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Institutionalising Northeast Asia: The energy market

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Abstract

Interest in more comprehensive institutional arrangements for Northeast Asia have been given a fillip by the suggestions emerging from the Six Party Talks on North Korea's nuclear program. The following paper looks at regional interactions on energy and related policies. It asks whether the regional actors see conflicts emerging within the region in their individual attempts to solve their energy security concerns, or whether they envisage cooperative ways for resolving such problems. In the light of this, it asks whether there could be a functionalist basis arising from energy cooperation for a wider process of community-building in Northeast Asia.

It concludes that within the region, multilateral institutional mechanisms face major political, economic and technical problems. On most energy issues, the regional economies are likely to continue to look mainly to links with institutions outside the region. There are areas in which regional cooperation would be beneficial, yet the opportunities available from such cooperation will face major obstacles in the absence of institutionalised cooperation processes in the broader economic and security fields.

Institutionalising Northeast Asia: The energy market

STUART HARRIS*

INTRODUCTION

In considering the role of institutions in the energy market in Northeast Asia, one problem is how to categorise the energy market itself. As a market, it fits into both the discussion of economic institutions and the realm of economic interdependence and cooperation favoured by liberal institutionalists, who generally see cooperation as having a stabilising effect in the region.

Yet a major concern of the countries of Northeast Asia is energy security. This takes energy into the broader field of security analysis and the realist argument that security is a principal motivation of foreign policy. Realists tend to see international relations as a zero-sum game, making competition more attractive for the major states, rather than developing institutions leading to cooperation. Countries in Northeast Asia would commonly be seen as concerned with relative gains and future uncertainties—factors unlikely to contribute to stabilising the region.

These differences are reflected in how the scope for multilateral cooperation may be judged differently by realist political scientists and liberals, with the liberals largely overlapping with economists. Realists are more inclined to see energy rivalry deepening tensions in great power relations in Northeast Asia. Economists, in particular, are more inclined to emphasise market forces where, in a context of historically high energy prices, more efficient energy use and more investment in energy production and refining capacity would be stimulated. Both approaches accept that there may be benefits from cooperation in the provision, for example, of

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public goods; they differ, however, over specific needs for cooperation and its objectives.[1] These differences are important in determining the scope for cooperation within the region.

International cooperation is a conscious act that requires decisions by governments to adjust their behaviour. Willingness to do so may stem from a persuasion that common interests exist and cooperation could be a better way to pursue the national interest than acting unilaterally. Cooperation, when what one country does helps achieve the objectives of other cooperating countries, can reflect informal acceptance of particular patterns of behaviour, but it commonly comes by way of policy coordination through multilateral institutions.[2] Hence the continuing interest among liberal institutionalists lies in turning competition into cooperation by way of such institutional mechanisms. Not uncommonly, those mechanisms may do little more than act simply to facilitate information exchange and agreements among governments, but this is the way expectations converge and norms often develop. Realist political scientists, however, even when accepting that scope for cooperation does exist, tend to see multilateralism as constraining, and are more concerned with responses to apprehensions about security of supply that they see as likely to intensify tensions. In the case of energy supply they commonly see the issue as a zero-sum situation: more oil for country A means less for country B. Given the relatively competitive nature of oil market distribution, this only holds if it is assumed that country B could be otherwise denied the oil.[3]

The emphasis in international discussions at the regional level has been on energy supply, and there are limits to the scope for cooperation in that context. A particular area where cooperation is feasible and beneficial is in investment in the oil industry; underinvestment has been a contributing factor to the tightness of energy supply since 2003, and uncertainty about future prices will remain to inhibit investment. Investment cooperation—to

[1] See, for example, the contrasting views in Kent Calder and Fereidun Fesharaki, 'Energy and Security in Northeast Asia: Fueling Security', Policy Paper 35 (San Diego: Institute on Global Conflict and Cooperation, University of California, 1998).

[2] Robert Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984), pp. 51–2, 238.

[3] A point acknowledged by the US Department of Energy in 'National Security Review of International Energy Requirements', Report to Congress under Section 1837 of the Energy Policy Act 2005, February 2006.

share the risks—may increase overall oil supply. Cooperation also has benefits in the case of stockpiles, and potential benefits in terms of reduced costs and increased supply reliability through international cooperation in electricity grids. Cooperation may be more readily envisaged on the demand side. This can include transferring technologies that can increase energy efficiency, lowering environmental impacts, developing alternative energies and pursuing demand management more generally. This raises issues of intellectual property, but they may be resolvable in an energy cooperation framework.

There are many Northeast Asian energy issues that potentially provide a regional basis for cooperation. Against this is the question of whether gains from cooperation are countered by the political risks that cooperation implies. The paper looks at regional interactions over energy from two perspectives. First, do the countries in Northeast Asia see conflicts emerging among themselves because of their expected needs in the energy field? And do they see gains as possible when cooperating with others in the region? Second, there is the functionalist argument that, in a region singularly lacking in cooperative institutional mechanisms, cooperation in the energy field might contribute to the creation of a sense of regional community that develops institutions to manage that cooperation. In either case, however, there would be major political, economic and technical problems to overcome.

