of public funds and federal property under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements. The Deputy Minister of Fuel and Power of the Russian Federation, V.Z. Garipov, and the Minister of Natural Resources of the Russian Federation, B.A. Yatskevich, are acquainted with the certificate. The certificate includes written remarks by the Ministry of Fuel and Energy of Russia according to which audit's conclusions are drawn (table of discrepancies).

5. The Certificate of Audit of Natural Resources Committee on the Sakhalin area. With the certificate it is acquainted acting as Chairman of Natural Resources Committee on Sakhalin area В. Е Горетый.

6. The Certificate of Audit of Open Society Rosneft-Sakhalinmorneftegas. The first assistant to the General director of Open Society Rosneft-Sakhalinmorneftegas JU.G is acquainted with the certificate. Dumanskiy.

7. The Certificate of Audit of Department on development of raw mineral resources of a continental shelf of Sakhalin Area Administration. With the certificate it is acquainted acting as director of Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration) of A.S. Nadsadin. The submitted remarks to the Certificate of Audit of Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration) concern structure of the certificate and do not deny conclusions auditing about the infringements revealed during carrying out of the given audit.

8. The Certificate of Audit of Management of the Ministry of the Russian Federation under taxes and tax collections on the Sakhalin area. The head of Management of the Ministry of Taxes and Tax Collection of the Russian Federation is acquainted with the certificate on A.P. Samsonov's Sakhalin area.

9. The Certificate of Audit of correctness and timeliness of calculation and payment of insurance payments in the Pension fund of the Russian Federation resource users at execution of Agreements by them Production-Sharing Agreement Sakhalin-1 and Sakhalin-2, an effective utilization of means branch of the Pension fund of the Russian Federation. With the certificate are acquainted: the manager of branch of the Pension fund of the Russian Federation on G.V. Gudzev's Sakhalin area, the chief accountant of branch of the Pension fund of the Russian Federation on the Sakhalin area Dream Cy.

10. The Certificate of Audit of correctness and timeliness of charge and payment of insurance payments in Social Security Fund of the Russian Federation resource users at execution of agreements by them Production-Sharing Agreement Sakhalin-1 and Sakhalin-2, formations and an effective utilization of means the Sakhalin regional branch of Social Security Fund of the Russian Federation in 1998. With the certificate are

acquainted: the manager of the Sakhalin regional branch of Social Security Fund of the Russian Federation of G.K. Vatlina, the chief accountant of the Sakhalin regional branch of Social Security Fund N.I. Kamesh.

11. The Certificate of Audit of correctness and timeliness of calculation and payment of insurance payments in the Sakhalin territorial fund of obligatory medical insurance resource users at execution of agreements by them Production-Sharing Agreement Sakhalin-1 and Sakhalin-2, an effective utilization of means the Sakhalin territorial fund of obligatory medical insurance in 1998. With the certificate are acquainted: executive director of Sakhalin territorial fund OMS I.L. Zolotukhin, the chief accountant of Sakhalin territorial fund OMS O.A. Gadzelnikova.

12. The Certificate of Audit of the correctness and timeliness of calculation and payment of insurance payments to the State People's Employment Fund of the Russian Federation by resource users in executing the Production-Sharing Agreements for Sakhalin-1 and Sakhalin-2; effective utilization of means from the local State People's Employment Fund for the Sakhalin area in 1998. The Head of the Sakhalin Area State People's Employment Department, A.T. Ryazantsev, and the Chief Accountant of the Department, T.V. Kolosov are acquainted with the certificate.

The First Assistant to the Governor of the Sakhalin Area, I.P. Malakhov, and the Chairman of the Sakhalin Regional Duma, B.N Tret'yak were informed of the results of the audits.

Results of the Audits

I. Audit of the activity of the Government of the Russian Federation and government agencies government of the Russian Federation and the Sakhalin Area Administration protecting the interests of the Russian Federation in the Production-Sharing Agreements for the Sakhalin-1 and Sakhalin-2 projects.

1. Brief information regarding the Sakhalin-1 Production-Sharing Agreement.

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2. Brief information regarding the Sakhalin-2 Production-Sharing Agreement.

2.1. On August 10, 1991, the companies Marathon Petroleum Sakhalin, Ltd., MacDermott International Investment Co, Ltd., and Mitsui and Co, Ltd. (the MMM Consortium) made a joint offer for the investigation, development, and operation of marine hydrocarbon stocks located on the shelf of Sakhalin Island to the Russian party. In January 1992, the specified companies won the tender for the development of the feasibility report (FEASIBILITY REPORT) for the investigation and development of oil-and-gas deposits on the Sakhalin shelf as declared (Order №179-r of the Government of the Russian Federation dated December 23, 1991) by the Ministry of the Oil and Gas

Industry of the USSR and the State Committee on Geology, Fuel Power and Mineral Resource Use of the RSFSR.

2.2. Based on the results of the given competition, by Order №596-r of the Russian Federation Government on March 28, 1992, between the MMM Consortium, the Russian Federation, and ON Sakhalinmorneftegas the Agreement “On preparation of the feasibility report” has been made with the purpose of defining the technical, legal, financial, and commercial conditions under which the investigation and development of hydrocarbon stocks in the Piltun-Astokhskiy and Lunskiy deposits (located on the northeast Sakhalin shelf) will be carried out:

- Piltun-Astokhskiy oil-and-gas condensate deposit, 15-20 kilometers from the coastline, at depths of 28-32 meters;

- Lunskiy gas-condensate deposit, 12-15 kilometers from the coast line, 25 kilometers south-east of the developed Nabil’ oil-and-gas deposit, located within the limits of the island, at depths 41-48 meters.

2.3. In 1992, with the consent of the Russian part of Co-coordinating Committee on Performance of the Feasibility Report, Shell Development BV (September) and Mitsubishi Corporation (December) joined the MMM Consortium and became parties of the given Agreement. As a result, the MMMSh Consortium was formed.

2.4. On December 31, 1992, the FEASIBILITY REPORT for the development of the Lunskiy and Piltun-Astokhskiy deposits was submitted for consideration to the State Expert Committees of the Ministry of Economics of the Russian Federation and the Ministry of Ecology of the Russian Federation.

From February-March 1993, the FEASIBILITY REPORT was reviewed and approved by the Sakhalin Area Administration, the State Commission of Experts of the Ministry of Ecology and Natural Resources of the Russian Federation, and the State Commission of Experts of the Ministry of Economics of the Russian Federation.

2.5. Since December 21, 1993, the company Mitsui & Co., Ltd., having notified by the letter dated December 24, 1993 the Ministry of Fuel and Power of the Russian Federation, transferred its interests under the Agreement “On preparation of the feasibility report” to the subsidiary Mitsui Sakhalin Development Co. Ltd.

2.6. Marathon Petroleum Sakhalin, Ltd. acted similarly also. On January 1, 1994, the company transferred its interests to the subsidiary, Marathon Sakhalin Ltd., under the Agreement “On preparation of the feasibility report,” having notified the Ministry of Fuel and Power of the Russian Federation of its decision in the letter dated February 4, 1994.

2.7. In the same way, on March 1, 1994, McDermott International Investments Co. Ltd. transferred its interests to MacDermott Sakhalin, Inc., according to its notification of the

Ministry of Fuel and Power of the Russian Federation by letter dated March 14, 1994, under the Agreement “On preparation of the feasibility report.”

2.8. Three weeks later (on March 22, 1994), Mitsubishi Corporation transferred its interests under the Agreement “On preparation of the feasibility report” to its subsidiary Diamond Gas Sakhalin B.V, as the Ministry of Fuel and Power of the Russian Federation was notified in a letter dated March 25, 1994.

2.9. In April 1994, subsidiaries of the above mentioned companies and Shell Development Sakhalin B.V. (whose assignee according to conditions of the Agreement on January 31, 1995, became Shell Sakhalin Holding B.V.) according to Bermudas legislation created Sakhalin Energy Investment Company Ltd. with the purpose entering into a Production-Sharing Agreement and receiving licenses for the Piltun-Astokhskiy and Lunskiy sites of oil-and-gas deposits.

Capital for Sakhalin Energy was generated due to the means of the aforementioned shareholders, who, together with the subsidiaries, belong to a number of the leading global companies engaged in the investigation and extraction of crude oil, natural gas, and liquefied natural gas.

2.10. Decision № 672 of the Government of the Russian Federation dated June 16, 1994 “On the conclusion of the Agreement between the Russian Federation and Sakhalin Energy Investment Company, Ltd. for the development of the Piltun-Astokhskiy and Lunskiy oil-and-gas fields under the Production-Sharing Agreement has been approved, as reported, in coordination with the interested ministries and departments between the Russian Federation on behalf of the Government of the Russian Federation and the Sakhalin Area Administration, on the one hand, and Sakhalin Energy Investment Company, Ltd. (further - Sakhalin Energy), on the other hand.

The Ministry of Fuel and Power of the Russian Federation was authorized to sign the specified Agreement on behalf of the Government of the Russian Federation, and the Committee of the Russian Federation on Geology and Resource Use was authorized to issue licenses for development rights for the development of the Piltun-Astokhskiy and Lunskiy oil-and-gas fields on the conditions stipulated in the Agreement after the inception of validity.

2.11. The agreement on the development of the Piltun-Astokhskiy and Lunskiy oil-and-gas fields under a Production-Sharing Agreement was signed on June 22, 1994 and came into force on June 15, 1996.

Competition for the right of use of resources under the conditions of the Production-Sharing Agreement for Sakhalin-2 was not carried out.

2.12. Now, following the distribution of MacDermott International Investment Co. Inc.’s shares of participation in the Project, shares of the foreign corporate investors and their subsidiaries in the Sakhalin-2 project were distributed as follows: Marathon Petroleum

Sakhalin, Ltd., 37,5%; Mitsui Sakhalin Development Co Ltd., 25.0%; Shell Development Sakhalin B.V., 25,0%; and Mitsubishi Corporation, 12.5%.

Licenses for resource rights for oil-gas-condensate deposits:

Piltun-Astokhskiy (ShOM Series №10409, license type-NR) and Lunskiy (series ShOM № 10408, license type-NR) were issued by the Committee of the Russian Federation on Geology and Resource Use in 1996 and have the status of mining extraction. The licenses issued have a special special-purpose designation—the investigation and extraction of hydrocarbons. Borders of license sites are established according to Regulations on resource licensing, as authorized by Decision № 3314-1 of the Supreme Soviet of the Russian Federation dated 07/15/92.

The initial validity of the licenses given to Sakhalin Energy under the Sakhalin-2 Production-Sharing Agreement for the realization of hydrocarbons development (investigation, extraction) is 25 years in length.

The operator of the Sakhalin-2 Agreement is Sakhalin Energy with representation and branches in Moscow and Yuzhno-Sakhalinsk.

2.13. The Sakhalin-2 Production-Sharing Agreement will regulate the investigation, extraction, and processing of hydrocarbons stocks in the Piltun-Astokhskiy and Lunskiy license sites, including drilling, extraction, testing, uses of explorative, operational, and delivery wells, design, construction, installation and use of marine platforms and construction, installations of division of production, storehouses, modular and main pipelines, a liquefied natural gas (LNG) facility, and other works (including administrative and managerial activity) and projects necessary for the investigation, development of stocks, extraction, preparation, processing and transportation of hydrocarbons, materials handling, hydrocarbon marketing, use of production extracted on license sites, and additional proceeds covering charges and costs, and distributions of other such production and proceeds between the parties.

2.14. On conditions of the Sakhalin-2 Production-Sharing Agreement, the property right to the stocks of oil and gas belongs to the Russian Federation. Sakhalin Energy bears all charges connected to the development of the deposits and shall pay the Russian party, by deposits into the federal budget and the Sakhalin Fund, bonuses totaling 150 million US\$ in payment for the initial stages of the Project. After extraction begins, the Russian party, first, should receive 6% of realized production as a payment for resources, and then indemnification of the investors' expenses. The remainder of income should be distributed between the Russian party and Sakhalin Energy. According to the circuit of distribution of the incomes accepted in the Agreement the company should pay to Russian party profit tax at a rate of 32%.

Moreover, consecutive payments in reimbursement of expenses for exploration totaling 160 million US\$ suffered by the Russian party before date of the conclusion of the Agreement should be made also.

2.15. Hydrocarbon stocks in the Lunskiy deposit are confirmed by the State Commission on Stocks of Minerals at the Council of Ministers of the USSR in 1990 (Report №10968 dated 11/30/1991), on the Piltun-Astokhskiy State Commission on Mineral Resources of the Ministry for Environmental and Natural Resources Protection of Russia in 1993 (Report №166 dated 06/22/1993).

At the Agreement's inception of validity, the Lunskiy and Piltun-Astokhskiy deposits as a whole registered geological stocks of 336 million tons of oil and 461 billion cubic meters of gas. (Stock estimation reports were executed by the Institute SakhalinNIRImorneft and Open Company Sakhalinmorneftegas.)

2.16. In 1996 in the Astokhskiy site of the Piltun-Astokhskiy deposit, Sakhalin Energy analyzed data from prospecting well №15, drilled in 1992 by MMMMSh Consortium and has a reinterpretation of the seismic prospecting data 2D, which were practically unused in the 1992-93 calculation of stocks. Recalculation of oil-and-gas and condensate stocks shows three productive seams and in the Astokhskiy site.

2.17. Sakhalin Energy executed and submitted for the consideration of the State commission on Resource Stocks of the Committee of the Russian Federation on Geology and Resource Use a geological report, "Specification of geological structure and recalculation of stocks of oil, gas, and condensate at the Astokhskiy site, including a FEASIBILITY REPORT on oil extraction factors."

According to Report №401 of session of the GKZ State Committee on Geology and Subsoil Resources dated 10/11/1996 reserves/recoverable stocks of category C1 oil have increased to 1770/4401 thousand tons, reserves/recoverable stocks of category C2 have increased to 5256/1283 thousand tons. After updating the operative estimation of geological stocks, the Piltun-Astokhskiy and Lunskiy deposits 590 million tons of oil, and 636 billion cubic meters of gas. The new estimate of stocks and delivery in the report "Specification of geological structure and recalculation of oil, gas, and condensate stocks in the Lunskiy deposit" is to be published in the fourth quarter of 1999.

2.18. Sakhalin Energy conducted final calculations of the Piltun-Astokhskiy and Lunskiy deposits according to the requirements stipulated by the instructions "On the classification of stocks of deposits, perspective, and predicted resources of oil and combustible gases" and "On the maintenance, registration, and monitoring of representation in the State Commission on Resource Stocks at the Council of Ministers of the USSR (GKZ of the USSR) materials by estimation of stocks of oil and combustible gases" under the schedules authorized at the June 8, 1999 session of the Supervisory Council. The statement estimating oil stocks in the Lunskiy deposit will be presented to the GKZ of Russia on October 1, 1999, and regarding the Piltun-Astokhskiy deposit—in the fourth quarter of 2000.

2.19. Information on the geological structure of the specified deposits and hydrocarbon stocks where Sakhalinmorneftegas's share was 50% was used for the development of the feasibility report on the development of the Piltun-Astokhskiy and Lunskiy deposits.

3. Conformity with federal legislation for the inception and realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

3.1. The Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements were entered into before the Federal law 12/30/1995 №225-F3 “On Production-Sharing Agreements” came into force, but Clause 2 of the law gives them validity and thus they are subject to execution according to the conditions determined in them.

3.2. The Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements were made in infringement of the order established by statutory acts of the Government of the Russian Federation. According to Decisions №684 (dated 06/10/1995) and №672 (dated 06/16/1994) of the Government of the Russian Federation the projects of the present Agreements should be preliminarily coordinated with the interested ministries and departments of the Russian Federation. However, the required coordination of the project with interested ministries and departments of the Russian Federation was not carried out during preparation of the Sakhalin-1 and Sakhalin-2 Agreements at their signing.

As a result, in the specified Agreements, insufficient measures were taken in the interests of the State on questions of ecology, resource use, tax and customs legislation, and state control, leading to the infringement of Russian Federation interests which were expressed shown during realization of the given Projects.

3.3. Thus, the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements were entered into outside the frameworks of the legal legislative controls of the Russian Federation.

3.3.1. According to Item 28.5 of the Sakhalin-1 Agreement and Item 24(f) of the Sakhalin-2 Agreement, all subsequent changes of the legislation in whatever way affecting the original interests that are of no use to the investor are disavowed by the given Agreements, that is, the Agreements provide guarantees to investors from subsequent undesirable to them changes of Russian legislation.

According to Item 24(f) of the Sakhalin-2 Agreement, the Russian party guarantees that if, during the validity of the Agreement, legislation of the Russian Federation, by the legislation of subjects of the Russian Federation and legal certificates of institutions of local government establish regulations worsening commercial investor activities within the framework of the Agreement, changes will be made to the agreements, providing commercial results to the investor which could be received by him upon entering into the Agreement of the legislation of the Russian Federation, legislations of subjects of the Russian Federation and legal certificates of institutions of local government.

At the same time, if new laws and statutory acts promote the commercial success of the investor, they shall be accepted to his advantage. “Symmetrical” guarantees apply to the state as well, in the case of the occurrence of new circumstances,

unknown at the moment of signing the Agreements; the Russian Federation is also a party to the Agreements.

3.3.2. In accordance with Subitem B, Item 1, Addition 2, Appendix E of the given Agreement, each foreign employee of the foreign company, or Russian company having a subcontract with the investor's contractor, has the right to import a motor vehicle to the customs territory of the Russian Federation "without the payment of any customs, taxes, or royalties and without taking into account any quota requirements or licensing payments for items of domestic use and personal items, including motor vehicles." Thus, the customs bodies of the Russian Federation, according to Item 7, Point 2 of the Federal law "On Production-Sharing Agreements," are obliged to be guided not by legislative regulations of the Russian Federation, but the positions of the Sakhalin-2 Agreement.

3.3.3. According to Item 3, Addition 7, Appendix E of the Sakhalin-2 Production-Sharing Agreement, no requirement of the state entities of the Russian Federation and their officials regarding the abeyance or cessation of work, based on positions of the Russian legislation on preservation of the environment, work safety on the continental shelf, protection of the frontier of the Russian Federation, shall be applied, if not stipulated by the named Agreement. Drilling solutions, drilling sludge, or liquid extracted from wells, according to Item 4, Addition 7, Appendix E of the Sakhalin-2 Production-Sharing Agreement shall not be considered waste products forbidden to dump in the sea, even if the toxicity level of this dumping will exceed allowable levels established by Russian regulations and standards. The state bodies to which monitoring of the protection of the environment is assigned shall be guided by specified positions in the Sakhalin-2 Agreement instead of Russian legislation, regulations, and rules of conducting works accepted in the Russian Federation.

3.3.4. Changes and additions dated 03/03/95 to the Law of the Russian Federation "On Resources," amendments to the Law of RSFSR "On Foreign Investments in the RSFSR," by Federal laws dated 06/19/95, 11/16/97, and 02/10/99, and amendments by Federal law №32-F3 dated February 10, 1999 on acts of the Russian Federation, Law №225-F3, and Federal law №225-F3 "On Production-Sharing Agreements" dated December 30, 1995 are not distributed, according to the conditions of the Sakhalin-1 and Sakhalin-2 Agreements, to the broad range of activities of the foreign investors participating in the given projects (resource use, uses of continental shelf, realization of foreign trade activity, foreign investments, custom duties, payments in road forms, and the basic tax payments) and can be ignored by them in the case that they worsen or have the potential to worsen commercial results.

3.4. The government of the Russian Federation has concluded that the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements with the infringements of Russian Federation Law №2395-1 "On Resources" at their signing dated February 21, 1992: according to Item 13, establishing the order of the granting of licenses, the right of

resource use can be obtained by the user based on the decision of the Government of the Russian Federation by the results of competition or auction for the use of the resources of the continental shelf of the Russian Federation.

Moreover, Item 17 of the given law, regulating antimonopoly relationships, unequivocally forbids any changes of the order: “The actions of government and management entities, as well as any managing subjects (users of resources) are forbidden or (in the given order) are unauthorized when directed to replace competitions and auctions with direct negotiations.”

From preparatory documents of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, it follows that, under the given Agreements, competitions or auctions for resource use rights on the continental shelf of the Russian Federation were not carried out—substitutions were made:

- 1). Under the Sakhalin-1 Agreement, they were replaced by direct negotiations.
- 2). Under the Sakhalin-2 Agreement, they were replaced by competition to submit a FEASIBILITY REPORT for the investigation and development of oil-and-gas deposits on the Sakhalin shelf.

Thus, according to Items 13 and 17 of Laws №2395-1 “On Resources” of the Russian Federation dated February 21, 1992 (corresponding Items 10-1, 13, and 17, 03/03/95 edition №27-F3, dated 02/10/1999 №32-F3), the signature of the Ministry of Fuel and Energy of Russia as the state representative to the Sakhalin-1 and Sakhalin-2 Agreements is not an authorized action of the government and management entity.

3.5. Realization of certain activities under the Sakhalin-1 and Sakhalin-2 Agreements can be practically unlimited in time, and contractual attitudes following from them are initially designed for extremely long terms that contradict the currently in effect conclusions at the moment of the Agreements signing to the Law of RSFSR from July 4, 1991 “On foreign investments” and to interests of the Russian Federation:

3.5.1. The maximum term for the use of the resources, as established by the Law of RSFSR from July 4, 1991 “On Foreign Investments in the RSFSR”, is 50 years.

3.5.2. The license for the resource use rights based on the conditions of the Sakhalin-1 Agreement is given for duration of the Agreement, which, according to Item 8.1 of Item VIII, is valid for the period of geological studying of resources and the period of arrangement and extraction and any extensions if not completed earlier according to the conditions of the present Agreement. The Consortium can request a subsequent extension of exploration and extraction period, and the number of extensions is not limited, but extensions should occur in ten-year increments. Thus, the Sakhalin-1 Production-Sharing Agreement is termless.

3.5.3. The initial validity of the licenses given to Sakhalin Energy for the resource use rights under the conditions of the Sakhalin-2 Production-Sharing Agreement is 25 years. According to Part 2 Subitem (I) Item (c)3 of the given Agreements, the license will be valid for the entire period that the company deems work economically expedient. The company has the right to unlimited extensions of the license for consecutive five-year periods, with granting to the Russian party of notice in writing of intent to extend the license no later than 1 (one) year prior to the termination of the current license.

3.5.4. Item 8.1 of Article VIII of the Sakhalin-1 Agreement and Part 2 Subitem (I) Item (c) Item 3 of the Sakhalin-2 Agreement do not limit the general validity of the Agreements or extend the validity of the Agreements based on the will of the investor. Thus the conditions of the Agreements provide for extension of terms, stemming from non-transparent formulations: “if it (the Sakhalin-1 Agreement) is not stopped earlier than according to the conditions of the present Agreement” or “until the company considers continuation of work not to be economically expedient” (Sakhalin-2), which completely ignore the presence and interests of the second party, the Russian Federation.

In all practicality, Part 3 Subitem (I) Item (c) Part 3 of the Sakhalin-2 Agreement invalidates any opportunity to terminate the terms of the license, declared in Parts 1 and 2 of the same Subitem 3, by virtue of the fact that “the company has the right to appeal against a denied extension, at its own discretion, or administratively, or in courts of the Russian Federation, or in arbitration as stipulated by Item 30 of the present Agreement.” Thus, such “appeal suspends the denial, and the license continues to operate as before removal of the decision under this complaint,” automatically extending the license and ignoring the interests of the Russian party in favor of the investor.

Clause 3 of the Sakhalin-2 Agreement provides, that “extension of validity of the license does not entail a change of initial conditions of this license or the present Agreement unless both sides fail to consent to such changes.” That is, it is entirely possible that, after the end of the initial licenses of the Agreement, those regulations of the Agreement, which are not balanced with the interests of the state and which will contradict laws of the Russian Federation in force during this period, will be preserved without changes.

3.5.5. Thus, the regulations of the Sakhalin-1 and Sakhalin-2 Agreements for unspecified time-periods put the Agreements and investors outside of the legal field of the Russian Federation.

Similar legislative approval of unlimited time-periods for foreign investor resource use rights for unfinished investigation of deposits can result in significant missed benefits and even direct economic losses for the Russian party.

