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by John C.K. Daly

As the situation in the Middle East continues to deteriorate, from car bombings in Riyadh to pipeline attacks in Iraq, two Asian energy-deprived superpowers are nervously eyeing the developing chaos and wooing their nearest energy alternative, Russia. Both China and Japan are attempting to finalize deals for east Siberian energy reserves that will buffer them from an increasingly uncertain Middle East, where embassies and pipelines are increasingly under assault. As Russian Prime Minister Mikhail Kasyanov's recent visit to Japan has highlighted, Moscow is becoming accustomed to finding itself in the enviable driver's seat for determining the flow of Siberian crude, and is cynically playing off the two energy-starved powers in a bidding war.

China is the world's second-largest consumer of energy; Japan is in fourth place. Both countries are patronizing number 2 oil producer Russia for deals that can assuage their long-term needs. Home to about 10 percent of the world's proven oil and gas reserves, Russia raised production in June 2003 to 8.04 million barrels a day. China currently imports a small fraction of Russian production, receiving annually 6 million tons of Russian crude via railroad. Agreements have been signed to more than triple the volume of oil exports within the next two years. Imports are critical to China, as it currently imports nearly one-third of its daily requirement of 1.7 m bpd. Even worse for China, to sustain its current high level of economic growth, consumption is estimated to grow by 600,000 bpd annually for the foreseeable future.

Both countries have sobering statistics driving their policies. China currently gets more than 46 percent of its imported oil from the Persian Gulf, primarily from Saudi Arabia, Iran, and Oman. Chinese oil consumption, fuelled by its roaring economy, is predicted to increase in the near future by 25% per annum. China is expected in 2004 to overtake Japan as the world's second-largest oil consumer. Japan imports more than 97 per cent of its oil, with 81 per cent coming from politically volatile OPEC nations. While diversification policies since OPEC's 1973 oil embargo have seen the rise of natural gas and nuclear alternatives, oil still accounts for slightly more than half of the country's energy consumption. China's economy, roaring along at 7-8 per cent annually, has a growing thirst for oil. Both have competed to develop Russian east Siberian fields, but China's proposals now seem to have shut down those from Tokyo. Japan has since increased its attentions on developing Sakhalin.

The stakes are enormous, and for developing eastern Siberia's energy assets, China seems momentarily ahead. After considering for several years a $5 billion pipeline oil route across eastern Siberia from Irkutsk to Nakhodka for conveying Russian crude to Japan, Russia's pipeline monopoly Transneft concluded that the project would be unprofitable. Transneft CEO Semyon Vainshtock said the company's feasibility study for a 2,361 mile (3,800 km) proposed pipeline "left no room for doubt." For Asian energy consumers, the brutal and simple truth is that major Russian oil companies have refused to provide funding for eastern Siberian projects, preferring to exploit already existing fields.

In October 2002 Japan began buying Russian oil for the first time since 1978 as fears rose about relying on the Middle East oil as war in Iraq appeared increasingly imminent. Japan's Ministry of Economy, Trade and Industry (METI) regarded the pipeline project as a top priority policy issue, along with reviving nuclear power generation, to diversify Japan's portfolio of energy resources, especially after Japan lost concessions to the Saudi Arabian-controlled segment of the Khafji oil field three years ago. METI estimated that pipeline project would have helped Japan reduce its reliance on Middle Eastern oil to around 65 percent from current rates of nearly 90 percent. The recent Iraqi campaign underlined Japanese fears of vulnerability to interrupted Middle East flows; in March after the beginning of the Iraqi conflict, Japan "ramped up its sticks" to provide for 169 days of domestic consumption, thereby avoiding price spikes.

The incident brought back unpleasant memories of the aftermath of the 1973 war, when gas prices surged from 65 yen to 83 yen per liter two months after hostilities. Japan offered to cover fully the Nakhodka pipeline loans, which was due to become operational in 2009. The pipeline would have exploited eastern Siberian fields estimated to hold 4-5 billion barrels. The line was planned to run from Angarsk near Siberia's Lake Baikal to Nakhodka in a decision that clearly startled Beijing. Things will not run smoothly for China, however; Ged Davis, a former vice-president of Royal/Dutch Shell commented, China must be patient in dealing with Moscow, as "Russia's industry is very young. It is just beginning to develop."

In the covert rivalry between Japan and China for Russia's eastern petroleum, China surged ahead, as President Vladimir Putin signed an accord with China's then-president, Jiang Zemin, during his Moscow summit in 2001 for a pipeline to carry the same oil. The two countries signed their first friendship treaty in 50 years during the summit. The 1,491 mile (2,400 km) line to China's oil capital of Daqing was projected to cost $1.7 billion, making it practical to build for 600,000 barrels a day of exports, an amount that the region could produce. The pipeline is the largest economic cooperative endeavor between the two nations.

Japan's Nadkhodka line, projected to cost $5 billion was nearly three times the Daqing variant. Moscow sources say that Transneft was never the real source of support for the Nakhodka pipeline and was only responding to a government order regarding the route with the gas monopoly Gazprom and the state-owned oil company Rosneft pushing the route. Desperate to save the line, Japan earlier this year upped the stakes, offering to buy one-fourth of its oi1 exports from Russia during Prime Minister Junichiro Koizumi's visit to Moscow in January 2003. Japan's offer coincided with Yukos supporting the planned Chinese pipeline while Transneft initially backed the Nakhodka route.