For present purposes, the Northeast Asian region includes China, Hong Kong, Mongolia, Japan, North and South Korea and Taiwan. These countries and economic entities account for about 22 per cent of global primary energy consumption, China alone accounting for nearly two-thirds of that. In defining the region in the context of energy cooperation, it is necessary to also include eastern Russia, given its existing and prospective linkages as an exporter. Russia is the world's second largest oil producer/exporter and its gas reserves are the world's largest. Many existing proposals for multilateral cooperation in Northeast Asia involve Russia, as do most regional multilateral discussions on energy.[4] There is also a question, not dealt with here, of US involvement given its importance in the global energy market.

[4] Because of limited space, the general discussion will concentrate for the most part on the major players: China, Japan, the Republic of Korea—the second, third and fourth largest global oil importers—and Russia.

Outside of Russia, the regional emphasis is on consumption and imports. Although China is rich in energy resources—the only regional country that is, apart from Russia—and is a major energy producer, it has become an increasingly significant net oil importer and will become a substantial gas importer. In light of the price and supply uncertainties in the future energy market, but also for environmental reasons (and, in China's case, growing problems of domestic electricity supply), energy policy has become an important, indeed critical, component of national and international policy in the region.

Moreover, aspects of energy policy have become matters of some dispute, if at times indirect, between countries in the region. This has involved competition over investment/development projects, notably in Russia, and unresolved territorial disputes that have grown in political importance as the potential energy importance of such territories has become more salient. The importance of these disputes has intensified, since they often occur within a context of other regional political tensions. Thus a solution to the region's nuclear problems in North Korea will require a resolution of the energy supply question. More generally, environmental issues are growing in importance: deposits of acid rain originating externally have been a regional problem, notably for Japan, while climatic change is a general concern, as is the atmospheric pollution in China from the burning of 'dirty' coal.

THE GLOBAL SITUATION

The energy market is largely global, particularly for oil, and the region has to work within the global market framework. Sharp increases in Asia's energy needs, and those of China in particular, have clearly been among the contributors to the pressures experienced in the global market as a whole since 2003, and demand will grow in the future.

Much of the debate about the future of global oil and gas supplies is in response to the high oil prices experienced after 2003. These have led to arguments that oil prices in particular will stay at high levels, reflecting the gradual exhaustion of supplies of non-renewable resources. Economists tend to approach such claims with some scepticism. While accepting that fossil-fuel resources and their depletion will eventually constrain production, this is not regarded as likely in the near future. They believe the global energy markets will respond to high prices by dampening demand growth, stimulating new investment to find new resources and applying new

technological developments that will lower costs, unlock new deposits in existing areas and open new areas for discovery. Morris Adelman (a leading energy economist), in putting the economists' position thus, sees the problem much more as the adverse consequence of the OPEC (Organization of the Petroleum Exporting Countries) cartel's activities.[5]

Yet not all economists see the current situation in Northeast Asia as easily manageable. Economists generally accept that short-term supply shortages and price spikes can occur because of rapid demand increases in the face of capacity constraints in production, processing and distributional infrastructures. There are also grounds for questioning whether the major Northeast Asian countries are wrong to believe that the oil and gas markets may not be as open as economists like Adelman wish to think.

The major increase in pressure on oil prices since 2003 has reflected a mix of supply, demand and speculative factors. In the oil industry, production, processing and transport capacity are based on investments, the time-scales for which are lengthy and the financial magnitudes large. Although investments are made on judgements about future profitability, oil prices have varied greatly over the last 30 years with a difficult to discern trend—varying from US$8 to US$96 in 2003 prices.[6] Following the sharp oil price rises in the 1970s and early 1980s, and often with government assistance, investment in the industry was heavy and production capacity expanded rapidly. Excess capacity and consequent low oil prices in the late 1980s and 1990s induced a much lower level of investment in oil exploration and extraction, and also in related infrastructure such as refineries, pipelines and shipping facilities, and in stocks; what investors saw as a period of overinvestment was followed by 20 to 25 years of underinvestment.[7] Consequently, when global economic activity surged unexpectedly, as in 2003 and particularly in 2004, the industry came close to the limits of its capacity. Continued global economic growth and market uncertainty have held prices up.

[5] M. A. Adelman, 'The Real Oil Problem', *Regulation*, 27(1) 2004, pp. 16–21.

[6] International Monetary Fund, *World Economic Outlook 2005* (Washington, DC: IMF, 2005), p. 159.

[7] International Monetary Fund, *Global Financial Market Development* (Washington, DC: IMF, 2005), p. 37.

Increasingly, much decision-making affecting fossil-fuel exploration and production globally is subject to decisions and regulations of governments, and this has led to already substantial market uncertainties arising from, and contributing to, price volatility. Oil traders have also responded to reports of geopolitical problems in important oil-producing regions that have contributed to price volatility.

OVERVIEW OF THE NORTHEAST ASIAN ENERGY MARKET

In recent decades, economic growth in the overall Northeast Asian region has been considerable and consumption of energy has grown rapidly. Projections suggest that each of the regional economies will consume more energy, although at substantially different rates of growth.[8]

For individual regional economies, expectations vary according to the expected future energy mix and efforts at diversification. While others in the region will increase their demand at a slower rate, due in part to expected slower economic growth rates, industrial structure change to less energy-intensive activities will also be a factor. All projections expect that the region's import dependence will grow and that its imports, in the case of oil at least, will come increasingly from OPEC members.