Nevertheless, according to Item 7 of an Item 2 of Federal laws №225-F3 “On Production-Sharing Agreements” dated 12/30/95 (Edited 01/07/1999 №19-F3), the Sakhalin-1 and Sakhalin-2 Agreements are considered to correspond to the law’s measure in that its application does not contradict conditions of Agreements and does not limit the rights received and executed by the investors, under the given Agreements.

4. Maintaining the rights and interests of the Russian Federation during realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

4.1. In the performance of Presidential Decree №694 “On realization measures of the Federal law ‘On Production-Sharing Agreements’” of the Russian Federation dated 07/08/97 and Government Resolution №1132 dated 09/02/97 for the purposes of amplifying the state control over maintenance of the rights and interests of the Russian Federation at the enactment and realization of Production-Sharing Agreements:

- Commission of the Government of the Russian Federation for the coordination of the activities of federal enforcement authorities and government entities of subjects of the Russian Federation for the realization of Production-Sharing Agreements (further "Commission") is formed;
- Realization of the rights and obligations of the Russian Federation is assigned to the Ministry of Fuel and Energy of Russia under Production-Sharing Agreements of deposits of hydro carbonic raw material and the right to speak on behalf a name of the Government of the Russian Federation on all questions of such agreements.

4.2. According to the Resolution “On the Commission of the Government of the Russian Federation for coordination of the activities of the federal enforcement authorities and government entities of the Russian Federation for the realization of Production-Sharing Agreements, sessions of the Commission should be carried out quarterly.

The Commission is assigned:

- Preparation of offers for the development and financing of investment projects under Production-Sharing Agreements;
- Consideration of the list of resource sites, use rights, which can be given under Production-Sharing Agreements;
- Maintenance of operative decisions connected to the development and realization of investment projects under Production-Sharing Agreements;
- Instructions to the commissions for the development of resource use conditions and preparation of Production-Sharing Agreements within the limits of the competence of the Russian Federation;

- Consideration of projects for Production-Sharing Agreements before their consideration by the Government of the Russian Federation,
- Coordination of the activities of federal enforcement authorities, executive authorities of the Russian Federation, and enterprises and organizations executing Production-Sharing Agreements;
 - Development of offers for creation of a regulatory base for realization of Production-Sharing Agreements;
 - Monitoring the interests of the Russian Federation under Production-Sharing Agreements;
 - Consideration of projects of contracts for the distribution of the state share of production between the Russian Federation and subjects of the Russian Federation.

The Chairman of the Commission of the Government of the Russian Federation for the coordination of federal enforcement authorities and government executive bodies under Production-Sharing Agreements will supervise the activities of the Commission and bears personal responsibility for executing its assignments.

4.3. During Commission sessions, topics related to the projects were considered: customs registration and control of goods moved within the framework of Production-Sharing Agreements, participation by Russian enterprises in contract work, collection of VAT tax and return of VAT on the equipment, materials and activities of Russian suppliers, bonuses at the start of development of the first stage of the Piltun-Astokhskiy deposit, participation of Rosneft and Rosneft-Sakhalinmorneftegas in the project, mechanism of entering technical, building and ecological agreements for the feasibility report on construction prior to the end of detailed design development, eliminating VAT for investors, operators, contractors, suppliers, procurers and transporters of goods, rendering of services under the Agreements, creating authorized federal entities (AFE), and structure of the board of representatives of AFE under the Sakhalin-1 project.

4.4. The Commission work plan find it necessary to development the following statutory acts:

- “On the procedure for declaration of commercial opening of the development of hydrocarbon deposits under Production-Sharing Agreements;
- “On basic conditions and requirements for carrying out competitions (auctions) for contract works and services rights under Production-Sharing Agreements”
- “On procedural maintenance of the preparation, coordination, examination and statement of agreements and contract designs for natural resource development under Production-Sharing Agreements;”

- “On bookkeeping and reporting under Production-Sharing Agreements;”
- “On formation and use of liquidating funds under Production-Sharing Agreements;”
- “On structure and order of compensation of expenses under Production-Sharing Agreements;”
- “On regulations for entering, executing, and state monitoring of Production-Sharing Agreements;”
- “On executing competitions (auctions) for resource use rights with the purpose of geological exploration, study, investigation, and extraction of minerals under Production-Sharing Agreements;”
- “On insuring projects (services) under Production-Sharing Agreements;”
- “On organization, development, coordination, and state ekspertiza of FEASIBILITY REPORTs of investments in development of resource sites under Production-Sharing Agreements.”

4.5. September 21, 1999 the Commission, under N.E. Aksyonenko's presidency, considered essential changes and additions to authorized Positions:

- “On the structure and order of compensation of expenses under Production-Sharing Agreements” also refers to compensated expenses of the calculated rate charged to the remainder not compensated by the investor subject compensation at year’s end of expenses; deductions to the liquidating fund; charges to interconnected companies and the investor’s predecessor companies before the Production-Sharing Agreement come into force if the parties agreed upon it during preparation of the agreement;
- “On the formation and use of the liquidating fund under Production-Sharing Agreements” will be appended to provide for the accumulation of liquidating funds in a special account prior to the completion of works under agreements and their deposit in a credit establishment, chosen on a competitive basis by the investor and the state.

4.6. The following Positions are brought into consideration by the Government of the Russian Federation:

- “On the procedures for entering, executing, and state monitoring of Production-Sharing Agreements for resource use;”
- “On the procedure for declaration of commercial opening of the development of hydrocarbon deposits under Production-Sharing Agreements;”

- “On executing competitions (auctions) for resource use rights with the purpose of geological exploration, study, investigation, and extraction of minerals under Production-Sharing Agreements.”

4.7. The following regulatory acts are to be used during preparation and negotiation of PSAs by the corresponding ministries and agencies:

- “On insuring projects (services) under Production-Sharing Agreements;”

- “On basic conditions and requirements for carrying out competitions (auctions) for contract works and services rights under Production-Sharing Agreements.”

4.8. The Commission of the Government of the Russian Federation has no actual leverage for the management of the Sakhalin-1 and Sakhalin-2 Agreements, as a condition of the Agreements: “the Russian party shall compensate any damage suffered in connection with adverse changes in Russian laws, sub-statutes and regulatory documents by state entities...” (Item 24F of the Sakhalin-2 Agreement). In the case of disputes between the state and the investor under the Sakhalin-1 and Sakhalin-2 Agreements and failure to resolve such disputes by mutual consultation, disputes will be addressed in international arbitration court.

4.9. During audit of the executed Agreements under the Sakhalin-1 and Sakhalin-2 projects, the Ministry of Finance of Russia issued the Order dated 08/11/99 №53n “On Resolutions reflecting Bookkeeping and reporting of operations under Production-Sharing Agreements.” №740 (07/03/99) and №741 (07/08/99) are authorized by of the Government of the Russian Federation’s Resolution “On structure and order of compensation of expenses under Production-Sharing Agreements” and “On the formation and use of the liquidating fund under Production-Sharing Agreements.”

The given Resolutions are not applicable to the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements. For these Agreements, unique regulations defining the structure of reimbursable expenses and formation and uses of the liquidating fund are authorized by the Sakhalin-1 and Sakhalin-2 Agreements, Item 7 of Item 2 of the Federal laws dated 12/30/95 “On Production-Sharing Agreements,” in the №19-F3 edition dated 01/07/99 which establish the regulations according to which the Agreements are made prior to the present Federal law, and are subject to execution according to the conditions determined in them.

Moreover, according to Item 1.7 of “On structure and order of compensation of expenses under Production-Sharing Agreements” executing agreements made prior to the enactment of the Federal law “On Production-Sharing Agreements,” the definitions of reimbursable expenses and expenses deducted by taxable base under the profit tax as established by the specified Agreements are applied.

4.10. For the preparation of new statutory acts and conditions for executing the Federal law “On Production-Sharing Agreements,” the Ministry of Fuel and Energy of Russia issued the following orders:

- regarding timely and quality performance of the preparation of offers for legislative and regulatory acts by the Government of the Russian Federation for changes and additions following from Federal law “On Production-Sharing Agreements” (02/13/96, №28);

- regarding the assignment of the Russian External Economic Association Zarubezhneft (RVO Zarubezhneft) to perform ekspertizas, analysis, and other works connected to the preparation and execution by the Ministry of Fuel and Energy of Russia of the rights and obligations of the Russian Federation under Production-Sharing Agreements concerning raw hydrocarbon deposits (dated 12/09/97, №422);

- regarding the formation of an advisory group to develop a regulatory base for the development and execution of Production-Sharing Agreements (dated 10/08/98, №327);

- regarding the interaction of structural divisions of the Ministry amongst themselves and coordination of their activity within the framework of the specified agreements with government entities of the Russian Federation and subjects of the Russian Federation and other organizations (dated 03/10/98, №81).

4.11. The government of the Russian Federation by Order №903-r (dated 06/08/96), assigned AFE functions to the Ministry of Fuel and Energy of Russia, which by Order №255 (dated 10/24/96) delegated the functions to RVO Zarubezhneft which executed them from October 1996 until November 1997.

4.12. Within the Ministry of Fuel and Energy of Russia, a Department for the preparation and realization of Production-Sharing Agreements was created, guided by “Regulations about the Department.” (Authorized on March 6, 1998 by the Ministry of Fuel and Energy of Russia).

4.13. According to Item IV “Management of the Agreement” under the Sakhalin-1 project, the Russian Federation shall create a special state entity on Sakhalin. This AFE shall carry out the rights obligations taken on by the Russian Federation under the present Agreement and shall operate as its representative under the present Agreement. The AFE is obliged to protect the interests of the Russian Federation, supervise the development of deposits with the purpose of auditing their conformity to conditions of the Agreement, and in such cases to notify the Consortium for their necessary elimination.

4.14. Decision №95 of the Governor of the Sakhalin Area Administration (03/30/94) creates a Department of Natural Resource Development on the continental shelf which coordinates and supervises activity for the development, extraction, and processing of raw hydrocarbon materials and mineral resources on the continental shelf of the Russian Federation, adjoining the Sakhalin and Kuril Islands.

4.15. The aforementioned department is guided by "Regulations about Department..." authorized by Decisions №304 (11/03/94) and №586 (12/09/97) by the governor of the Sakhalin Area. In cooperation with the operators of the Agreements, the Department coordinates works under the Sakhalin-1 and Sakhalin-2 Agreements.

4.16. RVO Zarubezhneft, together with the Department of Natural Resource Development of the continental shelf of the Sakhalin Area Administration, having developed and coordinated with the Ministry of Justice of Russia, the Ministry of Finance of Russia, and the Ministry of Fuel and Energy of Russia a draft resolution regarding the authorized federal entity (which until now it is not authorized), has developed a temporary technical order of accumulation and expenditure of excess funds (authorized March 1997), carried out analyses of investor work plans and budget estimates, prepared for negotiations, coordinated these documents when required, and analyzed accounting reporting.

Moreover, RVO Zarubezhneft prepared other projects under Production-Sharing Agreements on Sakhalin, analyzed the preparations and conditions of the main Production-Sharing Agreements of oil-and-gas projects in Russia, calculated their potential benefits for the Russian economy, executed negotiations with Russian potential contractors, supervised the use of Russian enterprises for works on the Sakhalin-1 and Sakhalin-2 projects, prepared and directed investors in seismological research and monitoring in the water around the deposits under the Sakhalin-1 and Sakhalin-2 Agreements.

4.17. Annual expense estimates (for 1996-1999) for support of the AFE were approved by the Ministry of Fuel and Energy of Russia, in agreement with the Ministry of Finance of Russia, and were compensated from the bonus funds listed by the operator of the Sakhalin-1 Agreement in 1996.

4.18. By Order №342 (11/03/97), the Ministry of Fuel and Energy of Russia has charged the Department for Preparation and Execution of Production-Sharing Agreements with monitoring the interests of the Russian Federation under the Sakhalin-1 Production-Sharing Agreement and to evaluate, on behalf of the Ministry of Fuel and Energy of Russia, plans, work plans, estimates, budgets, and other documents. This order removed AFE Functions from RVO Zarubezhneft.

Order №438 (12/18/98) by the Ministry of Fuel and Energy of Russia, in order to coordinate the activities of federal enforcement authorities and government entities of the Russian Federation subjects under Production-Sharing Agreements, a Board of AFE Representatives was created under the Sakhalin-1 Agreement.

4.19. Deputy Minister V.Z. Garipov from Ministry of Fuel and Energy of Russia and Deputy Director of the Department for Preparation and Execution of Production-Sharing Agreements, I.A. Danilov, were included in the list of member representatives on the Board. From the Sakhalin Area Administration, I.P. Farkhutdinov, Director of the Sakhalin Area Administration, V.I. Shapoval, Assistant Director the Sakhalin Area

Administration, and G. N. Pavlov, Director of the Department for the Development of Raw Mineral Resources on the Sakhalin continental shelf were all included in the Board of AFE Representatives.

4.20. Until November 1998, AFE work with the Consortium was conducted only via written correspondence in which projects work plans, investor expense estimates, and reports were discussed. For the entire period of AFE work, there is only one report from the 12/11/98 session and three reports of AFE working group sessions dated November 17-18, 1998, January 21, and April 28-29, 1999.

As the audit has shown, the created AFE is not capable of solving questions regarding the protection of Russian interests because many monitoring functions are outside its jurisdiction.

The AFE presented the Consortium with the opportunity to present budget estimates and annual reports in integrated parameters, to conduct accounting in English, and to not conduct audits. (According to the Sakhalin-1 Agreement the right to audit reports by the Consortium is stipulated by Appendix D of Unit VI Item 6.2 of the given Agreement. At the same time, according to the same regulation of the Agreement “the state has access to all accounting documents for audit or inspection....” for only two years following the end of the calendar year. Failure to exert the right of audit by the Russian party of reimbursed expenses reflected in reports, are considered automatically accepted).

In the AFE, there are no representatives from the Ministry of Finance of Russia or federal tax entities. A lack of experts with international expertise in bookkeeping and financial and economic activities, has led to (after three years since the date of the Agreement’s validity) problems in defining the structure of reimbursed expenses.

4.21. Order №459 (December 31, 1997) by the Ministry of Fuel and Energy of Russia, “On Supervisory Council for the execution of the Sakhalin-2 Agreement, according to conditions of the given Agreement, as authorized by the Supervisory Council, a structure of 10 members, with 5 persons from each party and the structure of working group of the Supervisory Council.

The basic duty of the Supervisory Council is consideration and the statement of plans of development and estimates of charges on development, annual work plans, and annual estimates.

The Working Group’s tasks include consideration of reports and results of the executed projects, current condition of projects, work plans for the next year, and preparation of decisions for sessions of the Supervisory Council.

The Sakhalin Area Administration in the Supervisory Council is represented by the Administration Chief, I.P. Farkhutdinov, the Director of the Department of Natural

Resource Development of the continental shelf, G.N. Pavlov, and the Assistant Director's Representative of the Sakhalin Area Administration in Moscow, R.M. Tishin.

4.22. The Supervisory Council functions in a structure of 12 people, among which 6 people are representatives of the Russian party. After the initial date, the Supervisory Council shall conduct sessions no less than four times a year. From this date (06/15/1996), only 9 sessions included discussion within the jurisdiction of the Production-Sharing Agreement. (It should be noted, that in the specified Supervisory Council there are no representatives of tax entities).

4.23. In agreement with "Regulations for state control over geological exploration, rational use, and protection of resources," (authorized by Decision №132 of the Government of the Russian Federation dated February 2, 1998) the Ministry of Natural Resources of Russia executes state geological monitoring in cooperation with corresponding federal enforcement authorities on questions of observance of statutory acts under the conditions of payments for resource use and targeted use for the extraction of raw mineral resources (ERMR).

According to the Regulation about the Ministry of Natural Resources, the authorized Decision from №588 (May 17, 1997) of the Government of the Russian Federation "On Regulations about the Ministry of Natural Resources of the Russian Federation" (Decisions of the Government of the Russian Federation from (08/13/1998) №950), the Ministry of Natural Resources of the Russian Federation as the state controller of the state fund shall monitor resource users, including realization of Production-Sharing Agreements.

In response to Request №04-498 (09/22/1999) to present materials under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, the Ministry of Natural Resources of Russia answered an inquiry from the Accounting Chamber of the Russian Federation in Letter №BM-23/4795 (10/08/99) (the requested materials by the Accounting Chamber of the Russian Federation were to have been submitted by 10/

04/1999) in which it was written: "the Ministry of Natural Resources of Russia has no materials, as it does not participate in the Production-Sharing Agreements of the specified project."

Thus, the Ministry of Natural Resources of the Russian Federation does not execute the monitoring functions assigned to it by Decision №588 of the Government of the Russian Federation (May 17, 1997) "On the statement of regulations about the Ministry of Natural Resources of the Russian Federation."

4.24. According to the Instruction of the State tax service of the Russian Federation from 07/16/95 №34 "On the taxation of the profit and incomes of foreign legal persons" the foreign legal persons who are formed according to the legislation of the foreign states and

carrying out enterprise activity in territory of the Russian Federation through permanent missions, shall pay profit tax.

Profit is defined as the difference between proceeds from the execution of production (works, services) minus VAT and excise tax, other income or expenses directly connected to the activities of foreign legal representatives in the Russian Federation; this amount is subject to taxation.

The list of expenses included in the calculation of profit tax, should be defined in the same way as for enterprises being legal persons under the legislation of the Russian Federation according to Regulations about structure of expenses on manufacture and realization of production (works, services), included in the cost price of production (works, services), and about the order of formation of the financial results which are taken into account at the taxation of the profit, the authorized Decision №552 of the Government of the Russian Federation (08/05/1992).

4.25. In infringement of Instruction №34 of the State Tax Service of Russia (07/16/95) “Regulations about expenses for manufacturing and realization of production (works, services), included in the cost price of production (works, services),” and the formation of financial results taken into account at taxation of profit, authorized by Decision №552 (08/05/92, Government of the Russian Federation) and Item 1, Appendix A of the Sakhalin-2 Production-Sharing Agreement, Sakhalin Energy includes all expenses, without restriction, as guided by Item 4, Appendix A to the Agreement, instead of positions of the Agreement regarding realization of Bookkeeping according to laws, sub acts, or other federal legislation.

4.26. According to Item 4, Appendix A “Principles of Bookkeeping” of the Sakhalin-2 Agreement, included in expenses are, without restriction, all expenses of the company and its related organizations and are compensated by allocation of a share of the hydrocarbons proceeds from realization of hydrocarbons and additional proceeds as agreed in Item 14 of the Agreement provided that they have been made according to authorized estimates or portions of the Agreement giving to the company the right to make an expense.

4.27. Not only regulatory restriction of reimbursable expenses and coordination with the investor of compensated and non-compensated expenses, but also the annual reports on the execution of work plans and budget estimates and subsequent state control over them (annual programs and estimates of expenses) are absent from the Sakhalin-1 and Sakhalin-2 Agreements.

Production-sharing variations, restricting state interests and lowering incomes in the federal budget that are equivalent to the use of budgetary funds in the Projects, are not stipulated by the Agreements.

4.28. Today there remain unresolved questions in the revision of working statutory acts of nature protection entities, boundary, customs, and tax services in view of features of the Federal law “On Production-Sharing Agreements.”

There are unresolved problems in connection with the creation of favorable conditions to Russian investors regarding financing their share of participation in said Projects, delivery of expert assessments, order of return of customs payments, and VAT.

4.29. Currently at the working group level, coordination of the internal statutory act has been negotiation, allowing the resolution of disagreements in the interpretation of such concepts, as “compensated exp enses” under the Production-Sharing Agreements to which Decision №740 (07/03/1999) of the Government of the Russian Federation from is not distributed.

It is supposed, that the Supervisory Council will affirmed the document in preparation before presentation by the investor of compensated expenses.

4.30. The process of approving the first stage development of the Piltun-Astokhskiy deposit appeared complex enough. As of today, Sakhalin Energy has received more than 1100 various approvals.

In particular, from total (182) required characteristics sheets, 13 concerning 17 units of “especially dangerous” equipment that was necessary for to register at the regional branch of Gosgortekhnadzor of Russia.

The marine production complex “Vityaz,” according to the current legislation of the Russian Federation is a dangerous industrial project and includes the following modules and constructions: ice-resistant stationary Molikpak platform; pipeline (2.5 kilometers) from the Molikpak platform to a floating single-anchor mooring; floating single-anchor mooring; Okha floating oil storage.

II. Audit of the activity of government entities of the Russian Federation in the Sakhalin area and the Department of Natural Resource Development on the Sakhalin continental shelf in the sphere of regulation of resource use under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1. Audit of activity of government entities of the Russian Federation in the Sakhalin area in regulation of resource use under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1.1. The Natural Resources Committee in the Sakhalin area (territorial division of the Ministry of Natural Resources of the Russian Federation) within jurisdictional limits shall monitor the state resources fund, the use and protection of water fund of

the Sakhalin area and the adjoining shelf, and, within the framework of executing state geological monitoring, is obliged to verify observance of the established order, regulations and rules for resource use, techniques and measurement of extracted volumes of raw hydrocarbons, including under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

In Letters №B3-6-04/295 and №AH-61/2158 (May 21, 1998) “On the interaction of state tax inspections with subjects of the Russian Federation and territorial (regional) entities, MNR, Russia” the State Tax Service of Russia and the Ministry of Natural Resources of the Russian Federation proposed to provide the greatest possible coordination of work plans and information interchange between tax entities and state geological monitoring entities.

However, until now, the Committee in cooperation with tax entities have not carried out a performance audit based on conditions of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1.2. Interaction between the Natural Resources Committee of the Sakhalin area and the Sakhalin Area Administration is only executed within the framework of activity of the working groups of the Supervisory Council under the Sakhalin-2 Production-Sharing Agreement whose structure includes the Chairman of Committee.

1.3. From 1996-1999, the regional geological fund on the Sakhalin area lists 14 projects within the framework of the Sakhalin-2 project, including drilling wells, seismic prospecting, engineering-geological and ecological-hydrometeorological researches.

At that time, the regional geological fund received the preliminary report on construction of exploratory well P A-16, logging results in an analogous form in wells P A-101, P A-105, P A-106.

2. Audit of activity of Department of Natural Resource Development on the continental shelf (Sakhalin Area Administration) for regulation of resource use under the Sakhalin-2 Production-Sharing Agreement.

2.1. In 1998, the Department of Natural Resource Development on the continental shelf (Sakhalin Area Administration) received information on the number of contracts made by Sakhalin Energy with contractors containing prices considerably exceeding working market prices for the Sakhalin area:

2.1.1. The company rented three apartments for a 3-year period in Yuzhno-Sakhalinsk (285 sq. meters and 325 sq. meters) at the price of 6000 US\$/month and a 283 sq. meters apartment at the price of 7000 US\$/month. Realistically, the market price of 3-4 room renovated/updated apartments in Yuzhno-Sakhalinsk range from \$250-500 US\$ /month, and an individual cottage from \$850 to \$1150/month.

2.1.2. Sakhalin Energy rented a 3-room apartment (for 1 year) in the village Smirnye for 767US\$, exceeding market rent rates for such a space in settlement Smirnye by 1500%.

2.1.3. Similar facts were true under separate contracts for the delivery of oil for company needs. Open Company Sakhtransbunker was contracted to deliver 2500 tons of winter diesel fuel for the Molikpak platform at a price of 185 US\$/ton, while similar fuel could be obtained from other suppliers at 150 US\$ /ton. Moreover, the same organization was contracted to deliver 3530 tons marine gas oil at a price of 300 US\$ for the Kholmsk Coastal supply base; similar fuel could be obtained from other suppliers for 210 US\$ /ton.

2.1.4. Sakhalin Energy signed a contract with Open Society SakhalinCenter Development Co., Ltd. for the termination of rent and other land rights to 0.56 hectares under construction of company offices for 500,000 US\$. A similar contract was signed by the joint venture Sphere Ayoka for refusal of the joint venture of land rights for a site under construction for residential space in Zimnoe village for 150,000 US\$.

2.2. All expenses listed in Item 2.1 are considered compensated. In this connection the Department of Natural Resource Development on the continental shelf (Sakhalin Area Administration) has offered Sakhalin Energy:

- to develop an internal agreement and instructions, making bookkeeping principles concrete, including regulating compensated expenses by establishing lower and upper limits;
- to clarify and substantiate prices and to exclude from the list of compensated expenses sums making a difference between the price of contracts (on residential rent and purchase of mineral oil) and mid-market pricing in the Sakhalin area;
- to exclude completely from compensated expenses termination of rent rights for land areas under construction for company offices and residential space in Zimnoe before representation by the company of corresponding economic and legal substantiations.

