



SAKHALIN II: **A SUMMARY OF SOCIAL PERFORMANCE**

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ALL DATA FROM SAKHALIN ENERGY UNLESS OTHERWISE INDICATED

1. SUMMARY

SAKHALIN STATISTICS

- Sakhalin Island is 948km long and home to 608,000 people; average population density is the same as the Highlands of Scotland.
- About half of the population lives in the capital city, Yuzhno-Sakhalinsk (174,000+), and the towns of Korsakov and Kholmsk (over 36,000+). Around 3,500 indigenous people, many pursuing traditional livelihoods, mostly live in the north of the island.

CONTRIBUTION TO RUSSIAN ECONOMY

- Sakhalin Energy's investment of approximately \$20 billion will be the largest single direct foreign investment in Russia to date. Once the project has reached cost recovery, annual benefit to Russia in royalties, profit hydrocarbons and taxes will be about \$2 billion per year.
- Over its expected life, Sakhalin II is forecast to provide \$50 billion for the Russian government based on an oil price of \$34/barrel.

CONTRIBUTION TO SAKHALIN ECONOMY

- Oil & gas inward investment has contributed to a five-fold increase in revenues for Sakhalin Island between 2002 and 2005.
- In 2005, nominal per capita income increased by 31.3% compared to 2004. Purchase power increased by 9.1% over the same period. The section of the population classed as "living below subsistence" decreased from 42% of the population in 2000 to 23.8% in 2005.

CONTRACTING & PROCUREMENT

- Since 1996, Sakhalin Energy has awarded contracts worth \$6.1 billion to Russian companies. In 2005 alone, Sakhalin Energy awarded 87% (\$1 billion) of its contracts to Russian contractors.
- The utilisation of Russian subcontractors is planned to exceed \$700 million in the construction of Russia's first Liquefied Natural Gas plant.

EMPLOYMENT & TRAINING

- Sakhalin Energy has invested \$7 million to train employees in 2005, of which \$5.9 million was spent on training Russian nationals.
- At the final quarter of 2005, the project was providing direct and indirect employment for nearly 23,000 people. 62% are Russian nationals, including 7,800 from Sakhalin.

INFRASTRUCTURE DEVELOPMENT

- A total of \$390 million has been spent by Sakhalin Energy on infrastructure upgrades between 2001 and April 2006.
- Over 70% (\$280 million) was spent on municipal or publicly accessible facilities including roads, hospitals and airports.

FUNDING SOCIAL & ENVIRONMENTAL IMPROVEMENTS

- In accordance with the Production Sharing Agreement (PSA) a one-off bonus payment of \$100 million was made by Sakhalin Energy to the Sakhalin Development Fund, run by the Sakhalin Oblast Administration. The fund invests in improvements to the infrastructure of the Sakhalin Region including the power sector as well as health, education and other social services.
- Voluntary payments of more than \$26 million, from contractor set-aside funds and Sakhalin Energy's social investment budget, have been made to projects. In addition, Sakhalin Energy has committed \$1.5 million over the next five years to fund the Sakhalin Indigenous Minorities Development Plan. The plan was developed in a tri-sector partnership with government and the Indigenous Minorities Council – a first for Russia.

ASSESSING & MANAGING IMPACTS

- Sakhalin Energy believes that the magnitude of negative impacts on the people of Sakhalin is relatively low. For example, so far the Company has compensated a total of 111 affected land-users, compared to 13,250 separate land parcels affected by the BTC pipeline in central Asia.
- Over 4000 people were consulted during the preparation of Sakhalin Energy's Social Impact Assessment, which led to detailed action plans for mitigating social impacts.

THE WAY FORWARD

- Over the past ten years, Sakhalin Energy has learned a great deal about what it means to be a good neighbour on Sakhalin Island. The Company continues to learn by listening to both critics and advocates of the project and by being responsive to local concerns.
- For example, in the past year, Sakhalin Energy was able to move from a position where local indigenous people were protesting about oil and gas activities on the island, to one where Sakhalin Energy, the Oblast Administration and indigenous people have joined forces to support the development of the local indigenous population.

2. INTRODUCTION

THE SAKHALIN II PROJECT

The project is the world's largest integrated oil and gas development and is a flagship investment transforming Sakhalin Island in the Russian Far East into a major energy province that will provide Russian gas to Asia-Pacific for the first time. As Russia has little offshore experience or energy infrastructure, the Sakhalin II project is incubating the Russian offshore oil and gas industry and building the future capacity that the country's energy sector will need to unlock its frontier energy reserves.

The social and economic impacts of a project like Sakhalin II are complicated and multi-dimensional. Sakhalin Energy takes its social performance very seriously. It is committed to making a genuine contribution to sustainable development on Sakhalin Island and in Russia more broadly, as well as assessing, managing and minimising any negative social impacts from its activities.

Among the challenges being faced along the way are dealing – sympathetically and effectively – with the social issues raised by the impact of such drastic change on communities (local and indigenous), and people within a traditional fishing-based economy.

SAKHALIN PAST

At the dawn of the 20th century, Sakhalin had an estimated 30,000 residents. However, due to its status as a Tsarist penal colony, the majority of these were convicts and political exiles. For centuries the island's resources have been stripped with little regard for the environment or the future. The focus was short-term and there was minimal capacity building of the population and little long-term infrastructure development – just enough to access and remove the timber, minerals and fish.

The early 20th century was an important time in the formation of the coal, oil, fishing, forest and agriculture industries, still basic in Sakhalin. At that time the foundations of the modern economy of the region were laid down.¹ Since then, there have been waves of industry to exploit the island's natural resources. Some has adhered to the principles of sustainability; much of it has not.

EXPLORATION IN SAKHALIN

The oil and gas industry is one of the oldest in the Sakhalin Region. Many consider 1925 as the starting point of the industrial development of the island's oil and gas stocks as this was when the first complex mining and geological expedition was directed here.

With the collapse of the Soviet Union and the downturn in the Russian economy in the 1990s, what little there was on the island in the way of infrastructure, power, water and health care systems deteriorated.

Meanwhile, demand for raw materials declined and unemployment and poverty increased. The move to a market economy also meant a painful withdrawal of state support for the native population. Today, most of the population lives in the southern half of the island, centred mainly around Yuzhno-Sakhalinsk, the capital city with a population of about 174,000. The island also has two ports: Kholmsk and Korsakov, each with a population of over 36,000. Of the 3,513 indigenous people on the island, there are 2649 Nivkh; 387 Uilta (Oroki); 266 Evenki; 140 Nanais and 71 Other.

SAKHALIN ENERGY'S ARRIVAL

When Sakhalin Energy arrived on the island in 1996, it was to the legacy of poverty and under-developed infrastructure and the population's unrealistic expectations of incoming industry and capital. However, the Company was determined to ensure that its approach help reverse this legacy by building local capacity as a result of the investment. But while Sakhalin Energy's contribution is important, it does not and should not replace the role of the government at local or federal levels.

The Sakhalin II Project is developing two energy fields: Piltun-Astokhskoye, primarily an oil field with associated gas, and Lunskeye, predominantly a gas field. The Project is being developed under a Production Sharing Agreement (PSA) – the first of its kind in Russia – between the Government of the Russian Federation, Sakhalin Oblast Administration and Sakhalin Energy.

