

Report of the Accounting Chamber of the Russian Federation

Regarding audit of payment documents of operators' contracts in the production section—projects Sakhalin-1 and Sakhalin-2, in reference to the definition of expenses subject to compensation according to the contract signed by the Russian Company Sakhalin Energy

for the purchase of the Molikpak platform

Basis for Audit:

Work plans of the Accounting Chamber of the Russian Federation for 1999 (Item 3.69) and 2000 (Item 3.3.5.)

Purpose of Audit: To establish the expenses incurred in 1999 by investors for the realization of Agreements in the production section for projects Sakhalin-1 and Sakhalin-2, including contracts with Russian firms.

Audit Results—Two Statements are Completed:

–Certificate regarding verification of payment documents of the Agreement's operator in the production section for the Sakhalin-1 project regarding definition of the expenses subject to compensation according to contracts by entered into with Russian firms. Exxon Petrogas Ltd. Vice-President D.L. Simerka and the co-chairman of the Authorized State Entity, V.Z. Garipov (with remarks) are acquainted with results of verification.

– Certificate regarding verification of payment documents of the Agreement's operator in the production section for the Sakhalin-1 project regarding definition of the expenses subject to compensation according to contracts by entered into with Russian firms as well as Sakhalin Energy payment documents regarding the purchase of the Molikpak platform. The Co-Chairman of the Supervisory Council V.Z. Garipov is acquainted audit document and has made remarks.

The First Vice-Governor of the Sakhalin Area, V.I. Shapoval, has refused to sign the specified certificates.

The list of the investigated documents is attached in [Appendix 1](#). Audit materials in the report are taken, in part, from the reported results of the verification audit of the Agreement's operator in the production section for the Sakhalin-1 and Sakhalin-2 projects. This report was approved at the session of Board of the Accounting Chamber of the Russian Federation in the report dated February 25, 2000 №6 (198).

Sakhalin-1 Project

Sakhalin-2 Project

As established, in August 1991 the companies Marathon Petroleum Sakhalin Ltd., McDermott International Investment Co Inc., and Mitsui and Co Ltd. (MMMConsortium) made a joint offer to the Russian party to investigate, develop and operate marine hydrocarbon resources located on the Sakhalin Island shelf, and in January 1992, won the competition advertised in May 1991 by the Ministry of Oil and Gas Industry of the USSR and the State Committee of the RSFSR for Geology, Fuel Power, and the Use of Mineral Resources.

According to Government of the Russian Federation Order №596 dated March 28, 1992 between the MMMConsortium, the Russian Federation, and ON Sakhalinmorneftegaz, the agreement “Regarding preparation of the feasibility report” was made with the goal of defining of technical, legal, financial, and commercial conditions under which the investigation and development of hydrocarbon stocks in the Piltun-Astokhskiy and Lunskiy deposits will be carried out.

In 1992, the MMM Consortium joined and became party to the agreement between Shell Development B.V. (September) and the Mitsubishi Corporation (December), result in the formation of the MMMSh Consortium.

Between February and March 1993, 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 approved the submitted Feasibility Report regarding the development of the Lunskiy and Piltun-Astokhskiy deposits.

Prior to the enactment of the laws of the Russian Federation regulating the application process for agreements on in the manufacturing sector, the legislative basis of Product Sharing Agreements for the Sakhalin-1 and Sakhalin-2 projects was Decree №2285 of the President of the Russian Federation dated December 24, 1993 “Questions of agreements in the production sector regarding fossil fuel extraction.”

In April 1994, with the purpose of reaching an agreement on conditions of the production unit and licensing for development rights in the Piltun-Astokhskiy and Lunskiy deposits the MMMSh Consortium has formed the company Sakhalin Energy International Company Ltd. (Sakhalin Energy, the Company), incorporated in the Bermudas.

Decision №672 of the Government of the Russian Federation dated June 16, 1994 “Regarding the Agreement between the Russian Federation and Sakhalin Energy

International Company Ltd., created the MMMSh Consortium for the development of the Piltun-Astokhskiy and Lunskiy oil and gas fields on production unit conditions” approved the draft agreement between the Russian Federation on behalf of the Government of the Russian Federation and the Sakhalin Area Administration and the Sakhalin Energy International Company Ltd.

The same Decision the Ministry of Fuel and Power of the Russian Federation was directed to sign the specified Agreement on behalf of the Government of the Russian Federation and the Committee of the Russian Federation on Fossil Fuel Geology—to issue the aforementioned license for development rights of the Piltun-Astokhskiy and Lunskiy oil and gas fields on the conditions stipulated in the Agreement after the commencement of validity. The Agreement for the development of the Piltun-Astokhskiy and Lunskiy oil and gas fields on the condition of the production unit (the Agreement, the Project, the Sakhalin-2 project) was signed on June 22, 1994.

Currently participation of foreign companies in the Sakhalin-2 Project is distributed as follows:

Shell Development Sakhalin B.V.–62.5%;

Mitsui Sakhalin Development Company, Ltd.–25.0%;

Mitsubishi Corporation–12.5%.

The operator of the Agreement for the Sakhalin-2 Project, Sakhalin Energy International Company Ltd. (further – Company Sakhalin Energy, the Company), has the offices in the cities of Houston (USA), Moscow, and Yuzhno-Sakhalinsk.