On a number of the mentioned problems, Sakhalin Energy gives an explanation that the majority of foreign employees of the company are shareholders, and thus a part of the company. Each company-investor has their own set of compensatory payments to foreign employees on a regular basis. Payment of personnel, residential rent, and its corresponding payment are differentiated depending on position/seniority and family makeup, traveling and living expenses, and other privileges and services given to foreign employees and Russian experts, sent abroad.

2.3. On the part of Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration), account and control over extraction and realization of production (oil and gas) is reduced to daily reception of reports from Sakhalin Energy

in which volumes of oil recovery are reflected, gas, water, results of well testing, and monthly reports on hydrocarbon extraction and forecasts on extraction and distribution of hydrocarbons to the next quarter of the current year.

24. During audit of maintenance of interaction of work with federal state bodies it has been established, that from the beginning of realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, the Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration) has not produced any joint document with the tax entities of the Sakhalin area on questions of accuracy and completeness of definition of taxable base under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

2.5. According to the assignment of Ministry of Fuel and Energy of Russia, the Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration) developed audit materials, which have been lead by firm financial and accounting advisers. The specified Department monitored Sakhalin Energy's management of bookkeeping as a whole and reference of charges by work types. Some expenses are in infringement of Russian legislation on bookkeeping, with the absence of some primary documents, and an excess of the principle of "sufficient expediency" leading to an increase in compensated expenses.

2.6. Since October 1998, the Sakhalin Area Administration posed Sakhalin Energy questions about the development of mutually acceptable documents on the interpretation of Item 4 "Expenses" of Appendix A "Principles of Bookkeeping" under the Sakhalin-2 Production-Sharing Agreement, which would promote a true reflection of annual expense estimates for carrying out their audit and definition of compensated expenses.

III. Audit of realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, performance by resource users of conditions of the given Agreements and the legislation of the Russian Federation at resource development sites, accounting for extraction, collection, and exchange of oil and gas.

1. Realization of the Sakhalin-1 Agreement and performance of conditions of the given agreement and legislation of the Russian Federation.

.....

2. Audit of progress on the Sakhalin-2 Production-Sharing Agreement, adherence of resource users to conditions of the given Agreement and to legislation of the Russian Federation for the development of resource, accounting for production, collection, and exchange of oil and gas.

2.1. The aggregate number of Sakhalin Energy employees as of July 1, 1999 was 337 persons, of them 248, or 74%, are Russian citizens working full-time with a company

labor contract. There are 104 Russian personnel in technical positions, 79 people in engineering, and 12 are management.

The total number of Russian experts working on direct turnkey contracts, and working with contractors of Sakhalin Energy equals about 1000 people, or nearly 60% of the general number, employed in realization of the Project.

According to work plans for development and improvement of professional skill for staff for the period from July 1996 until July 1999, 1344 people have completed the curriculum, including (in 1998) 689 people and in the first six months of 1999, 562 persons, on whom is spent 664,000US\$.

2.2. Financing work under the Sakhalin-2 Agreement is carried out by shareholders of Sakhalin Energy and by attracted foreign credits.

2.2.1. According to the report (06/05/1999) of Sakhalin Energy, realization of the Sakhalin-2 project will cost 5.093 billion US\$. Expenses for first stage development of the Piltun-Astokhskiy deposit, according to authorized by the Supervisory Council of the expense estimate, should total 660 million US\$.

2.2.2. For financing the first stage development of the Piltun-Astokhskiy deposit, the European Bank for Reconstruction and Development, Overseas Private Investment Corporation (OPIC) and the Export-Import bank of Japan (JEXIM) have, in coordination, given Sakhalin Energy a loan in the amount of 348 million US\$, totaling 50.3% of the estimate development expenses. The loan was given for a 10-year period with an average rate LIBOR + 2.125% annually (prior to Project completion) and average rate LIBOR + 3.292% annual (after completion of the Project). The loan is guaranteed by the sponsors (prior to the project's completion), and all movable and real estate of Sakhalin Energy, including rights under the Production-Sharing Agreement and insurance policies are transferred to creditors.

The Supervisory Council was informed of this fact only after signing all loan documents (report of session of the Supervisory Council, April 23, 1997), a direct infringement of Item 11(a) of the Agreements.

2.2.3. A related organization to the founding-company Mitsui Sakhalin Development Co. Ltd. was designated the supplier of financial services.

2.2.4. The total amount of capital investments under the Sakhalin-2 project is estimated up to 10 billion US\$.

2.3. Sakhalin Energy started works on geological studies of the Piltun-Astokhskiy deposits and realization of stage one development under the Sakhalin-2 Production-Sharing Agreement on the announcement of initial date (06/15/96) of Agreements and dates started of the first stage of development (12/31/97) of the given deposit.

The study period at the Piltun-Astokhskiy license site, according to the Sakhalin-2 Agreement (Item 7(a) and 8(a)), shall last 24 months and on Lunskiy license site, 36 months.

2.4. The general plans for the development of the Piltun-Astokhskiy and Lunskiy deposits are based on reception of the first oil from the Piltun-Astokhskiy deposit in the middle of 1999, with achievement of year-round oil recovery by the end of 2003, and the beginning of Lunskiy gas deliveries as liquefied natural gas in the middle of 2005.

2.4.1. In work plans on the development of the Piltun-Astokhskiy and Lunskiy deposits, the primary goals and purposes are formulated and the following directions of activity are stipulated:

- on the Piltun-Astokhskiy deposit—work evaluating the deposit, work prior to beginning development of the deposit, the first stage development of the deposit (Astokhskiy area), complete development of deposit, transportation and processing of production.

- on the Lunskiy deposit—works evaluating the deposit, development of deposit, transportation and processing of production.

2.4.2. The State Commission on Mineral Stocks of the Ministry for Protection of the Environment and Natural Resources of Russia and the Central Commission on the Development of Oil and Oil-and-gas Deposits of the Ministry of Fuel and Energy of Russia have recognized that the Astokhskiy deposit site was ready for development and according to the Sakhalin-2 Agreement on it the date started of development on December 31, 1997 has been declared. 14 wells are planned for drilling on the given site.

In September 1998, at the Astokhskiy deposit site the Molikpak platform (with eight columns of 30-inch directing pipes are hammered) has been established as operational and ice-resistant. In 1998-1999 from the Molikpak drilling platform the development of operational wells P A-101, P A-103, P A-105 and P A-106 took place.

Commissioning of the Piltun-Astokhskiy deposit will allow extraction, by calculations of Sakhalin Energy oil: in the second half-year 1999-1 million tons; in 2000 – 2.2 million tons; in 2001 – 2.3 million tons; in 2002 – 1.9 million tons, in 2003 – 1.6 million tons.

In 199, on the Piltun site, well P A-17 shall be drilled (should be completed in 1998), which was one of the factors of extend the deadline for presenting the full development of the Piltun-Astokhskiy deposit in a resolution of the Supervisory Council №5B/97/05 from June 25, 1997 as is determined on June 15, 1999 should to increase and make on two deposits maximum (by 2004) 9 million tons of oil and by 2010, 15 billion cubic meters of gas.

For the entire period of operation of a deposit, 94 million tons of oil and condensate and 310 billion cubic meters of gas should be extracted.

2.4.3. For verification of layer bedding depths, revealing breaks, definition of amplitudes of seismic fluctuations, and directions deposit veins, lithological structure of layers and retrophysical data, testing wells for longevity, oil stream discharge, Sakhalin Energy performed a three-dimensional seismic prospecting on a 1330 square kilometer area of the Piltun-Astokhskiy deposit on specified deposits in 1997. In 1998, at the Piltun-Astokhskiy deposit prospecting well P A-16 was drilled to a depth of 2480 meters, despite a design depth of 3200 meters. Three tests to verify the layers for boring pipes were conducted, industrial inflows of oil were received. Processing the subsequent interpretation of three-dimensional seismic prospecting data for the creation of a settlement model for the deposit has been continued.

2.4.4. Based on the preliminary data of processing and interpretation of three-dimensional seismic prospecting, drilling data and prospecting in well P A-16, Sakhalin Energy believes that the geological structure of the Piltun-Astokhskiy deposit is more complex than was estimated earlier, that geological stocks of oil demand verification, efficiency and collection basin of well P A-16 seem lower than projected earlier. All these facts demand further study of the deposit.

2.4.5. Sakhalin Energy, recognizing the necessity of studying previously unopened deep horizons, determining collection basin properties and efficiency of layers at the Piltun site, with the approval of the Supervisory Council, delays the decision of these problems until 2000-2001. In connection with this, the company offers the concept of systematic development of the Piltun-Astokhskiy deposit and, proceeding from this concept, will develop documentation of individual sites, instead of deposits as a whole. This could lead to a delay in the development of the deposit as a whole, or possibly untimely development of separate blocks on the Piltun site. The Russian party did not support the concept and, at session of the Supervisory Council on June 8, 1999, demanded that Sakhalin Energy present the complete development plan on all Piltun-Astokhskiy deposit sites in 2001 (Resolution №5B/99/02) [sic].

2.4.6. Work on the Lunskiy deposit are in preparation for development, assuming deliveries of liquefied natural gas beginning in 2005. The initial presentation of the plan shall occur on June 15, 1999. During the study period from the start (06/15/96) up to completion of the study period (06/15/99), Sakhalin Energy could not completely execute study of the Lunskiy license site, defining the internal and export commodity markets of gas.

Preparation of the development plan depends on successes in marketing and financing of the Project. The company considers, that the export gas market for today is not generated because of the Asian - Pacific region crisis.

This uncertainty with regard to gas consumers prevents completion of preparation of the development plan and other documents as stipulated by the Sakhalin-2

Production-Sharing Agreement and prevents declaration (according to the procedure established in the Agreement) of a start date for development of the Lunskiy deposit.

2.4.7. The Supervisory Council at a session on June 8, 1999 (Resolution №5B/99/03), in view of the state of affairs for marketing has extended the study period for the Lunskiy license site for an additional 24 months (until June 15, 2001) according to Item 8(c) of the Sakhalin-2 Production-Sharing Agreement. Thus, Sakhalin Energy will present by the specified deadline all necessary documents listed in the Agreement for the announcement of a development start date of the Lunskiy deposit and prepare the deposit for industrial development. Extension of the study period for the plan of development at the Lunskiy license site may delay the start of extraction of gas on the deposit until 2007.

2.4.8. For transportation of oil it is planned to use tankers with carrying capacities from 80,000 tons to 100,000 tons. According to Item 14 (“Use and distribution of hydrocarbons”) of the Sakhalin-2 Agreement, the total volume of hydrocarbons extracted on the license sites, shall be measured at a flange in output of the coastal technological complex.

In the future, some 800 kilometers of underwater and ground oil-and-gas pipelines are planned. The ground gas main will stretch from the north on the south throughout almost the entire island, creating a base for development of the island’s power infrastructure. In addition, the coastal technology complex for the preparation for transportation of oil and gas, two compressor stations, a factory for the manufacture of liquefied gas, oil-and-gas terminals for shipment of liquid hydrocarbons will all be constructed. Alongside a number of auxiliary buildings, residential housing in the city of Yuzhno-Sakhalinsk, and other structures will be constructed.

Examination of design decisions by a specialized organization has the conclusion, that the given decisions and required equipment correspond to specifications accepted in the Russian Federation for similar construction, and formed the basis for Gosgortekhnadzor of Russia to sanction this operation.

As a whole Sakhalin Energy plans for the full-scale development of the Piltun-Astokhskiy license site in complex with the development of the Lunskiy license site and deposits of other projects.

The question on creation of the basic objects of joint infrastructure with participants of the Sakhalin-1 and Sakhalin-2 Agreements is considered. All previous discussions on this question yet did not give positive results. Absence of cooperative contracts between investors leads to parallel research on oil pipelines, terminals, coastal pipeline along the east coast of the island, etc.

Under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, expenses for realization of state production are shifted to the shoulders of the state. For its realization it is necessary to choose competition, or to create a specialized commercial structure, that

demands additional expenses. In a number of foreign countries, the national (state) company engages in this practice.

2.5. The Supervisory Council has considered the three-year report of Sakhalin Energy on the progress of works on the Piltun-Astokhskiy license site. In connection with absence of a necessary regulatory base, complexities of geological study, and the sharp fall in prices for oil during this period, it is considered expedient to extend presentation of the economically justified plan of full development of the Piltun Astokhskiy deposit until June 15, 2001 (Resolution №5B/99/02, 06/08/1999), which does not contradict conditions of the Production-Sharing Agreement.

2.6. The annual program of works and the annual estimate for the works offered by Sakhalin Energy to performance of the Project, should according to conditions of the Agreement to be represented by the company to the Supervisory Council not later on September 15 each fiscal year.

The preliminary annual work plan and annual budget agrees with Item 10(a) of the Sakhalin-2 Agreement and shall be based on the plan of development and the expense estimate for development.

2.6.1. Work plans and expense estimates for the period from 03/31/92 for 06/30/96 (before initial date) did not agree—from the moment of creation of the Supervisory Council (September 1994), the first session took place only on July 24, 1996.

Expenses for this period, submitted by the investor to the Supervisory Council, totaled 124,801,000 US\$, including: before signing the Agreement – 87,598,000US\$, and after signing the Production-Sharing Agreement – 37,203,000US\$. The accordance of these expenses with the Supervisory Council and their statement was not carried out.

The work plan for second half of 1996 was approved at the first session of the Supervisory Council (07/24/96, Resolution №5B/96/02) in the sum of 63,154,900US\$, followed by (Resolution №5B/96/01) an offer by Sakhalin Energy for the development of the Piltun-Astokhskiy deposit, based on the concept of incremental development of the deposit.

An increase in the estimate in the second half of 1996 of 2,800,000US\$, the work plan, and the expense estimate in 1997 totaling 130,319,000US\$ were authorized 11/20/96 (Resolutions №5B/96/05 and №5B/96/06), or 2 months after the target date.

The increase in this estimate of 1997 charges up to 260,986,000US\$, or double, was authorized at a session of the Supervisory Council (07/25/97, Resolution №5B/97/09).

Work plans and expense estimates totaling 443,670,900US\$ in 1998 and 261,286,000US\$ in 1999 were authorized in an infringement of terms at sessions of

the Supervisory Council on 12/11/1997 and 12/08/1998 (Resolutions №8B/97/12 and №5B/98/06).

Thus the total amount of work stipulated by annual work plans from 06/30/96-12/31/99, including the period before the initial date, equals 1,156,698,800 US\$.

2.6.2. Sakhalin Energy presented annual work plans to the Supervisory Council on directions of activity and kinds of work. However, execution of the specified programs did not occur according to schedule.

An audit of the Agreement's execution under the Sakhalin-2 project, with an accounting period of 03/31/92-12/31/98 is analyzed.

2.6.3. Work plans of Sakhalin Energy on directions of activity and their execution for 1996-1998, including the period before initial date:

Table 2 (thousands, US\$)

Items	Prior to Inception		1996		1997		1998		Total		
	Budgeted	Actual	Budgeted	Actual	Budgeted	Actual	Budgeted	Actual	Budgeted	Actual	%
Evaluation of PA deposit			48772,8	42513,9					48772,8	42513,9	87,2
Study of PA deposit	10500	10500			18872	15830,2			29372,0	26330,22	89,6
Stage 1. Astokhskiy area							159467,5	221495,9	159467,5	221495,9	138,9
Prior to development of PA	13300	13300			181772	177501,6			195072,0	190801,6	97,8
Full development of PA							55973,2	50702,9	55973,2	50702,9	90,6
Transportation/processing PA							23574,0	9856,6	23574,0	9856,6	41,8
Total Piltun-Astokhskiy	23800	23800	48772,8	42513,9	200644	193331,8	239014,7	282055,4	512231,5	541701,1	105,8
Lunskiy (seismic prospecting)			350,0	167,0					350,0	167,0	47,7
Lunskiy (exploration) - gas	9900	9900	1832,1	667,4	7980	7997,0			19712,1	18564,5	94,2
Lunskiy (exploration) – oil					774	369,0			774,0	369,0	47,7
Lunskiy (development)							28616,2	8182,6	28616,2	8182,6	28,6
Lunskiy (transport/processing).							45557,0	24211,0	45557,0	24211,0	53,1
Total Lunskiy	9900	9900	2182,1	834,4	8754	8366,0	74173,2	32393,6	95009,3	51494,0	54,2
General Expenses					2781	3451,0	20370,0	14128,0	23151,0	17579,0	75,9
Management	91101	91101		-2,8	32391	28131,5	39277,0	55458,5	162769,0	174688,2	107,3
Construction					16416	21354,1	70836,0	66541,5	87252,0	87895,6	100,7
Bonuses			15000,0						15000		

Development Fund of Sakhalin						20000		20000		40000	
Total budgeted expenses	124801	124801	65954,9	43345,6	260986	274634,4	443670,9	470577,0	895412,8	913358,0	102,0
Actual charges (millions US\$)		124,8		58,7		290,3		483,5		957,3	
(Actual Expenses/ Budgeted expenses), % performance		100		89,1		111,2		108,9		106,9	

Analysis of the given programs shows that development of investments on directions of activity by Sakhalin Energy was carried out extremely irregularly, such that investments designated for one activity are actually used for other purposes:

- In the Piltun-Astokhskiy deposit, investments totaled 105.8%, from them only on the first stage, Astokhskiy area – 138.9%;
- In the Lunskiy deposit, investments totaled only 54.2%;
- For administrative personnel during the entire period of activity, expenses were 107.3%, thus only in 1998, 141% of budget;
- For the construction of office and housing – 100.7%;
- For general charges on researches for two deposits – 75.9%.

Budgeted expenses for the first stage development of the Piltun-Astokhskiy deposit were exceeded by 68,957,000US\$, by 11.2%. This increase in charges by Sakhalin Energy is connected to performance of large contracts on the Molikpak platform with foreign firms, including those reflected in the table:

Table №3

№	Project Type	Company	Total (thousands, US\$)
1.	Construction work	Sandvel	5995
2.	Re-equipment of the Molikpak platform	DEU	19245
3.	Marine operations	Van Oord	21791
4.	Installation of Single-Anchor Mooring	Van Oord	4425
5.	Operational drilling	Parker	10063
Total:			61519

These five contracts alone exceeded actual expenses by 61,519,000US\$.

2.6.4. The general charges of Sakhalin Energy total 957.3 million US\$ (106.9% of budget), due to the payments not related to compensated expenses, exceeding budget charges by 43.9 million US\$, including:

- Bonuses according to conditions of the Agreement for initial date and on the date development began on the Piltun-Astokhskiy deposit - 30 million US\$;

- Share of given credit – 11.9 million US\$;

- Funds “frozen” due to Inkombank’s bankruptcy - 2 million US\$.

Actual expenses on deposits are distributed as follows:

- Piltun-Astokhskiy - 637 million US\$, or 66.5% from the general charges, including on the first stage of development of this deposit – 519.6 million US\$ (54.3%),

- Lunskiy – 80.3 million US\$ (8.4% from the general charges);

- Both deposits (bonuses, payments to the Sakhalin Development Fund, construction costs for office and housing, unallocated charges on deposits before initial date) - 240 million US\$ (25.1%).

2.7. According to Item 3 of Appendix A of the Agreement, Sakhalin Energy maintains bookkeeping journals and registration documents in US\$. Expenses and receipts in rubles are recalculated in US\$. All other expenses and receipts in non US currency, are recalculated in US\$ at an average rate of purchase and sale, specified in the New York edition of the *Wall Street Journal* on the last working day of the month previous to date the expenses and receipts were incurred.

2.8. An audit of Sakhalin Energy for the period 06/31/96-12/31/98, including the period before initial date, the comparative analysis is lead:

- expenses stipulated by in the annual budget

- expenses submitted in Sakhalin Energy annual reports

- actual expense of Sakhalin Energy on records in accounting registers.

2.9. By audit it is established, that charges under the expense items stipulated by authorized estimates of expenses, and actual expenses on them, with breakdown by year and as a whole for all period are:

Table №4 (thousands, US\$)

Expense Items under the PSA	1996 and earlier	1997	1998	Total	% of result	1996 and earlier	1997	1998	Total	To Actual Expenses	(+/-)	%
	Budgeted Expenses					Actual Expenses						
Expenses before initial date	124801			124801,0	13,94	124801			124801	13,7	0,0	100
Rent payments	735			735,0	0,1	702,1			702,1	0,1	-32,9	95,5
Purchase of real estate	5860			5860,0	0,7				0	0,0	-5860,0	0,0
Materials and equipment	2		26774	26776,0	3,0	1028,5		23848	24876,5	2,7	-1899,5	92,9
Basic assets		64851		64851,0	7,2		82742,6		82742,6	9,1	17891,6	127,6
Payments to contractors	14307	121263		135570,0	15,1	23434,5	103547,9		126982,4	13,9	-8587,6	93,7
Third-party services			311270,5	311270,5	34,8			328021,9	328021,9	35,9	16751,4	105,4
Payments to personnel	4791	15332	27140	47262,7	5,3	3449,9	13245,6	24515	41210,5	4,5	-6052,2	87,2
Charges on business trips and communication	2245			2245,0	0,3	1818,1			1818,1	0,2	-426,9	81,0
Business charges		4540	16324	20864,0	2,3		4719	19568	24287	2,7	3423,0	116,4
Insurance	21	1000		1021,0	0,1	28,5	1075,6		1104,1	0,1	83,1	108,1
Legal cost and payment of legal aid	503	2113		2616,0	0,3	308,5	1498,3		1806,8	0,2	-809,2	69,1
Payment of services of advisers and advisers	1112,7	2072		3184,7	0,4	727,3	9541,3		10268,6	1,1	7083,9	322,4
Land and other property	0			0,0	0,0			650	650	0,1	650	
Office, housing, buildings	1444,5	5491		6935,5	0,8	768,3	3775,8		4544,1	0,5	-2391,4	65,5
Currency exchange	0			0,0	0,0	-2,8			-2,8	0,0	-2,8	
Professional Development	65			65,0	0,0	11,8			11,8	0,0	-53,2	18,2
Vocational training		657		657,0	0,1		336,6		336,6	0,0	-320,4	51,2
Personnel of related organizations outside of Russia	12326			12326,0	1,4	10382			10382	1,1	-1944,0	84,2
Payment of company services, related to it and foreign organizations	2297			2297,0	0,3	453,9			453,9	0,0	-1843,1	19,8

Personnel of service supplier			60897,4	60897,4	6,8			52636,2	52636,2	5,8	-8261,2	86,4
Administrative overhead charge	1000			1000,0	0,1				0	0,0	-1000,0	0,0
Miscellaneous costs	1328	5504	1265	8097,0	0,9	235	1482,7	1338,4	3056,1	0,3	-5041,3	37,7
Contingencies	2918			2918,0	0,3				0	0,0	-2918,0	0,0
Indirect costs		4510		4510,0	0,5		477,9		477,9	0,1	-4032,1	10,6
Direct costs		33653		33653,0	3,8		32190,9		32190,9	3,5	-1462,1	95,7
Bonuses	15000			15000,0	1,7					0,0	-15000,0	0,0
Development Fund of Sakhalin							20000	20000	40000	4,4	40000,0	
Total Budgeted Expenses	190756	260186	443670,9	895412,8	100	168146,6	274634,2	470577,5	913358,4	100	17945,1	102

1). From the payments made before initial date (July 1, 1992-July 1, 1996), charges for the preparation of the feasibility report totaled 60,190,000US\$; a bonus after the FEASIBILITY REPORT dated 03/30/1992 – 15,000,000US\$, on non-production research – 12,408,000US\$, offices in Moscow and Yuzhno-Sakhalinsk – 20,889,000US\$, on projects and research – 16,314,000 US\$.

2). Expenses for Russian personnel totaled 9,248,000US\$, or 22,4% of payments, foreign staff – 28,511,000US\$, or 69.2% (Russian personnel comprises 74% of the total personnel employed in the project, while foreign are only 26.4%). Reimbursement of foreign personnel for differences in the cost of living, housing stipend, and other standard privileges and payments to personnel and family members totals 3451,500US\$, or 8.4%.