In accordance with the PSA, revenue received from selling the Project's oil and gas is first subjected to a royalty charge of 6%, which is paid to the Russian Federation. Initially, according to the PSA, the royalty was split such that 60% went to Sakhalin Oblast and 40% went to the Russian Federation. However, after changes to the tax legislation in 2004, the Sakhalin Oblast's share was cut to 5%, with the remaining 95% going to the Federal Government.

Phase 1 of the Sakhalin II Project focused on oil development and went into seasonal production during the summer of 1999 at the Vityaz Production Complex (including the Molikpaq offshore platform). As the sea around the Vityaz Production Complex is covered with ice for approximately six months every year, production from Phase 1 is currently limited to the ice-free period of about 180 days.

Phase 2 of the Project is an integrated oil and gas development that will allow year-round oil and gas production. It will involve a further investment of approximately \$20 billion and will provide revenue for stable economic growth and further development of the Sakhalin region.

¹ For more information refer to <http://museum.sakh.com/eng/12.shtml>

3. ECONOMIC CONTRIBUTION

3.1 CONTRIBUTION TO RUSSIAN ECONOMY

Over the lifetime of the Sakhalin 2 project, a projected contribution of \$50 billion to the Russian economy will be made. In 2004, \$28.5 million in royalties was paid to Russia as a result of production from the Molikpaq offshore platform. Such royalties will continue throughout the life of the Project. Sakhalin Energy will use the remainder of the revenue to recover operational and development costs.

Once costs had been recovered (without profits) the difference between income and profit hydrocarbons will be split between the Russian Federation and Sakhalin Energy, as agreed in the PSA. Once the project has reached cost recovery, the annual benefit to Russia in royalties, profit hydrocarbons and taxes will be about \$2 billion per year.

The income from the sale of Sakhalin Energy's share of the profit hydrocarbons is subject to an income tax rate of 32%, which will be the major part of the direct benefits of the project to Russia. By the end of Phase 2, the levels of investment in the Sakhalin II Project (approximately \$20 billion to date) will make it the largest single foreign investment project in Russian history.

Sakhalin Energy has been a significant contributor to the Russian and island economies by paying taxes and royalties, procuring and contracting locally, creating direct and indirect employment and contributing to infrastructure and social investment, and will continue to do so.

The Russian Content Development policy commits to maximising the benefits of the project to Russians. The performance against the stated goal of 70% Russian content in employment and procurement is steadily improving and exceeding the goal in many areas.

3.2 CONTRIBUTION TO SAKHALIN ECONOMY

Living standards in the Sakhalin region are rising. Between 2002 and 2005, the island's internal revenues increased by more than 500%, making Sakhalin the most economically dynamic district of the Russian Far East.

Since the arrival of Sakhalin Energy, the standard of living on the island has greatly improved. According to the Report on Social-Economic Development of the Sakhalin Oblast for January-December 2005, nominal per capita income of the population increased by 31.3% in 2005 compared to 2004. This rise surpassed the inflation level by about 12%. Purchasing power grew by 9.1% year on year.

Growing income has led to a decrease in the share of the population with incomes below subsistence level. In 2005, those living below subsistence level dropped to 20.4% of the population or a little over 108,000 people. This compared to 21.3% or 114,000 people in 2004.

3.3 CONTRACTING & PROCUREMENT

Sakhalin Energy aims to use Russian contractors wherever possible. As well as contributing resources and employment, perhaps more importantly it also allows the enterprises involved to gain exposure to international standards and procedures, helping them to compete successfully in the international market.

Since 1996, Sakhalin Energy has awarded contracts worth \$6.1 billion to Russian companies. This includes the major contract for engineering, procurement and construction of two onshore pipelines to a Russian enterprise called Starstroi. In 2005 alone, 87% of contracts awarded by Sakhalin Energy were to Russian contractors, worth \$1 billion.

One of the first major project milestones to showcase Russian capability was the construction and installation of the Lunskeye and Piltun Concrete Gravity Base Structures in 2005. The selection of this type of structure was specifically made to maximise potential for Russian content and the strategy has delivered beyond all expectations.

The structures, built in record time in the port of Vostochny, involved 250 Russian companies and suppliers (ranging from local Nakhodka suppliers to national companies supplying steel, cement and fabrication services) and 2000 Russian nationals. 97% of the volume of materials used was purchased in Russia.

Sakhalin Energy encourages involvement of Russian enterprises in the Project as partners in joint ventures with international companies and requires its international contractors to maximise use of Russian subcontractors. The construction of the Onshore Processing Facility is being carried out by joint venture BETS (with a 50% Russian partner) with an original contract value over \$300 million.

In addition, a telecommunication project worth more than \$80 million is being executed by the Russian-Japanese joint venture Summit Kriljon Service Telecom.

The use of Russian subcontractors is planned to exceed \$700 million in the construction of the LNG plant. The major Russian companies involved in this project are Transstroi Engineering Corporation, IKEM, Nipigaspererabotka & Angarsk.

- For more examples and case studies see Appendix 1

3.4 SAKHALIN-BASED SUPPLIERS

Local Sakhalin enterprises are also actively involved in the project. The largest locally awarded contract so far is the \$85 million contract for pipelines maintenance depots. This went to a consortium of Sakhalin construction companies.

With the purpose of improving Sakhalin Energy's Russian content performance, the company adopted a new strategy for Russian content development in 2005. Sakhalin Energy's focus is on the sustainable development of Russian content through the proactive development of Russian business opportunities. This entails longer-term planning of future contracting and procurement activities and early identification of opportunities to involve Russian enterprises and people.

In 2006, as part of this policy to promote Russia's enterprise base, Sakhalin Energy posted a full list of tenders for 2006 to 2010 on its external website to stimulate interest among Russian enterprises and enable them to prepare for future requirements. Sakhalin Energy has also developed clear registration procedures and holds workshops for Russian enterprises and trade fairs in Sakhalin.

To underline its commitment to Russian content, Sakhalin Energy invited Joint Committee members from the Russian Party to witness the meetings of the company's tender board where contracts crucial to Russian Party's interest (e.g. those which have a large impact on Russian content) are discussed. The Special Tender Board met seven times in 2005.

Finally, all major contracts are audited regularly to evaluate Russian content performance and contractor efforts to use Russian human and industrial resources.

4. EMPLOYMENT & TRAINING

4.1 JOB CREATION

In the final quarter of 2005, 22,752 people were employed on the Sakhalin II project, either directly or through contractors. Of these, 14,076 (62%) were Russian, including more than 7800 (>34%) residents of Sakhalin Oblast. In the town of Korsakov alone, over 1,000 people were employed in the construction of the LNG site at this time.

Partly as a result of project activity and the direct and indirect employment opportunities created by it, unemployment on the island has fallen.

Sakhalin Energy has done more than just provide employment. The rapid oil and gas boom revealed a critical shortage of technically trained local staff. According to Irina Prokopova, Sakhalin Energy's technical learning adviser: "Although Russia's technical education is good, they weren't qualified for the company's advanced techniques. Sakhalin Energy is constructing the first Liquefied Natural Gas plant in Russia – we have no specialists here. Yet! We'd also like to keep young people here in Sakhalin – too many Russian trained technical and operations staff are working for foreign companies." The end result was that Sakhalin Energy decided to train 'in-house'.

In 2005, Sakhalin Energy invested \$7 million for training its employees, of which \$5.9 million was spent on training Russian nationals. This is in addition to the Company's contribution to a welding school and scholarship, apprenticeship and internship programmes.

The Company also provided 1,528 places on training courses in 2005. The training covers on-the-job training, formal courses, seminars and workshops in a broad range of disciplines such as safety, generic business skills, language and computer skills.