The agreement addresses the questions of investigation, development, and operation of hydrocarbon stocks on Piltun-Astokhskiy and Lunskiy license sites, including drilling, capping, testing and exploratory use, operational, delivery wells, design, construction, installation, and use of sea platforms and structures, installations of division of output, storehouses, modular and main pipelines, liquefied natural gas (LNG) factory, execution of other on-site work (including administrative and managerial activity) necessary for investigation, development of stocks, extraction, preparation, processing, and transportation of hydrocarbons to receiving points, marketing, on-site uses of licensed hydrocarbon output, and additional proceeds to cover expenses and costs, and distribution of the remaining output and proceeds among the parties.

The initial validity period of the licenses given to the Company Sakhalin Energy under the Agreement on the production sector for realization of hydrocarbons development (investigation, extraction) for the Sakhalin-2 Project is 25 years.

Total cost of the project – 10.2 billion US dollars.

The Sakhalin-2 project includes the Piltun-Astokhskiy and Lunskiy hydrocarbons deposits located on the northeast shelf of Sakhalin Island. According to the conditions of the Agreement, the property rights to the oil and gas stocks belong to the Russian Federation. The Company Sakhalin Energy bears all charges connected to the development of deposits and shall pay to the Russian party (to the Federal Budget and the Sakhalin Fund) bonuses in the sum total of 150 million the US dollars, toward the initial stages of the Project. According to the Agreement, following the inception of extraction the Russian party, shall receive 6% of the realized output as payment for the fossil fuel resources; only after that shall the investor's expenses be reimbursed. The remainder of the income shall be distributed between the Russian party and the Company, using the income distribution plan accepted in the Agreement. The Company shall pay the Russian party taxes on profits at the rate of 32%.

With reference to Clause 42 of the Law of the Russian Federation "Regarding fossil fuels" similar payments shall be distributed proportionally: for the benefit of the Government of the Russian Federation—40%; for the benefit of administration of the subject of the Russian Federation—60%.

In 1996, the Ministry of Finance of Russia approached the administration of the Sakhalin Area and has offered to transfer to the Sakhalin Area a bonus in the sum of 15 million US dollars, as stipulated by Item 17(a) Agreements. The specified funds on June 27, 1996 were credited to the account of the Finance Administration of the Sakhalin Area Administration.

Moreover, according to letter №V.I.-9271, dated 12/29/97, written by the First Deputy Minister of Fuel and Power of the Russian Federation V.I. Otta, the Company transferred 12 million US dollars of the federal share of the bonus in recognition of the inception of development of the Piltun-Astokhskiy oil-and-gas deposit to the Sakhalin Area Administration.

In agreement with Order №86 of the Ministry of Fuel and Energy of Russia, dated 03/18/98, the State Enterprise Institute of Geology and Development of Combustible Minerals (IGiRGI) is entrusted with the task of performing of examinations, analysis, and other works on in regards to estimating stocks, searching, investigating, and extracting of raw hydrocarbons. The aforementioned is also entrusted with realizing agreements in the production sector to which also transferred 3 million US dollars to the hard currency account of IGiRGI in AKB Inkombank.

On October 29, 1998, AKB Inkombank's license was withdrawn. On October 30, 1998, IGiRGI sued Inkombank to collect illegally withheld funds, which on the date of consideration totaled 50,473,902 rubles 75 kopecks, including interest. On November 4, 1998, the Arbitration Court of the city of Moscow made a determination regarding acceptance of the application to recognize AKB Inkombank as bankrupt and initiated procedures to supervise bank operations.

Thus, as of September 25, 1999 the Sakhalin-2 project did not receive the agreed-upon bonus income from the federal budget. Of the 30 million US dollars in bonuses paid by the Company, the Sakhalin Area Administration received 27 million dollars.

According to the Sakhalin-2 project, by December 31 of each fiscal year, beginning in the year that development begins in both the Piltun-Astokhskiy and Lunskiy licensed sites; the Company shall pay 20 million US dollars into the Sakhalin Development Fund. These funds will be spent in accordance with instructions from the Fund's managers and record made of such by the Sakhalin Area Administration. **Such payments relate to the compensated expense category and are subject to compensation according to Item 14 of the Agreement regarding allocation of a share of the liquid production or additional proceeds.**

Obligations of the Company regarding transfer of these payments shall expire upon the sum of payments reaching 100 million US dollars.

For the period of the inception date of the development of the Piltun-Astokhskiy license site (12/31/1997) the Sakhalin Area Administration has received 4 (four) payments totaling 80 million US dollars from Sakhalin Energy.

The Lunskiy deposit was opened in 1984, Piltun-Astokhskiy – in 1986. Both deposits were opened by Russian organizations with financing from the state budget.

According to the conditions stated in Item 17(d) of the Sakhalin-2 project, consecutive payments should be made in compensation for geologic prospecting expenses incurred by the Russian side valued at 160 million US dollars. Compensation will take place in two stages:

–Stage One (80 million US dollars) – Beginning with the first calendar quarter after the date on which not less than 30 consecutive days of hydrocarbon extraction and presentation of said materials for export occurred;

–Stage Two (80 million US dollars) –At the point in the process of hydrocarbon exploitation that the rate of profitability reaches 17.5% and the production shares between the Russian party and the Company are split exactly in half.

The Company shall make quarterly payments of 4 million US dollars in compensation to the Russian party for expenses previously incurred.

According to the contract dated April 3, 1997 between the Government of the Russian Federation and Sakhalin Area Administration, the geological prospecting expenses incurred by the Company prior to reaching the Agreement should be allocated as follows: 50% of payments to the federal budget; 50% to the Sakhalin Area budget.

