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Andrei Galaev: "Shareholders have no sympathy with us"

Andrei Galaev, CEO of Sakhalin Energy tells how Sakhalin-2 is prepared to meet global competition including Russian LNG projects.

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For many years Gazprom has been trying to take a serious share on the promising LNG market since the liquefied natural gas (LNG) does not depend on the pipe and gas tankers can be rerouted to any client. Everything depends on the price. However, the only LNG asset that Gazprom has to date is a 50-percent stake in Sakhalin Energy that Gazprom bought in 2007 after a chain of scandals around the project and its foreign shareholders. Andrei Galaev is the first nominee of Gazprom for the position of the Sakhalin Energy CEO. In his interview to Vedomosti he told us how his life has changed after he joined the company and why the revenues registered an unexpected hike. He also spoke about new projects and relations with bureaucrats.

Question – You were appointed the CEO of Sakhalin Energy in December 2009, replacing Shell's representative Ian Graig. Has Shell retained the right to nominate the CEO?

Answer – When I became the CEO and the shareholders agreed a new management structure, he kept seven directors on the board. The positions of the CEO, HR Director, Technical and Commercial Directors were reserved to Gazprom, and it is Gazprom that always nominates candidates for these positions. Shell is responsible for the nomination of the Financial, Operations and Legal Directors.

Q. – It turns out that the Japanese do not have an executive director at all?

A. – The Japanese shareholders have been giving us a very serious support, particularly in doing business with buyers. We highly appreciate their contribution. The Japanese in general are very sensitive and meticulous people that try to go into every detail, even the smallest one. From time to time representatives of other shareholders admit that any issue that the Japanese have reviewed and agreed is well-thought and verified.

Q. – What's the term of your contract?

A. – All directors are appointed once a year, in March. I was appointed twice, next time – the coming March.

Q. – Any idea about the outcome?

A. – Everything will depend on how the shareholders view our work. Yearend is the time of taking stock in four areas: safety – and for us this is the issue of utmost priority, then come performance and financial indicators, corporate development and HR. The resulting score is One, if we strictly meet the planned targets.

Q. – What are the scores for 2011?

A. – Above One. We were .25 points better than expected. A similar situation was a year ago. It is a very good indicator because the plans that we set forth are very tense, and the benchmark tends to become higher. Believe me the shareholders have no sympathy with us.

Q. – And you personally, do you plan to stay with the company? I do remember that in spring 2009 Ian Craig said that he would leave even he was nominated for the job.

Q. – Shell has its own personnel rotation policy. Shell's people have definite terms they can stay in office. I link my immediate future with Sakhalin.

Limited Window of Opportunities

Q. – As of 2010 your major shareholder Gazprom made several concessions to its European clients, adjusting contracts and reducing gas prices. Did the policy affect LNG from Sakhalin Energy?

A. – We were able to negotiate higher prices, by the way, with our major customers in Japan. Contracts were signed in 2010 and 2011, and the talks had begun much earlier, the moment LNG deliveries began. The talks with Korean KOGAS are still under way.

Q. – You began LNG shipments in 2009, and sources in Gazprom told us that they had been unpleasantly surprised to see low prices in the Sakhalin Energy contracts...

A. – This is not entirely correct. Between the signing of the contracts and the commencement of shipments prices significantly increased. Today, we sell our product – LNG – at very favorable terms.

Q. – And you will not disclose the price, won't you?

A. – Of course no, the shareholders will sack me tomorrow (laughing).

Q. – What were the volumes affected by price reviews? How much did Sakhalin Energy gain?

A. – Large volumes were affected. In 2011 alone, additional revenues exceeded \$1 bln.

Q. – The shareholders of Sakhalin Energy have been discussing expansion of LNG production and the construction of the third train for several years. When do you expect a decision?

A. – I think in the very near future, this year, at least. We do have technical capabilities to expand production. More important, we do not operate in vacuum, there is a competitive environment. Russia needs to compete on the global LNG market. There is a very limited window of opportunities when this can be done, i.e. 2016 – 2018 before the startup of big LNG projects in Australia.