4.2 APPRENTICESHIPS

The Sakhalin Energy Apprenticeship Training Scheme has a purpose built centre, 80 people on its books and plenty more wanting to join. It is a vocational programme with the guaranteed of a secure, well-paid job at the end of it. Students need a technical background from college or vocational school.

To date, 11 students have graduated to working on site for two years, and 78 trainees are going through the two year 'classroom phase', a mix of English language lessons and technical training. After six months of intensive language study, the apprentices receive broad technical training to equip them for a variety of jobs. Many will get overseas experience, in Malaysia or China for example, before returning to Sakhalin Energy.

4.3 INTERNAL COMPANY TRAINING

Generally, the programs can be grouped as following:

1. Operations and Maintenance training programmes for technicians
2. Language courses for Russians and non-Russians
3. HSE and Mandatory training
4. Specialised professional training - for technical and non-technical (finance, contracts, HR etc) discipline
5. Business and supervisory skills training
6. Long-term educational programmes for certifications (CIMA, ACCA, CIPS etc)
7. Graduate onboarding and development
8. Educational assistance

4.4 SAKHALIN ENERGY SCHOLARSHIP PROGRAM

Since 2003, Sakhalin Energy has also been running an annual scholarship program aimed at:

- Contributing to the development of a sustainable pool of Sakhalin Island talent who can be employed by the company in the future
- Providing increased access to education opportunities to (the best students from District Centres) that might have been previously impossible due to financial reasons
- Contributing to generating a positive image of the Company through assisting the Sakhalin talented youth in their higher educational undertakings

The total number of scholarships awarded since 2003 is 54. Of these, 20 were awarded in 2006 with the estimated annual scholarship fund approximately RUR 1,500,000 (approx \$55,000) plus RUR 200,000 (about \$7,400) for an advertising campaign to attract applicants.

4.5 SAKHALIN ENERGY INTERNSHIP PROGRAMME

The programme's objectives are:

- To provide senior students of Russian Higher Education Establishments with the opportunity to work in a large international corporation.
- To acquaint students with western business practices.
- To identify students with outstanding abilities who may be considered for permanent or temporary employment after graduation.

Eligibility:

- Students awarded with SEIC educational grant, and receiving their professional education in Russian Higher Education Establishments on the basis of SEIC Scholarship Program Agreements.
- SEIC employees' children receiving their professional education in Russian Higher Education Establishments on the basis of Trilateral Agreements between Sakhalin Energy, the University and Students.
- Other senior students of Russian Higher Education Establishments. These students will be considered for having internship on the competitive basis.

The duration of the internships may vary from four to eight weeks, with usual working hours from 9am till 6 pm. The students are paid on a fixed hourly rate. In 2005, 12 students took an internship with Sakhalin Energy. The 2006 Internship Program began in early June.

5. FUNDING SOCIAL & ENVIRONMENTAL IMPROVEMENTS

5.1 SUPPORTING THE PUBLIC SECTOR

As well as investing in infrastructure upgrades, Sakhalin Energy has funded social and environmental improvements on the Island. In accordance with the PSA, the Company made a one-off bonus payment of \$100 million to the Sakhalin Oblast Administration's Sakhalin Development Fund to invest in improvements to the infrastructure of the Sakhalin Region, including the power sector as well as health, education and other social services.

Furthermore, voluntary payments totaling more than \$26 million, from contractor set-aside funds and the company's social investment budget, have been made to fund projects that contribute to the sustainable development of Sakhalin Island. Such projects aid business development through micro-credit, youth development and environmental protection and improvement.

Separately, Sakhalin Energy has committed \$300,000 per year for the next five years to the Sakhalin Indigenous Minorities Development Plan. Agreed in April 2006, the plan will fund social, environmental and business development programmes led by indigenous people. The plan was developed in a tri-sector partnership with government and the Indigenous Minorities Council – a first for Russia.

Examples of Sakhalin Energy's investments are outlined in Appendix 2, and include:

- Introduction and funding of a Chair in Sustainable Development at Sakhalin University
- The Sakhalin Salmon Initiative to promote conservation and sustainable use of the island's salmon stocks
- Small business development loans
- The Small Grants, Big Deeds programme to strengthen civil society
- The Sakhalin Road Safety Partnership
- Restoration of the planting capacity of Smirnykh forestry
- The Aniva Bay partnership to ensure sustainable use of the area
- Reconstruction of a fish nursery farm on Igrivaya River following flood damage

Below are two case studies, but for more information about the projects listed above, please see Appendix 2.

5.2 CHAIR IN SUSTAINABLE DEVELOPMENT AT SAKHALIN UNIVERSITY

At the World Environmental Conference in Rio de Janeiro (1992) and at the World Summit for Sustainable Development in Johannesburg (2002), education, professional training and public information on environmental issues were mentioned among the most significant conditions for transition to sustainable development (SD) and the solution to problems of human survival. However, in Russia, the concept of SD is still not in the academic curriculum of higher education institutions on a large scale.

Therefore, Sakhalin Energy and Sakhalin State university, the leading higher education institution in Sakhalin Oblast, have established a Sustainable Development Chair. The Parties intend that the Chair will be established in the Sakhalin State University, as in for the purpose of formation of the sustainable development culture.

The Chair on Sustainable Development focuses on three areas to expand the SD principles on Sakhalin Island: introducing the educational aspect into the curriculum by building a relationship and using the tools for SD; selecting local projects that will expand the research and assist in teaching; and educating and informing the general public.

5.3 SAKHALIN SALMON INITIATIVE

The Sakhalin Salmon Initiative (SSI) strategy brings together businesses, local communities, and non-governmental organisations (NGOs) in an ambitious public-private partnership to promote conservation and sustainable use of wild salmon and their ecosystems, build institutional capacity for conservation, and promote sustainable economic development on Sakhalin.

SSI is rooted in an established partnership with the Sakhalin Regional Administration, the Sakhalin Wild Nature Fund, and the Wild Salmon Centre. Sakhalin Energy is a founding sponsor of SSI, which is also supported by several foundations and individuals.

Effective salmon conservation on Sakhalin requires a multi-disciplinary approach that incorporates a diverse group of local and international stakeholders. To ensure effectiveness, efforts will focus on priority basins to be identified from international key salmon rivers network determined by a consortium of international scientists; Sakhalin's natural production rivers (declared wild and off limits to hatchery construction in 2005); and designated protected areas.

To ensure that Sakhalin's salmon ecosystems and the communities they support thrive in the 21st century, the SSI will have three focal areas: Habitat Conservation, Conservation Capacity, and Sustainable Economic Incentives and Sustainable Use.

The SSI International Conference will convene representatives of government, academia, local and indigenous communities, NGOs, fishing and extractive industries and international organisations and institutions to:

- Finalise SSI's strategic priorities and action plans;
- Elaborate SSI programme activities and projects;
- Provide a forum for a range of issues relating to salmon, with input from local stakeholders and international experts, and;
- Secure institutional support for SSI as well as stakeholder ownership and endorsement.

6. INFRASTRUCTURE DEVELOPMENT

6.1 PRIMARY GROWTH

The island's economic growth is also being propelled by the Sakhalin II infrastructure upgrade programme, which is improving roads, health care facilities, telecoms and waste disposal sites to support Phase 2 construction. A total of \$390 million had been spent by Sakhalin Energy on infrastructure upgrades between 2001 and April 2006. Of this figure, over 70% (\$280 million) was spent on municipal or publicly accessible facilities including roads, hospitals and airports.