According to the Company letter dated 07/21/99, the first payment in compensation of Russian geological prospecting expenses shall be made in October 1999. On August 12,

1999, funds in the amount of 4 million dollars were deposited in the account of the Sakhalin Area Administration. In the fourth quarter of 1999 and during 2000, an additional 20 million dollars were deposited, adding 10 million dollars to the federal budget and 10 million dollars to the Sakhalin Area Administration.

Under the Sakhalin-2 project the Company accepts the concept of phased development of the Piltun-Astokhskiy of the deposit, as supported by the Supervisory Council on 07/24/96 (Resolution №SB/96/01). Stage one of the work plan included development of the Astokhskiy site with ongoing and simultaneous research into the Piltunskiy site.

General development plans for the Piltun-Astokhskiy (stage 1) and Lunskiy deposits are based on receipt of the first oil from the Piltun-Astokhskiy deposit in mid-1999, the achievement of year-round oil recovery by the end of 2003, and the beginning of liquefied natural gas deliveries from the Lunskiy deposit in mid-2005. **In violation of Items 5(iv) and 10(e) of the Sakhalin-2 Project, ratification of the work plan and cost estimates for 1998 and 1999, the Sakhalin Energy Company submitted a number of substantial changes to the work and costs without the consideration and support of the Supervisory Council.**

A comparative analysis of the actual charges and budget assignments relating to work activities and types of work for the period of 1998-1999 showed significant over-expenditures in some expense categories in Stage One of the development of the Piltun-Astokhskiy deposit due to a decrease in charges and the exclusion of individual types of work in other areas of activity authorized by annual work plans.

As implemented, the Company's financial policy has led to the latent rise in work costs in the first stage of the development of the Piltun-Astokhskiy deposit. First stage development expenses of the Piltun-Astokhskiy deposit assumed work costs connected to Molikpak platform, including engineering design and research work, logistics, manufacturing of the technological module platform, retooling the platform, customs and marine operations, drilling of operational wells, construction, installation and exploitation of construction projects.

A comparison of actual expenses from the first stage of development of the Piltun-Astokhskiy deposit to authorized annual work plans and cost estimates, shows cost overruns for two years in the amount of 102,201.4 thousand US dollars, including:

- In 1998, 62,028.4 thousand US dollars, or 38.9%;
- In 1999, 40,173 thousand US dollars, or 39.5%.

Overruns versus estimate costs by work type included:

– Drilling operational wells in 1998 – 5904.8 thousand US dollars (24.8%), in 1999 – 22,598 thousand US dollars (40.5%). In total 13 wells were drilled, of which 12 are operational and one injection well;

– Construction and installation of construction objects in 1998 – 3,384.8 thousand US dollars (31.6%), in 1999 – 12,253 thousand US dollars (87%), (projects on the connection and operational implementation of equipment and systems for extraction; personnel safety training; connection of wells, implementation of technological procedures on the Vityaz’ platform);

– Operation of construction objects in 1998 – 12,153.2 thousand US dollars (59.2%), in 1999 – 6119 thousand US dollars (21.1%); upon reception of financing in 1998 – 7893.9 thousand US dollars (852.3%).

At the same time, in 1998-1999 several projects related to the development of the Piltun-Astokhskiy deposit were not carried out, budgeting at 52,686.2 thousand US dollars. The Company shifted these funds to cover overruns in other areas of the budget.

Development of the Lunskiy deposit is now dependent on market conditions for LNG and the receipt of guarantees from potential buyers. Taking that into account, the Supervisory Council during the session dated 06/08/1999 (Resolution SB/99) has confirmed receipt of the Company report “Regarding completion of the program studying the Lunskiy license site” and, in accordance with Item 8(c) of the Sakhalin-2 project Agreement, the study period was extended until June 15, 2001.

During the audit it was revealed, that the hidden cost overruns on a number of annual program items and cost estimates were, in the final analysis, reflected in the estimated expense budget for the first stage development of the Piltun-Astokhskiy deposit, as authorized by the Supervisory Council on 07/27/1997 (Resolution SB/97/06) in the amount of 644,207 thousand US dollars.

According to conditions of the Production Sharing Agreement (Items 5(ii) and 9(b)), the Company is obliged to inform members of the Supervisory Council in cases where basic charges exceed authorized estimates by more than 5%.

The corrected budget reflecting actual expenses for the first stage of development of the Piltun-Astokhskiy deposit was submitted by the Company for consideration at the Supervisory Council session that occurred on 12/10/98. The updated budget included additional expenses in the amount of 68,957 thousand the US dollars, in connection with work on the Molikpak platform, while design expenses totaling 27,669 thousand US dollars for auxiliary construction objects in the Yuzhno-Sakhalinsk office and a residential complex “Winter” are excluded.

The reasons for increased cost estimates of the Russian party submitted to the Supervisory Council are based on Company data. Members of the Supervisory Council Working Group carried out an analysis of the increased costs of the work performed

based only on explanations of deviations from annual cost estimates executed directly by the Company. Primary documents confirming the reasons for cost increases were provided neither to the Working Group nor the Supervisory Council.

While the Sakhalin-2 Project Agreement stipulates that the Supervisory Council shall conduct meetings not less than four times a year, in 1998 only two sessions have taken place (June 19 and December 8), in 1999 – one session occurred on July 27.

According to Item 6(b), Appendix A " Principles of Bookkeeping " in the Production Sharing Agreement the Russian party has the right to audit the registration documentation of the Company on an annual basis. In reality, only one audit has taken place– in 1997.

Nonetheless, at the 06/08/1999 session of the Supervisory Council (Resolution SB/99/04) the specified cost estimates for first stage development were authorized in the amount of 685,495 thousand US dollars, or 11.2% greater than initially requested, without taking charges for auxiliary projects into account. Note also that the 1998 Financial Report and the conclusions of the auditing agency as stated in the Company's 1998 Annual Report were submitted for consideration to the Supervisory Council six months later.