On May 28 Yukos and China's National Petroleum Corporation (CNPC) signed agreements committing CNPC to purchase up to 5.13 billion barrels of Russian oil between 2005-2030 using the Daqing pipeline following its construction. One argument in Moscow favoring the Daqing line was that oil could be further exported abroad. The pipeline was planned with an initial annual rate of 20 million barrels, which could be raised by 2010 to 30 million barrels annually. While Moscow made vague noises about adding a Nakhodka spur later to the Daqing project, Japan's hopes were effectively crushed. The projects are seen as a further spur to increased Sino-Russian trade. Alexei Volin, deputy government chief of staff said that Russian-China energy projects could quadruple bilateral trade to $30-35 billion in five to six years. The trade issue is one with which Japan can't compete, as its foreign policy remains restricted by the Kuriles issue.

Japan has eyed development of the massive Sakhalin fields, but met here too with competition. On 1 July BP announced plans to explore for oil in a new set of Sakhalin fields with the partner Rosneft. To worsen the picture, Russia's Tyumen Oil Company announced plans for other Sakhalin fields. Rosneft hopes to pump its first oil in 2005. Foreign concerns are expected to invest about $13 billion over the next four years in Sakhalin to build pipelines, a gas liquefying plant, storage plants and roads. While Sakhalin energy will be exported to Asia, Japan seems once again to have missed out on entering the Russian market on the ground floor.

Russia's energy industry weaknesses are acute in offshore work; as a result, resources in Sakhalin's waters are being developed almost exclusively by foreign companies. Given the industry's lack of offshore capabilities, the Russian government is actively courting foreign companies. Oil fields now under development hold an estimated 3.3 billion barrels of oil, equal to about a quarter of Alaska's North Slope reserves.

It is precisely the lack of infrastructure in pipelines and ports that is thwarting Moscow's attempts to provide an alternative to the turbulent Middle East. Inclement weather in the Black Sea and northern Baltic ports have bottlenecked exports, creating a glut in Russia's domestic market. China and Japan both hold strong positions in offering guaranteed markets, financing and technical expertise. While Japan's energy market is largely stable, however, China's consumption is rising. The International Energy Agency projects that demand for oil will increase in 2004 by 1 million barrels a day, or 1.3 percent, due largely to growth in consumption in the China and the United States.

Japan has had some success in the Sakhalin market. A gas contract was signed by Tokyo Gas Co. agreeing to a 24-year contract to purchase a maximum of 1.1 million metric tons of LNG annually between 2007 and 2031 from the Shell-led consortium, Sakhalin Energy Investment Company. Japan's desperate search for energy diversity has also looked eastwards across the Pacific, with the Tokyo Gas Co. exploring the possibility of NGP imports from Alaska's North Slope.

China has won the initial round of competition for Siberian energy because of the twin effects of a significant existing trade relationship combined with a cheaper pipeline proposal. Japan is hardly out of the race however, and is clearly in the lead on capturing a market share of Sakhalin crude. While China represents a greater potential market over the next few decades if currently growth predictions are accurate, Japan has significant financial and technical resources that the Russian energy industry would love to exploit. The lack of a peace treaty bedevils Japanese attempts to exploit the mineral riches of Siberia.

While China seems to have won the pipeline race, the Russian government is throwing up discrete obstacles. Speaking in Beijing in late September, Russian Prime Minister Mikhail Kasyanov said that while Russia would honor its commitments to a Chinese pipeline, environmental and technical feasibility studies would delay initial work on the pipeline for several months. Kremlin insiders have noted that President Putin has stated a preference for the Japanese plan. Project leader YUKOS has commented that the pipeline is already a year behind schedule, so even if Moscow makes a quick decision, the first oil would not be shipped until 2006. Nor is China limiting itself to Russian reserves; in its insatiable appetite for petroleum, China in early October reached an agreement with the Kazakh government to build an $800 million 400,000 bpd pipeline from Western Kazakhstan to northwestern China; construction is due to begin next year.

Kairgeldy Kabyldin, director of KazMunaiGaz commented that Russian prevarication about the Siberian Daqing line had played a role. For its part, Japan is negotiating with Tehran over a possible $2 billion deal despite Washington's displeasure.

The situation is rich with historical irony, as both countries will be importing energy from territory that they previously ruled. China lost what is now Russia's Far Eastern Maritime provinces due to a nineteenth-century pair of what the Chinese still refer to as the "Unequal Treaties" ceding the region to Russia. Japan ceded its claims to Sakhalin in the 1875 St. Petersburg Treaty, but received back the southern half of the island in the 1905 Portsmouth Treaty, which ended the Russo-Japanese War. The USSR invaded southern Sakhalin in August 1945 and Moscow has remained in possession ever since. Undoubtedly compounding the anguish of Japanese nationalists is the knowledge that full-scale production at the Okha oilfields in southern Sakhalin began in 1921, when Kuhara, Mitsubishi Mining, Okura Mining, and the Nippon Oil Co. formed the Hokushinkai joint-stock consortium. The company operated eight oil reserves, the most productive being the Okha field, which produced approximately 20 thousand tons of oil from 1920 to the first half of 1925. Now they have to buy what was once theirs from the gaijin.

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