Due mainly to China's growing import requirements, notably for its transport sector, its demand will constitute an increased share of global energy consumption and account for increased demand in global energy markets. International Energy Agency (IEA) projections suggest that China's annual oil imports could grow to 12.5 million barrels per day (mbd) by 2030 (from 3 mbd in 2004), close to three-quarters of projected US levels for the year 2030.[9] The region's dependence on the Middle East for crude oil in particular is high—over half current imports—and is likely to increase gradually to closer to three-quarters of imports.

The energy mix among the regional countries differs. China still depends more heavily on coal than others, and will remain so for some decades, although it is looking to diversify into natural gas and nuclear energy. It is also the only significant oil producer—in size not far behind Iran. Its current reserves are not substantial, but its scope for further discoveries is

[8] International Energy Agency, *World Energy Outlook 2004* (Paris: OECD/IEA, 2004).

[9] International Energy Agency, *World Energy Outlook 2006* (Paris: IEA, 2006).

considered promising.[10] Not all regional energy problems arise in the international energy market, although they may contribute to it. China's recent problems have included shortages of electricity-generating capacity and structural problems in coal production and transport. Part of its increased demand for oil and gas in 2004 and 2005 was for use in power generation. While most of its power-generating capacity will be based on coal, the planned increased use of natural gas will make China a large gas importer. In Japan, South Korea and Taiwan, oil plays a major role, but all three have already become more diversified. Japan and Korea are significant users of natural gas; like China, they have major plans for expansion of their existing nuclear industries.

Cooperation among regional countries would need to reflect the different involvements of regional governments in their energy industries and the different mix of actors. Generally, while in these economies the state remains central to energy policy, governments also have a major impact on choices made in the use of energy. In what is complex interdependence, as Robert Keohane and Joseph Nye have defined it, state enterprises, including financial institutions and specialist ministries, often develop different perspectives from their dealings with similar agencies of other countries in ways that may influence or diverge from state behaviour.[11] This does not always reflect how they operate in practice. Gaye Christoffersen argues that China's state-owned enterprises are more market-oriented than Russia's private oil companies, which are more statist in character.[12]

In China, state-owned enterprises are the producers and importers and are responsible for investment in production and exploration internationally. Japan and South Korea, like China, have interests in major pipeline investments in Russia. Through a government-owned company, Japan had until recently a support programme for private companies to invest in overseas energy projects in areas close to the region. South Korea still has a

[10] John V. Mitchell, Peter Beck and Michael Grubb, *The New Geopolitics of Energy* (London: Royal Institute of International Affairs, 1996), p. 112.

[11] Robert Keohane and Joseph Nye, *Power and Interdependence: World Politics in Transition* (Boston, MA: Little, Brown, 1977), chapter 2.

[12] Gaye Christoffersen, 'Angarsk as a Challenge for the East Asian Energy Community', paper presented at conference on Northeast Asian Security: Traditional and Untraditional Issues, Renmin University of China, Beijing, 2–4 April 2004, p. 4.

state-owned company responsible for its supply diversification and supply security efforts internationally, with exploration and production interests in 13 countries.

Nevertheless, such investments may have a limited impact on energy security. For China, despite its large overseas investments, only around 10 per cent of its oil imports are expected to come from equity oil output.

CURRENT PROBLEMS AND THREAT PERCEPTIONS

The range of energy problems faced by the Northeast Asian countries are wide but, as noted, they need to be fitted within the global market. Oil and, to an increasing degree, gas are fungible commodities and Northeast Asia cannot isolate itself from the global market. Nor, given oil's fungibility, are the consequences of any substantial increases in the region's ties to equity oil likely to be significant globally. Within the region, although Northeast Asian countries share the characteristic of extensive import dependence (apart from Russia), they do not see the problem in the same way. All in the region are anxious about physical supply interruptions and price volatility, and about ensuring the adequacy of energy supplies in the light of expected future demand growth. For Japan, and to a degree South Korea, it is also about how to maintain existing supplies at reasonable prices, and so maintain competitiveness in the face of the rapidly growing Chinese (and expected Indian) demand.

Both China and Japan share concerns about transportation, notably sea-lane security. Both have also become concerned about energy infrastructures, including in supply as well as refining, generating, distribution and handling capacity. China, in particular, has concerns about urban environmental issues arising from the use of coal in electricity generation, and lack of capacity in domestic electricity supply due to industry and transport problems in the face of major demand growth.

Future energy availability has been a growing concern in the region. In practice, although economically recoverable fossil-fuel resources are finite and will eventually restrain production, such restraints are not likely in the near future if the needed investment in exploration and production takes place. Problems of adequacy of total global energy or even oil supply seem

less urgent than much of the public debate might suggest.[13] In the meantime, the market might be expected to provide a reasonably satisfactory mechanism that offers access to available supplies for all able to meet the competitively determined price, with limited scope for manipulation.

While economic market issues may dominate, geopolitical factors are important motivations for regional governments—in part as a perception, but in part reality. Policy-makers recognise that their growing requirements domestically will have to face increased competition from the rest of the world, including the United States, which will not necessarily rely on market forces. Adelman notes for example that the United States has to 'protect' OPEC 'from outsiders or neighbours'.[14] To Adelman, references to 'protection' are apparently benign; to the region, such references are a reminder that the market is not as free as he argues. Given the global uncertainties, the rapid growth in actual and prospective oil and gas demand in the region in the face of slower production increases has led to considerable policy uncertainties in every regional country, and a perception that global sources of oil and gas will have difficulty meeting all the increased needs.

