

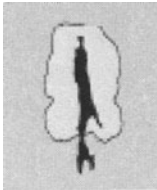


September 4, 2002

Dr. Peter Watson  
President and Chief Executive Officer  
US Overseas Private Investment Corporation  
VIA FAX

Dr. Watson,

Today's **Wall Street Journal** front page feature article, entitled, **Stymied in Alaska, Oil Producers Flock To a Newer Frontier**, indicates that the oil and gas projects off-shore of Sakhalin Island in the Russian Far East are proving to be environmental and developmental catastrophes. As world leaders concerned about sustainable development conclude meetings at the Earth Summit in South Africa, we find it disconcerting that the US Overseas Private Investment Corporation (OPIC) continues support for the dubious and risky Sakhalin II project.



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We outline below how OPIC's continued involvement in the project violates its statutory and other requirement to supports only projects that have substantial US participation, that are commercially and financially sound, that do not adversely affect the US economy, host country development or environment (including biodiversity and endangered species), and that do not violate host country law.

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We note with regret that your office did not reply to a related letter addressing many of these issues that Sakhalin Environment Watch and seventeen other non-governmental organizations sent to you on December 10, 2001. We now call on OPIC to comply with the law by revoking its loan guarantee for the Sakhalin II project.

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**Lack of US Participation:** In 1997, OPIC approved a \$116 million US taxpayer-backed loan guarantee for the Sakhalin II project. OPIC's website cites that its US "clients" in the project are the Houston, Texas-based Marathon Oil, and the New Orleans, Louisiana-based McDermott International.<sup>1</sup> Marathon Oil and McDermott International previously held 37.5% and 25% shares respectively in the Sakhalin II project, which is being implemented by Sakhalin Energy Investment Company, Ltd (SEIC). OPIC stated, "...the effects of a project in the Russian Far East will resonate loudly in the Gulf coast and in other communities across the U.S. that will benefit from project procurement and business generated by future investment."<sup>2</sup>

At the time, Pacific Environment and other observers questioned the veracity of this statement, and of OPIC's support for the project, given that the actual client, SEIC, is not a US company, but a joint venture company incorporated on the Bahama Islands. In addition to our

<sup>1</sup> "OPIC Clients Close-Up;" OPIC 1997 Annual Report

<sup>2</sup> Ibid #1.

environmental concerns, we questioned what the US benefits are from a joint venture based in an off-shore tax haven. However, these questions were rendered moot when it became known that by the year 2000, Marathon Oil and McDermott International had both withdrawn from the project. With no US company involved in Sakhalin II, OPIC's previous dubious argument for supporting the project, as well as its claim to adhere to its statutory mandate to mobilize and facilitate the participation of United States private capital and skills, now ring completely hollow.

**Lack of Economic and Financial Soundness:** OPIC's requirement under the Foreign Assistance Act to take into consideration the commercial and financial soundness of projects has been violated. According to official project documents for Phase II, the project sponsor states "economic analysis shows that Phase I by itself is not a profitable project."<sup>3</sup> SEIC admits that a proposed second phase of the project will only be profitable if, in addition to the oil, they are able to sell a minimum of nine million tons of gas annually. News reports indicate that, despite years of efforts, the project sponsors have been unable to conclude contracts for the sale of gas.<sup>4</sup> Hence OPIC's statutory commitment regarding the economic and financial soundness of projects has been violated.

**Adverse Host Country Development Impact:** OPIC's requirement under the Foreign Assistance Act to ensure its determination of support for projects are guided by economic and social development impacts and benefits has also been violated. According to a report of the Auditing Chamber of the Russian Federation (February 2000),<sup>5</sup> the project has had no economic benefit for the budget of Russia. According to this report, due to provisions in the Production Sharing Agreement, project sponsors will pay US\$ 19 billion less in taxes than they otherwise would have over the life of the project. In addition, current and potential losses to local fisheries that potentially result from project will have an additional negative impact. Hence, the project clearly has adversely affected host country development.

**Adverse Environmental Impact:** OPIC's statutory requirement under the Foreign Assistance Act to decline support for projects that pose a major or unreasonable hazard to the environment and its obligations with regard to endangered species have also been violated. The waters off-shore of Sakhalin are among the richest fisheries on the Pacific Rim with one of the few healthy wild salmon fisheries left in the world. They are also home to 25 marine mammal species, including 11 endangered species, most notably the critically endangered Western Pacific Gray Whale. Yet, the Sakhalin II project poses a major and unreasonable hazard through myriad impacts including construction disruption, seismic testing, potential catastrophic oil spills and ongoing discharge of production wastes into a delicate marine environment in the absence of adherence to required safeguards and in difficult climate and seismic conditions (including high earthquake activity, heavy ice pack, frequent storms and fog).

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<sup>3</sup> Preliminary Environmental Impact Assessment for Phase II of the Sakhalin-II project, Sakhalin Energy Investment Company, November 2001, p. 8-5 of Russian version.

<sup>4</sup> *Vedomosti*, July 12, 2002 and others.