The audit established, that during the 06/27/2000 Supervisory Council session, the Company submitted another change in cost estimates for first stage development for approval, and increase of 51,504 thousand US dollars to 737,000 thousand US dollars, or 7.5%.

The Company submitted this second change in cost estimates of the first stage development of the Piltun-Astokhskiy deposit to the Supervisory Council in July 2000, six months after the end of the financial (calendar) year.

In essence, the Company has supplied the Russian party with information regarding the Company's true expenses. The 1999 Financial Report, certified by the joint-stock company PriceWaterhouse Coopers Audit on 4/24/2000, was submitted in conjunction with the estimate. The 1999 Financial Report reflected Company general expenses totaling 1,199,805.9 thousand US dollars (March 30-December 31, 1999).

After July 27, 2000, no Supervisory Council sessions took place, and as of 11/24/2000 the report of the last Supervisory Council session had not yet been approved.

A proposal to examine the specified questions and to make recommendations to the Council for consideration was not approved by the Supervisory Council. Ultimately the Company has not presented to the Russian party with materials substantiating reasons for cost overruns in the contracts.

Despite the unsatisfactory work of the Supervisory Council and the Authorized State Entity, almost 2 billion US dollars has been invested in the development of the Sakhalin Island shelf and the strategic value of hydrocarbon extraction in the Far East region. The

Government of the Russian Federation yet to hear the government representatives' report regarding their work in the agencies representing the Russian party.

Expenses for the construction of office space, housing, and other auxiliary objects exceeding cost estimates in first stage development were covered by annual work plans and cost estimates.

Actual expenses for these budget items in 1998 totaled 66,541.5 thousand US dollars, in 1999 – 32,815 thousand US dollars, and from the development project's inception – 120,710.6 thousand US dollars, or 4.3 times greater than the originally authorized cost estimates for stage one development of the Piltun-Astokhskiy deposit.

Full development of the Piltun-Astokhskiy and Lunskiy deposits has been postponed due to the economic inexpediency of projects and ongoing expenditures on administrative personnel that have not yet been reduced.

In 1998 actual management expenditures totaled 54,251.5 thousand US dollars (12.1% of total annual charges), and 51,283 thousand US dollars in 1999 (19.7%).

According to Company explanation, the increase in charges in 1998 is essentially connected to the performance of large contract made between the Sakhalin Energy Company and foreign companies, including:

Construction work (Company Sendvel) – 5995 thousand US dollars;
Reequipping the Molikpak platform (Company DAU) – 19,245 thousand dollars;
Marine operations (Company Van Oord) – 21,791 thousand US dollars;
Installation of a one-anchor mooring – SAM (Company Van Oord) – 4425 thousand US dollars; and
Operational drilling (Company Parker) – 10,063 thousand US dollars.

Actual expenses exceeded budget on these five specified contracts only, totaling 61,519 thousand US dollars.

In 1999, cost overruns occurred as a result of using non-optimum drilling muds, leading to cases of pipe seizure and core casing in wells with more significant angles of gradient, and a delay (until March 2000) in receiving permission to use special drilling muds.

According to Item 20(a) of the Production Sharing Agreement, all registration documentation shall be stored in one office location in Russia and be conducted in English and Russian languages. In actuality this information is dispersed among all branches of the Company.

In accordance with an official inquiry from the Accounting Chamber Commission, Sakhalin Energy Company provided the most significant seven contracts and as well as

the Molikpak platform contract, only two of which were printed in Russian, the others in English.

Verbal and written translations of separate sections of the contracts, made with the help of Sakhalin Energy Company translators, required additional time for studying and analysis.

As shown in the analysis of the submitted documents, a significant rise in the cost of stage one development of the Piltun-Astokhskiy deposit was a direct consequence of the failure by the Company to study technical decisions and expenses for the development of the Astokhskaya area deposit.

The Sakhalin Energy Company entered into primary contracts for the reconstruction and modernization of the Molikpak platform with companies DEU, Van Oord, and joint-stock company Amur Shipbuilding Factory in 1997. Development of the feasibility report for the construction of the Piltun-Astokhskiy license site (Stage I: Astokhskaya Area) was completed only in May 1998.

Working drawings were given to the contractor based on the contractor's readiness for individual projects. A number of projects were not included in the annual work plan and budget. Furthermore, during reconstruction additional works on new project construction and increased expenditures were necessary.

Essentially, projects were carried out aggressively with the goal of obtaining oil production in the most productive deposit site with the view of indemnifying previously incurred expenses and receiving additional investments for further development of the deposit.

In 1998-1999, in order to eliminate subquality work, unforeseen projects, and additional human and material resources, stage one development expenses of the Piltun-Astokhskiy deposit incurred cost overruns of 102.2 million US dollars.

Modernization of the Molikpak platform consists of an expansion of existing drilling slots, construction of wellhead seating, lengthening drilling rig skids, alteration of pipe warehouse doors, modernization of helicopter platform, and attaching a platform's support.

In 1997, Sakhalin Energy concluded two contracts with the DEU Corporation and DEU Heavy Industries Ltd. (further DEU) for the performance of projects to update a platform and manufacture of the technological module.

The initial budget for the modernization of the Molikpak platform budgeted 52,148 thousand US dollars. Actual expenses reached 70,528 thousand US dollars, or 18,380 thousand US dollars in excess of budget.