For the countries in Northeast Asia, therefore, their understanding of problems and threat perceptions can be divided into short-term concerns—raising the question of emergency responses, and the need for enhanced data/information in real time to avoid under or over-reactions—and longer-term concerns. All have longer-term anxieties that there will be a competitive and potentially conflictual scramble for available supplies—possibly a self-fulfilling belief if widely enough held.

NORTHEAST ASIA AND ENERGY COOPERATION

Northeast Asia as such lacks any broad regional multilateral processes to deal with economic, security and specifically energy issues. Countries and economic entities in the region, however, are part of institutional arrangements that deal with energy issues at a broader international level. Given that critical parts of the energy market—notably the oil market—

[13] Stuart Harris and Barry Naughten, 'Economic Dimensions of Energy Security in the Asia-Pacific', in Michael Wesley (ed.), *Energy Security in Asia* (Oxford: Routledge, 2007), pp. 174–94.

[14] Adelman, 'The Real Oil Problem', p. 21.

are global in character, and many of the energy issues on which cooperation would be beneficial are global rather than regional, the question arises of where regional cooperation might fit in.

The major global institution is the International Energy Agency, established in the 1970s to develop international energy cooperation following the Organization of Arab Petroleum Exporting Countries (OAPEC) oil embargo. At present it is limited to OECD membership; Japan and South Korea are members, but there are continuing dialogues between the IEA and China on energy issues.

The IEA does deal with coal, nuclear power and unconventional energies but, given the reason for its establishment, not surprisingly its main effort has been in the oil market. In that context it has had four main areas of attention. The most prominent now is the setting of rules for the establishment and utilisation of emergency stockpiles. These were brought into operation in September 2005 when members agreed collectively to release stocks following Hurricane Katrina. Japan and Korea have stockpiles that exceed the 90-day stock mandatory for IEA members; China has also started to build an emergency stockpile. Other key elements of the IEA process, each of which has been important at times, are an emergency supply-sharing system, oil market monitoring[15] and oil demand restraint with both short and long-term dimensions. Although there are regional aspects to these processes, they all mainly benefit from global rather than regional cooperation.

Other multilateral processes dealing with energy and involving regional countries include the Asia-Pacific Economic Cooperation (APEC) and the UN regional body, the Economic and Social Commission for Asia and the Pacific (ESCAP). Japan, South Korea, China and Taiwan are members of APEC, which has an active Energy Working Group (EWG). ESCAP has similarly been pursuing regional cooperation on energy. It has organised meetings on energy cooperation in Northeast Asia, resulting in the Vladivostok statement of April 2003 on cooperation possibilities. In

[15] In 1979, although production increased despite the cut in Iranian exports, prices doubled following the market uncertainty it created. Cited in Keohane, *After Hegemony*, p. 228.

addition, Russia, Japan and Mongolia are signatories to the Europe-based Energy Charter Treaty, and China and South Korea are observers.[16]

Much of the regional multilateral dialogue about energy and energy cooperation that involves Northeast Asian countries is broader in its dimensions than Northeast Asia, often including Southeast Asia and at times the United States. These dialogues do suggest areas where cooperation could be beneficial. APEC's EWG has on its agenda an energy security initiative, including efforts designed to respond to oil price volatility, develop emergency measures aimed to improve sea-lane security and increase stockpiling. Also on its agenda are longer-term factors, ranging from energy substitutes, including natural gas, nuclear energy and renewables, to clean fossil energy and sequestration of carbon dioxide.

Beyond governmental discussion, there has been extensive regional discussion of energy cooperation or an energy community on Track I.5 or Track II levels over at least two decades, generating what Christoffersen refers to as an epistemic community across Japan, China, South Korea, Russia and sometimes the United States.[17]

Much of what constitutes multilateral energy cooperation in the region now seems to lie with APEC. Thus, within APEC's EWG, cooperation in practice has largely involved efforts to improve data accuracy and transparency, exchanges on information and experiences, and moves to adhere to best practice methods. Commonly, energy cooperation has been bilateral rather than multilateral.[18]

WHAT IS THE SCOPE FOR FUTURE REGIONAL COOPERATION?

There are various ways in which cooperation could benefit the countries of Northeast Asia and might lead to a more general integration of the region in a cooperative manner. Many of these are of a public goods nature. The areas discussed briefly are joint emergency stockholding, natural gas and oil pipelines, electricity supply grids, the investment climate and territorial disputes. The major approach for short-term

[16] The treaty is designed to provide a kind of World Trade Organization framework for energy relations between Western Europe and emerging Eastern European states.

[17] Christoffersen, 'Angarsk as a Challenge'.

[18] US Department of Energy, 'Secretary of Energy Samuel Bodman Announces New Department of Energy Office in Beijing, China', press release, 30 June 2005, <www.energy.gov/news/1674.htm>.

reliability is stockpiling. Nevertheless, emergency stockpiles may not provide much of a basis for regional as distinct from global cooperation. Regional cooperation could make sense on the supply side of the energy system in relation to investment in exploration and production, and the establishment of electricity supply grids and of oil and gas pipelines.