DESCRIPTION OF UPGRADES 2001 TO APRIL 2006	MILLION \$
Road and Bridge Upgrades - North of Nogliki	16.8
Nogliki Airport Upgrade	19.11
Waste Management	10.23
Health Infrastructure Upgrade	6.07
Land Clearance Support Projects	1.16
2003/04 Federal Roads and Bridges	107.27
2006/07 Federal Roads and Bridges	11.87
Municipal Roads and Bridges	11.83
2001/2002 Works	0.01
Roads and Bridge Maintenance Works and Snow Clearing	7.46
Korsakov-Prigorodnoye Road Upgrade	0.35
Kholmsk Community Projects	1.89
Korsakov Township Upgrade Works	1.59
Railway Upgrades	18.83
Marine Works	16.21
UXO & Survey Projects	36.76
Facilities	12.36
SUB TOTAL:	279.80

6.2 ROADS & BRIDGES

In late 2002, Sakhalin Energy and the Sakhalin Oblast administration agreed on a programme of road and bridge infrastructure construction works under a Protocol of Mutual Obligations. The work will continue until the end of 2007. To date, the work on roads, culverts, gutters and permanent and temporary bridges has been done in cooperation with Sakhalin Road Department (Sakhavtodor), has involved local island contractors: SU-4, Vostokdorstroy, Tymovsk Road Construction Department and Sakhalin Construction and Investment Company.

Road and bridge upgrades and the asphaltting of roads in townships that are experiencing increased traffic flow as a result of the Phase 2 construction period have been done in seven of the island's municipalities at a cost of approximately \$14.5 million.

In July 2005 Sakhalin Energy and Oblast administration signed the Addendum to the Protocol of Mutual Obligations: Sakhalin Energy will asphalt the Makarov road (about 10 km) and reconstruct the Lesnaya bridge (Porechye), the cost of which will be shared with the Oblast.

Sakhalin Energy, in conjunction with Sakhavtodor, also asphalted about 12 km of roads in the communities of Tikhaya, Grebenskaya, Tumanovo, Leonidovo, Matrosovo, Palevo and Novoye. The work was done by local construction companies Pereval, Temp-Sakhalin Vostokdorstroy. Sakhalin Energy and Exxon financed asphaltting works in Val.

Extensive repairs of the road sections were done in Makarov, Smirnykh, Tymovsk, and Poronaysk districts.

6.3 HOSPITALS

Upgrades of hospitals, financed by Sakhalin Energy, in Nogliki and Poronaysk and the region's main hospital in Yuzhno-Sakhalinsk began in 2005 at a total cost of \$7.2 million. This will enable safe, unimpeded emergency health care services for both local residents and communities as well as Sakhalin Energy and its contractors and subcontractors.

Blood bank rooms (in all three hospitals), surgeries, intensive care units, resuscitation rooms and reception rooms (in Poronaysk and Oblast hospitals) have undergone major refurbishment. New medical equipment, including X-ray machines, blood banks, digital ultrasonic scanners and artificial kidney machines, was bought at a cost in excess of \$3 million, and funding provided for emergency care training and operation, as well as maintenance for the next four years.

Ambulances fully equipped defibrillators, ventilators and emergency response equipment have also been supplied to six district hospitals at Nogliki, Poronaysk, Kholmsk, Korsakov, Dolinsk and Yuzhno-Sakhalinsk.

6.4 KHOLMSK

Sakhalin Energy has also undertaken a number of goodwill projects in Kholmsk in agreement with the district administration. These include the deployment of oil spill response equipment, the beautification of Primorsky Boulevard, the replacement of a local kindergarten roof, first aid equipment and furniture for children's clinic, and an emergency medical centre at the hospital.

6.5 KHOLMSK PORT

To receive Phase 2 construction materials and onshore processing facility cargo, Sakhalin Energy upgraded Kholmsk fishing port in 2003-2004. Ancillary works at the port included office upgrades. At the end of 2004 approximately 100 local people were employed full-time in the port by contractor 3-S and three Sakhalin freight companies were working permanently in the port managing the onwards transfer of cargo.

The port's warehousing requirements have been reviewed to ensure they meet the project's longer-term onshore and offshore supply requirements. Sakhalin Energy is also investigating establishing an economic development zone to encourage local service providers to supply construction consumables, filters, oil etc during the operational stage from 2007.

6.6 NOGLIKI AIRPORT

After extensive upgrades done jointly by Sakhalin Energy and Exxon, Nogliki Airport was opened for daylight operation in October 2004. The temporary approval issued in 2004 was withdrawn in 2005. The airport remains closed to all fixed-wing aircraft but remains operational for helicopter use.

6.7 AVIATION

Sakhalin Energy supported the development and operational certification of a Russian designed and developed health and usage monitoring system (HUMS). This has now been installed in one of the helicopters used by Sakhalin Energy, the first time such a system has been used in Russian aviation. Sakhalin expects to have the remaining systems installed during the 3rd quarter of 2006.

HUMS monitors the condition of all rotary devices in a helicopter during flight and can detect even the smallest vibration created by the simplest of marks on a drive gear. All the data is captured by the onboard monitors and is processed and analysed after each flight. This diagnostic system can identify potential defects, provide early warning of impending failures and the information to reduce flight vibration levels, all of which improve flight safety and contribute to overall long term maintenance cost savings.

All Aviashef helicopters operated for Sakhalin Energy Offshore flights now carry two improved life rafts, the RFD 18R Mk1 Helirafts, Each carries 18, is fully reversible and has a boarding ramp and canopy, improving safety and capacity.

6.8 SHAKHTERSK AIRPORT

Sakhalin Energy has enabled the airport to buy and install OMI-1 lighting and signaling equipment to improve the safety of flight operating within Sakhalin.

6.9 UNEXPLODED ORDNANCE

One of the dangerous legacy issues on Sakhalin is unexploded ordnance (UXO), which threatens human and animal life. Since 2002, Sakhalin Energy has funded clearance work carried out by the military and following Russian Federation legislation.

UXOs are demolished or removed, as are military chemicals, and Russian and Japanese war dead have been disinterred. The Russians were reburied with full military honours and the Japanese cremated according to Shinto rites.

The company also funds and supports a number of military support teams who are responsible for responding to civilian callouts on military UXO, materials and equipment.

7. ASSESSING & MANAGING SOCIAL IMPACTS

Construction and operation of a large oil and gas development inevitably leads to unintended social and economic impacts. Considering the scale of the development, Sakhalin Energy believes that the magnitude of negative impacts on the people of Sakhalin is relatively low. For example, so far the Company has compensated a total of 111 affected land-users, compared to 13,250 separate land parcels affected by the BTC pipeline².

A number of areas of potential impact have been identified, including:

- Increase in cost of goods and services;
- Impact on community infrastructure and road safety;
- Environment impacts on community (dust, noise, exhaust fumes);
- Negative impacts on quality of life (community's perception);
- Impacts on natural resources – fishing, gathering and hunting;
- Access to livelihood resources;
- Conflict between local residents and camp workers;
- Spread of Sexually-Transmitted-Diseases (STD's), prostitution and crime

7.1 SOCIAL IMPACT ASSESSMENT (SIA)

The SIA was conducted between September 2001 and October 2002 to provide a social baseline and help the company predict and manage the social impacts from the project. It was run by a group of local, Russian and international experts and consultants, and nearly 3600 Sakhalin residents were consulted during the process. In addition, almost 4300 people were involved in the Environmental, Social and Health Impact Assessment consultations in 2003-2004 that led to detailed action plans for mitigating social impacts. These are summarised in the Health, Safety, Environment and Social Action Plan (HSESAP).