Q. – How long does it take physically to build [the third LNG train – AK]?

A. – Three to four year, I think.

Q. – How much will it cost?

A. – We did not make [exact] calculations. We can speak only approximately, relying on the world practice. Rough estimates suggest in the order of \$5 – 7 bln, taking into account the experience we have and bearing in mind that the available infrastructure is not comparable with the one that existed several years ago.

Q. – However, the resource base issue is still pending. There is much talk that the reserves from the Lunskoye field, your major asset, will not be enough.

A. – Technically, it is possible to feed the third LNG train with our [gas] volumes, but it is not feasible. Therefore, the most effective option provides for gas to be supplied by a third party.

Q. – What are the available options? Gas from Sakhalin 3 that Gazprom develops? Or from the neighboring Sakhalin 1?

A. – This is, of course, beyond the company level. The issue should be dealt by the shareholders, Gazprom above all, since it is Gazprom that is responsible for gasification of the Far East. The approved plans call for a fast development of Sakhalin 3, but the project – as far as I know – is targeted for the domestic market. As for Sakhalin 1, Gazprom – as you know – has been negotiating gas supplies for a long time. Everything depends on the outcome of the talks and on where gas will be delivered to from the project. Technically, there is no problem to connect [Sakhalin 2 with Sakhalin 1] through the Sakhalin – Khabarovsk – Vladivostok system. Everything is next door there, just several kilometers apart.

Reputation is an Expensive Asset

Q. – Gazprom has been considering another LNG project, in Vladivostok. In addition, NOVATEK plans to launch the Yamal LNG plant to supply LNG to the Asia and Pacific Region. Will there be need for the third LNG train of Sakhalin Energy?

A. – I believe that all three projects can coexist, there will be interest from buyers. First, there are forecasts that demand for gas will double in Asia and the Pacific by 2020. This is a very promising market, and it must be accessed. The European export direction has been contracted and, frankly speaking, this is not the easiest market at all. Second, buyers always try to diversify the supply sources – from the point of view of their energy security. Today, our LNG – the only Russian LNG available on the market – accounts for about 8 to 9 percent in Japan's import. In other countries, the share is even smaller. Therefore, Russia is interested in having new LNG production capacities commissioned with us but not somewhere in Qatar or Australia. Likewise, buyers – from the point of view of diversification of supply sources – are also interested in buying LNG not only in Qatar or Australia, but other countries as well.

Q. – In any case your LNG will compete with other supplies from Russia.

A. – We are not afraid of competition. Our project opened the door for Russia to the Asian and Pacific [LNG] market for the first time. New projects will need a long time to take their share on the market. We – touch wood – showed ourselves to a very good advantage over those three years. Corporate reputation is an expensive asset, particularly on this market. We have never failed to deliver. A short distance, proximity to the buyer is not only an advantage but a headache as well. The supplier inevitable

face additional technological obligations when it takes 2 or 3 days rather than months to make a delivery. This is exactly what we were doing over the last three years: building a well-tuned delivery mechanism, working hard with our buyers and other stakeholders, the customs, and border guards.

Q. – The price of your LNG, is it lower because of proximity [of the supplier] to the buyers?

A. – The price at the “inlet gas metering unit” is determined by the market. We have no intention to use dumping prices. It is no good for our shareholders and the Russian party, and I believe this is damaging to reputation.

Q. – Talking about failed deliveries. The startup of your LNG plant was delayed. The buyers expected the first gas in 2008, and received it in the long run only in March 2009...

A. – Projects of such scope and construction timeframe inevitably face reviews of initial completion schedules. At the same time, all obligations were met: we managed to negotiate new delivery dates with some of our buyers, to meet other commitments we had to buy LNG on the market.

Q. – Sources in Gazprom told us that Sakhalin Energy had lost over \$1 bln on the price difference between its contract prices and LNG market prices the company had to pay to meet its obligations. How big were the losses in reality?