There are a number of other collaborative strategies that can be followed as well. They include research and development in energy conservation, adoption of conservation measures and existing technologies and diversification strategies. Given an energy community, exchanges of information and technologies in energy saving and environmental protection technology would be greatly encouraged and facilitated. Japan in particular has much to offer in the region. It is not clear, however, that this alone would provide a sufficient functional basis for establishing a regional community.

Emergency oil stockpiles

It was noted earlier that short-term concerns in the region involve the potential vulnerability of energy supplies to instability for various reasons, including coercion, military conflict, civilian unrest and terrorist acts. There are also fears of vulnerability to interruptions at sources and in the routes and means by which energy supplies are transported.[19] There is increasing interest in offsetting these vulnerabilities through emergency fuel stockpiles, particularly as private participants in the energy markets tend to underinvest in supply reliability and especially in stockholding. So far, stocks have been unilaterally held. Following the 1970s' oil embargo and high prices, in 1978 Japan was the first country in Northeast Asia to stockpile oil systematically. In 1980 South Korea also began to build up an emergency oil stock. In its case, it also arranged to hold stocks with Statoil, the Norwegian state oil company. China's stockpiling activity is in the early stages, although Saudi Arabia is considering holding stocks in China.[20]

[19] Paul Stares, 'Introduction and Overview', in Paul Stares (ed.), *Rethinking Energy Security in East Asia* (Tokyo and New York: Japan Centre for International Exchange, 2000).

[20] Kim Ghattas, 'Chinese Leader Ends Saudi Visit', 24 April 2006, <http://news.bbc.co.uk/go/pr/fr/-/2/hi/middle_east/4938474.stm>.

There is a clear public good aspect to oil stockpiling. Oil is fungible, and any release of stocks from one stockpile lowers prices for all consumers. Since all economies benefit, emergency stocks have been seen as providing a logical case for collaborative government action to avoid free-riding. There have been many discussions of collaborative stockholding for this purpose in the Asian region, under many auspices. These include those of the IEA, the Asian Cooperation Dialogue (ACD), ASEAN+3 (Association of Southeast Asian Nations plus China, Japan and South Korea) ministers and the APEC EWG in March 2005.[21] Cooperation on this, as on other energy issues, has been endorsed in principle by Northeast Asian countries, including in the Qingdao Initiative communique issued by the ACD in 2004.

There are many difficulties in reaching agreement on how to manage emergency stocks in a collaborative programme that would need some multilateral framework: private or government stocks? Financed in what way? What is held—crude oil or product? When to buy? What should trigger releases from stocks? And what countries would collaborate—globally, regionally, subregionally (Northeast Asia) or nationally?

Japan and Korea already operate their stocks within the IEA framework. Moreover, given that all net importing economies benefit, and not just those in Northeast Asia, it is logical for emergency stocks to fit within a global rather than a regional framework.

Natural gas and oil pipelines

Natural gas consumption will grow faster in Asia than in other regions in the future, while oil consumption growth will be among the fastest. Not surprisingly, China, Japan and South Korea are interested in the supply of oil and gas from Russia. Developing an import capacity from Russia would help in diversifying supply sources and is also seen as improving Northeast Asia's competitive position with respect to Middle East suppliers, which add an 'Asian premium' to the price of exports to Asia. For its part, Russia clearly wants to diversify its energy exports to Northeast Asia and improve its competitive position. Russia is a major oil

[21] Eui-Soon Shin, 'Joint Stockpiling and Emergency Sharing of Oil', paper presented to Asian Energy Security Workshop, Beijing, 13–16 May 2005, <www.nautilus.org/aesnet/2005/index0_6_22_05.html#item1>.

producer, ranking seventh in the world in terms of proven resources; it also has a little over one-quarter of the world's proven resources of natural gas. Consequently, Russia's Siberian oil and gas reserves have the potential to contribute significantly in meeting Northeast Asia's increased energy demand.

Russia is likely to become a major gas supplier to all the countries in Northeast Asia in a matter of years if the political and commercial problems can be overcome and the very large financial issues can be resolved. To link Russia and Northeast Asia by way of pipelines could, if achieved, knit the region together.

In the wider Asia context, there have been frequent discussions about forming a regional natural gas pipeline network. For various reasons, this idea has not progressed much beyond the conceptual discussion stage. While exports of gas through pipelines have been extensively discussed in Northeast Asia, more tangible progress has been made with respect to oil exports. Russian oil has been exported to China by rail since 1991.[22]

The various options considered include a gas pipeline from Sakhalin Island through North and South Korea, though under present circumstances that would face US concerns insofar as US companies would not be permitted to participate in such an oil pipeline;[23] a gas pipeline from Sakhalin to northern China; a gas pipeline from Sakhalin to Japan; a gas pipeline from western Siberia to Xinjiang; a gas pipeline from Irkutsk to northern China; and the oil (but perhaps accompanied by gas) Pacific Pipeline, now apparently to be routed from Taishet to Nakhodka. These pipelines will service markets in Japan, China, perhaps South Korea and maybe even the United States. China and Japan supported different proposals for the routing of these pipelines: Japan wanted a northern route to Nakhodka; the Chinese preferred a southern route to Nakhodka via Daqing in China. The Russian compromise has been to accept the route

[22] The decision has apparently been taken to start the pipeline from Taishet rather than Angarsk for the ecological protection of Lake Baikal.