In October 2005, Sakhalin Energy conducted a Social Impact Assessment Addendum (SIAA) focusing on issues that have arisen since early 2003, and the management and mitigation commitments made by Sakhalin Energy to address these issues, including new management procedures introduced since 2003. It also studied further issues that were not fully addressed in the original SIA. In addition, the SIAA details the consultations and social impact mitigation measures implemented in 2003-4 to meet Sakhalin Energy commitments.

Both the HSESAP and the SIA can be found in the online library at www.sakhalinenergy.com

7.2 SYSTEMS AND PROCESSES FOR IMPACT MANAGEMENT

Sakhalin Energy manages its impacts in the same way as all other critical business issues – with systems and processes that identify priorities and detail the plans for addressing them. The overarching system is the Health, Safety and Environment and Social Action Plan (HSESAP), which outlines the company's approach to managing social impacts in line with international standards. In addition, there are separate plans for specific social impacts, for example:

- Resettlement Action Plan (RAP) that is in line with World Bank guideline requirements and Russian Federation legislative requirements
- Sakhalin Indigenous Minorities Development Plan (SIMDP), developed in partnership with government and the Indigenous Minorities Council
- Public Consultation and Disclosure Plan (PCDP) that details our approach to public communication, including a procedure for receiving grievances
- Cultural heritage plan for minimising our impact on cultural and archaeological resources

7.3 MONITORING IMPACTS AND CONSULTING LOCAL PEOPLE

The social assessment team monitors key social indicators and conducts community surveys to continually assess the impact on local people and look for ways to improve. The network of Community Liaison Officers (CLOs) meets with community members and local government officials to identify and resolve any problems with the project.

Sakhalin Energy has also established an easily accessible grievance procedure so that anyone on the island may address a complaint or concern to Sakhalin Energy. All grievances are recorded and a commitment given to respond within a set time period.

The 11 Sakhalin Energy CLOs and five contractor CLOs meet regularly with local people and also work with the island's extensive local government network, as people are used to raising their concerns through local government. The CLOs visit communities and their key tasks are to:

- Be the primary eyes and ears for the project in communities;
- Provide an avenue for the Company to communicate with stakeholders;
- Provide an avenue for stakeholders to contact the company;
- Maintain a record of project impacts on the Sakhalin communities;
- Communicate changes in the community profile to key Sakhalin Energy audiences;
- Assist and support local project functions; and
- Provide primary administration in the grievance process.

Awareness of the grievance procedure among project-affected communities is raised by:

- Leaflets in CLO offices and administrative centres on regular basis;
- Leaflets in the libraries, administrative centres and on information boards in smaller communities that CLOs visit regularly;
- Advertisements in all local newspapers, with an estimated readership reach of 43,000.
- Postcards with information and the contacts of a CLO in charge of the district. This postcard is delivered to over 17,000 homes along the pipeline route.

A series of public consultations in the Tymovsk, Smirnykh, Poronaisk, Makarov, Dolinsk and Aniva districts has recently been completed with over 160 participants.

² The Baku-Tbilisi-Ceyhan (BTC) pipeline will take oil from the Caspian Sea to the Mediterranean through the countries of Azerbaijan, Georgia and Turkey

7.4 REDUCING IMPACTS

In all cases where impacts are identified, Sakhalin Energy works to minimise and manage them.

Impact of camps

Sakhalin Energy recognises the potential social impact from an influx of workers living in a construction camp. A number of policies and processes address specific social issues, including a No Hunting, Gathering or Fishing Policy, a camp management policy and code of conduct to minimise impacts on neighbouring communities, and an anti-alcohol and drug policy for employees.

Traffic/Road Safety

\$750,000 has been donated to the Sakhalin Road Safety Partnership over three years, as well as conducting vehicle inspections, driver training and running a seatbelt campaign – all designed to reduce the risk of traffic accidents. More information is in Appendix 2.

HIV/AIDS

The potential impact on the health of local community was assessed by Sakhalin Energy between 2001 and 2003, prior to the start of Phase 2 of the project. In particular, the influx of a large contractor workforce, mainly originating from areas within the Russian Federation with significant incidence and prevalence rates of HIV/AIDS, was identified as an issue given the Island still had low rates.

The Company decided to actively manage this issue together with stakeholders including UNAIDS and the Sakhalin regional authorities. A jointly-organised high level workshop was held in March 2004 for senior business and community leaders. This was the first meeting of its kind where HIV/AIDS issues were discussed between industry partners and local government. It resulted in a joint commitment to respond to STD/HIV/AIDS and other diseases of a social character.

The Company's approach is to develop and strengthen partnerships with the stakeholders, based on open and transparent communication lines and aligned with the Shell Group Guidance, working on awareness, education, prevention and the development and implementation of a Sakhalin Energy HIV/AIDS standard.

To date, significant progress has been reported, of which the most important elements are the establishment of official joint Community-Company Committees, completion of Issue related workshops, an official Resolution signed by the Vice Governor for Social and Health Affairs, implementation of a Hospital Infrastructure Upgrade focused on emergency care at three key hospitals on the Island with improved control of Blood Borne Pathogens, camp management focus on Sexual Transmitted Diseases (STD) & HIV/AIDS and Alcohol and Drug issues, support for school awareness programs and training of volunteers.

E. COMPENSATING AFFECTED PEOPLE AND COMMUNITIES

Sakhalin Energy operates a Resettlement Action Plan, in line with World Bank guideline requirements and Russian Federation legislative requirements, to award compensation to affected peoples living in Sakhalin. This includes resettlement of people to new properties and/or compensation for loss of crops from the LNG site and pipeline right of way.

Compensation totaling US\$3.6 million has been paid to 111 land users (including 51 unregistered land users) who are affected by the project footprint. In 90% of cases this is a temporary impact only.

The company has designed a Supplementary Assistance Programme to cover situations where obligations to compensate under World Bank directive OD 4.30 are more extensive than or conflict with Russian legislation. By compensating unregistered land-users the project is setting new standards for social performance in the Russian Federation.

In line with World Bank guidelines, Sakhalin Energy has offered a voluntary compensation package to dacha (summer home) owners located near the LNG site but whose properties are not located close enough to require resettlement under Russian law. This issue is being resolved at the moment. In addition, two commercial fishing companies were paid a total of \$3 million in compensation for loss of fishing access.

Compensation payments also cover impacts on fisheries. In accordance with Russian Federation Law and regardless of whether there is an impact on fishing or not, Sakhalin Energy paid \$11 million in October 2005 in potential fish damages compensation. The amount was calculated by the Russian Ministry of Agriculture and is being used to develop salmon hatcheries on Sakhalin.

Sakhalin Energy is also trying to fund construction of a park in Korsakov, to offset for the recreation impact on Prigorodnoye Beach. This is stalled due to problems with the local administration but the company is determined to push it forward as soon as possible.

8. THE WAY FORWARD

Sakhalin Energy anticipates a major shift in social performance priorities over the next few years as the project moves from the construction to the operations phase. Today's impacts, ranging from traffic to land and livelihood impacts, will decline as construction ends. Similarly, many of the benefits from the construction stage of the project, such as employment and local contracts, will decrease. Managing this transition effectively is Sakhalin Energy's primary social performance priority.