3). Payments for travel, living expenses, and communications, as well as business expenses for participation in sessions of the Supervisory Council total 588,300US\$, or 2.25% of general charges under this line item.

4). Expenses necessary for the repair or restoration of property due to damage or destruction as a result of a fire, flooding, storm, ice, theft, failure, or other reasons distinct from the deliberate wrongful actions of Sakhalin Energy, its related organizations and its subcontractors were not covered in estimated expenses and thus not included.

2.9.1. Estimated expenses in 1996 gave bonuses for initial date in the sum of 15 million US\$ (see section V.IV of this report) which should not be included in compensated

expenses. Actually, this sum is paid to the Russian party and is not included in budget expenses.

2.9.2. Agreements provided on conditions and payments subject to compensation in Development Fund of Sakhalin 40 million US\$ have been made by Sakhalin Energy, but they were not included in estimates of charges.

2.9.3. Analysis shows:

1). Estimated expenses for 1998 were submitted by Sakhalin Energy in infringement of Item 4 "Expenses" of Appendix A "Principles of Bookkeeping" to the Agreement regarding reference of charges on elements of expenses.

2). In 1996, 17 expense lines were stipulated, in 1997 - 12, in 1998 - only 6 clauses were stipulated.

3). In 1998 the six authorized expense lines did not include payments to contractors, services to advisors and consultants, legal aid, payments on office maintenance, rent and insurance payments, compensation of personnel of related organizations. Instead, integrated expense lines for payment of third-party services, personnel of service supplier, direct supplier costs etcetera were included, and from these lines, all expenses stipulated by the Agreement, therefore items authorized by the budget, are redistributed under other expense lines indicated below.

Table 5 (thousands, US\$)

Actual Expenses by Expense Account (redistribution)	Expense accounts authorized under the Budget							
	Third-party services	Business expenses	Office expenses	Company services, related company services	Service provider personnel	Misc. costs	Direct costs	Total
Total	328021,9	24287	4544,1	453,9	52636,2	3056,1	32190,9	445190,1
Including:								
Services of advisers	15024,1			440,2				15464,3
Legal services	2303,6							2303,6
Office support	15786,4		2865,4					18651,8
Rent payments	4137		1678,5					5815,5
Insurance	2071,8							2071,8
Services of contractors and incomplete construction	288698				21346,2	465,4	8235,9	318745,5

Travel and lodging expenses		23986,5						23986,5
Training		300,9		13,7				314,6
Personnel, related organizations					31289,9		23955	55244,9
Currency exchange						334,5		334,5
Miscellaneous costs						2256,2		2256,2

2.10. According to Item 16(c) of the Sakhalin-2 Production-Sharing Agreement, Sakhalin Energy is obliged annually (in April) to present the Supervisory Council with an annual report for previous fiscal year, audited by an auditor firm. PriceWaterhouse was nominated to be the independent auditor by the Supervisory Council, for carrying out on a parity basis with Russian firm RosEkspertiza the annual audit of the accounting report of Sakhalin Energy (Resolutions №SB/97/03 and №SB/97/14).

The specified firms lead audits of the use and distribution of hydrocarbons, receipt of hydrocarbons and additional proceeds for 1996, 1997, and 1998.

2.11. According to Item 1 (“Definitions; interpretation”) of the Agreement for development of the Piltun-Astokhskiy and Lunskiy oil-and-gas fields under the Production-Sharing Agreement concept, the annual budget in the annual work plan details budgeted for execution of the plan; the annual report details expenses and the use of hydrocarbons, proceeds from their realization, and additional proceeds in the given financial year. Stipulated Item 16(c) “Expenses” mean any expenses listed in Item 4 of Appendix A “Principles of Bookkeeping.”

2.11.1. The annual report for the period from March 30-December 31, 1998 under the Sakhalin-2 project is submitted in the following format:

Table №6 (thousands, US\$)

	03/30/1992 until 12/31/1996	1997 as of 12/31/1997	1998 as of 12/31/1998	03/30/1992 until 12/31/1998
Expenses before initial date	124801			124801
Expenses for purchase of basic contractor goods and services	24463	194991	334542	553996

Expenses for services rendered to Sakhalin Energy and related foreign organizations	10382	23955	31290	65627
Expenses for services of advisers and consultants	1476	11517	17328	30321
Personnel Expenses	3450	13246	24515	41211
Traveling and living expenses	1818	4719	19268	25805
Office expenses	1499	4851	21995	28345
Professional development	26	337	301	664
Miscellaneous costs	235	997	1025	2257
Profits/losses at currency exchange	-3	21	313	331
Development Fund of Sakhalin		20000	20000	40000
Total before amendments at recalculation on cash method	168147	274634	470577	913358
Amendment at recalculation on cash method	-24120	- 38826	- 37285	-100231
TOTAL	144027	235808	433292	813127

2.11.2. Sakhalin Energy submitted to the Russian party annual reports for 1996, 1997, and 1998 without detailed decoding.

2.11.3. The firms auditing the annual reports concluded that instead of a detailed analysis of expenses incurred by Sakhalin Energy in the performance of the corresponding work plan, a description was given of basic approaches to compiling the annual report and the main provisions of a accounting practice with a brief listing of expenses incurred by Sakhalin Energy in connection with the Sakhalin-2 project, a verbatim copy of Appendix A from the Agreement.

In the section entitled, “General approach to compiling the annual report,” it is noted that “the company has prepared the annual report according to requirements of the Appendix regarding bookkeeping principles for the Production-Sharing Agreement.”

It is difficult to agree with the conclusions of the independent auditors regarding conformity of the annual report to the requirements of Appendix A (Sakhalin-2 Production-Sharing Agreement) “Principles of Bookkeeping.” As established by the audit, annual reports submitted by Sakhalin Energy to the Russian party deviate from the specified Bookkeeping Principles and do not correspond to the conditions stipulated by the Sakhalin-2 project.

2.11.4. In the Sakhalin Energy annual report there are no comparisons of actual to budgeted expenses resulting in a lack of authentic and complete information on actual expenses by expense line.

The audit established that expense categories shown in the Sakhalin Energy annual report deviated from actual expense categories and approved budgeted expense categories. In drafting the annual report, Sakhalin Energy merged actual expenses for categorized expenses, illustrated in budgeted expenses in separate lines. Because of which, annual expense categories in the annual report are not comparable with expenses categories in the budget. So:

1) In “Expenses for purchase of basic contractor goods and services”—553,996,000US\$ in expenses are included under the following categories:

- “Basic assets” – 82,742,600US\$;
- “Third-party services; expenses for uncompleted construction projects (industrial and non-productive purpose)”—288,648,000US\$;
- “Payments to contractors”—126,982,500US\$;
- “Direct costs or payment of services to Sakhalin Energy and related foreign organizations for office and residential infrastructure”—8,235,900US\$;
- “Service supplier personnel”—21,346,000US\$;
- “Payment for equipment and materials”—24,876,000US\$;
- “Miscellaneous expenses for office and residential infrastructure”—465,000US\$;
- “Land rights expenses”—650,000US\$.

2). In “Expenses for services rendered to Sakhalin Energy and related foreign organizations”—65,627,000US\$ in expenses are included for personnel of these organizations for payment of traveling and living expenses in the following categories:

- “Personnel from related organizations outside of Russia”—10,382,000US\$,
- “Direct costs of service supplier for personnel from related organizations”—23,955,000US\$,
- “Personnel of service supplier for personnel from related organizations”—20,420,000US\$,
- “Personnel of the financial, marketing and consulting services”—10,870,000US\$.

3). In “Expenses for services of advisers and consultants”—30,321,000US\$ included the following charges:

- “Payment for services of advisers and consultants”—10,268,000US\$;

- “Legal costs and legal aid”—1,807,000US\$;
- “Third-party services for payment of expenses for advisers and consultants”—15,024,000US\$, and “Legal costs and legal aid”—2,304,000US\$;
- “Services of related organizations for payment of expenses for advisers and consultants”—440,000US\$;
- “Indirect costs for service supplier for consulting help”—478,000US\$.

4). In “Expenses for traveling and living expenses” 25,805,000US\$ for traveling and living expenses included communication expenses of 1,818,000US\$ and business expenses 23,987,000US\$.

5). In “Office Expenses”—28,345,000US\$ included:

- “Office, project, communications, transportation, and housing expenses”—4,544,000US\$, “Rent payments”—702,000US\$, “Insurance”—1,104,000US\$;
- “Third-party service office expenses”—15,786,000US\$, “Rent payments”—4,137,000US\$, “Insurance”—2,072,000US\$.

6). In “Professional Development Expenses”—664,000US\$ included business charges for 301,000US\$, professional training for 348,300US\$, services rendered to Sakhalin Energy and related organizations for tuition fees 14,400US\$.

7). In “Currency Exchange Expenses”—331,000US\$ included expenses for currency exchange and miscellaneous costs.

The audit shows that Sakhalin Energy’s annual reports do not show as separate categories that correspond to the approved budget, instead redistributes expenses such as rent payments, insurance, legal cost and payment of legal aid, personnel of service providers, indirect costs, and direct costs of service providers to other categories.

2.11.5. In violation of Item 5(viii) of the Sakhalin-2 Production-Sharing Agreement, Annual reports from 1997 and 1998 were not considered at the session of the Supervisory Council.

Management of the Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration) repeatedly addressed questions concerning to the annual report to the president of Sakhalin Energy. In spite of that, the submitted materials do not include a report on execution of the expense budget, showing a comparison of actual expenses (by year and cumulative totals from the inception of work on the Project) with breakdown on types of activity, work and elements of expenses as stipulated by the expense budget in the authorized work plan.

Upon the insistence of the Russian party, in August 1999, Sakhalin Energy presented the Supervisory Council Working Group the accounting balance for 1998, a division of expenses by development project in the Piltun-Astokhskiy and Lunskiy deposits from the inception of work, and a report on the execution of the 1998 expense budget.

2.12. An analysis of expense categories stipulated by the expense budget lead during the present audit, execution of budgeted expenses in authorized expense categories, and actual expenses, and expenses reflected in annual reports of Sakhalin Energy, has shown:

Table 7 (one thousand US\$)

List of Expenses under PSA	Budgeted Expenses		Expenses by elements of expenses	Expenses According to Annual report	Total
	Authorized	Actual			
Expenses before inception	124801	124801	124801	Expenses before inception	124801
Basic assets	64851	82742,6	82742,6	Expenses for basic contractor goods and services	553996
Third-party services	311270,5	328671,9	288698		
Payments to contractors.	135570	126982,4	126982,5		
Direct supplies costs	33653	32190,9	8235,9		
Service provider personnel	60897,4	52636,2	21346,2		
Materials and equipment	26776	24876,5	24876		
Miscellaneous costs (contractors)	8097	3056,1	465		
Purchase of real estate	5860	0	0		
Land and other property	0	0	650		
Personnel of related organizations outside of Russia	12326	10382	10382	Expenses for services rendered to Sakhalin Energy and related organizations	65627
Direct supplier costs	0	0	23955		
Personnel of service supplier	0	0	31289,9		
Payments to consultants and advisors	3184,7	10268,6	10268,6	Expenses for consultants and advisors	30321
Legal cost and payment of a legal aid	2616	1806,8	1806,8		

Third-party services (advisers and consultants)	0	0	15024,1		
Third-party services (legal services)	0	0	2303,6		
Payment of services of Sakhalin Energy and related foreign organizations	2297	453,9	440,2		
Indirect costs	4510	477,9	477,9		
Personnel costs	47262,7	41210,5	41210,5	Personnel costs	41211
Travel and lodging expenses (incl. communications)	2245	1818,1	1818,1	Travel/lodging expenses (incl. communications)	25805
Travel/Business charges	20864	24287	23986,5		
Office, settlements, objects	6935,5	4544,1	2865,4	Office expenses	28345
Office, settlements, objects (rent of payments)	0	0	1678,7		
Third-party services (charges on office)	0	0	15786,4		
Third-party services (rent payments)	0	0	4137		
Rent payments	735	702,1	702,1		
Insurance	1021	1104,1	1104,1		
Third-party services (insurance)	0	0	2071,8		
Professional Development	65	11,8	11,8	Professional Development	664
Vocational training	657	336,6	336,6		
Business charges (training)	0	0	300,9		
Payment of services of Sakhalin Energy, related organizations (training)	0	0	13,7		
Miscellaneous costs	0	0	2256,2	Miscellaneous costs	2257
Exchange	0	-2,8	-2,8	Exchange	331
Miscellaneous costs (currency exchange)	0	0	334,5		
Administrative overhead charge	1000	0	0		0
Contingencies	2918	0	0		0
Bonuses	15000	0	0		0
Development Fund of Sakhalin		40000	40000	Sakhalin Development Fund	40000
Adjustment			-100231	Adjustment	-100231
Total Budgeted Expenses	895412,8	913358,3	813125,8	Total	813127

2.13. Sakhalin Energy shall maintain its books in accordance with Items 20(a) and 24(a) of the Sakhalin-2 Agreement “Principles of Bookkeeping” (Appendix A to the Agreement), and according to laws, statues, regulations, and other certificates of state bodies working in the Russian Federation which are officially commissioned and generally accessible. At the same time Item 1 of Appendix A “Principles of Bookkeeping”, provides that in case of divergences between the specified Appendix and positions of the Agreement, the Appendix to which it makes, positions of the Agreement are determining.

At the date of signing the Sakhalin-2 Agreement, regulations about bookkeeping and reporting in the Russian Federation were in effect, authorized with Order №10 of the Ministry of Finance of the Russian Federation 03/20/1992, and Order №170 (09/26/1994) (with additions and changes) by which uniform bookkeeping and reporting rules were established on territories of the Russian Federation only for the organizations being legal entities operating under the legislation of the Russian Federation.

The specified resolution became invalid with introduction of the Resolution №34n authorized by order of the Ministry of Finance of Russia on 07/29/1998 and developed based on the Law “On Bookkeeping.” The given Position (Item 2) provides that branches and representatives of foreign organizations on the territory of the Russian Federation, shall conduct bookkeeping using rules established in the foreign organization’s country if the latter do not contradict international standards of financial reporting.

2.14. According to Item 3(a) Appendix A of the Agreement, bookkeeping should be carried using cash method. Expenses should be registered based on actually paid expense, including taxes, transportation, and other charges connected to it, minus all discounts actually applied and deductions and should be allocated to capital expenses or current expenses.

Sakhalin Energy maintained its records using on the method of charge of expenses (GAAP, USA - Standard Bookkeeping Principles). Upon compilation of the annual report, incurred but still outstanding expenses are deducted from the total of all expenses. For these purposes, Sakhalin Energy wrote in the annual report “an amendment recalculating using the cash method” which for all period totals 100,231,000US\$. It is necessary to note, that the sum under this clause reduces total expenses without distribution on elements of expenses. It simplifies company bookkeeping but does not allow authentic analysis of expenses actually made by the company under each clause of charges.

The expenses reflected in the annual report after amendments showing recalculation using cash method, reimbursable to Sakhalin Energy, as of December 31, 1998, total 813,127,000US\$, or 90.8% of budget allocations.

2.15. In October 1997, under the initiative of a member of the Consortium, Sodeco, investors audited the joint account and accounting documents of the operator in 1996. The audit was carried out at the Houston headquarters. The chief accountants of

Sakhalinmorneftegas-Shelf and Rosneft-Sakhalin took part in the audit. The audit was carried out with the purpose of verifying actual charges versus authorized expenses in 1996. The verification was carried out by comparing these charges with records in the account journals. No discrepancies were found in the journals.

2.16. In 1998, the Russian party audited registration documentation for 1996-1997 under the Sakhalin-1 and Sakhalin-2 Agreements. The initiator of audit was the Ministry of Fuel and Energy of Russia. The audit was carried out by Financial and Accounting Advisers (further FAA), having won the tender among Russian audit consulting firms.

FAA uncovered infringements in accounting, document storage, and reference of expenses to compensated expenses in both Sakhalin Energy and Consortium records.

As a result of the audit of the registration documentation of Sakhalin Energy, in 1998, FAA found that expenses not subject to reimbursement, for the period with 1995 for 1997 totaled 4,768,500US\$.

It was noted that Consortium annual reports were not audited, Agreement Resolutions concerning bookkeeping procedures were broken according to Russian Bookkeeping rules, and records were not maintained in Russian. Expense budgets were submitted using integrated parameters, complicating work with them.

2.17. Models of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements are complicated by inclusion of reimbursable expenses of taxes and charges of payments by investors for the investigation of deposits and other expenses reducing aggregate profits of the state.

Under the given Agreements, a number of problems arose in connection with defining Project costs, allocating expenses to for reimbursement, decisions regarding the audit conducted by Financial and Accounting Advisers.

Operators of the Agreement challenged the conclusions made by FAA experts. In its remarks, FAA operators directed disagreements to the Ministry of Fuel and Energy of Russia.

Almost a year has elapsed, and the disagreements between the companies (Sakhalin Energy and Exxon) and by the auditing party have been resolved. Uniform approaches in the interpretation of economic and accounting concepts of Agreements have not been agreed upon.

2.18. In July 1998, the results by the Laboratory of Economic Development of Oil-and-gas Deposits and software of Open Society "VNIIOANG " was received. It concludes was an overview of each remark made by FAA because of the audit under the Sakhalin-1 and Sakhalin-2 Agreements.

It is noted that the Agreements were signed prior to acceptance of the Federal law “On Production-Sharing,” “About Bookkeeping,” and other laws, sublaws, and statutory acts. In connection with this, there is a stipulation, according to Item 5, Item of 2 of the Law “On Production-Sharing,” requiring their acceptance after signing of them.

In order to avoid ambiguity, it is recommended that statutory acts be developed (instructions of the various ministries and departments) according to which positions of each of the specified Agreements would be completed with tax inspectors, customs officers and other interested organizations.

IV. Audit of accuracy and timeliness of receipts to the Russian party of bonuses and other payments under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1. According to the Sakhalin-1 and Sakhalin-2 Agreements, single payments (bonuses) for a total sum 65 million US\$ should be listed to the Russian party, including:

- according to the Sakhalin-1 Agreement (Item 32.1 and Item XXXII) at the inception of the Agreement, the Consortium shall pay a bonus of 15 million US\$ (10 million US\$ to the Sakhalin area and 5 million US\$ to the Federal budget);

- according to Item 17(a) of the Sakhalin-2 Agreements, no later than 20 calendar days after inception of the Agreement, Sakhalin Energy shall pay a bonus of 15 million US\$ to the Russian party, a bonus of 15 million US\$ at the beginning of development of the Piltun-Astokhskiy deposit.

At the start of the audit, according to the Sakhalin-2 Agreement, Sakhalin Energy shall credit the to the Russian party’s account 20 million US\$ as a bonus for beginning development of the Lunskiy license site - Item 17(b). In connection with extension of the study period of the given site until June 15, 2001, the specified bonus was credited to the Russian party.

2. A portion of the specified funds should be in the federal budget. However, as the audit has shown, these funds did not yet reach the federal budget accounts, equivalent to the use in projects of budgetary funds not stipulated by Agreements.

3. The total funds to have been credited to the federal budget according to Item 17 of the Sakhalin-2 Agreement require clarification.

3.1. Item 2 of the Contract dated April 7, 1997 between the Government of the Russian Federation and Sakhalin Area Administration on the distribution of Russian share of income under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements provides that bonuses are distributed between the parties of the present contract in this way: 40% of each bonus shall be at the disposal of the Government of the Russian Federation, 60% of each bonus shall be deposited in the currency

fund of the Sakhalin Area. This distribution in agreement with Item 42 of the Laws of the Russian Federation “On Resources” corresponds to payments for using resources of the territorial sea.

3.2. According to Item 42 of the Law of the Russian Federation “On Resources,” payments for resource use on the continental shelf of the Russian Federation are completely within the federal budget.

3.3. The audit established that the questions listed in Items 3.1 and 3.2 have not yet been solved.

4. In the resource use rights licenses given by the Ministry of Natural Resources of the Russian Federation under the Sakhalin-2 Agreement, strict attribution of wildlife management sites to the continental shelf or the territorial sea it is not conducted. Therefore, in licensing the Piltun-Astokhskiy site, for which payment deadlines have been reached, the site is located in the Sea of Okhotsk, approximately twelve miles from the northeast coast of Sakhalin.

4.1. At the moment that the Agreements were enacted, the concept of “territorial sea” and “continental shelf” were not determined by Russian legislation. The standard regulations were established by United Nations Conventions on Marine Law (Montego Bay, 12/10/1982), which were used in Federal law of the Russian Federation dated 11/30/1995 №187-F3 “On the continental shelf of the Russian Federation” and the Federal law dated 7/31/1998 (№155-F3) “On internal sea waters, territorial seas, and the contiguous zone of the Russian Federation.”

According to Item 3 of the Conventions, each state has the right to establish width of the territorial sea up to a limit, not exceeding twelve nautical miles, measured from initial lines determined according to the present Convention.

4.2. Clause 76 of the specified document defines a continental shelf as: “the Continental shelf of the coastal country includes the sea-bottom and underwater resource areas reaching to the limits of its territorial sea.”

4.3. From Appendix 1-3 “Structures of three-dimensional seismic prospecting,” the June 1999 report on the progress of work under the Sakhalin-2 project in 1998 on the Piltun-Astokhskiy deposit states that the deposit is not located “approximately twelve miles from the northeast coast of Sakhalin”, but that the majority (approximately 60-70%) is within the limits of territorial waters, i.e. within the limits of the 12-mile zone.

4.4. According to Item 42 of the Law “On Resources,” payments for resource use should be a combination of payments for using resources of the territorial sea and payments for using resources of the continental shelf of the Russian Federation. This question has not yet been settled. There is no official decision based on the Law

declaring the federal share of payments received (40%), 100% or the amount expressed in percentage proportional to territories' shares.

4.5. From the Ministry of Finance of Russia Letter №04-08-24/45 (11/04/98) signed by M.A. Motorin addressed to Assistant Minister V. Z. Garipov at the Ministry of Fuel and Energy of Russia, the Ministry of Finance of Russia (without any legal substantiation or consideration of the geographical features of the sites in relation to the 12-mile zone) has unequivocally defined that the federal budget share for resource use is only 40%. The Ministry of Fuel and Energy of Russia had no objections to the given question. Thus, federal controls on behalf of the Ministry of Finance of Russia and Ministry of Fuel and Energy of Russia have illegally underestimated the share of the Russian Federation by no less than 2.7 million US\$ that should have been credited to the federal budget.

5. According to completed accounts at the Ministry of Fuel and Energy of Russia (Letter №04-08-24/45 of the Ministry of Finance of Russia, 11/04/98), single payments upon achieving certain results under the Sakhalin-1 and Sakhalin-2 Agreements should be made to corresponding Vneshtorgbank accounts at the Republic National Bank of New York (further "Bank of New York"), New York, USA №608-205-524 and, in the future, shall be deposited in the Federal budget to account №40503840900000000685 of the Ministry of Finance of Russia at Vneshtorgbank.

6. The management of Ministry of Fuel and Energy of Russia (Letter of Ministry of Fuel and Energy of Russia dated 08/30/99, №БГ-7058) has established a different route for the movement of foreign investor payments – monies are transferred via bank-correspondents (Bank of New York, and Bank of Tokyo Ltd.) to Kvota Bank, Vtoroy Bank, and Inkombank to the accounts of (RVO) Zarubezhneft №00100700007 and the Institute for the Geology and Development of Combustible Minerals.

7. The following documents form the basis for directing investor funds to the Russian party via the federal budget:

- Letter №04-06-05 dated 06/13/96 by K.V. Kotov, Deputy Chief of the Department of Tax Reforms of the Ministry of Finance of Russia. (In agreement with Letter №04-06-05 of the Ministry of Finance dated 01/18/96 during tenure, during the period 01/01/96-12/31/96 K.V. Kotov was plenipotentiary of the Ministry of Finance of the Russian Federation with regard to decisions on all questions connected to realization of Agreements under the Sakhalin-1 and Sakhalin-2 projects;

- "The Temporary Technical Order for the Accumulation and Expenditure of bonus funds paid to the Russian Federation according to the Production-Sharing Agreement." According to Letter №04-06-05 from the Ministry of Finance of Russia dated 03/12/97, the Ministry of Fuel and Energy of Russia authorized the for a one-week period (03/20/97).