[23] Although KoRus, a consortium of Russian, South Korean and American companies, claims to have US political support. North East Asia Economic Forum, 'Promoting a Northeast Asian Energy Community', *Final Report on 2000–2004 Research* (Honolulu: North East Asia Economic Forum, March 2005), p. 55. Developments in the Six Party Talks in 2007, if sustained, could see this become a viable proposition.

supported by Japan, but with a branch line to Daqing possible later.[24] It proposes, however, that priority for the oil should go to China, with oil in the meantime continuing to be transported by rail.

The 10 years it has taken to reach a 'final' decision on the route of the Pacific Pipeline have been widely seen as a test of the cooperative processes among the two countries. Certainly, there have been efforts by both sides to influence the outcome. In practice, it is more an issue of Japan and China siding with different and competing domestic interests within Russia[25] and, to some extent, uncertainty about the adequacy of available oil resources to meet the needs of both countries and make any particular route economic.[26]

The question is whether the development of these various proposals, or their evaluation, provides a basis for regional institution-building. There are strong arguments that decisions on natural gas would benefit from multilateral consultations among Russia, Japan, China and Korea. And environmental as well as energy security incentives exist: in the case of gas, Japan and Korea would gain from China's increased use of gas rather than coal mainly for environmental reasons, to reduce the acid rain falling on the two countries.

There are various options for routes and subroutes for natural gas and decisions will be needed on various issues, such as Russia's domestic development needs; where natural gas fits within the national energy policies of regional economies, including against alternative energies; the future role of gas-to-liquids; the strength of the environmental issues; and the questions of ultimate market requirements and pricing arrangements.

These are complex issues, and it may need confidence-building measures elsewhere if they are to be managed in a multilateral forum. They may be seen as having a degree of urgency that may sharpen regional minds. Yet

[24] 'Taishet-Nakhodka Pipeline Has No Alternatives', *Alexander's Gas and Oil Connections*, 9(18) 21 September 2004; John Helme, 'China to Get First Crack at Russian Oil: Putin', *Asia Times Online*, 16 July 2005, <www.atimes.com/atimes/China/GG16Ad01.html>.

[25] Vladimir Ivanov, 'A Subregional Energy Community: Climbing a Ladder of Aspirations' (Niigata: Economic Research Institute for Northeast Asia, 2004).

[26] Robert E. Ebel, 'Russian Reserves and Oil Potential', paper presented at Centre for Global Energy Studies Conference, London, 15 March 2004; Vladimir Milov, 'The Russian Oil Pipeline: More Questions Than Answers', Northeast Asian Energy Focus, August 2005, pp.10–14.

unpredictable Russian decision-making and doubts about its reliability as a supplier have raised concerns in the region.[27]

Electricity supply grids

There has been technical interest for a long time in an electricity supply grid among countries of Northeast Asia. In each of the major regional economies, electricity demand is expected to grow rapidly and generating capacity needs to expand correspondingly. The potential for cooperation in electricity supply is substantial and could meet a significant part of Russia's wish to develop eastern Russia on the basis of energy exports, which could include electricity generated from coal, gas or hydro. For Northeast Asia this would enlarge and diversify its energy supply significantly. Gains could be made from an internationally linked electricity supply grid which could take advantage of the fact that daily and seasonal peak demands vary substantially in the region. There are many reasons to account for the lack of progress: North Korea is one, but not the major one.

Although the ultimate economics have yet to be confirmed by detailed studies, there is a wide belief that generation of electricity and linkages through a power grid can provide a range of benefits to those involved in terms of supply reliability, lower financial costs for infrastructure development, lower electricity costs to consumers, reduced environmental impacts and diversification of energy supply for energy security.[28]

No official endorsements have yet come from governments, but interest that has been shown in the past might be expected to increase. Any progress in this direction would need to overcome technical, financial and political challenges.[29] The difficulties include identifying and agreeing upon the best routes. There are various possibilities—a land route which, for South Korea, would involve North Korea, but alternatives involve China and Japan. In

[27] See, for example, Interfax, 'Beijing Says Not Fully Satisfied With Oil, Gas Cooperation With Russia', Interfax, 3 March 2006.

[28] Won-Cheol Yun and Zhong-Xiang Zhang, 'Electric Power Grid Interconnection in Northeast Asia', East–West Center Working Paper No. 63 (Honolulu: East–West Center, March 2005); Asia Pacific Energy Research Centre, *Electric Power Grid Interconnections in the APEC Region* (Tokyo: Institute of Energy Economics, 2004).

[29] Won-Cheol Yun, 'A Strategic Approach to Electric Power Interconnection in Northeast Asia', paper presented at APEC Study Center Conference, Seoul, May 2004.

addition, as well as economic feasibility questions there would be technical issues, reform of differing market structures, pricing philosophies and regulatory processes. None is insuperable, and there are examples of existing grids in Europe, North America and Southeast Asia that demonstrate the possibilities and benefits.

Any movement forward, however, would require a long process of consultation and eventually negotiation among the parties involved. This would have some functional benefits of the kind raised in the introduction to this paper. On the other hand, the lack of any broader consultative process in place in Northeast Asia may well be the reason why multilateral discussion of such proposals at governmental level has been so limited.