Over the past ten years, Sakhalin Energy has learned a great deal about what it means to be a good neighbour on Sakhalin Island. The Company continues to learn by listening to both critics and advocates of the project and by being responsive to local concerns.

For example, in the past year, Sakhalin Energy was able to move from a position where local indigenous people were protesting about oil and gas activities on the island to one where Sakhalin Energy, the Oblast Administration and Indigenous People have joined forces to support the development of the local indigenous population.

From this experience and others, Sakhalin Energy can say that its best social outcomes have three key elements in common: building partnerships, maintaining an open dialogue with stakeholders, and working through external groups and individuals to achieve common goals.

Sakhalin Energy intends to continue building transparent processes for consultation and dialogue in order to manage the social challenges of the coming years.

8.1 IMPLEMENTING OUR COMMITMENTS TO DELIVER BENEFITS AND MANAGE IMPACTS

With support from leadership and cooperation with government and external groups, Sakhalin Energy's dedicated social performance team and network of CLOs will be working to ensure quality implementation of our commitments.

The commitments are summarised in several key documents that provide the framework for social impact management and delivering benefits to the people of Sakhalin.

Performance against these commitments is measured through objective, quantitative indicators in the Social Compliance Monitoring Handbook, and through our process for monitoring compliance with the Health Safety, Environment and Social Action Plan. The information generated allows us to monitor our progress, as well as providing information to allow for course changes and adaptation of management systems as appropriate.

8.2 DEVELOPING A LONG TERM SD/SI STRATEGY

As discussed in Sections 5 and 6 of this report, Sakhalin Energy has made major commitments to social development on the Island since project inception – including infrastructure upgrades, a one-off bonus payment of \$100 million to the regional government's Sakhalin Development Fund, and voluntary payments to sustainable development projects totaling more than \$26 million (from contractor set-aside funds and the company's social investment budget).

Initially, as the impact of construction has been highly visible and the infrastructure needs in communities are great, there was significant pressure to spend the SD funds on short-term infrastructure projects. Care has been taken to respond to community requests without taking over the role of government, or building unrealistic expectations amongst local people.

Gradually, the Sakhalin Energy social team has been promoting longer-term approaches and capacity building of local organisations on the Island. A set of flagship partnerships has been launched with two primary characteristics: external participation in decision-making and capacity building. These will continue to provide benefits over the next few years.

For example:

- The partnership with ACDI-VOCA promotes diversification of livelihoods and economic opportunity through business advisory services and small loans. Further development of this kind of initiative will be essential as direct employment opportunities from the Sakhalin II project decline.
- The Sakhalin Indigenous Minorities Development Plan will provide on-going benefits to indigenous groups over the transition years.
- The Sustainable Development Chair at Sakhalin State University (developed in partnership with the NGO Living Earth Foundation) will help to promote understanding of sustainability and long term thinking about the future of the island.

As the project moves to the operations phase, Sakhalin Energy will continue to support the long-term social and economic development of Sakhalin Island through sustainable mechanisms.

Sakhalin Energy will also explore options for providing long-term support to social initiatives and local economic growth. The company will work with stakeholders on the island over the next twelve months to further shape this plan and determine the most appropriate role for Sakhalin Energy, in relation to other industry players and Government.

8.3 MANAGING DEMOBILISATION

Sakhalin Energy began the thinking about demobilisation during the social impact assessment at the time of project start-up and a number of processes are already in place to manage the issue. These processes – in line with Russian legislation – are designed to minimise the social and economic impacts of demobilisation.

Throughout the project, Sakhalin Energy has demonstrated a high commitment to building Russian skills in new technologies, in anticipation of long-term growth in the oil and gas industry in the Russian Far East. These skilled workers, many of them from Sakhalin Island, will be competitive in the future job market. The challenge will be to manage the supply and demand of the Russian staff to be demobilised from Phase 2 of the project.

A dedicated team with a specific budget will be managing a three-pronged demobilisation strategy:

- The first element comprises the contractual obligations to staff which will reside with the present employer, either Sakhalin Energy or a contractor.
- The second element is the establishment of a demobilisation process for both Sakhalin Energy and contractor staff which begins with the collection of data and then provides for the matching of labour supply and demand with other businesses and government entities in Russia.
- The third element is a system that matches work seekers with employers, allowing Sakhalin Energy and others access to staff that have worked on Sakhalin II.

Sakhalin Energy's overall goals for the next five years are to implement the commitments it has made and to deliver benefits and manage impacts during the transition from construction to the operations phase.

The Company aims to run an operation that delivers benefits for local people and has minimal and well-managed negative impacts. This is what the Company believes it means to be a good neighbour, and it hopes to work together with government, communities, NGOs, lenders and others to achieve this goal.

APPENDIX 1: RUSSIAN CONTENT

1.1 THE VYKSA STEELWORKS

The ZAO United Metallurgical Company (OMK) has supplied over 320km of pipe to Sakhalin Energy to date. A pipe coating plant set up in Vostochny as a Joint Venture (JV) between Transprom Resource (A Severstal Company) and Japanese Metal One has provided 500 jobs training local employees in the latest pipe coating techniques. In total, Sakhalin Energy awarded the purchase orders for line pipe supply worth of \$100 million to joint venture companies with at least 50% Russian ownership.

1.2 TRANSPORTATION OF LNG VOLUMES

For the transportation of LNG volumes, Sakhalin Energy has awarded contracts to two Japanese-Russian shipbuilding consortia for the long-term charter of three new-build LNG ships. JSC Sovcomflot are one half of a JV contract for two of those ships and the Primorsk Shipping Cooperation are one third of the other consortium. This is another first – Russian involvement in LNG shipping – and both Russian Companies will play a key role in manning these ships with Russian crews.

1.3 MARINE VESSEL PROCUREMENT

Russian construction success in marine services extends further to the construction of two ice-class harbour tugs and two line handling boats, which will be built in Russian yards. Tugs will be constructed in Admiralty yard in St-Petersburg, line boats will be fabricated in Zvezda yard in Nakhodka.

Sakhalin Energy signed the long-term charter agreement for three new-build platform supply Vessels with two Prisco-Swire joint venture companies: PSV Sakhalin Offshore Limited and Prisco Swire Offshore Pte. Limited. Both companies are registered for taxation purposes in the Russian Federation and are 50% owned by a subsidiary company of the long established Russian shipping group Primorsk Shipping Corporation (Prisco). The total value of these contracts exceeds \$600 million. The three vessels will be crewed by a total of 48 mariners (16 per vessel), plus another 30 or so on paid leave at any time. The Russian Content Plan states that the vessel crews will be 100% comprised of Russian nationals for the entire 15-year charter period.

1.4 BUSINESS GROWTH AND STANDARDS UP-GRADE

Today, Sakhalin II contractor Primorsk Shipping Corporation (Prisco) is a world away from its origins as a state-owned shipping company delivering aviation supplies to the Russian Far East. The company invested in skills upgrading to adapt to international ways and comply with the highest standards of health, safety and environmental management. It now meets technical specifications and maintenance standards and is both legally and financially transparent

Prisco now meets Sakhalin Energy's tough requirements and today 6% – 8% of its cargo is for Sakhalin Energy. The company now has 3,000 Russian staff, owns 40 tankers and is the main oil products carrier on the Far Eastern routes.