Instructions for the transfer of payments due to the federal budget contained in K.V. Kotov's letter №04-06-05 (06/13/96) and “the Temporary Technical Order for the Accumulation and Expenditure of bonus funds...” have crudely broken the regulations for transfer of payments to federal budget accounts, and the responsible officials, having ratified and executed these legal statuses, have exceeded their powers with regard to allocating budgetary funds.

The Ministry of Fuel and Energy of Russia with the consent and cooperation of the Ministry of Finance of Russia, did not use budgetary funds apportioned to the Russian Federation as directed, including in the interests of commercial banks. The transfers of payments that occurred to the organizations of Ministry of Fuel and Energy of Russia and in part on accounts of Sakhalin Area Administration should be attributed to illegal withdrawals from the federal budget, which are subject to return. The damage to the federal budget is estimated at no less than 19.7 million US\$.

8. According to conditions of the Sakhalin-1 Agreement, investors paid bonuses of 15 million US\$ to the Russian party on the effective date of the Sakhalin-1 Agreement. Transfer of funds should occur by July 10, 1996.

8.1. Transferred to currency accounts:

- To the Finance Administration of the Sakhalin Area Administration - 10 million US\$: 5 million US\$ on January 18, 1994 (KB Sakhobank) and 5 million US\$ on June 26, 1996 (Sakhalin Regional Branch of Promstroybank);

- To RVO Zarubezhneft - 5 million US\$, 07/17/96 (Kvota Bank).

The use of the bonus at a rate of 5 million US\$, credited to RVO Zarubezhneft, is determined by Letter №04-06-05 from the Ministry of Finance of Russia dated 07/19/96. The funds are authorized for spending to finance expenses in connection with functions of the Authorized Fiscal Entity under the Sakhalin-1 Agreement.

In 1998, according to the “Temporary Technical Order for the Accumulation and Expenditure of bonus funds...” and under the instructions of the Ministry of Finance of Russia and Ministry of Fuel and Energy of Russia, RVO Zarubezhneft refunded the operator of the Sakhalin-1 project, expenses connected with payment of customs and excises duties in the sum of 208 million rubles and 300,000US\$.

As of 07/12/1999, the remainder of the bonus funds at RVO Zarubezhneft was 3,145,700US\$.

8.2. The Central Administration of the Federal Treasury explained in Letter №04-08-2n/45 from the Ministry of Finance of Russia dated 11/04/98, that the bonuses paid by the Investor (single payments) are subject to transfer to the federal budget to the budgetary account of the Ministry of Finance of Russia at Vneshtorgbank.

The Ministry of Fuel and Energy of Russia advised account numbers and essential elements in Letter №04-08-24/24, on 08/04/98. However, as of now, the remaining funds have not been transferred from the currency account of RVO Zarubezhneft.

8.3. According to Item 8 of the Agreement, 12/18/1993, for development Feasibility Report, the foreign party shall pay a non-reimbursable bonus of 10 million US\$ to the Sakhalin Area Administration. Payment of the bonus will be made in two stages.

At the first stage, the foreign party shall pay the Sakhalin Area Administration 5 million US\$ within 20 business days after signing the Agreement. The remaining sum shall be paid after the Agreement's start of validity.

8.4. By virtue that the Sakhalin-1 Production-Sharing Agreement is the preparation stage, Sakhalin Energy did not report payments for resource use rights (royalties) to the tax entity.

8.5. According to Items 15.1 and 15.2 Article XV of the Sakhalin-1 Production-Sharing Agreement, payments for the contractual water body and payments for the right for geological study of resources are stipulated. Within the first thirty days of the first contract year and each following contract year, the Consortium shall make rent payments of US\$400/kilometer² of the contractual water area.

At the end of the geological study period, payments for geological study rights (specific US\$ amounts/kilometer²) will be stopped, and annual payments for contractual water areas will increase to US\$400/kilometer².

According to specified positions of the Agreement, Exxon paid the Russian party rent payments for the contractual water area and for geological study rights for three contract years totaling 691,200US\$, of that amount 184,300US\$ is listed in the federal budget.

9. As of September 25, 1999, the federal budget did not receive any bonus funds under the Sakhalin-2 project.

Of bonuses paid by Sakhalin Energy totaling 30 million US\$, the Sakhalin Area Administration received 27 million US\$, while 3 million US\$ was received by the Institute for the Geology and the Development of Combustible Minerals.

9.1. In 1996, the Ministry of Finance of Russia transferred 15 million the US\$ to the Sakhalin Area Administration as the full bonus stipulated by Item 17(a) of the Agreement. The specified funds were received on June 27, 1996 on the account of the Finance Administration of the Sakhalin Area Administration.

9.2. In connection with a request by the governor of the Sakhalin area to the Chairman of the Government of the Russian Federation, a bonus marking the beginning of development (on December 31, 1997) of the Piltun-Astokhskiy deposits was distributed as follows:

- 10 million US\$ (December 31, 1997) was credited to the account of the Finance Administration of the Sakhalin Area Administration. (Source- Letter №VO-9271 to the management of Sakhalin Energy from the First Deputy Minister of Fuel and Power of the Russian Federation, I. Otta, dated 12/29/97);

- 2 million US\$ was credited to the Sakhalin Area Administration account. (Source- Instruction №VCh-P2-9034 from Chairman of the Government of the Russian Federation, V.S. Chernomyrdin, dated 12/04/97, as well as Letters №VO - 3046 (04/17/98) and №VO - 3114 (04/20/98) by the Acting Minister of Fuel and Power of the Russian Federation, V.I. Otta, regarding the funds transfer to the Sakhalin Administration and about a special-purpose designation of these funds for construction of the Noglikskiy gas power stations). The Economic Committee of the Sakhalin Area Administration having received funds in the amount of 2 million US\$, directed the Noglikskiy power station in the form of a target payment from the Ministry of Fuel and Energy of Russia;

- 3 million US\$ were transferred to the accounts of the state enterprise “Institute for the Geology and Development of Combustible Minerals” (further - IGDCM). (Source - Order №86 from the Ministry of Fuel and Energy of Russia dated 03/18/98, charging IGDCM with the performance of ekspertizas, analysis, and other projects regarding estimation of stocks, searches, investigations, and extractions of raw hydrocarbons in the preparation and realization of Production-Sharing Agreements). Compensation of expenses incurred by the state enterprise IGDCM in connection with ekspertizas and analysis was provided by the federal share of funds paid by investors under Production-Sharing Agreements, according to the expenditure of such funds and annually budgeted expenses of the IGDCM for these purposes, as authorized by the Ministry of Fuel and Energy of Russia.

On the basis of Letter №AK-5078, not coordinated with the Ministry of Finance of Russia, from the Acting Minister of Fuel and Power, A.G. Kozyrev, dated 06/24/98, Sakhalin Energy paid 3 million US\$ of the federal share of a bonus on the beginning of development of the Piltun-Astokhskiy oil-and-gas deposit to the hard currency account of IGDCM at the commercial bank Inkombank. As established by the audit, the Institute for the Geology and Development of Combustible Minerals and Inkombank contractually agreed to open a foreign currency bank account beginning 06/15/98 for the realization of settlement and other bank operations (the cost of opening the account was 200US\$). The account opened by the bank has received a total of 2,999,800US\$ as of July 6, 1998 (minus the cost of opening the account).

Currency payment assignment №1 (09/22/98) was made to Inkombank regarding the transfer of all remaining funds, totaling 2,999,800US\$ to the settlement account at Vtoroy Bank. As of the date of funding on September 25, 1998, a write-off of the above-stated funds was made. However, in connection with lacking funds in the corresponding bank account, the payment assignment was not executed.

On October 29, 1998, the license of the joint-stock bank Inkombank was withdrawn. According to Item 20 of the Laws of the Russian Federation “On banks and bank activity,” all bank obligations to clients have been fixed in rubles at the rate on the date the license was withdrawn. On October 30, 1998, IGDCM sued Inkombank for collecting illegally withheld funds that on the aforementioned date the amount, including interest, 50,473,902 rubles and 75 kopecks. On November 4, 1998, the Moscow Arbitration Court made a determination accepting Inkombank’s insolvency and began supervisory procedures that are still in operation.

A court case is currently underway regarding the inconsistencies of Inkombank.

10. According to the Federal law dated January 7, 1999 “On modification and additions to the Federal law ‘On Production-Sharing Agreements’” under the Production-Sharing Agreements executed projects shall be financed by Ministry of Fuel and Energy organizations in part by funds received from through realization of the agreements, by way of the federal budget.

Financing of such works come from federal budget funds after actual receipt of income from specified budget payments in the realization of the Production-Sharing Agreements. As of now, this issue has not yet been decided by corresponding Decisions of the Government of the Russian Federation.

11. According to the Sakhalin-2 Agreement by December 31 of each fiscal year, beginning with the year that work began at the Piltun-Astokhskiy or Lunskiy license sites, Sakhalin Energy pays 20 million US\$ to the Development Fund of Sakhalin.

11.1. These funds are spent according to the fund managers’ instructions and are credited to an account specified in written form by the Sakhalin Area Administration. Such payments are related to the category of reimbursable expenses and are subject to compensation according to Item 14 of the Agreement regarding allocation of liquid production or additional proceeds.

Sakhalin Energy’s obligations regarding transfer of these payments elapse after the accumulated sum of payments reaches 100 million US\$.

11.2. By audit it is established, that, since the start of development of the Piltun-Astokhskiy license site (12/31/1997), the Sakhalin Area Administration has received two payments from Sakhalin Energy totaling 40 million US\$, including:

- 12/31/1997 to the Sakhalin Regional Branch of Promstroybank - 20 million US\$;
- 09/25/1998 to the Moscow branch of ABN AMR O bank - 10 million US\$;
- 09/25/1998 to Ing Bank—Eurasia, New York - 10 million US\$.

11.3. The audit established that all payments received under the Sakhalin-1 and Sakhalin-2 Agreements by the un-appropriated currency fund of the Sakhalin Area were used according to budgeted incomes and expenses of the currency fund of the Sakhalin Area.

11.4. Reports on the execution of budgeted income and expenses from the Area currency fund in 1996, 1997, and 1998 are authorized by Decisions of the Sakhalin Regional Duma accordingly on 01/17/97, 06/29/98, and 07/05/99. The summary report on the execution of budgeted income and expenses of the Sakhalin Area currency fund for 1996-1998 are below:

Income and Expenses	1996	1997	1998	In total
Unused remaining funds at start of fiscal year	360,0	1046,7	2467,1	3873,8
All Income	21916,7	32366,5	22692,5	76975,7
including income received from Sakhalin-1 and Sakhalin-2:				
- bonus before initial date of Sakhalin-2	15000,0			15000,0
- bonus Sakhalin-1	5000,0			5000,0
- bonus on Piltun-Astokhskiy deposit of Sakhalin-2		10000,0	2000,0	12000,0

- Development Fund of Sakhalin Sakhalin-2		20000,0	20000,0	40000,0
- support of experts from Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration)	75,0	150,0	150,0	375,0
All expenses, including:	21326,7	30936,4	25008,7	77271,8
Loan, including:				
- preparation of fuel and energy complex for winter season	9019,0	1030,7	870,0	10919,7
- pediatric polyclinic in Yuzhno-Sakhalinsk	1110,0		350,0	1460,0
- hospital in Korsakov	1000,0		2000,0	3000,0
- restoration of stage in the Chekhov Theater	500,0			500,0
- the bridge in settlement Makarovka	400,0	826,9		1226,9
- reconstruction of main heating line, Aniva	400,0			400,0
- construction of Yugo-Lugovskiy deposit in Aniva Region	200,0			200,0
- construction of school for 1266 students, Okha	1000,0	978,8	1600,0	3578,8
- repair of school, Krasnaya Tym'	120,0			120,0
- expansion of underground water-intake, Yuzhno-Sakhalinsk	380,0	274,8		654,8
- interest-free loans to city and village administrations	4000			4000
- GP Airport Yuzhno-Sakhalinsk	459,7	2897,6	600,0	3957,3
- Aniva Area Administrations			118,1	118,1
- power supply, Ozerskiy village			300,0	300,0
- Sakhalin Area Administration - repair of building and other needs		314,5	273,5	588,0
- Area Administrations - payments to various funds	10	44,1	120,0	174,1
- Sakhalin Area Administration - payment to fund Sakhalin-Stikhiya		272,4	105,0	377,4
- School for hearing and speech impaired children, Dolinsk		318,3		318,3
- Construction of school, Yablochnoe		328,8	250,0	578,8
- Addition to therapeutic wing of regional hospital		783,9	2000,0	2783,9
- Sakhalin Area Administration, Noglikiski power station			4400,0	4400,0
- repair of school, Nevel'ska administration			130,0	130,0
- Department of public health services (insulin, anti-tubercular preparations, medical equipment)	218,7	1780,4	2224,8	4223,9

- expenses of experts from Department of Natural Resource Development of the Continental Shelf	75,0	150,0	150,0	375,0
Department of social protection		175,2	130,0	305,2
Department of public health services			121,0	121,0
Department of Internal Affairs - purchase of communications facility and equipment for emergency power supply		296,2		296,2
Department of education, culture and sports		134,0	300,0	434,0
Regional Center SanEpidNadzor	100		110,0	210,0
GP Oblzhilkomkhoz, construction of municipal projects		1500,0	317,9	1817,9
State TV-broadcasting company Sakhalin	300			300
Sakhalinmornefteprodukt, short-term credit	1000			1000
Area administration constituent payments, including:				
- construction of Noglikskiy gas power station	685,0	5225,9	5000,0	10910,9
- constituent payment Ministry of Fuel and Energy of Russia (Noglikskiy gas power station)			2000,0	2000,0
- creation of lumber industry enterprises		2000,0		2000,0
- modernization of Gornozavodskiy concentrating factory		511,0		511,0
- creation of motor transportation enterprise		3000,0		3000,0
- purchase Boeing 737-200 for GP airline Sakhalin Airways		2000,0		2000,0
- support of financial institutions		500,0		500,0
- governor's reserve fund for other contingencies		2574,1	192,2	2766,3
- Reserve of the Sakhalin Regional Duma			81,6	81,6
- Transfer to Fishery Development Fund			291,8	291,8
- Interest payments for use of credits	200,6	2030,0		2230,6
- Miscellaneous costs	148,7	141	232,7	522,4
- UKS area administration for reconstruction and construction		85,5		85,5
- Development of investment projects and programs, bills		313,6	131,5	522,4
- Support of local commodity producers		448,7	500,0	948,7

11.5. Both the Lunskiy and Piltun-Astokhskiy deposits were opened by Russian organizations with funds from the state budget. According to the Sakhalin-2 Agreement

(Item 17 and the Agreement), earlier expenses incurred by the Russian party for prospecting works are estimated at 160 million US\$.

Their compensation will be made in two stages:

- the first stage (80 million US\$) - beginning the first calendar quarter after the date on which within no less than 30 successive days that hydrocarbon extraction was conducted along with presenting hydrocarbons for export,

- the second stage (80 million US\$) – when hydrocarbon extraction profitability reaches 17.5% and production-sharing between the Russian party and Sakhalin Energy will be carried out proportionally at 50%/50%.

The Company shall reimburse the Russian party 4 million US for earlier incurred expenses on a quarterly basis.

11.6. According to the Contract between the Government of the Russian Federation and the Sakhalin Area Administration dated April 3, 1997, reimbursable expenses incurred by Sakhalin Energy for prospecting works before date of the conclusion of the Agreement shall be distributed as follows: 50% of payments to the federal budget and 50% - to the budget of the Sakhalin Area.

According to the letter of Sakhalin Energy dated 07/21/99, the first reimbursement payment for Russian expenses for prospecting works shall take place October 1999.

The Deputy Minister of Fuel and Power of the Russian Federation, V.Z. Garipov, and the Deputy Minister of Finance of the Russian Federation, M.A. Motorin, announced the banking requirements for the transfer 4 million US\$ to the account of the regional budget of the Finance Administration of the Sakhalin Area Administration to GRKTs Yuzhno-Sakhalinsk.

At the same time, the First Vice-Governor of the Area, I.P. Malakhov, announced other bank requirements for transfer of the specified payment to ABN AMR O Bank, New York.

The Ministry of Fuel and Energy of Russia in Letter №VG-7008 (08/27/99) signed by Deputy Minister of Fuel and Power of the Russian Federation, V.Z. Garipov, has found it expedient, in accordance with the Assignment №PP-748 (05/29/1998) of Russian Federation President, to direct 2 million US\$ of federal funds reimbursed by Sakhalin Energy for earlier incurred expenses for prospecting works under the Sakhalin-2 project, a special-purpose designation by the Sakhalin Area Administration for the development of Kuril Islands power supply.

4 million US\$ were transferred August 12, 1999 from the Sakhalin Area Administration to the ABN Moscow AMR O bank account. By Order №243-r of the Governor of the Sakhalin Area dated August 31, 1999, the funds paid in compensation of Russian

expenses for prospecting works, incurred prior to the date the Agreement was entered into for the Sakhalin-2 project are distributed as follows:

- management of the Kuril program - construction of a small hydroelectric power station on the Matrosskaya river in the northern Kuril area, Mendeleevskaya hydroelectric power station on Kunashir Island, and Okean hydroelectric power station on Iturup Island, 1,200,000 US\$;

- Open Society Vostokgeologiya for drilling two wells for the Mendeleevskaya hydroelectric power station, interest-free loan of 200,000US\$;

- Joint-stock company Pelenga Godo for reimbursement of expenses for construction of diesel power station on Skhikotan Island Shikotan, 240,000US\$.

12. According to Item 41 of the Laws of the Russian Federation dated 03/03/95 №27-F3 “On Resources,” the investor is obliged to make regular payments for using resources (royalties).

12.1. Federal Law №32-F3 dated 02/10/99 “On entering into acts of the Russian Federation of changes and the additions” following from the Federal law “On Production-Sharing Agreements” changes the Law of the Russian Federation “On Resources” which state that the order and sizes of payments for resource use and the collection of such payments in execution of Production-Sharing Agreements are established by specified agreements according to legislation of the Russian Federation.

12.2. Under the Sakhalin-1 and Sakhalin-2 Agreements, calculation of royalties is made only after the beginning of realization.

V. Audit of accuracy and punctuality of tax calculations and payments by resource users to the federal budget in execution of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1. With the goal of realization of Item 13 of Federal Laws 12/30/95 №225 “On Production-Sharing Agreements,” on 05/27/97 the Sakhalin Regional Duma accepted Laws №36 and №37 of the Sakhalin Area “On taxation in execution of the Agreement for the development of the Chayvinskiy, Odortinskiy and Arkutun-Daginskiy oil-and-gas fields under the Production-Sharing Agreement” (Sakhalin-1 Agreement) and “On taxation in execution of the Agreement for the development of the Piltun-Astokhskiy and Lunskiy oil-and-gas fields under the Production-Sharing Agreement” (Sakhalin-2 Agreement) respectively.

In the preambles of the given laws defining the subject of the legislative regulation, the concept of “investor,” aside from actual investors, includes related organizations, contractors, and subcontractors presumably involved in the realization of works. This definition directly contradicts Item 3 of the Federal Laws “On Production-Sharing Agreements,” where it is stated that investors are: citizens

of the Russian Federation, foreign citizens, legal entities, and associations created on a contract basis for joint activities and not having the status of a legal entity, carrying out investments of their own or loaned funds in prospecting, investigation, and extraction of raw mineral materials and being resource users under conditions of the Agreement.

Aforementioned Laws №36 and №37 of the Sakhalin Area dated 05/27/97 conflicted with the Federal law “On Production-Sharing Agreements,” as the given Laws assume an expanded interpretation of the concept “investor.” In this connection, the given legislative acts are accepted by the tax entities of the Sakhalin area for use only regarding investors as defined by the Agreements and the Law of the Russian Federation “On foreign investments.”

2. According to Item 1 of Item 13 of Federal Law №225-F3 (12/30/95) “On Production-Sharing Agreements,” other than profit tax and royalties, during validity of the Agreement, the investor is released from the collection of taxes, duties, excises, and other obligatory payments (except for obligatory payments for social and medical insurance of workers, citizens of the Russian Federation, and also in the State Employment Fund of the population of the Russian Federation), as stipulated by the legislation of the Russian production-sharing under the Agreement’s conditions.

2.1. On conditions of the Sakhalin-1 and Sakhalin-2 Agreements, single payments (bonuses) for resource use are not included in the list of tax payments and, consequently, are removed from control of tax entities.

2.2. According to Item 22 of the Sakhalin-1 Production-Sharing Agreement, the Consortium pays the profit tax, value-added tax, payments for contractual water area, payments for geological study rights, and royalties for hydrocarbon extraction.

According to the given Agreement, profit tax is defined as the difference between proceeds from hydrocarbon extraction and expenses made in connection with development of the deposits. Profit taxes in the Russian Federation are at a rate of 13%, in the Sakhalin area – an additional 22% (total rate of 35%). Thus, the Agreement assumes a reduction in the rate if corresponding laws reduce them, by decrees or future decisions.

2.3. Under the Sakhalin-2 Agreement, Sakhalin Energy, its contractors, and subcontractors are payers of the profit tax, the VAT, and resource royalties.

According to the given Agreement, Sakhalin Energy, its contractors, and subcontractors pay profit taxes according to the Law of the Russian Federation “On the profit tax of enterprises and organizations.” The Agreement also determines that the conditions, rates, and order of collection of profit taxes shall remain unchanged during the entire validity of the Agreement. The cumulative rate of all

federal, regional, and local budgets for profit taxes from Sakhalin Energy, its contractors, and subcontractors shall not exceed 32%.

3. Federal Law №62-F3 (03/31/99) “Modifications and additions to the Law of the Russian Federation ‘On the profit tax of enterprises and organizations’” changes Item 5 of Laws of the Russian Federation “On profit taxes of enterprises and organizations,” according to which profit tax rates of enterprises and organizations, listed in the federal budget, is established at a rate of 11%, in budgets of subjects of the Russian Federation - under the rate established by the legislature of subjects of the Russian Federation, not over 19% (total rate no more than 30%). Law №109 (05/11/99) of the Sakhalin Area since April 1, 1999 establishes the rate of the tax enlisted in the budget of that area, at a rate of 19%.

4. Federal Law №32-F3 (02/10/99) changes the Law of the Russian Federation “On profit tax of enterprises and organizations” according to which “at execution of the Production-Sharing Agreements, entered into before enactment of the Federal law “On Production-Sharing Agreements,” applies conditions for the calculation and payment of profit tax, including the tax rate established by the specified agreements.”

5. Under Sakhalin area calculations for profit tax, investors did not advise the Management of the Ministry of Taxes and Tax Collection of Russia (the State Tax Service of Russia), since realization of the Sakhalin-1 project was in a preparatory stage (hydrocarbon extraction had not yet occurred), and under the Sakhalin-2 Agreement the first extracted oil was to ship for export at the end of September 1999.

6. The issue of compensating investors for VAT paid by them for the purchase of equipment and materials and the payment of services has not yet been resolved under the Sakhalin-1 and Sakhalin-2 Agreements.

6.1. Law №1992-1 (12/06/92) of the Russian Federation “On value-added tax” (ed. Federal Law 12/06/94, №57-F3) stipulates, that, in case of excess tax on commodity - material assets whose cost is actually attributed to production costs, for the above taxes estimated for realization of goods (projects, services), the subsequent difference is attributed to forthcoming payments or is compensated by general tax payments in a ten-day term from the date of receipt of invoice for the corresponding period.

6.2. According to the Sakhalin-1 Agreement, the Consortium and each Consortium member has the right to be reimbursed for VAT within 5 working days after submission of monthly tax declarations. In the instance that the full VAT reimbursement is not paid during the aforementioned 5 working day period, the unreimbursed VAT will be recorded in the financial reporting of the Consortium as the sum subject to payment by the Government of the Russian Federation, and for such sum the interest under annual LIBOR plus 4%, beginning the day directly following the last day of the above-stated reimbursement period, prior to full reimbursement of the sum is charged.

6.3. Under the Sakhalin-1 Agreement for September 1, 1999, VAT (including interest) subject to reimbursement is 28,550,610 US\$.