There have already been suggestions that at a broader level the Six Party Talks could provide the basis for a multilateral security process in Northeast Asia.[30] An agreed outcome from these talks will require a satisfactory solution to the problem of energy supply for North Korea.

In the context of the Six Party Talks on North Korea's nuclear programme, proposals have been made by South Korea for the supply of electricity from the South to the North as part of a solution. The particular South Korean proposal, however, faces practical as well as political problems.[31] The practical problem relates to the inadequacy of the existing electrical grid in North Korea. In the same way as the nuclear reactors promised under the previous agreed framework could not, in themselves, have met North Korea's energy needs, the South Korean offer does not provide a solution given the largely non-existent electricity grid in North Korea. A proposed alternative is a regional tie-up with Russia and South Korea, which would have the added advantage of enhancing North Korea's electrical supply security from political influence in South Korea, but Pyongyang's grid problem would still need to be resolved.

[30] See Bates Gill, *Rising Star: China's New Security Diplomacy* (Washington, DC: Brookings Institution, 2007), p. 58.

[31] Peter Hayes, David von Hippel, Jungmin Kang, Tatsujiro Suzuki, Richard Tanter and Scott Bruce, 'South Korea's Power Play at the Six-Party Talks', East Asia Science and Security Collaborative Special Report, Nautilus Institute, 21 July 2005, <www.nautilus.org/napsnet/sr/2005/0560ROK_Energy_Aid.pdf>.

The investment climate

Contributing to the changed oil market situation was an industry capacity ceiling that reflected a substantial period of inadequate levels of investment. Given the rapid growth of energy demand in Northeast Asia, the future investment needed to meet its energy exploration, development and related infrastructure requirements is very large; one estimate simply for the Pacific Pipeline, for example, is $16 billion. An overall estimate is $830 billion for the next 10 years and another $570–$870 billion for associated supporting infrastructure.[32]

Without a satisfactory and predictable legal, regulatory and policy framework that includes management of risk and property rights, the ability to attract the necessary very large private sector funding, and in some cases governmental finance, will be greatly reduced.

To achieve that kind of investment climate requires not just cooperation but knowledge and understanding of the needs, and willingness of governments to take action to provide its basis. Interest has been expressed in extending to Northeast Asia a parallel form of the European Union Energy Charter Treaty, to provide a body of common rules covering key issues such as protection of investments, encouragement of more transparent and competitive markets and promotion of energy efficiency. Such a treaty would reduce risk and uncertainty (including discrimination) in energy-related investment and trade projects. It could also help promote increased energy efficiency and reduced environmental impacts of energy production and use.

Each country has an incentive to cooperate with others in developing oil fields in particular, but also gas pipelines and electricity grids. These incentives are what led Japan in the past to help China with oil development in Xinjiang: to increase overall supply, with consequent consumer market and price benefits.

Territorial disputes

Cooperation often results from concerns to avoid or overcome conflicts. Where disputes over sovereignty are not easily resolved or where competition with other oil or gas-importing countries may create

[32] North East Asia Economic Forum, ‘Promoting a Northeast Asian Energy Community’, p. 43.

unwanted tensions, the question of joint development is at times a compromise step. China has entered into such arrangements with several countries outside the Northeast Asian region. Agreements are in place with Vietnam and the Philippines as part of its concern to maintain good relations with ASEAN over the South China Sea. Its energy cooperation also includes joint investments with India in Sudan and Iran, aimed at containing tensions that might come from their competition in the oil market.

In Northeast Asian countries, in their individual efforts to achieve increased supply security, competition and tensions have emerged. Significant conflicts exist between Japan and China (and Taiwan) over the Senkaku Islands (Diaoyutai), in the unresolved ocean border area in the East China Sea and over the Okinatori islet in the Pacific south of Japan;[33] between Japan and South Korea over the Dokdo (Takeshima) Islands; and between Japan and Russia over the Northern Islands.

In these disputes, competition for fishery resources, nationalism and broader issues of history and geopolitical competition are present. That they have emerged in heightened form in part at least reflects the concerns about energy security. This has been argued, for example, over the area of the East China Sea, where China has been exploring and drilling for natural gas in waters on China's side of the Japanese-defined (but which China disputes) line bordering Japan's exclusive economic zone.

Although joint development of ocean resources has been proposed, talks between the two sides have been inconclusive. The Chinese development is already at an advanced stage, and this puts Japan at a disadvantage. The continuing efforts by the Chinese to explore and develop within the disputed area could in fact be seen as putting pressure on Japan to agree to China's joint development proposals, as yet with no positive response from Japan.[34] The situation is not helped by China's unwillingness to provide information that Japan regards as necessary for its decisions. Some industry sources, however, doubt that this is a particularly attractive area, with the

[33] China claims it is a rock; Japan (with mechanical help) an islet. Japan has granted a Japanese company oil exploration rights.

[34] Kosuke Takahashi, 'Gas and Oil Rivalry in the East China Sea', *Alexander's Gas and Oil Connections*, 9(16) 18 August 2004.

natural gas resources not seen as substantial and production costs likely to be high.[35]

In these circumstances, the region's options are limited. More might have been possible had there already existed a regional cooperative institutional arrangement; in a regional, as distinct from a bilateral, dialogue, a sense of 'shaming' or 'peer pressure' has some influence.

SCOPE FOR A REGIONAL INSTITUTION?