A. – The delays were insignificant as compared to the project completion time. One should also take into account the conditions in which the project was built – there were no analogs in Russia, and projects of this size are very rare in the world in general. The project was built on the Sakhalin Island that virtually had no infrastructure: 26 thousand workers and specialists had to be brought in. Do not forget about the weather, geological and seismic conditions. All these were hard to forecast and predict. As for the LNG costs we had to pay to meet our obligations, I don't view them as losses. In fact, these were deferred revenues, after all. Gas did not disappear into thin air! All costs were agreed with the Russian side and the shareholders.

Q. – Over the last several years you have been repaying to the shareholders via a stock redemption scheme. How much did you repay them thru this scheme?

A. – I cannot give you the numbers, but we are doing faster than planned to complete the payback period. Earlier, we thought to repay the costs incurred by the investors in 2013 – 2014. Today, we plan to have profit production this spring. This issue was the source of many debates. The PSA efficiency was another source of disputes. Life has proved the efficiency [of PSA] in the long run.

Q. – In addition to profit production, there are also dividends payable under the PSA terms. The Russian Federation has been paid dividends as the holder of the “special” share. Do you have forecasts about dividend payments for other shareholders?

A. – First, dividends shall be paid to the Russian Federation, followed by payouts to our shareholders. There are forecasts, of course, but I cannot make it public.

No Soft Pedaling

Q. – After the recent accident with the Kola platform, did you feel tougher control on the part of bureaucrats? It is clear that the accident is in no way related to your company, but you also transport [platforms]. Were there any inspections, perhaps?

A. – Do you know when we felt? After the [Deepwater Horizon] accident in the Gulf of Mexico had happened. We did not wait for inspectors to come to us. We immediately launched additional inspections and audit of all our technological processes, though we operate entirely different platforms. Safety has always been the utmost priority for us. For example, we encourage and invite “interference” in process: when someone sees that work is performed in an unsafe manner and halts the work, regardless of the rank of the person who is doing the work. Say, you see someone working at a height of 1.5-2 meter, without a lifeline. What do you do? Tell him or her to stop!

Q. – Bureaucrats have been talking for a long time about some novelties and tougher rules for offshore operations. Were you affected by new guidelines?

A. – No. Frankly speaking, we are not afraid since we have very high [safety] standards per se, and they are much higher than Russian standards. In some cases, they are even higher than international standards. I am talking not only about production but all process up to road safety. For instance, it is prohibited to talk on the mobile phone when driving. We don't welcome the use of headsets! People may be dismissed if and when caught talking on the phone when driving. I personally keep an eye on the way our directors drive. Every week – when I find someone broke the rules or departed from them – I talk to the offender. No soft pedaling to anyone. And my performance is visible to everybody.

Q. – However, the situation with your very first platform – Moliqpak oil platform. Last year, a government report said that some of the wells the platform operated were shut down “due to a significant sloughing of sand resulting from wells water out”.

A. – That was not a systemic failure and it did not threaten any major catastrophe. Water encroachment and sanding of wells were expected but occurred earlier than had been initially forecasted. There is always room for uncertainty in our industry, particularly when little is known about new acreages and geology thereof. Certainty improves with operations. As a result, we spent two years on modernizing Moliqpak. We have almost completed modernization and are working toward resuming the drilling of new and working over older wells that were water flooded and suspended.

Q. – Your [Sakhalin Energy] are producing some 6 mln tons of oil. This is much smaller in terms of volume than LNG you produce. What is the share of oil in your revenues?

A. – Oil accounts for a significant fraction of revenues, around 50 percent.

Q. – What are production forecasts, taking into account well maturity on your major – Astokhsky – block?

A. – I shall not give you any numbers. To maintain the current production rate, serious investments are needed because Moliqpak is very first platform in Russia, it is a sufficiently old facility that requires continued maintenance. As for a further development of production, it depends on a decision of the shareholders. We are currently appraising the Yuzhno-Piltukh block. There are plans calling for 2D seismic and sonic tests this year at the site of the potential location of a new platform. Of course, the new

block's potential is not as good as that of the Astokhsy acreage, but this is a promising block. Therefore, a decision should be made before yearend as to how and by what means we will develop the acreage.