7. According to the Sakhalin-2 Agreement, any VAT paid by Sakhalin Energy, related organizations, foreign contractors, or subcontractors, are reimbursable within 5 days from submission of monthly reports reflecting such payments by the entity.

7.1. On December 29, 1997, S.V. Kirienko, the Minister of Fuel and Power on behalf of the Russian Federation and Sakhalin Energy signed a Memorandum of Understanding on regarding taxation, according to which unreimbursed VAT is listed in the Company's accounting documentation as the sum subject to payment to the company by the Russian Federation, together with annual interest under LIBOR +4 (4%), charged on that sum, beginning the day of the aforementioned five-day term directly following the last day and until all sums subject to reimbursement are paid in full.

Thus, the given regulation in the Sakhalin-1 Agreement, is distributed to the Sakhalin-2 Agreement. However, taking into account that the Memorandum of Understanding on taxation under the Sakhalin-2 Agreement was signed after enactment of Federal Law №255-F3 (12/30/1995) "On Production-Sharing Agreements", adding such a regulation to the Sakhalin-2 Agreement without legislative acknowledgement is wrongful.

7.2. As of September 1, 1999 under the Sakhalin-2 Agreement, unreimbursed VAT (including interest) totals 35,080,287 US\$.

8. Until 02/17/1999, the Management of the Ministry of Taxes and Tax Collection of Russia in the Sakhalin Area refused to reimburse the Companies for VAT due to a lack of corresponding alterations in the Law of the Russian Federation "On VAT." Simultaneously, the Management of the Ministry of Taxes and Tax Collection of Russia in the Sakhalin Area repeatedly put questions on VAT reimbursement to the Ministry of Taxes and Tax Collection of the Russian Federation and to the Regional Duma of the Sakhalin Area.

9. The problem of VAT reimbursement has been presented to the Accounting Chamber of the Russian Federation, directed in April 1998 to the Government of the Russian Federation, the State Tax Service of Russia, and in the report directed to the State Duma and Council of Federation. In Reply №ShS-15-01/325 (05/15/98), the State Tax Service of Russia informed the Accounting Chamber of the Russian Federation, that in the performance of the assignment of the First Vice-President of the Government of Russian Federation B.E. Nemtsov on 04/30/1998, the State Tax Service of Russia developed a corresponding mechanism for VAT reimbursement under the Production-Sharing Agreements.

However, up to 02/11/99, federal entities (Ministry of Fuel and Energy of Russia, the Ministry of Finance of Russia, the Ministry of Taxes and Tax Collection of Russia) had not established the order of VAT reimbursement, therefore, compensation at the moment of audit was not made and on a monthly basis the Russian Federation loses interest of about 250 thousand US\$.

10. Federal Law №32-F3 (02/10/99) “On changes and additions by the Russian Federation to the Federal law ‘On Production-Sharing Agreements’”, changes to the Law of the Russian Federation “On VAT,” providing special taxation for investors and the contractors working within the framework of the Federal law “On Production-Sharing Agreements” (reimbursement of VAT to the investor from the budget occurs even if the project is not completed). By law, it is also stipulated that in performance of Production-Sharing Agreements, entered into by the Russian Federation with investors before enactment of the Federal law “On Production-Sharing Agreements,” conditions for calculation and payment of the tax as established by the specified agreements applies.

Thus, the positions of the Memorandum of Understanding under the Sakhalin-2 Production-Sharing Agreement, questions on reimbursement of VAT to the investor are included in the contradiction with the named law as they change conditions of the Agreement entered in to prior to the enactment of the Federal law “On Production-Sharing Agreements.”

11. In connection with assignment of the State Tax Service of Russia (Letter №06-3-12/1, 05/26/98), in June - July 1998, the Management of the Ministry of Taxes and Tax Collection of Russia in the Sakhalin Area led documentary audits on the question of the accuracy of definition of the VAT reimbursement sums to operators under the Sakhalin-1 and Sakhalin-2 Agreements.

11.1. The audits established that, for the audited period, for the operator-companies Exxon (for the period 10/01/96-1/1/1998) and Sakhalin Energy Investment Company Ltd. (for the period 07/01/96-3/31/1998) the majority of audited tax declarations had infringements of Item 7 of the Laws of the Russian Federation (12/06/91) №1992-1 “On VAT” (taking into account changes and additions).

In particular, VAT reimbursements from the budget, not allocated by suppliers in primary documents and independently estimated at settlement were presented in the documents, in the acquisition of light cars, (credited) material resources (works, services) prior to their payment to suppliers, on material assets and services from physical entities, on material assets and expenses not connected to production (works, services), and other infringements.

11.2. As a result of the audits, there was an overestimate of the VAT presented for compensation (including discrepancies) by Exxon – 943311,7 US\$, Sakhalin Energy - 990629,9 US\$.

11.3. The expense account audit by tax bodies of the Sakhalin Area under the Sakhalin-1 and Sakhalin-2 Agreements is complicated by the following circumstances:

1). The expenses under Agreements passes through accounts open in foreign banks, not allowing an opportunity to carry out a reliable audit in connection with complexity of reception of the primary documents confirming payment of made charges outside the Russian Federation.

2). Calculation of the companies of all charges make on special system of accounts IDEAS which includes a combination of western and Russian accounting systems, developed especially for operators of the Sakhalin-1 and Sakhalin-2 Agreements by PriceWaterhouse, not corresponding to Regulations about structure of expenses on manufacture and realization of production (works, services), included in the cost price of production (works, services) and the order of formation of the financial results which are taken into account at the taxation of the profit, authorized by the Decision of the Government of the Russian Federation 05.08.92 №552 (in view of changes and additions). The companies' structure of expenses in the activity is not guided by the specified Regulations.

12. Resolution №740 (07/03/99) “On structure of expenses and compensation of expenses under the Production-Sharing Agreements,” authorized by the Decision of the Government of the Russian Federation, created conditions allowing investors not to execute the requirement, showed to the enterprises of the Russian Federation that can to lead to unreasonable increase in compensated expenses and as a consequence - to reduction in the hydrocarbon production share of the Russian Federation.

13. The Ministry of Taxes and Tax Collection of Russia (State Tax Service of Russia) was not involved in preparation of the Sakhalin-1 and Sakhalin-2 Agreements, projects of the given Agreements on the coordination regarding tax payments were not received by the Ministry, and did not participate in the negotiations on the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

In both projects' FEASIBILITY REPORTS there are no calculations comparing economic results of work in the conditions existing for Russian resource users and conditions attracting the investor based on the Production-Sharing Agreements.

14. During the Accounting Chamber audit, Chamber representatives together with Management of the Ministry of Taxes and Tax Collection of Russia on the Sakhalin area compared payments to the budget under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements and in conditions of the taxation resource users not using production-sharing agreements. It is established, that except for the Sakhalin-1 and Sakhalin-2 Agreements from total budgetary payments of deductions for mineral resource production, excises on hydrocarbons, and concessionary terms for profit taxes during extraction assumed according to conditions of Agreements of

volume of oil settlement reduce budgetary revenue in mid-annual calculation by 1875 million US\$, and for the entire period – by 61692 million US\$, including 51766,7 million US\$ in the federal budget.

Payment Deviations of for Sakhalin-1 and Sakhalin-2 Projects
from the existing tax laws (millions, US\$)

№P/P	Payment Type	Sakhalin-1 Project		Sakhalin-2 Project	
		Total	Federal Budget	Total	Federal Budget
1.	OVMSB	-19320	-19320	-4570	-45670
2.	Hydrocarbons excise	-10873	-10873	-10818	-10818
3.	VAT (internal market)	-	-	64,4	53,7
	VAT (external market)	-	-	-64,4	-64,4
4.	Profit tax	-12485	-4472	-3626	-1703
	Total	-42678	-34665	-19014	-17101,7

Drawing a full conclusion on efficiency levels of the given projects for the Russian party is not possible because the Russian party did not analyze the tax component of technical and economic parameters.

15. The audit of performance of representations of Accounting Chamber of the Russian Federation, accepted by the Boards of Accounting Chamber of the Russian Federation on April 17, 1998 based on results of the thematic audit of tax collection and payments in the budget under the Production-Sharing Agreements according to the Federal law “On Production-Sharing Agreements” in Management of the Ministry of Taxes and Tax Collection of Russia on the Sakhalin area, established:

15.1. Representation of Accounting Chamber of the Russian Federation on the Sakhalin area did not present information to the State Tax Service of Russia with Management of the Ministry of Taxes and Tax Collection of Russia.

15.2. As of today, there is an unfulfilled demand from Item 26 of the Federal law from 12/30/95 №255-F3 “On Production-Sharing Agreements” regarding acceptance of the necessary normative documents on special tax execution under Production-Sharing Agreements.

15.3. The debts for obligatory payments to enterprises of the Sakhalin area as of 09/01/99 totals 2073.4 million rubles, including in the federal budget – 1213.0 million rubles, or 58.5%. The arrears as of the specified date totals 1796.4 million rubles, including in the federal budget – 1086.4 million rubles, or 60.5% of the total arrears.

15.4. Debts on TEK enterprises as of 09/01/1999 under the consolidated budget are 417.7 million rubles, including to the federal budget – 266.0 million rubles, or 63.8%. The arrears in the consolidated budget are 395.1 million rubles, including in the federal budget – 258.6 million rubles, or 65.5% of the total arrears.

Thus, the arrears on TEK enterprises as of 09/01/99 to a total sum of arrears on all enterprises of area makes under all budgets of 22%, in the federal budget – 23.8%.

15.5. Arrears of obligatory payments in the budget as to all enterprises of the Sakhalin area, and on TEK enterprises, as of 09/01/99 in comparison with 01/01/99 has increased in the consolidated budget on all enterprises by 18%, including in the federal budget - on 26.4%, on TEK enterprises in the consolidated budget - on 27.2%, including in the federal budget - on 34.6%.

15.6. In the certificate of the previous audit of Accounting Chamber of the Russian Federation of the State tax inspection on the Sakhalin area from February 27, 1998, the main defaulters among TEK enterprises were the same enterprises.

15.7. Within the framework of the existing tax laws, tax bodies of the Sakhalin area worked with enterprises to decrease the arrears in payments in the budget (exhibiting of collection orders, withdrawal of available money resources, written requirements about repayment of arrears, acceptance of decisions about collecting arrears on property of the enterprises). So, for example, in March of that year the decision was made and directed to Management of Federal service of tax police of the Russian Federation on the Sakhalin area about tax collections, and penalty fees due to property SakhalinUgol for 279.9 million rubles; as of now the budget has not received anything.

Taking into account that the arrears on the main enterprises - defaulters of the fuel and energy complex in comparison with the previous audit of Accounting Chamber of the Russian Federation has decreased minimally, it can be concluded that efforts by tax workers of the Sakhalin area for reduction of debts do not give appreciable results.

15.8. In Presentation №03-03-15/137 of the Accounting Chamber of the Russian Federation to the State Tax Service of Russia on 04/22/1998, results of the previous audit noted that in infringement of Decision of the Government of the Russian Federation (07/24/95) №749 “On centralization in the federal budget of funds collected in payment

for land” the Finance administration of Sakhalin Area Administration does not list in the federal budget for 1995-1997 a due share of the land tax and rent at the rate of 8.7 million rubles (or 75% from due). The present audit established that for the specified period and for 1998, the funds collected in payment for land were not paid to the federal budget. As a result, the federal budget has received less than its share of land taxes subject to centralization: for 1995-1997 11552.9 thousand rubles, for 1998 – 4287.0 thousand rubles (considering denomination). The Finance Administration of Sakhalin Area Administration repeatedly addressed the Ministry of Finance of the Russian Federation and Management of the Federal Exchequer in the Sakhalin Area with the request to reckon the above-stated debts because of a transfer from the federal budget, but with no response.

15.9. In the presentation by the Accounting Chamber of the Russian Federation to the State Tax Service of Russia regarding the 1998 audit it was emphasized that maintenance of payments is significantly affected by a lack of appropriate interaction of tax bodies with the tax police (1996-1997 joint audits of large defaulters of Rosneft - Sakhalinmorneftegas, SakhalinUgol, Sakhalin Energy were not carried out).

During the current audit it is established, that tax bodies and the tax police did not audit large defaulters that, for 9 months of 1999, are the same enterprises.

15.10. In reply by the State Tax Service of Russia to the presentation of the Accounting Chamber of the Russian Federation on the results of the previous audit, there was information that in the third quarter of 1998, the State Tax Service of Russia plans to carry out a thematic audit examining the State Tax Inspection Service of the Sakhalin Area at execution of Production-Sharing Agreements by the results of which a decision to apply disciplinary measures will be accepted.

However, at completion of the present audit carried out by Accounting Chamber of the Russian Federation, it is established that the Ministry of Taxes and Tax Collection of Russia did not carry out an audit examining the Management of the Ministry of Taxes and Tax Collection of Russia of the Sakhalin Area.

16. Letter №01-05-03/1685 (08/24/99) Ministries of Taxes and Tax Collection of Russia have assigned the Management of the Ministry of Taxes and Tax Collection of Russia to lead on the Sakhalin area exit tax audit of Exxon and Sakhalin Energy on the following issues:

- calculation and payment of taxes, payments and fees for execution of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, including calculations and payments of VAT, royalties, rentals, bonuses, income taxes of foreign legal entities raised at a source of payment, local taxes, and tax collections;
- validity of interest expense for unreimbursed VAT showed by investors for reimbursement from the budget;

- results of previous tax audits in bookkeeping and tax reporting of investors presented to tax inspection in place of a tax accounting statement.

16.1. According to the aforementioned letter and according to Decisions №114 and №115 of Management of the Ministry of Taxes and Tax Collection of Russia on the Sakhalin area dated 08/30/99, currently exit tax audits are being carried out at the specified enterprises. At completion of the present audit by the Accounting Chamber of the Russian Federation, the audit by the tax entities of the specified enterprises is not finished

17. During audit of performance in Rosneft-Sakhalinmorneftegas of representation of Accounting Chamber of the Russian Federation from April 17, 1998 on the collection of taxes and budget payments under the Production-Sharing Agreements, entered into according to Federal Law №225-F3 (12/30/1995) "On Production-Sharing Agreements," at the enterprises and the organizations of the Sakhalin area it is established, that:

17.1. Fifteen structural divisions and representatives in Moscow, Yuzhno-Sakhalinsk, Khabarovsk, Vungtau (Vietnam) in structure of Open Society " Rosneft - Sakhalinmorneftegas " now are not legal entities and all calculations, including budget payments and unappropriated funds since November 1997 are from the uniform settlement account. It should be noted that from the moment of the previous audit the funds received in total amount of realization increased from 23% in 1997 to 75.4% six months in to 1999.

17.2. The account of the defaulter from the previous audit of Accounting Chamber of the Russian Federation in Rosneft-Sakhalinmorneftegas was not open, and with Russian Presidential Decree №734 dated June 29, 1998 canceling the action of Item 1-4 of Decree №1212 of the President of the Russian Federation dated August 18, 1996 about opening defaulters' accounts, the compulsion has lost urgency.

17.3. The arrears on payments in the federal budget as of January 1, 1999 was 54.2 million rubles, from them royalties – 22.6 million rubles, or 42%. As of September 1, 1999, the arrears on payments in the federal budget have decreased to 63.1 million rubles, from them royalties to 32.6 million rubles, or 51%. Thus, the decrease in the arrears in payments to the federal budget as a whole share of the arrears in royalties has increased in the first 9 months of 1999 from 42% to 51%.

17.4. In spite of the fact that Rosneft-Sakhalinmorneftegas has the aforementioned arrears in the federal budget, the enterprise continues financing the Sakhalin-1 Production-Sharing Agreement through a subsidiary, Sakhalinmorneftegas-Shelf. On July 1, 1999, the sum of the debt was 564,385,000 rubles, more than 5 times exceeding debts to the federal budget.

17.5. Investment in joint activity with RVO Zarubezhneft in the sum of 15,684,000 rubles, connected with operation of the drilling installation Kuril for work on the Vietnam shelf has not undergone changes as was a lump sum, and volume of long-term

investments in the joint activity of Gelengikturist connected to construction of a medical center has been reduced, owing to increased investment in projects from 8,298,800 rubles to 999,000 rubles.

17.6. Rosneft-Sakhalinmorneftegas had an opportunity to liquidate debts under taxes in the federal budget, as it had available remaining funds from the settlement account for 1/01/99 in the sum of 22,485,000 rubles and for 09/1/99 60,142,000 rubles for the same accounting dates made more than half of debts to the federal budget.

18. The audit has shown that from the moment of presentation of Accounting Chamber of the Russian Federation in the State Tax Service of Russia no documents were received concerning the essence of presentation Rosneft-Sakhalinmorneftegas.

18.1. Tax bodies of the Sakhalin area did not carry out audits for the same period on the given question on Rosneft-Sakhalinmorneftegas.

18.2. In the audited period delayed payments to the federal budget by Rosneft-Sakhalinmorneftegas were not paid.

VI. Audit of accuracy and timeliness of calculations and payments by resource users of insurance payments to state unappropriated funds under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1. All calculations on payments to state unappropriated funds were made by subsidiaries of Sakhalin Energy and Exxon only by way funds transfer to the subsidiaries' accounts.

2. The condition of calculations of the Sakhalin Energy subsidiary for insurance payments to the state unappropriated fund is characterized by the following data:

2.1. 8,006,600 rubles were subject to insurance payments to the Pension Fund of the Russian Federation in 1998, of which within a year 7,023,500 rubles have been paid. Overdue debts total 983,100 rubles. For 8 months of 1999, 20,631,700 rubles are owed, of which 21,689,500 rubles have been paid.

2.2. Insurance payments totaling 1,870,200 rubles have been paid to the Social Security Fund of the Russian Federation in 1998. Internal organizational expenses equal 290,500 rubles, of which 1331,900 rubles were paid. On 1/1/1999, debts against the Sakhalin regional branch of Social Security Fund total 591,000 rubles. For the first half of 1999, insurance payments total 2,740,900 rubles and expenses total 739,600 rubles. 2240,500 rubles were paid for repayment of duties to the settlement account of regional branch. Debts as of 07/01/1999 were reduced to 481,800 rubles. The debt was completely liquidated during the present audit.

2.3. 1246,900 rubles were paid to the obligatory medical insurance funds (3.6%) from in 1998, including territorial (3.4%) - 1177,600 rubles. Current debts totaling 174,800 rubles were liquidated by January 1999. The first 6 months 1999 charged 2143,100 rubles,

including in territorial - 2024,100 rubles. The debts as of 07/01/99 equaled 324,400 rubles were liquidated in July 1999.

2.4. Sakhalin Energy paid 667,100 rubles to the State Employment Fund of the Russian Federation in 1998 for insurance payments. From January until August 1999, it paid 887,200 rubles. Payments were made on time and in full.

3. The condition of the Exxon subsidiary's insurance payments is characterized by the following data:

3.1. 1270,800 rubles were charged to the Pension fund of the Russian Federation in 1998, while only 401,900 rubles were paid. The delayed debts on 01/01/99 in view of charged fines of 48,200 rubles equal 917,100 rubles. For the first 8 months of 1999, charges of 1879,800 rubles were made, while (including duties), 2758,600 rubles were paid.

3.2. Insurance payments to the Social Security Fund of the Russian Federation in 1998 totaled 275,200 rubles. The company's own charges for social insurance total 55,100 rubles, while 62,000 rubles were paid to the regional branch. On 1/1/1999, delayed debts against branch totaled 148,300 rubles. For the first half of 1999, payments 268,300 rubles were made. Own charges made for this period total 83,100 rubles; the regional branch was paid 287,900 rubles. As of 07/01/99, the current debts of the company totaled 48,900 rubles and were liquidated in July 1999.

3.3. Payments to the obligatory medical insurance fund in 1998 totaled 183,400 rubles, including in territorial - 173,200 rubles, while only 64,000 rubles were paid. Overdue debts on 01/01/1999 total 119,400 rubles, debts with fines of 56,300 rubles. Debts were liquidated in the current six months of the current year. For the first 6 months of 1999, 297,800 rubles were charged, including territorial - 281,200 rubles. The current debts as of 07/01/99 total 39,300 rubles and were liquidated in July 1999.

3.4. Insurance payments in the State fund of employment of the population of the Russian Federation in 1998 total 127,000 rubles, of which only 110,200 rubles were paid. Insurance payments totaling 30,000 rubles charged for in the first 8 months of 1999 are completely paid. The debts as of 01/01/99 total 16,800 rubles; as of 07/01/99, the debt was reduced to 7,300 rubles and liquidated during the audit in September 1999.

4. The delayed debts of branch of Sakhalin Energy for insurance payments to the Pension fund of the Russian Federation as of 01/01/99 totaled 983,100 rubles. The debt occurred in October 1998 in connection with the insolvency of the bank where the settlement account of the organization was located. For untimely payment of insurance payments are charged fines of 40,400 rubles. As of 09/01/99, debts on payments and fines were completely liquidated. Overpayment of insurance payments as of this date totaled 74,700 rubles.

The debts of this organization in Social Security Fund of the Russian Federation as of 01/01/99 totaled made 591,0 thousand rubles. During the audit (09/14/99), all company and subsidiary debts were liquidated.

There were no overdue debts in the State Employment Fund of the Russian Federation, or in federal and territorial funds of obligatory medical insurance branch of Sakhalin Energy in the audited period.

5. The overdue debts of the Exxon subsidiary for insurance payments in RFR as of 01/01/99 totaled 868,900 rubles. Late insurance payments are charged fines in the sum of 165,300 rubles. As of 9/1/1999, the debts were liquidated. The overpayment on insurance payments as of this date is 9,9000 rubles.

The debts of this organization in Social Security Fund of the Russian Federation as of 01/01/99 totaled 148,300 rubles. As of 09/01/99 all debts were paid.

The debts on insurance payments in the State Employment Fund on 1/1/1999 totaled 16,800 rubles. During audit, the remaining debts were completely liquidated by the company.

The overdue debts of the Exxon subsidiary for the Sakhalin territorial fund of obligatory medical insurance in 1998 made insurance payments of 119,400 rubles and fines of 56,300 rubles. During the first six months of 1999, the debts were liquidated. At the moment of audit there is no past due debt.

Agreements for the repayment of delayed debts on payments and fines in the state unappropriated funds with owners of licenses for using sites of resources did not consist, collection orders on their bank accounts were not made.

6. Settlement accounts of Sakhalin Energy and Exxon subsidiaries were in Sakhalin Inkombank.

In connection with the 10/29/1998 response, Inkombank has the right to carrying out of bank operations; the Sakhalin branch stopped account operations. September-October 1998, the specified payers made insurance payments in RFR totaling 1808,900 rubles, however the subsidiary account did not receive them. The bank claims a debt. Aside from the claimed sums, 409,300 rubles of fines are charged to the bank for delayed execution of payments. Branch claims in February and April 1999 are directed to the Pension fund of the Russian Federation for the decision of representatives of PFR by proxy branches regarding satisfaction of requirements to Inkombank.

The same bank in October 1998 did not make insurance payments to the current account of the Sakhalin regional branch of Social Security Fund of the Russian Federation in the sum of 21,200 rubles, transferred by an Exxon branch, and 294,600 rubles, transferred by a Sakhalin Energy branch. These payments were reissued by the specified organizations; claims for return of means to the Inkombank branch are showed by payers.

VII. Audit of legality, rationality of selection of legal entities among which orders were made for services, manufacturing of the equipment, means, and materials necessary for geological study, extraction, and primary processing of minerals at execution of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreement.

1. Legal basis for selection of legal entities among which orders for services, manufacturing of the equipment, means and the materials necessary for geological studying of extraction, and primary processing of minerals at execution of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

1.1. Federal Law №19-F3 of the Russian Federation dated January 7, 1999 (Item 2, Item 7) “On Production-Sharing Agreements” provides obligations of the investor “to grant to Russian legal entities the right of priority to participate in works under the Agreement as contractors, suppliers, transporters or in other quality on the basis of contracts with investors... to accommodate orders for manufacturing equipment, means, and materials necessary for geological study, extraction, and primary processing of minerals, at a rate of no less than 70% of the total cost of such orders to Russian legal entities and 30% to foreign legal entities carrying out the corresponding activity and registered as tax payers in the territory of the Russian Federation.”