Under the contract №C-E1 with DEU Company, between May 1997 and October 1998, total expenses were 59,241.1 thousand US dollars for the annual work plan and the estimatee 1998 budget, including 10,154.7 thousand US dollars paid for changes to the contract for projects not earlier stipulated by the contract.

Under the contract №C-CO, between the Company and the same firm on January 31, 1997, based on total executed projects and services rendered services costing 16,199.4 thousand US dollars, contract work totaling 4396 thousand US dollars was executed according to contract changes and additions.

In violation of the conditions specified by the contract, Sakhalin Energy Company has accepted the Molikpak platform with substantial subquality work and has begun to transport the platform to an installation site in the Astokhskaya area of the deposit in order to deliver the platform to its base location during the icefree period.

While 27,420 man-hours were originally planned for the completion of these projects to re-equip the Molikpak platform – 67,756 man-hours were actually spent, including 17,765 man-hours for uncompleted projects in DEU Company shipyards, 5181 man-hours due to an increase in the number of projects related to putting the technological module into operation, and 10,760 man-hours for changing the design of five operational wells and others unforeseen in the work plan.

In connection with increase in the number of projects, unforeseen prior to the project, expenses for construction work grew from 28,904 thousand US dollars in 1997 to 36,590 thousand US dollars in 1999, or an increase of 7686 thousand US dollars.

22,879 thousand US dollars were budgeted for the purchase of supplies and equipment necessary for the assembly of the technological module and the payment of services for the delivery of this equipment. Actual expenses for logistics were 23,268 thousand US dollars, including 1852 thousand US dollars in 1998 and 705 thousand US dollars in 1999.

The agreement between Sakhalin Energy and the Gulf Canada Company on the purchase of the Molikpak platform was entered into in 1996. According to Sakhalin Energy, expenses were 29,713 thousand US dollars, including 1511 thousand US dollars in 1996 and 28,202 thousand US dollars in 1997.

The Company has not presented primary documents confirming the specified payments to the Accounting Chamber Commission, motivating the refusal because the audit of the primary documentation had already occurred by January 1, 1998.

At the same time, in economic analysis of the construction feasibility report (Appendices №11-3 and №11-4) “Feasibility report for the Piltun-Astokhskiy license site. Stage 1: Astokhskaya Area” (Houston, USA, 1998) in the column “Capital Expenses” the sum of 26507 thousand US dollars is specified for the installation of the Molikpak platform.

Such divergence and persistent unwillingness on the part of the Company to present to the Commission the primary payment documents put the reliability of the total expenses (29,713 thousand US dollars) for the first stage development of the Piltun-Astokhskiy deposit in doubt.

Under the specified budget, the cost of manufacturing a Molikpak platform support totaled 53,757 thousand US dollars, compared to 53,542 thousand US dollars stipulated by the initial budget.

After final assembly of a support in the city Bolshoy Kamen' (Primorsky Krai), the support was transported to the DEU shipyards, located in the city of Okpo (Korea), where modernization and repair of the Molikpak platform was carried out.

Prior to beginning the reconstruction project, experts from various departments conducted an inspection of the technical condition of the main body of the platform, as a result of which conclusions were drawn regarding opportunities for its continuing operation.

Payment of customs payments was not provided on a separate budget line in the work plans. Actual charges for customs payments to Russian customs bodies and customs registration advisory services totaled 1228 thousand US dollars, including, 1215 thousand US dollars in 1998, and 13 thousand US dollars in 1999. During installation of the platform it was necessary to conduct a certain amount of marine projects. In particular the following projects were performed: ocean-floor excavation works in preparation of the sea-bed; filling with sand and then consolidation of the central part of the established platform, and its enrockment on the perimeter of the rockbed.

30,435 thousand US dollars were budgeted to carry out the specified projects. Actual charges, according to Sakhalin Energy, totaled 49,326 thousand US dollars.

In December 1997 in contract №C-G3 the Van Oord Company was contracted to perform the following projects: for services towing the Molikpak platform from the joining platform to a design point of installation, underwater dredging, platform preparation, delivery, transportation, and enrockment, technical support, manufacturing and installation of the pipeline, installation of single-anchor mooring (SAM) and the Molikpak platform. The total cost of the contract was 24,475 thousand US dollars.

According to the contract (Item 9.1), the contractor was obliged to finish work no later than November 1, 1998. In October 1998, blasting for compaction of the platform anchor and installation of instrumentation were both completed, as well as the platform's framing and enrockment, however, not all projects were completed in the specified term.

In September 1998, during the installation of a one-anchor mooring cable breakage occurred and the SAM sank, having incurred serious damage and broken the integrity of the petropipeline from the Molikpak platform to the SAM.

Sakhalin Energy and the Van Oord Company signed a memorandum of understanding (MOU) on December 18, 1998 regarding work to raise and repair the SAM, restore the pipeline and other works. An addendum to the MOU was made on February 24, 1999, extending the contract period to June 17, 1999. On September 22, 1999 a final settlement was agreed upon. The specified works proceeded until November 30, 1999, or for an entire year longer than agreed.

As established by an audit of the primary documents, the Company paid 10,151.6 thousand US dollars to resolve the consequences of SAM incident, or 10 times greater than provided for by the initial contract. However, the Supervisory Council did not discover or consider the reason for the incident and by whose fault it occurred. According to contract stipulations, the contractor shall carry out all emergency works. Therefore, 9000 thousand US dollars, spent by the Company to liquidate the SAM incident are not reimburseable expenses.