1.5 TECHNICAL CAPACITY UPGRADE AND INFRASTRUCTURE DEVELOPMENT, CONTRACT 3-S COMPANY

A five-year contract for the provision and maintenance of the shore base in the Kholmsk Sea port was awarded to Russian Sakhalin shelf service company (3-S). As part of this, the following works in the Kholmsk Western Sea Port were performed:

- Upgraded the existing equipment and purchased new dock portal cranes, forklifts, pipe carriers and powerful dock portal 60 t crane;
- Constructed warehousing facilities for the storage of pipeline and offshore platform supplies equipped with the state-of-the-art racking system;
- Increased the harbour depth to 9.5 m to enable approach of ice-class vessels; removed wreck from the sea bottom.

The port upgrade enables a year-round handling of all the marine cargo traffic in Sakhalin and supply vessels involved in the transportation of materials and equipment to the offshore oil and gas production location.

1.6 TECHNICAL CAPACITY UPGRADE AND INFRASTRUCTURE DEVELOPMENT

Russian ZAO Koksokhimmontazh Trust took part in the construction of the Russia's first LNG plant. This enterprise constructed two oil storage tanks with a capacity of 100,000m³ each. ZAO Koksokhimmontazh possesses extensive experience in construction of oil storage tanks in various, including harsh, environments, but construction of the tanks for the above project required application of new approaches and technology. Involvement in Sakhalin II Project enabled this company to amass work experience in use of international standards and new technologies in tanks construction.

1.7 MAXIMISING RUSSIAN CONTENT AND UTILISING RUSSIAN INDUSTRY

In April 2006, Sakhalin Energy awarded an \$85 million contract for the construction of five pipeline maintenance depots along the pipeline right of way to a consortium led by Sfera. The consortium also includes Transstroy Sakhalin and SU-4/FSC. This represents over 95% Sakhalin content and is the largest contract awarded exclusively to Sakhalin Island contractors in the Sakhalin II Project development. This award confirms Sakhalin Energy's commitments and efforts aimed at Sakhalin business development in line with the new Russian content development strategy focused on maximising opportunities for Russian enterprises in Sakhalin II Project.

1.8 TECHNICAL CAPACITY UPGRADE, OMK-VYKSA MILL

OMK-Vykxa Mill successfully completed the first order for Sakhalin II conductor pipe in Russia. This is the first time that a submerged arc welded (SAW) 30 inch conductor with a 1.5 inch wall thickness was manufactured in Russia to API-5L, PSL-2+ specification.

With this achievement the OMK-Vykxa mill and their Severstal plate manufacturing partner are now one of the few companies in the world that can manufacture this product to such high specification. With a rapidly expanding offshore market inside and outside Russia, this will provide a platform from which to compete.

APPENDIX 2: SUSTAINABLE DEVELOPMENT PROJECTS

2.1 THE SAKHALIN INDIGENOUS MINORITIES DEVELOPMENT PLAN (SIMDP)

Nivkhi, Evenki, Oroki and Nanai are small communities of indigenous people who live on Sakhalin Island. These peoples are as ancient as Russia itself. Originally from the Arctic regions, they have lived through the Russian Empire, communism, perestroika and now under the Russian Federation.

In total, there are approximately 3,500 people who can be classed as indigenous on Sakhalin today. The way of life for these small rural groups hasn't changed much over the centuries. They're no longer completely nomadic, but still survive on the land: reindeer herding, hunting, fishing and berry collecting.

The Sakhalin Indigenous Minorities Development Plan (SIMDP) — available for download at www.sakhalinenergy.com — is a programme of support for Sakhalin's indigenous minorities — regardless of where they live. Sakhalin Energy prepared it in partnership with the Sakhalin Indigenous Minorities Council and the Sakhalin Oblast Administration. It will continue for the life of the Sakhalin II project with planning done as a series of five year plans.

The key objectives of the SIMDP are to:

- Avoid or mitigate potential negative impacts caused by the Sakhalin II project;
- Improving the lives and livelihoods of Sakhalin's Indigenous Minorities through a programme of development support; and
- Enhancing the capacity of Indigenous Minorities to actively participate in the management of the SIMDP and similar development programmes

Recognising that the Sakhalin II project has an impact on the island's indigenous minorities, Sakhalin Energy began consulting with the island's indigenous minorities in 2001 as part of the project's Social Impact Assessment (available for download at www.sakhalinenergy.com)

In June 2005, a working group of Sakhalin Indigenous Minorities Council members, Oblast representatives and Sakhalin Energy staff and consultants was formed to provide input into the preparation of the SIMDP, which was released in 2006.

Part of the SIMDP process was engagement about project impacts and the mitigation measures currently planned by Sakhalin Energy and the company consulted widely with the island's indigenous minorities about these and priorities for development support.

The priorities for the communities are social benefits like education and health, (particularly access to dental care and anaemia treatments) were seen to be very important, but their main priority was that their lifestyle should become sustainable, to allow it to be passed on to the next generation.

Sakhalin Energy has committed to spending \$300,000 per year for the next five years on this plan. This is a unique commitment to indigenous people funding, and it is guaranteed, whether or not the European Bank for Reconstruction and Development advance a loan to the second phase of project. Half of the money is earmarked to be spent on maintaining traditional economic activities, such as reindeer herding and fishing so that traditional lifestyles can be maintained. There will also be some investment in health, education and culture. The plan also invests in capacity building and training — 10% of the money will go into a mini grant fund to be governed by the indigenous people themselves.

Included in the plan's mitigation measures and despite the project affecting less than 1% of the land used as spring and summer pastures by indigenous reindeer herders, is Sakhalin Energy's payment of three million roubles (around \$110,000) in compensation. The company has also given herders extra help by providing radios and fuel.

With fishing another primary source of both food and income for indigenous people, the company paid \$11 million in fish damages compensation to the Russian Authorities as part of Russian laws to mitigate against potential impacts on fisheries.

There has also been public praise for the company from the European Bank of Regional Development Bank, which sees the SIMDP as an essential commitment under the Company's social agenda. The indigenous people themselves say the SIMDP represents an historic change, and is the kind of agreement they've been asking for, for decades.

2.2 SMALL BUSINESS DEVELOPMENT LOANS

In 2005 Sakhalin Energy partnered ACDI-VOCA, a self-sustaining cooperative, to strengthen its capacity to make loans for small business development and start-ups in the Nogliki and Tymovsk area, together with representatives of the Oblast and small business association. Entrepreneurs and employees of small businesses are then provided with the necessary financial and non-financial services to expand and participate in regional economic development. Sakhalin Energy contributed loan capital with ACDI-VOCA matching funds for staff and overseeing and administering the loan programme. Through its existing cooperative, ACDI has already opened an office in Nogliki, Tymovsk and held its first meetings, as well as provided loans to the local entrepreneurs.

2.3 STRENGTHENING CIVIL SOCIETY

In 2006, Sakhalin Energy outsourced the administration of its grant programme, *Small Grants – Big Deeds*, to the local NGO Pilgrim, which had previous grant experience. The main goal of *Small Grants – Big Deeds* is strengthen capacity of the local NGOs, initiative groups and social institutions to resolve local issues and implement community projects. Pilgrim and its partners have already conducted information and training sessions throughout the island and 129 applications (2005: 87 applications) were submitted from various districts. The decision on which 40 projects will be funded was made in June 2006.

2.4 SAKHALIN ROAD SAFETY PARTNERSHIP

According to the World Bank, Russia ranks number one in the world for road accidents, with a fatality rate almost double that of other leading industrialised countries.