<sup>5</sup> "Report on the results of a complex evaluation of the use of government property provided on the basis of the right for use of mineral resources to subjects of entrepreneurial activity on the basis of retribution, in particular the payment of taxes, collections, and other payments to the federal budget, as well as insurance payments to government non-budget funds during the execution by them of the Production Sharing Agreements 'Sakhalin-1' and 'Sakhalin-2' and the fulfillment of the conceptions of the Auditing Chamber, adopted at the Collegium of the Auditing Chamber of the Russian Federation on April 17 1998 based on the results of a thematic evaluation of the organization of levying of taxes and payments into the budget during the execution of the Production Sharing Agreement in correspondence with the federal law 'About Production Sharing Agreements' at enterprises and organizations of Sakhalin Region," March 21, 2000

NGOs have repeatedly stated their concern about project impacts that have already resulted from the Sakhalin II project. For example, as documented in the Wall Street Journal article, local fishermen report that “(i)n 1999, the first year of commercial oil production, herring by the thousands washed up dead on local beaches, and local schools of saffron cod have since shrunk dramatically.” These collapses have particularly negative impacts on native inhabitants, which depend on fish as a basis of their economy and traditional culture.

Regarding the threats from Sakhalin II to the Western Gray Whale population in particular, the Scientific Committee of the International Whaling Commission (IWC) notes “that it is a **matter of absolute urgency** [emphasis maintained]...to reduce various types of anthropogenic disturbances to the lowest possible level.”<sup>6</sup> Russian Academician and ichthyological expert M. E. Vinogradov has stated, “Without designing special measures for gray whale conservation, the continuation of the ‘Sakhalin-II’ project can lead to extinction of this unique population.”<sup>7</sup>

Despite the threats that Sakhalin II poses to the Western Gray Whale, and OPIC’s imperative to prevent project impacts that harm endangered species, project sponsor have not taken effective action. In 1998, OPIC required project sponsors to adopt a Habitat Conservation Plan for the Western Gray Whale. However, instead project sponsors produced for OPIC a legally and scientifically insufficient Western Grey Whale Protection Plan, and even this was not approved by OPIC until December 2001, four years after project approval.<sup>8</sup> Project sponsors then withheld the plan from the public until March 2002. According to expert input submitted by twenty five independent NGOs, this OPIC-approved plan lacks scientific credibility due to:

- The refusal of project sponsors to vet the draft plan for public comment prior to its approval by OPIC and the company’s refusal to disclose critical comments submitted on the draft plan from cetacean experts;
- The lack of independent scientific review and public access of data and research results;
- Inaccurate representation of scientific data as a result of financial pressure by the Company on scientists involved in whale research;
- The lack of information about mitigating adverse effects;
- The lack of review of potential and likely impacts to Gray Whales from the expansion of the second phase of Sakhalin-II and cumulative impacts of other oil development in the area;
- The lack of review of impacts on a proposed whale reserve in the area.<sup>9</sup>

Meanwhile, project sponsors have done little to ensure its oil spill prevention and response system meets US or international standards. Independent experts from Alaska and the Shetland Islands issued a report in 1999 – called "Sakhalin's Oil: Doing It Right" -- warning that the current oil spill prevention and response measures leave the coastlines of Sakhalin and Hokkaido vulnerable to a catastrophic spill. The report recommended 78 specific measures -- including such basic recommendations as mandatory tanker routes, increased monitoring of tanker traffic, notifications to

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<sup>6</sup> Report of the Scientific Committee, International Whaling Commission, Section 10.7.5, July 22, 2001, p. 54.

<sup>7</sup> Letter to Academician Yu.S. Osipov, President of the Russian Academy of Sciences, B.A. Yatskevich, Minister of Natural Resources, and E.I. Nazdratenko, Chairman of the State Committee of Fisheries, #1-33/149 on June 6, 2001.

<sup>8</sup> “Western Gray Whale Protection Plan: A Framework for Monitoring and Mitigation Measures Related to Sakhalin Energy Oil and Gas Operations on the Northeast Coast of Sakhalin Island, Russia,” Sakhalin Energy, March 2002.

<sup>9</sup> August 15, 2002 letter by Sakhalin Environment Watch and twenty four other NGOs to Sakhalin Energy Investment Company Limited regarding the “Western Gray Whale Protection Plan: A Framework for Monitoring and Mitigation Measures Related to Sakhalin Energy Oil and Gas Operations on the Northeast Coast of Sakhalin Island, Russia.”

fishing vessels if a tanker is in the area, and increased spill response equipment and improved access to the shoreline where it would be deployed -- but these have not been acted upon by SEIC. As a result, Sakhalin and Hokkaido remain vulnerable to a catastrophic spill, made even more likely by increased tanker traffic foreseen under phase II of the project. As the Wall Street Journal article indicates, "Spill response in Canada, Norway and Britain is generally far more comprehensive," and in Alaska, following the disastrous Exxon Valdez spill, "state and U.S. officials ordered the industry to set up a massive spill-response system for Prince William Sound." SEIC's lack of action to increase its oil spill prevention and response measures -- despite repeated requests from the public to do so -- further underscores its lack of attention to environmental standards and violation of OPIC environmental policy requirement to apply.