1.2. The Sakhalin-1 Production-Sharing Agreement does not contain quantitative requirements to share participation with Russian organizations and enterprises under the Project. At the same time, in the Agreement (Item 21.3F) Item 6.1D stipulates the requirement that the investor in the presence of equivalent offers to performance contract works by Russian and foreign organizations is obliged to prefer the Russian competition participant.

1.3. The Sakhalin-2 Production-Sharing Agreement (Item 12.d) underlines that distribution of contracts for delivery of goods and/or rendering of services in connection with performance of the works of Sakhalin Energy shall first of all involve Russian enterprises meeting the requirements of the Project under price, quality and terms of performance of works. Moreover, the Agreement obliges the investor to arrange maximum increase in the share the Russian participation each year, and that the final share of Russian participation in works for the entire term of the project shall be 70%.

1.4. Concrete data regarding the participation of Russian contractors in projects is presented within the framework of special reports of project operators (Sakhalin-1 Project) annually and to the Supervisory Council (Sakhalin-2 project) - quarterly.

2. Organization of contract works and procedure to attract legal entities to perform works (services) under the Sakhalin-1 and Sakhalin-2 project Agreements.

2.1. Operators maintain lists of potential contractors and suppliers on the basis of own estimations and the information given to them by partners (other investors) and enforcement authorities of the Russian Federation in whose territory the works connected to the development of the Sakhalin shelf are carried out.

For the right to enter contracts or participate in competitions, the potential contractor should be provided a basic list of qualified contractors or to demonstrate to Sakhalin Energy that it has the corresponding financial and technical resources for delivery of such goods and services according to requirements for quality, terms, and pricing (Item 2.3. On organization of logistics and contract works. Piltun-Astokhskiy license site development project. Stage 1: Astokhskaya Area.).

The company develops a list of qualified contractors under each Project in view of initial information from the Russian party on qualified Russian contractors as stipulated in the Production-Sharing Agreement.

Sakhalin Energy specifies this list in each annual work plan and gives the Russian party an opportunity to offer Russian enterprises for their consideration for inclusion in such list. The applicants included in lists of qualified contractors receive an invitation from the company to apply for participation in the competition and a questionnaire.

2.2. Main principles and rules of activity for the purchase and conclusion of Exxon contracts as the operator under the Sakhalin-1 project are stated in the initial procedures of the conclusion of contract.

According to Item 4.2.1 of this document in a case when the bid is carried out on a competitive basis, the quantity and type of received offers depends on the estimated cost of the application. The consortium declares competition on all contracts where cost exceeds five millions US\$.

To be included in the list of applicants, from each supplier or contractor is required to prove convincingly enough for the operator that it possesses the financial and technical resources corresponding to the requirements of the operator (Items 6.3.3, Initial procedures of contract negotiations).

2.3. The process of informing the results of the competition (Item 6.4, Initial procedures of contract negotiations) is carried out by in writing, provides reception of information necessary for drawing up the contract.

2.4. Before application, the operator develops a plan of consideration of the application and organizes a “Contract Evaluation Work Group” for its review.

2.5. The plan of consideration of applications is broken into projects carried out after reception and opening of applications with the purpose of revealing most attractive. This plan provides for the study of all aspects of the application including technical opportunities, commercial questions, organizational competence, financial condition, mobilization readiness, and general appreciated expenses.

2.6. The main factors considered are:

- expense factors, including cost of the money connected to the offered payment schedule;
- technical conformity to specifications;
- requirements of the Production-Sharing Agreement concerning preference to the Russian party and preferable suppliers;
- actions and programs regarding safety precautions and protection of the environment;
- maintenance service and repair, and post-sale service (Item 6.7.2, Initial procedures for contract negotiations).

2.7. Consideration of applications should be documented to a card file and be included in the recommendation package. As a rule, the technical evaluation and the commercial analysis document are the review documents.

2.8. After consideration of applications or the negotiations process are complete, the recommendations are confirmed by the general director, or the representative appointed by him.

If the contract cost is:

- more than 2 million US\$ for the explorative period;
- more than 5 million US\$ for the development period, and also in case of presence of contracts containing deviations from initial procedures for contract negotiations, contracts with an incomplete application for more than 2 million US\$ or for more than 500 thousand US\$ with any operator subsidiary or any non-operator, the general director asserts the right to make recommendations to the working committee.

2.9. The final choice of the contractor is carried out with application of procedures established by operators.

These procedures include many factors depending on the size of the project (the contract, the order), his concrete requirements, importance, and amount of works. Key factors include:

- 1). Quality - the contractor should have a proven ability to perform the work (service) according to the quality standards and safety, accepted in the oil-and-gas industry, including performance of requirements connected to the safety of personnel and the environment.
- 2). Terms - at realization of such scale projects in view of a high degree of interdependence of stages and schedules even inside one object, and also in view of the short calendar period of favorable weather (the navigating period) - performance of

works (services) and deliveries of the goods in the terms established by the contract are extremely important characteristic.

3). Cost of works (services) - offered prices should be competitive in view of market conditions for the performance of the certain works (services). Preference shall be given to those contractors who can not only carry out the task on time, with high quality, but also finance these works independently before their full completion or conclusion of certain stages. Only after acceptance of volumes to receive payment from the operator on conditions agreed upon contractually.

4). Conditions of insurance - the contractor at own expense shall insure the personnel (including subcontractor personnel), machines, equipment, and materials. Insurance rates and sums will be stipulated beforehand by the conditions of the contract.

5). Guarantees - the contractor should guarantee the performance of works (services) according to the contract requirements. In the case of default of guarantee certificates on the part of the contractor, sanctions shall be made for the sum of the losses caused to the Project operator connected to a delay of performance of works on release of a product, delivery of object, rendering of other services can be applied.

2.10. Under the condition of conforming offers to participants of competition to requirements of Items 1-5, as stated in Item 2.9 of this section, operators of Agreements, in summarizing competitions shall prefer (all other things being equal) enterprises and organizations from among Russian contractors. (An enterprise is considered Russian if direct or indirect individual share in it of Russian legal or physical entities, including state bodies, total 50% or more).

Monitoring over the observance of interests of the Russian contractors shall be carried out by the AFE (Sakhalin-1 Project) and the Supervisory Council (Sakhalin-2 project). The applicant winning the competition shall sign a contract for the performance of works or services.

2.11. The main principles and rules of activity for purchase and the conclusion of contracts for the performance of works (services) under the Sakhalin-2 project are stated in "Order of logistics and contract works, Piltun-Astokhskiy license site project development. Stage 1: Astokhskaya area."

According to Item 2.2 "On logistics and contract works," Sakhalin Energy should aspire to competitive distribution of all contracts and orders for delivery, except in cases when the price of the contract is minimal or there is only one qualified contractor. In addition, all contracts on the delivery of goods (services) above 15 million US\$ should be distributed by the company on a competitive basis among potential contractors adequately qualified to established conditions, except in cases of acceptance by the Supervisory Council of other decisions. In the case of the presence of only one qualified contractor, Sakhalin Energy shall negotiate the contract with said contractor.

2.12. The subsequent stages on the conclusion of contracts under the Sakhalin-2 projects a whole are similar to the stages stated in Initial procedures of the conclusion of contract contracts (the Sakhalin-1 project).

2.13. The presence of “Initial procedures for the negotiation of contracts” (the Sakhalin-1 project) and “On logistics and contract works” (the Sakhalin-2 project) do not give the Russian party guarantees that contracts will be conducted on an exclusively competitive basis.

At a session of the Supervisory Council (Report №6, 11/12/1997, Items 6,7, 13), it was noted that for the third quarter of 1997 of 35 made contracts 23 were made without competition, and the majority of them with foreign contractors. Some potential contractors were not notified of contracts assumed for conclusion, although as by the audit, the Order of logistics and contract works by this time had already come into force.

2.14. A legitimate opportunity for the acceptance of decisions at any stage of the competition is created by the lack of requirements to competition by suppliers, contracts and orders it was carried out on one variable parameter under all other rigidly fixed boundary conditions, or on several variable parameters, but at presence of the uniform formula (with weight factors on each variable parameter), reducing variable competitive parameters to a scalar.

3. On attracting of Russian enterprises and organizations to participate in the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

3.1. The operator of the Sakhalin-2 Production-Sharing Agreement should provide 70%age share of the Russian participation in the Project by manufacture of the necessary goods and services.

Thus, Sakhalin Energy guarantee a 70% level of Russian participation in their quarterly or annual calculations or fo r all the past period, justifying that by the interpretation that the 70% share is the level that is necessary to during the entire validity of the Project. (Report №4 of the session of the Supervisory Council, Items 3-4, 04/23/97).

Taking into account the open-ended character of the given Agreement, it can be asserted with a high degree of probability that achievement of 70% Russian participation in the Agreement is an obligation that cannot be executed.

3.2. In November - December 1994, the Sakhalin Area Administration together with the Committee of the Russian Federation on Defensive Industries, the Ministry of Fuel, and Energy of Russia and the administrations of other areas and regions of Russia conducted an initial study of potential Russian contractors under the Sakhalin-2 project.

The foreign participants included representatives of the companies Sakhalin Energy, Mitsui, and Diamond Hydroelectric Power Station B.V.

Meetings in the cities of Yuzhno-Sakhalinsk, Korsakov, Sovgavan, and Komsolmolsk-na-Amur, Nogliki, Khabarovsk, Vladivostok, and Moscow in which representatives of 90 Russian enterprises and organizations from such areas as research, design, construction, transport, and communication were included on the list. 17 enterprises were visited.

3.3. Development and realization of the program of preparation and participation of Russian enterprises in the realization of oil-and-gas projects of development of a continental shelf is carried out in the Sakhalin area according to orders of the governor of the Sakhalin area (№562-r on 12/22/95, №207-r on 07/26/1996, etc.).

The Agreement between the Sakhalin Area Administration, the Khabarovsk and Primorsky regions from June 30, 1997 “On the development of economic cooperation” whose subject (Item 1.5.1) describes “the interaction of parties in questions of maximal use of the capacities of industrial, scientific, building, transport and other enterprises and organizations, and also techniques, equipment and materials of the Sakhalin area. The Khabarovsk and Primorsky regions in the performance of contract works and services connected to investigation, extraction, transportation, and use of oil and gas, construction of objects of industrial and infrastructure within the framework of the Sakhalin-1 and Sakhalin-2 projects.

3.4. Within the framework of performance of Agreements, lists of potential contractors of the Sakhalin area, the Primorsky and Khabarovsk regions, including 365 organizations and enterprises were developed and communicated to operators of the Projects.

The Ministry of Fuel and Energy of Russia conducted works on providing Project operators information on potential Russian contractors though initially the information was insufficient (Reports of the Supervisory Council, 11/20/96 and 01/22/97).

3.5. In 1999, the Ministry of Fuel and Energy of Russia together with the Ministry of Economics of Russia, RKA and Open Society KomPomash completed an edition of “Composite Catalogue of equipment, materials, and services for the oil-and-gas industry” containing data on more than 260 enterprises and organizations of Russian industry providing oil-and-gas equipment (under 240 integrated listed products and services) for the project operators.

The specified Catalogue in May 1999 was transferred in the working order to the representative of Sakhalin Energy.

3.6. Now, the Ministry of Fuel and Energy of Russia carries out work on the development of an electronic database on equipment for the Sakhalin-2 project.

The Ministry of Fuel and Energy of Russia also conducted consultations and meetings with representatives of Russian enterprises on regarding their participation in realization of projects of shelf development at a conference and exhibition on the topic.

Work on the selection, study, and preliminary qualification of Russian enterprises and organizations by Project operators are conducted with the use of their own database and information from the Ministry of Fuel and Energy of Russia, Sakhalin Area Administration, and other sources.

3.7. Operators, by telephone and letters of enquiry, carry out preliminary qualification of Russian contractors concerning opportunities of manufacturing of required production, use of special commercial and technical questionnaires, meetings with representatives of the enterprises and organizations, participation in exhibitions, conferences, and seminars.

3.8. Exxon is conducting specified works in the framework of “Strategy of attracting of Russian contractors.”

In 1996-1997, Exxon conducted studying and pre-qualifying selection of potential Russian contractors in these areas: equipment (units), heavyweight steel, pressure vessels, heat exchangers, etc. Works were carried out with 60 Russian enterprises and organizations, including leading defense complex enterprises (SevmashPredpriyatie, Zvyozdochka, Izhorskies Factories, NPO Iskra, TsKB MT Rubin, TsKB Korall, Leningrad Metal Factory, etc.).

Exxon estimated the number of the enterprises that pre-qualified. A number of enterprises do not correspond to requirements of the Investor, which may be eliminated under condition of consecutive performance of corresponding plans.

3.9. Sakhalin Energy is guided by the “Evaluation Method for Russian contractors” in the given project.

On the data submitted during audit by Sakhalin Energy, 54 Russian suppliers were approved by the Operator, separate which kinds of production or their manufacture as a whole are certificated or prepared for certification under the international standards (AS ME, API, ISO, etc.). Of 54 enterprises, 18 manufacture materials (mainly various grades of steel), 4 manufacture steel designs, 32 manufacture and deliver oil-and-gas equipment.

In Far East region, of 40 enterprises, more than 20 are focused on production of interest to the Sakhalin-2 project. Perhaps 30 of 75 scientific research institutes and KBs available in region, about 20 of 70 building organizations working there, and 75 of 90 organizations specializing in providing services may be attracted to the project.

3.10. From operator materials and results of discussions that took place with operators’ representatives during the audit, it follows that principal causes of discrepancy are:

- lack of experience manufacturing equipment with the requirements needed on the shelf (climatic, mechanical, ergonomic, etc. parameters),
- lack of necessary experience conducting commercial operations with international consumers,
- insufficient level of safety precautions and labor safety;
- lack in some cases of certificates of quality under international standards,
- unreliable deliveries of products;
- weakness of financial position and, as a consequence, difficulties with purchase of materials and completing products;
- inefficient technical and economic parameters, in particular, because of high tariffs for transport charges;
- impossibility in some cases to provide complete delivery of systems (complexes) of equipment and service over the lifetime development of the deposits (25+ years).

4. Work of management entities for the expanded participation of Russian enterprises and organizations in works under the Sakhalin-1 and Sakhalin-2 Agreements.

4.1. With the purpose of expanding participation in the Project of Russian enterprises and organizations, the management entities for the realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, alongside with work carried out on a constant basis by working groups, the joint committee of the Supervisory Council and the Department of Natural Resource Development of the Continental Shelf (Sakhalin Area Administration), have performed the following work:

- introduced an Order organizing logistics and contract works for development of the Piltun-Astokhskiy license site;
- ratified “Regulations about a joint committee” and agreed upon participation of joint committee Sakhalin Energy’s process of organizing contract works in all stages of development (except for decision-making on winners of competitions and contract negotiations);
- made consistent the procedure nominating suppliers of financial, marketing, non-production, and other services;
- solved methodical issues regarding the mechanism of contract works and definitions of share of participation of Russian contractors under the Production-Sharing Agreements,
- expanded work to create a database of potential Russian contractors,

- established norms for size of contracts concluded on a competitive basis,
- reconsidered previous decisions on contract negotiations to expand the share of participation of Russian organizations under the Production-Sharing Agreement;
- executed necessary requirements of the Russian party concerning granting of information by Sakhalin Energy regarding contract works and “transparency” of work under the announcement of competitions, their results, and contracts with winners of competition;
- planned measures coordinating the Sakhalin-1 and Sakhalin-2 projects regarding creation of a joint infrastructure and, in particular, on designing sea platforms by Russian institutes and their manufacture in Russia with maximal use of Russian potential.

4.2. Under the Sakhalin-2 Agreement, Sakhalin Energy should present each session of the Supervisory Council reports on the program performance of Russian staff using the professional development program. Moreover, in the general report on the state of affairs, the company should specify the number of employees, the number of Russian citizens working in an aggregate number, number of persons completing professional development training, and the number of non-production and supervisory posts.

4.3. Interagency Working Group for the Protection of Russian Business Interests in Competitions and Tenders for Realization of Contracts and Services was not used. The aforementioned Commission of the Government of the Russian Federation formed by the Decision on December 29, 1997 was not used. No sessions of the specified working group took place.

5. Results of work on attracting Russian enterprises and organizations under the Sakhalin-1 and Sakhalin-2 projects.

5.1. According to reports on the contract works given during the audit by Exxon, and reports on attracting Russian businesses, submitted by Sakhalin Energy, analyses the data on the Russian participation in realization of the Sakhalin-1 and Sakhalin-2 Agreements. From resulted by resource users the data follows:

1). Under the Sakhalin-1 Agreement:

- in 1997 and 1998, 56 Russian organizations (basically Sakhalin) received contracts to perform works;
- the quantity negotiated contracts reflect a participation share by Russian enterprises in 1997-1998 is 55.4% and 68.8%, based on total contracts for the specified period of 55.0% and 56.5%;

- there was a decrease, since 1998, in total Sakhalin Energy work contracts and in the quantity of contracts made with Russian enterprises. In 1998 in comparison with 1997 the total contracts decreased by 3 times, contracts with Russian enterprises by 2.5 times, accordingly the sum of contracts by 11.3 and 10.8 times. In the first quarter of 1999, that trend was preserved.

From important contracts entered in 1998 under the Sakhalin-1 Agreement, it should be noted that NK Rosneft together with eight Russian project institutes (including TCKB MT Rubin, TCKB Korall, CahNIPI, VNIPI) worked on a conceptual design of an operational platform.

2). Under the Sakhalin-2 Agreement:

- Russian contractors and subcontractors for July 1, 1999 had 1103 contracts valued at more than 404 million US\$, including Sakhalin contractors with contracts of 350 million US\$;

- based on the quantity of contracts, the Russian enterprise share of participation in 1996-1998 was, respectively 54.5%, 29.0%, 48.9%; and total agreements - 76.9%, 50.2%, 58.3%.

Contracts with Russian contractors in connection Sakhalin-2 Agreement projects consist basically of re-equipping the Molikpak platform for oil recovery in the complex conditions of the Sakhalin shelf, trade operations (drilling, start-up, and adjustment projects), transport services, rent of technical means, industrial and residential construction, civil projects (settlement Zimnoe, 37 million US\$; new offices, 8.2 million US\$; camping in Nogliki, 2.8 million US\$; total 48.0 million US\$), energy and water supply, food deliveries, medical services, design and scientific exploratory work, maintenance of various regulatory, technical, and legal decisions. There are Practically no contracts for creation and delivery of highly technical equipment necessary for realization of the Sakhalin-2 Agreement.

There were cases when the Russian party was not offered any potential contractor work, in connection, with which contracts were made with foreign suppliers—in the first quarter of 1997, large contracts not using Russian enterprises were negotiated. These contracts include the actual purchase of the Molikpak platform (29,000,000 US\$), two contracts on its towage (6,900,000 US\$), and a contract to manufacture the technological module (12,495,000 US\$).

At a session of the Supervisory Council on April 23, 1997 in Yuzhno-Sakhalinsk, low participation by Russian contractors was justified by Sakhalin-2 project representatives of Sakhalin Energy:

- two Russian enterprises participated in the competition—Amur Ship-Building Factory (ASF) and a Russian shipping company. ASF subsequently withdrew its bid. After visiting the second enterprise participating in competition, representatives of Sakhalin

Energy and marine inspectors concluded that its ships are insufficiently equipped for towage of a platform;

- of 17 contracts valued from under 3 million US\$ to 5 million US\$, the Russian party was not offered any large-scale contracts for potential Russian contractors;

- Russian companies possessed minimal experience;

- the 70% share for Russian participation specified in the Production-Sharing Agreement is the goal of the entire term of the Project.

According to Item 13 of the Sakhalin-2 Production-Sharing Agreement, Sakhalin Energy should provide maximal participation of Russian citizens in projects located in Russia, connected with the Agreement, including work carried out directly by the company as well as work of operators and subcontractors. In performance of this obligation, Sakhalin Energy shall report use of Russian staff in Russia indicating the proportion of Russian citizens working and professional development, which should include an estimation of quantity and types of training considered expedient employing Russian labor.

5.2. Taking into account the scale and complexity of the Sakhalin-1 and Sakhalin-2 projects and that their investors are affiliated companies of world leaders in the oil-and-gas industry, basic economic and social effects can be achieved by maximal involvement of Russian organizations, companies, and enterprises in the projects.

5.3. As a whole, the proportion of Russian contractors in the Sakhalin-1 and Sakhalin-2 projects based on the investors' data is 55%-58% (in terms of cost)—insufficient for the initial stages of work in development of the Sakhalin Island shelf and demands measures to raise levels to 70% or higher.

5.3. The opportunity to for almost limitlessly reimbursement for expenses prompts the operator to purchase the most costly contracts, the most expensive equipment and services from “its” or “friendly” companies, with the natural aspiration of foreign companies to operate in coordination with equipment and services manufacturers does increase the share of Russian contractors in the Sakhalin projects.

As it was already noted, according to the Sakhalin-1 and Sakhalin-2 Agreements, the investor can include any structural costs in the budget. Moreover, it is advantageous to the investor to serve as the operator of projects under the Agreement; in many cases the investor can benefit not from profitable production but from income from foreign contractors, who are, in some cases, affiliated entities.

Low participation of Russian contractors in works under the Sakhalin-1 and Sakhalin-2 project competitions will be influenced by the existing practice of contract competitions using a multitude of variable parameters and an absence real

leverage on the part of authorized federal entities and the Supervisory Council to limit non-competitive contracts being negotiated in the future.

6. Projects related to the Molikpak platform.

According to the work plan, Sakhalin Energy has conducted a lot of commercial activity, construction of industrial installations, and equipment assembly. The permanent, ice-resistant marine platform Molikpak will consist of the following blocks, units and modules: supports under the platform base, platform base, technical module; drilling block; the residential block. Only 2 blocks are new—the additional ice-resistant steel base (a support under the platform base) and the technical module. All the others were made during construction of the Molikpak platform in 1982 and modernized in 1997-1998.

Manufacturing of the platform base support caused by the necessity of increase the height of the platform to 15 meters was carried out at a shipbuilding factory in the city of Komsomolsk-Na-Amur in 4 blocks, with subsequent transportation and assembly to a single whole in a factory in Bolshoy Kamen'.

After final assembly of the support in Bolshoy Kamen' (Primorsky Krai), it was towed to the DEU shipyard (Okpo, Korea) where modernization and repair of the Molikpak platform for subsequent joining to the platform and the support was carried out.

The Gosgortekhnadzor of Russia conducted an audit and monitoring using non-destructive methods of all equipment of the drilling block on the Molikpak platform, built and established in 1982.

6.1. 53,607,000US\$ were spent for manufacturing, testing, and delivery of the steel basis (curbstone) to the platform assembly location. 35,500,000US\$ were spent for projects at the shipyards of the Amur Ship-Building Factory (Komsomolsk-on-Amur).

6.2. 71,393,000US\$ were spent for modernization of the upper structures of the Molikpak platform at DEU (South Korea) shipyards, of which 19,771,000US\$ exceeded initial budget projections. Thus, the work conducted by companies at the Amur Shipbuilding Factory shipyards is 28% of the total expenses for manufacturing, testing, and delivery of the steel foundation (curbstone) to the platform assembly location, and on modernization of the upper structures of a platform.

6.3. In reality, this cost could have been much less, since with this kind of purchase it would have been impossible to obtain reliable and complete data on either the design and equipment or their cost.

6.4. Budget overruns for modernization of the upper platform structures can be explained by (according to materials of the Supervisory Council session on 12/10/1998) the fact

that only a small share of initial costs was spent on the old platform (approximately 10%).

The initial budgets included incomplete expenses updating of out-of-date blueprints and data, and the replacement of a greater than predicted amount of equipment in order to meet the strict requirements for the platform's operation in conditions of the Sakhalin shelf.

Cost overruns included:

- HVAC system for the residential module – 1,500,000US\$;
- HVAC system for the pump module – 250,000US\$;
- General HVAC – 300,000US\$;
- Intermediary steel bases of a platform – 2,750,000US\$;
- Safety system – 1,500,000US\$;
- Drilling systems – 1,690,000US\$;
- Delivery and installation of equipment, etc. - 11,781,000US\$.

6.5. According to Sakhalin Energy, 133 experts (of whom 123 are Russian citizens) work on the Molikpak platform. (These data were not audited on payrolls).