The arrival of the oil and gas industry on Sakhalin Island in the mid 1990s and the recent availability of cheap, second-hand vehicles means that one in three Sakhaliners now has a car. This, on an island whose roads were designed for less than half that number, has meant a sharp rise in road safety problems. Statistics show that you are ten times more likely to be involved in a fatal accident on the roads in Russia than anywhere else in Europe.

This is largely due to a combination of lack of seatbelts, drink-driving, speed, poor road conditions, or just being a pedestrian. Bad weather is also a factor, but so too is a lack of road safety awareness among adults and children alike.

Since the Project relies heavily on the use of cars and trucks to transport crews all over the island, a three-year Sakhalin Energy road safety campaign, called "Think, Drive, SURVIVE!" made sense. Throughout 2005 and 2006, according to the company's own figures, the Sakhalin II Project will employ around 5000 drivers, use 2500 vehicles and will drive six million kilometres a month, carrying out work at sites and camps all over Sakhalin, and at other sites throughout the world.

The campaign was aimed at all 17,000 staff working for Sakhalin Energy, as well as its contractors and sub-contractors. A number of initiatives were launched, including regular vehicle inspections, driver training programmes (specifically for difficult conditions), and a seat belt campaign.

This latter had the advantage of being a very visible change in road safety culture, since seat belt wearing in Russia is notoriously low in spite of it being a legal requirement. It also had the advantage of being very cheap and effective – people can see if drivers are not wearing them!

The penalties within the company are also severe: should a Sakhalin Energy driver be spotted driving without wearing a seatbelt more than once (the company has four mobile traffic cameras, checking drivers), he or she will be dismissed. There have been no fatal accidents among company employees or contractors since the seat belt campaign was introduced, and there have been several serious crashes where people have walked away because they were wearing a seat belt.

But Sakhalin Energy drivers need to live and drive in the real world – which in Sakhalin's case is covered in snow and ice for six months of the year. During summer, the poor state of the roads becomes all too obvious alongside the lack of a safe driving culture.

Evidence shows that most of the local population will be involved in at least one traffic incident during his or her lifetime. As well the tragedy following loss of life, Sakhalin Energy found itself facing a genuine business risk of having to deal with the repercussions of losing and replacing injured staff.

2.5 RESTORING THE PLANTING CAPACITY OF SMIRNYKH FORESTRY

In August 2004, Smirnykh Forestry – with some help from Sakhalin Energy – began collecting spruce cones, storing them in controlled conditions, processing the seeds and planting them out. This was done by local residents in June 2005. The process was managed tightly, samples analysed in laboratories and seed quality certificates obtained.

From the success of this small beginning, Smirnykh Forestry has now signed agreements with several other forestries and the project could be replicated in other Sakhalin districts to develop a sustainable timber industry.

2.6 FISH FARM RECONSTRUCTION

A fish nursery farm on Igrivaya River began operation in 2003 but, after spring-autumn flooding, some of the nursery's facilities such as buried abutments and ground for taking spawners were damaged and needed reconstruction and improvement.

To help provide more jobs, economic benefits for the enterprise and assistance in maintaining the ecological balance in Aniva Bay, Sakhalin Energy supported the reconstruction. Work including strengthening adjacent river banks, increasing the height of the nursery outer and dividing walls, installing new lighter cover plates for the nurseries and constructing a concrete fish catcher to replace the existing wooden structure.

The fish farm reconstruction now also provides financial support for 40 additional inhabitants of the Ozersky settlement (including family members). More than 700,000 RUR of additional taxes will go to the federal budget from the project implementation.

APPENDIX 3: KORSAKOV CASE STUDY

Korsakov, located approximately 15km northeast of Prigorodnoye – the site of the Sakhalin Energy LNG/OET facilities – is one of the closest communities to Sakhalin Energy’s facilities in Prigorodnoye and will be a key local beneficiary of the project.

3.1 FINANCIAL BENEFITS

3.1.1 Increased employment opportunities in Korsakov

At the height of construction activities in 2006, up to 7000 people will be employed at the site in Prigorodnoye, and it is expected that 1500 of these will be from Korsakov. During the operational phase of the Project, in addition to the local residents employed in plant maintenance/operations positions, a number of support services will be required that will stimulate employment opportunities locally.

3.1.2 Increased training and knowledge transfer for skilled jobs for local residents

Sakhalin Energy aims to recruit 50% of LNG/OET staff within 100 km of the LNG plant (with efforts focused on the Korsakov district). The company has also invested in a craft worker’s training programme, a young Russian engineers training programme, an apprentice programme and a companies training scheme, all of which provide training for Sakhalin’s residents.

3.1.3 Increased tax payments from contractors and subcontractors registered in Korsakov

The latest figures available show that for the first six months of 2004, the estimated tax income from the project to the Korsakov budget is more than 20 million roubles. Even if tax income remains constant during the construction phase of the project (it is anticipated that it will rise), the amount of additional money to local budget will be 160-200 million roubles (\$5952-\$7440). In cooperation with the relevant Russian Authorities, Sakhalin Energy and our main sub-contractor CTSD is using its best efforts to ensure that all LNG/OET contractors and subcontractors register locally and pay local taxes.

3.1.4 Development of support services industry

It is planned that in excess of 90% of the staff employed to work within the 5500 man construction camp in various service industry roles will be local Sakhalin people. Support services including security services, catering and administration services will also be required during the operational phase.

3.1.5 Multiplier effect

It is anticipated that there will be a multiplier effect on local businesses as local residents working at the site or engaged in activities related to the Project have more disposable income to spend in the city.

3.2 SOCIAL BENEFITS

As part of Sakhalin Energy’s commitment to the sustainable development of the island, its Social Development Programme identifies areas in which the Company can contribute to the economic development and social well being of Korsakov and its residents. The Korsakov Partnership on Sustainable Development (made up of the Korsakov Administration, Korsakov District Assembly, Korsakov Business Club, an NGO called Mercy&Health and Sakhalin Energy) works with aid organisations and regional non-governmental organisations to identify suitable projects to support, particularly targeting health, environment and social programmes, and has the following objectives:

- Stimulate self-sufficient community development and enhance social capital in community
- Enhance economic capital in community and stimulate entrepreneurial development and income generating initiatives.
- Mobilise local resources for solving community issues by promoting the idea of community-based schools and volunteerism.

In addition the SD programme offers:

- Coordinated efforts to create an example of effective business-case benefits for government and private sectors. If this experience is successful, similar Memoranda of Understanding may be adopted in other areas.
- A balanced consideration of economic, social and ecological factors, that meets the needs of the present without compromising the ability of future generations to meet their own needs.
- Inclusive and continuous community participation in the programme.
- Improved management of social risks, including an effective grievance procedure.
- Programme management – to collaborate with the purpose of implementing clear and transparent process that allocates roles and responsibilities, provides a workable governance structure for the Council on Sustainable Development in Korsakov.

Sakhalin Energy has already demonstrated its commitment to social and community programs in the Korsakov district by supporting the following initiatives, in addition to other smaller scale projects:

- Development of a fish nursery on the Igriviya River
- Support of Korsakov Road Safety Day (traffic safety awareness).
- Modern maps to all Korsakov districts schools.
- Sporting equipment to all Korsakov district schools.
- Books for Korsakov district libraries.
- Environmental projects in Korsakov schools.
- Small social projects (Small Grants - Big Deeds Programme).
- Korsakov Social Rehabilitation Centre.

The social initiatives of the Korsakov grant program, organised with support of Sakhalin Energy’s external affairs department, began in May 2005, and has approved 13 projects for development.



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