Irrespective of these flawed plans, OPIC violated the Foreign Assistance Act when it approved the project in the first place. According to OPIC's environmental policy in place at the time, "for most categories or activities, OPIC requires that projects meet World Bank environmental, health and safety guidelines."<sup>10</sup> One applicable guideline is the World Bank Group policy on Natural Habitats,<sup>11</sup> which OPIC later incorporated into its Environmental Handbook in part as a means to assure adherence to its statutory requirements. The Natural Habitats policy, which dates back to 1995, states, "The Bank does not support projects that, in the Bank's opinion, involve the significant conversion or degradation of critical natural habitats." This policy defines "critical natural habitats" as "areas with known high suitability for bio-diversity conservation; and sites that are critical for rare, vulnerable, migratory, or endangered species," which certainly includes habitat for the critically threatened Western Gray Whale. The policy defines "degradation" as modification of a critical or other natural habitat that substantially reduces the habitat's ability to maintain viable populations of its native species," which Sakhalin II is documented to do. It is therefore clear that under its statutory mandates to decline support for projects that pose a major or unreasonable hazard to the environment and its obligations with regard to endangered species OPIC should never have approved the Sakhalin II project.

Moreover, when OPIC conducted environmental due diligence on the first phase of Sakhalin II, the project sponsor's representation to OPIC of the proposed next phase was incomplete, and indeed materially different in many important respects. This expansion will far more negatively harm the critically threatened Western Gray Whale with new seismic activities and construction of additional platforms adjacent to whale habitat area, an undersea pipeline routed directly through whale feeding ground, and other impacts. The proposal also includes roughly 800 kilometers of pipeline down nearly the entire length of Sakhalin Island to be trenched directly through streams bearing salmon and other salmonid species, including the Sakhalin taimen, listed as endangered in the Russian Federal Red Book. The proposal also includes construction of the world's largest liquefied natural gas processing facility and oil terminal at the Southern tip of Sakhalin Island. This expansion was not assessed by OPIC during the first phase, will dramatically increase the project's major and unreasonable hazard to the environment, and present a clear violation of Foreign Assistance Act requirements.

Finally, OPIC approval of the Sakhalin II project occurred in the absence of an Environmental Impact Statement (EIS), in violation of the National Environmental Policy Act.<sup>12</sup> As a lawsuit filed

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<sup>10</sup> OPIC Environmental Handbook, Overseas Private Investment Corporation, December, 1996.

<sup>11</sup> World Bank Operations Manual, Natural Habitats, OP 4.04.

<sup>12</sup> Friends of the Earth, Greenpeace, City of Boulder, CO, v. Peter Watson, OPIC, August 22, 2002.

this week by Friends of the Earth US, et.al. indicates, Sakhalin II illegally contributes to global climate change through its financing activities.

**Foreign Policy Contradictions:** OPIC approved the discharge of untreated production and drilling waste from Sakhalin II directly into the sea, despite the fact that Russian environmental law prohibits this practice and that superior technology to avoid this is readily available to project sponsors. This inferior practice of sea discharge was legally exempted by the project's Production Sharing Agreement, which supercedes the environmentally superior Russian law. This directly contradicts US Agency for International Development and other agency programs to promote the rule of law in Russia. Hence, OPIC's support for the Sakhalin II project violates Foreign Assistance Act requirements that its decision to support projects be especially guided by ways in which that project complements, or is compatible with, other development assistance programs or projects of the United States.

**Violation of Host Country Laws:** OPIC's requirement that it not back projects that violate host country laws has also been violated. Russian NGOs have filed an environmental lawsuit against the Russian government to halt any construction or industrial development that would affect gray whale habitat area, naming SEIC as a third party defendant. Russian law clearly prohibits harm to the habitat of Red Book (listed endangered) species. Meanwhile, the massive die-off of herring and steep decline of saffron cod population potentially linked to the project leads local citizens to continuously request information from EBRD on the ongoing operations of Sakhalin II. Despite repeated promises by project sponsors for ongoing consultation and access to information, NGOs have been compelled to file a lawsuit against the Russian government and project sponsors to obtain public-interest information about this project due to the company's failure to release information or to work cooperatively with local concerned citizens.

**Conclusion:** This letter documents the ways in which Sakhalin II was approved, operates, and proposes to expand in violation of OPIC statutory requirements and internal policy. Accordingly, we call upon OPIC to revoke its loan guarantee for this project.

We request a reply from your office regarding each of the specific violations of OPIC's statutory requirements and internal policies raised in this letter. We also request that you inform us when OPIC will comply with the law and revoke its loan guarantee for the Sakhalin II project, and if it does not concur, on what rationale this position is based.

Respectfully,

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Chairman  
Sakhalin Environment Watch

Doug Norlen	David Gordon
Policy Director	Associate Director
Pacific Environment	Pacific Environment

CC: Distribution

Attachment: September 04, 2002 Wall Street Journal article