During the 1999 extraction season on the Vityaz' platform there were two incidents involving cables connecting the floating bulk oil storehouse (FBOS) "Okha" with the SAM. The FBOS "Okha" is fastened to the SAM by two parallel cables. In the first case (on September 28, 1999), the cables broke, as a result of which 1 up to 3 barrels of oil were spilled into the sea from the connecting pipeline. In the second case (on October 31, 1999), there was only partial damage and stretching to the parallel mooring cables allowed an adjustable disconnection from the SAM and the prevention of oil flooding. Following the first incident, an investigation the cause was begun, in which the Marlow Rolls Company (the manufacture of the mooring), the SBM Company (developer of the SAM), and Sakhalin Energy took part. No Russian experts were invited to participate in the investigation of the failures.

As a result of the investigation the conclusion was made that in both cases the reasons for the breakage and destruction of the mooring cables was the unsuccessful design decision for their attachment, allowing contact between the bale rod of the SAM and the cables passing through it, as well as the lesser durability of cables with the parallel veins, used for fastening floating bulk oil storage with a single-anchor mooring, in comparison with braided cables.

Sakhalin Energy has spent 3.84 million US dollars for the liquidation of the consequences of those failures and ongoing oil spill recovery. These costs should be reimbursed by insurance companies and Sakhalin Marine Limited, leasing FBOS to Sakhalin Energy.

As of yet, Sakhalin Energy has not been compensated, although, according to Item 4(n) "Damage and destruction of property: Appendix A" "Principles of bookkeeping," compensation in the form of insurance payments under insurance contracts, the premiums of which are included in budgeted expenses, shall be reflected as a reduction of expenses.

On the Vityaz' industrial-output complex, the entire system of oil and gas extraction is automated, and all parameters are illustrated for the operator on a computer.

On the Molikpak platform, there are 13 functioning wells, from which 12 are producing wells and 1 gas-injection. Meters are not established on each individual well, as crude oil and associated gas enter the well together.

Indicators installed on the Molikpak platform (turbine, ultrasonic, and diaphragm counters) are not official measures of extracted oil and gas volumes. Well production rates are calculated after the gas is separated from the oil in a test separator upon which Solartron turbine counters for gauging oil and water are installed, and a “Smart” meter gauging gas (based on a diaphragmatic Daniel flow meter). Well output data are operational and are entered into the computer system for regulating the selection of crude oil, maintaining reservoir pressure and other parameters related to working the deposit.

The gas is extracted from the oil through a system of separators, and then goes to the general gas system, while the oil enters the main pipeline. On each separator, a “Smart” meter is installed. The total amount of extracted gas is calculated by summing the indications of four counters (one test and three technological). From here, gas from the general system is used for the Molikpak platform’s own needs as well as for reinjection into the oilshelf. Internally-used and reinjected gas is measured by diaphragmatic flow meters. For lack of a transport system, the rest of the gas is burnt on a flare. After gas separation, the oil enters the main pipeline, where, after measurement on the Controlatron target ultrasonic meter, it enters the two kilometer pipeline along the SAM and further into the FBOS.

The floating bulk oil storage is a converted tanker with a capacity of 136.8 thousand tons, divided into 12 tanks compartments. Each tank is equipped to two measurement devices: a SAAB radar device which determine the volume of the tank, and an electronic UTI measurement recorder, measuring the tank’s oil levels and automatically calculating its volume.

The specified two methods of gauging are redundant and are monitored. During the period of September-October 1999, the difference in the indicators was 0.2%. These data also are operational and are compared to indicators on the Molikpak platform. Radar measurement is carried out hourly and is also compared to the Molikpak platform parameters. Hourly divergences in measurement equal 1.5-3%.

Tank measurement using electronic tapes is carried out once daily. This device measures oil and water volumes; the data collected will be exported to a computer system, but are operational.

Thus, for September 2000 the Molikpak platform meters showed 1.9% higher volume than the FBOS meter indicated.

Official oil volumes for reciprocal indicators belong to the fiscal branch of FMC Smith, located on exit flare of the FBOS and consisting of a system of devices and liquid counters including calibrating instruments. In September 2000, meter deviations between the FBOS and the oil shipment accounting unit for 4 shipments of oil deviated by 0.09%.

All listed measuring devices used oil and gas recovery conform to Russian Gosstandart, and Russian Gosgortekhnadzor sanctions their use.

Tanker loading occurs via a trailer flange in the presence of Russian Border and Customs Officials. Unit component indicators are removed by these agencies and registered in a journal. During the oil shipment period Border Guards and Customs Officials seal bypass lines, preventing loading from the FBOS via the unit component.

After loading the tanker and removal of the unit component indicators by the Customs Service consignment occurs. A customs declaration stamped "Export permitted" accompanied by a customs inspections certificate gives the right to export oil from Russia. The final, official volume of extracted oil is determined at the end of the navigation season and is based on the volume of shipped oil exported from Russia and the amount remaining in FBOS tanks, which at season's end is used as export and is transported to an icefree port for the winter. Proceeding from this volume, the data from well extractions and other parameters on the Molikpak platform are corrected, and operational data are no longer valid.

According to Item 12(e) of the Production Sharing Agreement for the Sakhalin-2 project, the Company shall provide the Supervisory Council with a report on participation of Russian industrial enterprises in the jobs for each project. In addition to this general report about progress on jobs, the Company shall specify the quantity and price (in US dollars) of all contracts made for the accounting period as well as the quantity and value of contracts made with Russian enterprises for the same period.

In 1999, Sakhalin Energy entered into 1862 contracts and orders for goods and services valued at 53.0 million US dollars. The total cost of the jobs carried out by Russian enterprises under these contracts equals 27.8 million US dollars, or 52.5%.