The situation in Northeast Asia may not seem conducive to multilateral cooperation in the energy field, nor to the establishment of related institutions to develop norms and guidelines or manage such cooperation. Learning processes, however, have taken place among the regional actors, and each of the major countries is accustomed to participating in international multilateral institutions—including, to varying degrees, those involved with energy issues. There is already considerable interaction among regional countries that has led to improvements in economic ties and transport and telecommunication linkages. Various proposals in the past have been made to pursue multilateral cooperation, often coming from Japan but in which others have participated. The idea of a regional energy collectivity emerged marginally in the now-suspended Tumen River Project (involving China, North Korea and Russia), under the United Nations Development Programme auspices.

Much of this was at the level of state enterprises and agencies rather than at government level, and any future regional institution would have to involve the private sector effectively. Nevertheless, governments have been involved in international cooperative efforts. Japan, China, Russia and South Korea are participants in the multilateral efforts on nuclear fusion energy and the hydrogen economy, and all but Korea on carbon sequestration.

The first international Conference on Northeast Asian Natural Gas Pipelines was held in Tokyo in 1995, with China, North Korea, Kazakhstan and Japan participating. Subsequent discussions also included Russia, Mongolia and South Korea. Japanese Prime Minister Ryutaro Hashimoto wanted to integrate Japan, China and Russia in a broader Northeast Asian multilateral process, but the dispute over the Kuriles tended to limit

[35] Ralph Jennings, 'Oil, Gas Bounty in Disputed Sea Area not a Given', *Japan Times*, 29 March 2005, <http://search.japantimes.co.jp/cgi-bin/nn20050329f2.html>.

progress. Other forms of multilateral approach were pushed by Russia under President Boris Yeltsin, who wanted to further Northeast Asian integration in part to improve Russia's claims as being a great Pacific power along with China, Japan and the United States. China also wanted a four-power group, but not an institution. According to Christoffersen, however, China included participation in an East Asia energy community as one element in the steps to ensure energy security in its Tenth Five-Year Plan (2000–05).[36]

The energy situation has changed the policy dynamics markedly. Considerations of economic costs and benefits have been increasingly interlinked with energy security. This might suggest a more competitive rather than cooperative regional response. Examples given in this paper, however, point to the virtual inevitability of cooperation—and more than on a bilateral basis—if countries in the region are to increase energy security.

In a fully competitive market system, government direct involvement—unilateral or collective—would be necessary only in providing a legal, contractual and regulatory framework. Not only do the conditions that such a market assumes not exist, but there are widespread public good aspects that need international cooperation.

Periodic tensions between Japan and its neighbours pose problems for collaboration. If energy is seen as an economic issue, however, the usual capacity to separate economic from political factors should hold where territorial claims are not directly involved. It has been possible in the past to argue that, in the fraught China–Japan relationship, economic issues have been largely kept separate from political issues in a relationship lacking in trust, even when tensions were high.[37] The demonstrations in China against Japanese enterprises in 2005 may have weakened but not eliminated that belief.

CONCLUSION

Are there grounds for concluding that governments in Northeast Asia have accepted that, by coordinating policies through an institutional mechanism, they gain increased scope for pursuing their own national interests?

[36] Christoffersen, 'Angarsk as a Challenge'.

[37] Greg Austin and Stuart Harris, *Japan and Greater China: Political Economy and Military Power in the Asian Century* (London and Honolulu: Hurst/University of Hawaii Press, 2001).

There have been many suggestions for institutionalising the dialogue on Northeast Asian energy issues in a Northeast Asian Energy Community. This idea has been given further stimulus by the suggestions emerging from the Six Party Talks on North Korea's nuclear programme.

Japan has long sought international energy cooperation as a means of buttressing its energy security; in particular, it has taken a view that unless China's energy problems were dealt with, Japan would have greater difficulty in dealing with its own problems.

In the early 1990s, China was reluctant to embrace interdependence in the energy field as it faced the prospect of becoming a net oil importer. In 2002, China's '21st Century Oil Strategy' made no provision for regional cooperation. This has changed, but how far the learning process has shifted Chinese thinking in favour of a multilateral energy regime is still unclear.[38] Moreover, its enhanced perception of insecurity may now also be a factor in how Chinese leaders relate to their neighbours and China's willingness to cooperate.

Logic suggests that on most energy issues the regional economies will continue to look mainly to links with institutions outside the Northeast Asia region. This could lead to an 'outside-in' process of Northeast Asian institutionalisation in some instances. Within the wide range of institutions in which regional economies are already involved, some limited progress has been made towards developing rules and norms involving regional governments, notably on stockholding for Japan and South Korea and on investment-in-principle guidelines for Russia, Japan and Mongolia. 'Inside-out' institutionalisation of Northeast Asian regional cooperation on energy could provide a basis on which full advantage could be taken of the opportunities that Russia's resources offer in alleviating some, at least, of Northeast Asia's energy security concerns. At the same time, the lack of a regional economic and security institutional arrangement, ad hoc or formal, may itself be a problem in optimising the exploitation and reliability of those opportunities.

[38] Christoffersen, 'Angarsk as a Challenge', p. 6; Tang Fuchun, 'Energy Cooperation Urged of NE Asian Countries', September 2006, <http://sars.china.com.cn/english/2006/Sep/180039.htm>.

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