6.6. Realization of the Project as a whole provides for the construction of two more oil platforms on the Piltun-Astokhskiy deposit and two gas condensate platforms on Lunskiy deposit.

VIII. Use of federal property

1. The Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements do not stipulate use of federal property. At the same time, directly or indirectly, use of federal property for realization of the given Agreements occurs.

1.1. The credit mentioned in Item 2.2.2 (Section III) in the amount of 348 million US\$ is submitted a guarantees by sponsors (before end of the project), and also under granting creditors a charge on all movable and real estate of Sakhalin Energy, including resource use rights under the Production-Sharing Agreement and insurance policies.

1.2. In the Sakhalin-2 Production-Sharing Agreement, priorities have not been set for expense reimbursement for credit and financial services. This has allowed Sakhalin Energy, without coordination with the Supervisory Council, to pay one of its own founders (Mitsui Sakhalin Development Co. Ltd.), an affiliated entity 870,000US\$ to be paid at upon contracting with the auditor, PriceWaterhouse Coopers, an indirect fee for providing certain expertise and services. A similar indirect fee certain expertise and services connected to construction of a liquefied natural gas factory totaling 10 million US\$ was paid to another founder, Shell Sakhalin Holding B.V.

Interest for the credit will be paid by These “services” by affiliated entities will be paid, according to the Agreement, by compensatory production, that is, reducing the share of profitable production, causing an income reduction for the federal budget of the Russian Federation. Conditions for the loan (348.0 million US\$), in coordination with the European Bank of Reconstruction and Development, the Overseas Private Investment Corporation (OPIC), and the Export-Import Bank of Japan (JEXIM) assume its use in concealed, veiled form of budgetary funds and properties not stipulated by the Agreement in the form of resource rights.

2. Within the framework of project work under the Sakhalin-2 Agreement, the Russian party received its main funding from the federal budget received as single payments (bonuses) in interests of the Sakhalin-1 and Sakhalin-2 Agreements. So, the 1999 budget, authorized on February 1, 1999 by the Deputy Minister of Finance of the Russian Federation, M.A. Motorin, and the Deputy Minister of Fuel and Power, V.Z. Garipov, stipulates the a total sum of 882,600 rubles.

Since the special-purpose designation of funding received from the federal budget is the support of the Russian party, the Commissions for the development of resource use, the AFE, and the Supervisory Council, the funds can be attributed to the indirect use of federal property under the Sakhalin-1 and Sakhalin-2 Agreements not stipulated in Agreements.

3. According to Item 128 “Matters of civil rights” of the Civil Code of the Russian Federation, information is related to civil rights matters.

3.1. With reference to information received from prospecting, Federal Law №225-F3 dated 12/30/1995 “On Production-Sharing Agreements” in Item 2 Item 11 (“Right to property ownership and information”) concretizes this position and directly assigns property rights to given information to the state: “All primary geological, geophysical, geo-chemical, and other information, data on its interpretations derivative data, and samples of rocks, cores, and liquids received by the investor as a result of works under the Agreement belongs to the state.”

3.2. In the Agreements primary geological, geophysical, geo-chemical and other information, data on its interpretations and derivative data, and also samples of rocks,

including cores, liquids received by the investor as a result of performance of works under agreements are not mentioned as property rights.

Moreover, if according to Item XXXI of the Sakhalin-1 Production-Sharing Agreement, the parties “can freely use information for the purposes necessary for performance of obligations under the present Agreement, including disclosing of information to related organizations and its use by them for these purposes”, as well as provide the information to other entities according to the given clause of the Sakhalin-2 Agreement, then this question is not settled at all.

3.3. The rights of the state established by federal legislation to primary geological, geophysical, geo-chemical and other information received by the investor as a result of performance of works under the Agreements does not mention and does not worsen commercial results of activity of the investor, accordingly do not violate the requirement of Item 28.5 of the Sakhalin-1 Agreement and Item 24(G) the Sakhalin-2 Agreement. Thus, use by the investor of geological, geophysical, geo-chemical data, and other information received by said investor during performance of projects is the use of federal property.

3.4. An audit of AFE and Supervisory Council documents has shown that insufficient attention was paid to information as a special kind of federal property.

VI. Conclusions:

1. Regarding conformity to federal legislation about the negotiation and positions of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements:

The government of the Russian Federation entered the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements with infringements of regulations Items 13 and 17 of Law №2395-1 “On Resources” in effect at the time of signing from February 21, 1992.

In infringement of Item 13 of the specified Law, under the conditions of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, competitions for resource use rights were not carried out. Thus, the Ministry of Fuel and Energy of Russia’s (as the federal representative) action, signing the Sakhalin-1 and Sakhalin-2 Agreements, according to Item 17 of Law №2395-1 (2/21/1992) “On Resources” of the Russian Federation is an unauthorized action of a government entity.

The Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, in infringement of Item 10 of the Law “On Resources” an Item 40 of the Law “On Foreign Investments in the RSFSR,” both in effect at the moment of the Agreements’ signing, are, essentially ,open-ended.

According to the Sakhalin-2 Agreement, customs entities of the Russian Federation and state environmental monitoring agencies, should not be guided by legislative regulations, but rather, the given Agreement.

The planned (by the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements) exclusion from payments to the budgets of deductions for hydrocarbon production, excises on hydrocarbons for the extraction period predicted in accordance with Agreement conditions, reduces payments to the budget at the semi -annual calculation by 1875 million US\$, and for the entire period - by 61692 million US\$, including payments to the federal budget by 51766.7 million US\$.

Nevertheless, according to the regulation of Item 2, Federal Law “On Production-Sharing Agreements,” the Sakhalin-1 and Sakhalin-2 Agreements have been enacted and are subject to execution according to the conditions set forth in them.

2. Regarding maintenance of the rights and interests of the Russian Federation:

2.1. In the Agreements, no approval of the annual report on execution of the work plans and budgets is required; there are no real restrictions on the structure and quantity of expenses reimbursed by Russian raw materials.

In the Sakhalin-1 Agreement, there is no requirement to conduct an annual audit and reimbursable expenses are not set forth by categories.

2.2. In the Sakhalin-1 and Sakhalin-2 Agreements, the interests of the state regarding ecology, resource use, budget receipts, and state control are insufficiently taken into account.

2.3. Contrary to Regulations №588 (5/17/1997) and №950 (8/13/1998) about the Ministry of Natural Resources of the Russian Federation, approved by the Government of the Russian Federation, the Ministry of Natural Resources, as the state manager of the federal resources fund, fails to monitor resource users during realization of Production-Sharing Agreements of Sakhalin-1 and Sakhalin-2.

2.4. The government of the Russian Federation has not reviewed working statutory acts of environmental protection agencies, boundary, customs, and tax services in view of the Federal Law “On Production-Sharing Agreements.”

2.5. The Government of the Russian Federation does not monitor the execution of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements or the volumes of extracted raw hydrocarbons.

2.6. The Commission of the Government of the Russian Federation for the coordination of federal enforcement authorities and government agencies of the Russian Federation does not solve to the fullest extent possible the problems of

realization of Production-Sharing Agreements (definition and decision of questions of coordination, sanctions, approval, and agreements, including state ekspertizas on technical, economic, and environmental problems). The specified Commission has not solved problems related to reimbursement of customs payments and VAT.

2.8. The Board of Representatives of authorized federal entities (the Sakhalin-1 Agreement) and the Supervisory Council (the Sakhalin-2 Agreement) have completely failed to protect the interests of the Russian Federation, as stipulated by the given Agreements:

- until November 1998, the authorized federal entity did not lead any sessions; the coordination of annual budgeting and work plans was conducted by correspondence only; and the Board did not execute demands to the project operator to conduct bookkeeping in Russian, present primary documents in the Yuzhno-Sakhalinsk office, or carry out annual audits;

- representatives of the Ministry of Finance of Russia, federal tax bodies, and international accounting, finance, and economic experts were not included in the structure of authorized federal entities;

- the Supervisory Council did not provided demand financial activity reports from the operator of the Sakhalin-2 Agreement according to conditions of the Agreement and Russian legislation.

2.9. No sessions of the Interdepartmental Working Group for the protection of Russian enterprises interests in competitions and tenders for the realization of contract works and services have taken place. The IWG was formed on December 29, 1997 by the decision on the Commission of the Government of the Russian Federation for the coordination of the activities of federal enforcement authorities and of the Russian Federation for the realization of Production-Sharing Agreements.

2.10. Ministry of Fuel and Energy of Russia insufficiently effectively works on the creation of a database of potential Russian contractors. The information is being organized without using the existing classification system of manufacturing and services under the Sakhalin-1 and Sakhalin-2 projects.

2.11. Unconditional competition for the selection of contractors under the Sakhalin-1 and Sakhalin-2 Agreements (for the purchase of equipment and services) is not being used. Initial Procedures for Contract Negotiations (Sakhalin-1 project) and the Procedure for Organization of Logistics and Contracts (Sakhalin-2 project) contain requirements according to which agreements for contract work should be made on an extremely competitive basis.

At the same time in the third quarter of 1997, of 35 contracts made by Sakhalin Energy, 23 took place without competition, and the majority of them were made with foreign contractors.

2.12. Competition requirements (for suppliers, contracts and orders) and the competition winner are both defined by the investor. The choice of contractor is carried out in the absence of requirements that the competition be carried out on one variable parameter (with other variables being fixed), or on several variable parameters with a uniform formula (with weight factors on each variable), thus reducing variable competitive parameters to a scalar. A similar approach creates legitimate opportunity for acceptance of any decisions at any stage of the competition.

2.13. Operators of Agreements do not provide a 70% participation of Russian manufacturers of goods and services. The operator of the Sakhalin-2 Agreement considers this requirement only as it applies to the entire term of the project, which, due to the lack of a definite end to the project, releases the operator from performance of the given obligation.

3. Regarding realization of the Sakhalin-1 Agreement:

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4. Regarding realization of the Sakhalin-2 Agreement:

4.1. An operative estimation of geological stocks of the Piltun-Astokhskiy and Lunskiy deposits, the right of use with which is given under the Sakhalin-2 Agreement, is estimated at 590 million tons of oil and 636 billion cubic meters of gas.

For financing the first stage of development of the Piltun Astokhskiy deposit, the European Bank for Reconstruction and Development, the Overseas Private Investment Corporation (OPIC), and the Export-Import Bank of Japan (JEXIM) have offered Sakhalin Energy a loan of 348 million US\$, totaling 50.3% of the estimate development budget. The loan has been given for a ten-year period, with an average interest rate of LIBOR + 2.125% annually (before the end of the project) and at an average rate of LIBOR + 3.292% annual (after end of the project). The loan was carried out with sponsor guarantees (before end of the project) and the creditors charge for all movable and real estate of the company, including rights under the Production-Sharing Agreement and insurance policies.

4.2. In the Sakhalin-2 Production-Sharing Agreement, loan conditions (a maximum level loan interest rate) are not determined, giving the investor the opportunity to get loans from anyone, with no limitations, while expenses to service the loan are compensated by Russian raw materials.

4.3. According to the June 5, 1999 report from Sakhalin Energy, realization of the Sakhalin-2 Agreement will cost 5.093 billion US\$.

As of December 31, 1998, 957.3 million US\$ has been invested in the project.

The expenses subject to compensation of Sakhalin Energy, as of December 31 1998 equal 813.127 million US\$, or 85% of investments.

4.4. The project operator is artificially restraining development of the Piltun Astokhskiy deposit as a whole and works on Lunskiy deposit:

- Sakhalin Energy offers the concept of step-by-step development of the Piltun Astokhskiy deposit and proceeding from this concept, develops documentation for the development of separate sites instead of the deposits as a whole. This could lead to extending the entire term of development of a deposit as a whole;

- work on the Lunskiy deposit are in the preparatory stage of the development plan which depends on factors not allowing completions of preparation of the development plan and other documents stipulated by the Sakhalin-2 Agreement such that, according to the procedure established in the Agreement, to declare prior to the beginning of development of the Lunskiy deposit.

4.5. The financial and economic activities of Sakhalin Energy precludes objective evaluation:

- in infringement of Item 4, Appendix A, Sakhalin-2 Agreement “Principles of Bookkeeping,” in 1998 the company submitted a budget not corresponding to the Principles of Bookkeeping in regard to expenses, thus the quantity stated expenses was reduced from 17 in 1996 to 6 in 1998; in the budget, integrated expense categories were authorized from which subsequent charges for various expenses not stipulated in the estimate were made;

- annual company reports are made with deviations from specified principles of bookkeeping and do not correspond to conditions of the Agreement. Expense categories are redistributed; there is no comparison of actual expenses to the budget, not giving authentic and complete information for actual made expenses in each expense category;

- the company carried out bookkeeping using accrual rather than the cash method as stipulated by the Agreement;

- calculation of all expenses and the definition of reimbursable expenses do not correspond to the Sakhalin-2 Agreement rules regarding bookkeeping according to Russian legislation;

- a portion of the expenses passes through accounts open in foreign banks, which, as in the case of the Sakhalin-1 Agreement, renders practically impossible control over their reliability as regards the complexity of obtaining primary documents generated outside the Russian Federation that confirm payment of actual expenses.

4.6. As of July 1, 1999, the aggregate number of employees of Sakhalin Energy, according to the data of the resource user, was 337 persons, of them, 248 persons, or 74%, were Russian citizens.

For the period from 1996-1998, according to the operator's data, under the Sakhalin-2 Agreement, payments to personnel charges for Russian personnel totaled 9,248,000US\$ or 22.4% of total personnel charges, foreign employees cost 28,511,000US\$ or 69.2%; moving expenses, indemnifications of foreign personnel for cost of living adjustment, housing allowance and other standard privileges and payments to personnel and family members cost 3,451,500US\$ or 8.4% of the specified expenses.

5. Regarding receipt by the Russian party of bonuses and other payments under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements:

5.1. According to Item 2 of the Contract dated April 7, 1997 between the Government of the Russian Federation and Sakhalin Area Administration regarding distribution of the Russian share of incomes under realization of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements, the federal share of each bonus is 40% of the total. Such a distribution contradicts Item 42 of the Laws "On Resources," corresponding to payments for resource use of the territorial sea as 30-40% of the territory of the Piltun-Astokhskiy deposit is located on a continental shelf of the Russian Federation, and payments for using resources of a continental shelf of the Russian Federation fall completely within the federal budget.

According to Item 42 of the Law "On Resources," payments for resource use should represent a combination of payments for resource use of the territorial sea and payments for resource use of the continental shelf of the Russian Federation. The specified Contract has led to a decrease in the sum of bonuses due the federal budget for the period since the Sakhalin-2 Agreement came into force until the development of the Piltun Astokhskiy deposit of no less than 2.7 million US\$.

5.2. The Ministry of Fuel and Energy of Russia, with the consent and connivance of the Ministry of Finance of Russia for no specific reason used budgetary funds due the Russian Federation and commercial banks. Said transfers of payments to the organizations of the Ministry of Fuel and Energy of Russia and in part to the Sakhalin Area Administration are illegal withdrawal of fund from the federal budget, and as such, are subject to return. The damage to the federal budget is estimated at no less than 19,7 million US\$.

6. Regarding accuracy and timeliness of calculation and payment of resource users insurance payments to the state unappropriated fund in execution of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements:

The past-due debts of the Exxon and Sakhalin Energy Consortium formed in 1998 for insurance payments and fines was liquidated without application by branches of the state unappropriated fund of additional measures to collecting said funds. In 1999, insurance payments were paid by them in due time and completely

7. Regarding accuracy and timeliness of the calculation and payment by resource users of taxes to the federal budget under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements:

7.1. Monitoring of the accuracy of calculation resource users taxes and their subsequent payment to the federal budget is complicated in connection with the absence of a precise list of compensated expenses and their regulatory restrictions.

7.2. The Exxon and Sakhalin Energy Consortium made tax declarations in infringement of Item 7 of Law №1992-1 of the Russian Federation (12/6/1991) “On VAT,” unreasonably demanding reimbursement from the budget for VAT, not allocated by suppliers in primary documents and independently calculations.

8. Regarding the use of the federal property:

During the negotiation and realization of the Sakhalin-1 and Sakhalin-2 Agreements, the Government of the Russian Federation and the federally authorized entities did not give due attention to questions connected to resource data on researched mineral stocks and other resource properties in determining their value or danger as a special type of federal property.

In the Agreements, primary geological, geophysical, geochemical, and other data including interpretation and derivative data, and also rock samples (including cores and liquids) received by the investor as a result of performance of works under the Agreements are not mentioned as objects of property rights.

Moreover, if, according to Item XXXI of the Sakhalin-1 Production-Sharing Agreement, parties “can freely use information for purposes necessary for performance of obligations under the present Agreement, including disclosing of information to related organizations and its use by them for these purposes,” and can also provide the information to other persons according to the order stipulated by the present clause of the Sakhalin-2 Agreement, this question is not settled at all.

VII. Offers:

1. To continue present monitoring the operator of the Agreement with the purpose of definition on the basis of payment documents:

- expenses of the operator subject to reimbursement according to the operator contract, including actual expenses of Sakhalin Energy for purchase of the Molikpak platform,

- the portion of operator expenses subject to compensation, according to the operator's contract, entered into with Russian manufacturers of goods and services.

2. To direct representation to the Government of the Russian Federation on questions of eliminating infringements omission revealed during monitoring with offers:

- to bring the governmental normative legal certificates into accordance with requirements of the Federal law "On Production-Sharing Agreements" and to arrange conformity with the specified requirements of departmental regulations;

- to compensate the federal budget payments for resource use resources (bonuses) according to the Sakhalin-1 and Sakhalin-2 Agreements;

- to harmonize the April 7, 1997 Contract between the Government of the Russian Federation and Sakhalin Area Administration with the Law of the Russian Federation "On Resources" regarding distribution of the Russian share of incomes between the federal budget and the Sakhalin area under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements;

- to provide receipt of payments in the federal budget for resource use with reference to the Sakhalin-1 and Sakhalin-2 Agreements;

- to consider the financing by the Russian party of its share under the Sakhalin-1 Agreement,

- to advise (according to existing Russian legislation and conditions of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements) investors of the specified Agreements of the requirements limiting artificial delay of the development of deposits, and in the case of default of the given requirements, to apply the sanctions stipulated by Agreements, including judicially,

- to provide the constant monitoring over the Government of the Russian Federation or the federally authorized entities for the preparation and realization of Production-Sharing Agreements,

- to include representatives of the Ministry of Finance of Russia, federal tax bodies, and international accounting, finance, and economics experts in the structure of the authorized federal entity under the Sakhalin-1 Agreement;

- to present investors of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements the requirements (according to conditions of the specified Agreements and existing Russian legislation) regarding approval of annual work plans and budgets, annual reports and as well as the need to maintain (in Russian) records in accounting registers, storage

of primary documents in the Russian Federation, to carrying out annual audits, and in the case of default of the given requirements, to apply measures stipulated by Agreements, including judicially;

- to create a database of all equipment, materials, and services required for the realization of the Production-Sharing Agreements;

- to protect the interests of Russian equipment manufacturers and service providers need for realization of the Production-Sharing Agreements, including the introduction of tariffs and other regulations;

- to guarantee 70% Russian participation in the project under the Sakhalin-2 Agreement.

3. To direct a inquiry to the State Office of Public Prosecutor of the Russian Federation regarding a legal estimation of the actions of Ministry of Fuel and Energy of Russia and Ministry of Finance of Russia officials in their handling of the distribution of bonuses to the federal budget under the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements.

4. To send the present report to the State Duma and the Council of Federal Assembly of the Russian Federation.

In order to prevent a repeat of the failures of the Sakhalin-1 and Sakhalin-2 Agreements in new Production-Sharing Agreements and with a view protecting the interests of the Russian Federation during negotiation and realization of such agreements, the Accounting Chamber of the Russian Federation should request that the Federal Assembly of the Russian Federation to consider changes and additions to the Federal law “On Production-Sharing Agreements,” taking into account the following requirements.

1. Resource and wildlife use by an investor along with the state under Production-Sharing Agreements, including in connection with performance by Russian government entities and Russian monitoring and supervisory agencies functions, should be guided by Russian Federation legislation at the moment of the agreement’s signing, and not just by the text of the agreement itself. Alternatively, the Russian party should copy all Russian legislation into such agreements, or the relevant portion of the regulations of Russian legislation essential for the resource user, as has taken place on Sakhalin.

2. In case of a change of Russian legislation regarding safety precautions, ecological, and other requirements, new regulations should be obligatory for resource user (as distinct from the situation that developed on Sakhalin with drilling solutions), although the user should have the right to fair indemnification of additional expenses (partial indemnification of not-received profit), determined as agreed or under by court decision.

3. To establish by law the formation, structure, and restrictions on reimbursable investor expenses with Russian raw materials, including restrictions on their absolute amount in percentage of the cost of extracted raw materials (in order to prevent the situation that

developed on Sakhalin, where the investor has the right to record all expenses, without restriction).

4. To require the investor select suppliers of equipment and services and negotiate contracts on an extremely competitive basis, using either only one variable with all other variables fixed, or several variable parameters with a uniform formula (weight factors on each variable), thus reducing variable parameters to a scalar. Absence of precise requirements for competitiveness creates unlimited opportunity of acceptance of any decisions.

5. To exclude the requirement of competitiveness of Russian equipment “in terms of delivery,” replacing this with a requirement to observe the terms established by the coordinated work plan.

6. To exclude the requirement of competitiveness of Russian equipment “in terms of quality,” replacing this with a requirement for parity “price/quality” or establishing precise requirements on quality (conformity to standards, etc.) as conditions.

7. To require guaranteed patronage of Russian mechanical engineering in the competition, including disallowing operators and legal entities participating in project works exemption under the Agreement from collection of customs, VAT, and import taxes in the customs territory of the Russian Federation on goods and services.

8. To establish sanctions of resource users for non-observance of the quota for Russian enterprises in orders for equipment, materials and services and to stipulate time intervals (quarter, year) during which the 70% level must be met.

9. To provide system of sanctions of resource users for non-observance of requirements for conducting bookkeeping and reporting, and also for failure to conduct documentation in Russian and storage of documentation in the territory of the Russian Federation.

10. To require an annual state audit of financial and economic activity of the resource user, annual work plans, annual expense budgets, and reports on the execution of the work plan and actual expenses.

11. To disallow the signing of contracts without competition of the agreement by decisions of enforcement authorities, without public discussion and support by federal laws.

12. To exclude the right of independent executive authority, without public discussion and decision of Federal Assembly, to enter a mode of Production-Sharing Agreements on resource sites including oil fields, with stocks up to 25 million tons in conditions when no federal law interferes with the division of deposits into any quantity of smaller sites.

13. To establish, that only those sites substantiated by the Government of the Russian Federation would be conclusions of Accounting Chamber of Federation be included in

the lists of resource sites for development based on Production-Sharing Agreements. To establish, that Production-Sharing Agreements manditorily consist of projects under agreements entered into by the Accounting Chamber of the Russian Federation (in both cases positive conclusion of an agreement is not inferred, rather the requirement of consideration of the conclusion of the Accounting Chamber is important in decision-making so that no one could assert that consequences of the decisions were unexpected).

14. To preclude the transfer of resource sites into a Production-Sharing Agreements as an “obligation of the Russian Federation” and a result of competitions granting resource sites under Production-Sharing Agreement, i.e. to prevent compulsion of the Federal Assembly to agree with all illegally executed actions of the Government of the Russian Federation.

15. To oblige the investor to (within three calendar months from the date of signing the agreement) insure risks of default of financial and other obligations by him under the Production-Sharing Agreement, and also risks connected to consequences of failures (floods of oil and mineral oil, etc.); to establish a law defining sums of insurance, and also the requirement to satisfy corresponding insurance companies.

16. To establish by the law the process for formation and use of the liquidating fund used by the resource user with the purpose of accumulation financial assets, necessary for the preservation and liquidation of mining development and all types of wells, dismantling equipment and other constructions (platforms, metalwork, construction projects, etc.), connected with using resources according to the Production-Sharing Agreement.

Vice-President

Auditing Chamber of the Russian Federation _____ Yu.Yu.
Boldyrev

Appendix №1

The following documents were investigated and used in the audit of the Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements:

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and gas on Production-Sharing Agreement; other documents.