In entering 167 contracts on a competitive basis with an average value of 4.2 million US dollars, not a single Russian enterprise qualified as possessing the necessary resources for conformity with the competitive requirements stipulated in the "Procedures for logistics and contracts." The Company notified the Russian party that it had carried out such competitions according to the established procedures.

Of the remaining 1695 contracts, with an average value of 48.8 million US dollars, 717 contracts totaling 27.2 million dollars were transferred to Russian companies.

However, as established, existing reporting does not reflect actual participation of Russian contractors in realization of the Sakhalin-2 project. For example, in 1999, Russian companies entered into contracts totaling 27.2 million US dollars, while only 22 contracts valued at over 1 million rubles were paid. In the 1997-1999 period, 54.8 million rubles or in 2 times more contracts were signed. However, these figures are not comparable, as receipts follow in part from contracts entered into for terms of 1 -30 years. There is no tracking of contract payments for Russian and foreign contractors.

In 1999, Sakhalin Energy personnel expenses totaled 38,145 thousand US dollars, including salary and taxes of foreign employees (21,993 thousand US dollars), salary and taxes of Russian personnel (7066 thousand US dollars), employee moving expenses (740 thousand US dollars), expenses and benefits for the support of employees (8537 thousand US dollars), as well as Russian employee benefits and support (550 thousand US dollars).

The average number of employees of Sakhalin Energy was 335 people, of them the Russian citizens totaled 253 people, or 75.5%, as corresponds to Production Sharing Agreement. Average annual expenses for Russian citizens equal 30.1 thousand US dollars, the average monthly salary (including taxes) of Russian personnel equals about 2500 dollars, while foreign employees earn an average of 17 thousand US dollars, including benefits, 25 thousand US dollars.

Wages are paid to Russian employees of contract organizations according to the Russian regulatory documents. As of January 1, 2000, 1250 workers have participated in the realization of the Sakhalin-2 project.

Conclusions

Under the project Sakhalin-1

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Under the Sakhalin-2 project.

8. The Sakhalin-2 project includes the hydrocarbons deposits of Piltun-Astokhskiy and Arkutun-Daganskiy located on the northeast shelf of Sakhalin Island. General development plans for the Piltun-Astokhskiy (stage one) and Lunskiy deposits are based on reception of the first oil from the Piltun-Astokhskiy deposit in mid-1999, achievement of year-round oil recovery by the end of 2003, and the beginning of liquified natural gas deliveries from the Lunskiy deposit in the middle of 2005.

9. The operator of the Sakhalin-2 project is the Sakhalin Energy Company. The total amount of capital investment under the Sakhalin-2 project is estimated at 10 billion US dollars. Charges of the Company during the period 1992-1999 totals 1199.8 million US dollars. The Russian party has received 94 million US dollars, including: bonuses in the amount of 27 million US dollars, payments to the Sakhalin Development Fund totaling 60 million US dollars, 4 million US dollars paid to compensate Russian prospecting expenses; and 3 million US dollars to the Institute of Geology and Development of Combustible Minerals.

10. In infringement of Items 5(iv) and 10(e) the Sakhalin-2 project after receiving

approval of the work plan and budgeted expenses for 1998 and 1999, Sakhalin Energy enacted a number of essential changes to the types of jobs and expense lines without the notification or consideration of the Supervisory Council.

11. Comparative analysis of actual expenses and budget allocations for specific activities and job types for 1998-1999 showed significant cost overruns in some expense categories in stage one development of the Piltun-Astokhskiy deposit caused by a decrease in expenses and exclusion of specific job types specifically authorized by the annual work plan.

Sakhalin Energy's financial policy has ultimately led to a hidden rise in the cost of work during stage one development of the Piltun-Astokhskiy deposit.

12. Actual expenses of stage one development of the Piltun-Astokhskiy deposit have exceeded the authorized annual work plan and budgeted expenses for two years in the amount of 102,201.4 thousand US dollars, including:

- In 1998 – 62,028.4 thousand US dollars, or 38.9%;
- In 1999 – on 40,173 thousand US dollars, or 39.5%.

Work activities totaling 52,686.2 thousand rubles that were not executed in the development of the Piltun-Astokhskiy deposit the Company have been redistributed to cover cost overruns.

13. The hidden overruns in a number of budget lines from the annual work plan were finally reflected in the budget for stage one development of the Piltun-Astokhskiy deposit, as authorized by the Supervisory Council on 07/27/1997 (Resolution SB/97/06) for 644,207 thousand US dollars. During the 12/10/1998 Supervisory Council session, the Company submitted for consideration the specified expense budget for the stage one development of the Piltun-Astokhskiy deposit, corrected under actual expenses with over-expenditures totaling 68,957 thousand US dollars. Reasons for the rise in expenses were presented to the Supervisory Council by representatives of the Russian party based on Company data. The Supervisory Council did not perform an audit of primary documents confirming the reasons for cost increases. Despite this, at a session of the Supervisory Council taking place on 06/08/1999 (Resolution SB/99/04) the specified expense budget for first stage development, without taking into account auxiliary project expenses, was authorized at the rate of 685,495 thousand US dollars, or 11.2% more than the originally authorized estimate.

14. The Sakhalin-2 project agreement stipulates that the Supervisory Council shall meet not less than four times a year, while in 1998 only two sessions took place (on June 19 and on December 8), and in 1999 only one occurred (on July 27).

According to Item 6(b), Appendix A “Principles of bookkeeping” of the Production Sharing Agreement, the Russian party has the right audit registration documentation of the Company once annually. For the past four years, an audit has occurred only once – in 1997.

15. During the 7/27/2000 session of the Supervisory Council, or six months after the end of the financial (calendar) year, the Company presented an additional change of expense budget for stage one development with a request to reconsider an increase from 685,495 thousand US dollars to 737,000 thousand US dollars, or a gain of 51,504 thousand US dollars (7.5%) more. After the 07/27/2000 session, no further meetings of the Supervisory Council took place. A report of this session of the Supervisory Council has not yet been approved.

According to an explanation by the Company, in 1998, the increase in expenses was connected to the execution of large consecutive contracts entered into between Sakhalin Energy and foreign companies. Thus, in only five contracts, with companies Sandwell, DEU, Van Oord, and Parker, were expenses totaling 61,519 thousand US dollars in excess of budget.

16. As shown in analysis of the documents submitted, the significant rise in the cost of stage one development of the Piltun-Astokhskiy deposit was caused by insufficiently in-depth initial study by the Company of technical decisions and expenses for the development of the Astokhskaya area of the deposit.

Under the contract №C-E1 with DEU from May 1997 until October 1998 expenses totaled 59,241.1 thousand US dollars, including 10,154.7 thousand US dollars in changes to the contract for 10 work jobs not earlier stipulated by the contract, the annual work plan or the 1998 expense budget.

Under the contract №C-CO with the same firm, entered into on January 31, 1997, of a total contracted 16,199.4 thousand US dollars, 4396 thousand US dollars were spent on jobs and services rendered due to changes and additions to the contract works.

In addition to violating the conditions of the specified contracts, Sakhalin Energy has accepted the Molikpak platform with the substantial subquality work. While 27,420 man-hours were originally planned for the completion of work on re-equipping the Molikpak platform, 67,756 man-hours were actually spent, or 2.5 more than planned.

Despite the failure by contractors to meet the terms of re-equipping the Molikpak platform, which required additional unforeseen expenses, Sakhalin Energy has not demanded compensation for the damage caused by contractors, as additional works were carried out due to miscalculations by the Company.

17. Sakhalin Energy received the Molikpak platform from the Gulf Canada Company in the third quarter of 1997. Expenses for its purchase, according to the Company, total 29,713 thousand US dollars. The Company has not presented the Accounting Chamber

Commission supporting primary documents regarding the specified payments, thus motivating a refusal due to the fact that a review of the primary documentation already occurred on January 1, 1998.

At the same time in the economic calculation for the Feasibility Report for construction (Appendices №11-3 and №11-4) “Feasibility Report for the Piltun-Astokhskiy license site. Stage 1: Astokhskaya Area” (Houston, the USA, 1998), in the column “Capital Expenses” for the sum of 26507 thousand US dollars is specified for the purchase of the Molikpak platform installation.

Such divergence and persistent unwillingness on the part of the Company to present to the Commission the primary payment documents put the reliability of the total expenses (29,713 thousand US dollars) for the first stage development of the Piltun-Astokhskiy deposit in doubt.

18. The terms for development of the hydrocarbon deposits on the Sakhalin Island shelf are constantly being postponed by the Company, while ongoing expenses for administrative personnel are not reduced.

In 1998, actual charges for management totaled 54,251.5 thousand US dollars (12.1% of total annual expenses), in 1999, 51,283 thousand US dollars (19.7%).

19. In September 1998, during the installation of a one-anchor mooring cable breakage occurred and the SAM sank, having incurred serious damage and broken the integrity of the petropipeline from the Molikpak platform to the SAM.

Sakhalin Energy paid Van Oord 10,151.6 thousand US dollars for liquidation of the consequences of the SAM incident, 10 times more than provided for in the initial contract. However, the Supervisory Council did not discover or consider the reason for the incident and by whose fault it occurred. According to contract stipulations, the contractor shall carry out all emergency works. Therefore, 9000 thousand US dollars, spent by the Company to liquidate the SAM incident are not reimburseable expenses.

20. In September and October 1999 on a Vityaz’ platform there were two incidents involving cables connecting the floating bulk oil storehouse (FBOS) “Okha” with the SAM.

Sakhalin Energy has spent 3.84 million US dollars for the liquidation of the consequences of those failures and ongoing oil spill recovery. These costs should be reimbursed by insurance companies and Sakhalin Marine Limited, leasing FBOS to Sakhalin Energy.

As of yet, Sakhalin Energy has not been compensated, although, according to Item 4(n) “Damage and destruction of property: Appendix A” “Principles of bookkeeping,” compensation in the form of insurance

payments under insurance contracts, the premiums of which are included in budgeted expenses, shall be reflected as a reduction of expenses.

Offers

1. Direct a declaration to the Government of the Russian Federation to accept measures for the elimination the inadequacies revealed by audit. The declaration would also press for:

- the creation of necessary regulatory-legal basis for the realization of Production Sharing Agreements;
- appropriate execution by the Supervisory Council and the Authorized State Entity of the conditions of the Sakhalin-1 and Sakhalin-2 Agreements 2 regarding the protection of the economic and state interests of the Russian Federation, including a participation rate by Russian contractors of 70% or higher;

- the development of a program for the creation of domestic enterprises on sea platforms for the extraction of shelf hydrocarbons and in the territorial waters of the Russian Federation;
- the establishment of constant monitoring of the realization of the Production Sharing Agreement, regular federal hearings by enforcement authorities according to the decision of the Government of the Russian Federation dated February 2, 2001 №86, “Regarding measures to improve federal agency activities by the enforcement authorities in the preparation, conclusion, and realization of Production Sharing Agreements, and the monitoring of their realization.”