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Prospects for energy cooperation in North-East Asia

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The cooperation between the Russian Federation, the People's Republic of China, and Japan in the field of energy is one of the major factors defining the foreign policies of these countries and determining the strategic environment in Northeast Asia.[1] For several years now, each of the three countries has been considering means of ensuring long-term energy security (Japan and China), and the appropriate use of existing energy potential to modernise the state and improve its international standing (Russia).[2] Although the energy cooperation between these countries is still of a limited scope, the dynamic development of the regional energy markets is to be expected, given the fast changing international setting. The nature of future relations between the three powers (whether cooperative or confrontational) in the field of energy will have an impact on both regional and global security, particularly if one considers the growing political and economic significance of the Asia-Pacific region.[3] An analysis of the present state of this cooperation and of its future prospects entails a discussion of the existing international and domestic conditions determining the policies of the three main actors: Russia, China, and Japan.

1. The international background

Energy policy is increasingly often recognized as an integral part of a country's foreign and security policies in their broad sense. This is true particularly in the case of the largest consumers and producers of energy, whose social and economic development is strongly dependent on the state of energy markets,[4] mostly on account of the volatility of the oil and natural gas markets leading to a significant increase in world prices of these resources. The main source of this instability is thought to lie in disturbances between supply and demand caused by rapidly growing needs for petroleum in Asian countries, especially in China and India,[5] and the shrinking production capacity of certain producing areas, such as the North Sea.[6] Another cause is political and/or social instability in regions that play a crucial role on world energy markets, i.e., the Middle East (Iraq and Iran), Nigeria, and Venezuela.[7] All the above factors have led the major consumers (the United States, China, Japan, and the European Union) to take determined steps in order to diversify their sources of supply.

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1 This analysis does not include the People's Democratic Republic of Korea (almost entirely dependant on supplies from abroad, mainly from China), Mongolia, or South Korea, given these countries second-rank significance as energy importers in North-East Asia.

2 See: Y. Nakamura, *Energy Security: Strategic Viewpoints*, Institute for International Policy Studies, Policy Paper 298E, May 2002; K.E. Calder, *Japan's Energy Angst: Asia's Changing Energy Prospects and the View from Tokyo*, National Bureau of Asian Research, September 2004; E.S. Downs, *The Chinese Energy Security Debate*, "The China Quarterly", No. 177, 2004; C. Constantin, *China's Conception of Energy Security: Sources and International Impact*, University of British Columbia – Centre for International Relations, "Working Paper" No. 43, March 2005, www.iir.ubc.ca/Papers/Constantin-WP43.pdf; В. Милов, И. Селивахин, *Проблемы энергетической политики России,* «Рабочие материалы», № 4, 2005, Московский Центр Карнеги, www.carnegie.ru/ru/pubs/ workpapers/wp-04-2005-www.pdf.

3 See, for example: *The Energy Dimension in Russian Global Strategy*, Baker Institute Study, October 2004, www.rice.edu/energy/publications/russianglobalstrategy.html; *Geopolitics of Natural Gas, An Analysis of Prospective Developments in the Natural Gas Trade and Geopolitical Implications,* "Baker Institute Study", No. 29, March 2005, www.rice.edu/energy/publications/studies/study_ 29.pdf; *Energy Security: Implications for U.S.-China-Middle East Relations*, James A. Baker III Institute for Public Policy, July 2005, www.rice.edu/energy/publications/energysecurity_US_China_MiddleEast.html.

4 J.V. Mitchell, *Renewing Energy Security*, Royal Institute of International Affairs, July 2002, www.chathamhouse.org.uk/pdf/research/ sdp/Renewing%20Energy%20Security%20Mitchell%20July%202002.pdf; R. Skinner, *Energy Security and Producer-Consumer Dialogue. Avoiding Maginot Mentality*, Background Paper for Government of Canada Energy Symposium "Energizing Supply: Oil and Gas Investment in Uncertain Times", Ottawa, October 2005, www.oxfordenergy.org/presentations/SecurityOfSupply.pdf; F. Hoogeveen and W. Perlot (Eds.), *Tomorrow's Mores. The International System, Geopolitical Changes and Energy*, Clingendael International Energy Programme, December 2005, www.clingendael.nl/publications/2006/20060117_ciep_study_hoogeveen_perlot.pdf.

5 According to the International Energy Outlook 2005 report, drawn up by the Energy Information Administration – an institution subordinated to the US Department of Energy – in the years 2002–2025, the world consumption of energy will rise by 57%, of which the majority will be accounted for by developing economies, particularly China. See: www.eia.doe.gov/oiaf/ieo/pdf/0484(2005).pdf.

6 *Natural Gas Supply for the EU in the Short and Medium Term*, Clingendael International Energy Programme, March 2004, pp. 8–9, www.clingendael.nl/publications/ 2004/20040300_ciep_paper.pdf.

7 For more on the situation on world petroleum market, see: A.H. Cordesman and K.R. Al.-Rodhan, *The Changing Risks in Global Oil Supply and Demand: Crisis or Evolving Solutions?*, Center for Strategic and International, First Working Draft, October 2005, www.csis.org/media/csis/pubs/050930_globaloilrisks.pdf. In connection with increasing uncertainty about the political situation in producer countries, investment risk has been on the rise, and so have investors' profit related expectations. The authors of the report draw attention to seven main factors increasing risk: an unstable situation in exporting countries, infrastructure threatened by terrorism in Persian Gulf countries, the spread of weapons of mass destruction, embargoes and sanctions, ethnic conflicts, natural catastrophes, and technical breakdowns.

The above-mentioned circumstances contribute to the growing significance of Russia as an energy supplier, as a potential counterbalance to the unstable Middle East (and to OPEC as a whole) and – in the medium and long term – as one of the major global exporters. In the near future, rivalry between the main consumers for the access to Russian resources is expected to grow. Japan and China are already competing for the resources of Western and Eastern Siberia and of the Russian Far East.[8] Given the rapidly growing needs of the Chinese economy, the probability of rivalry between China and Europe is also increasing. This could lead to the emergence of a qualitatively new international situation that could prove to be very advantageous for Russia.

2. The domestic settings

2.1 The Russian Federation

The political significance of Russia as a global actor has been falling since the early 1990's. The legal successor of the USSR has evolved from a world superpower to a regional power with dwindling influence both in Europe and in Asia. Till this day, the Russian Federation has been suffering from the effects of the deep structural economic crisis – the legacy of inefficient Soviet system and the result of uncompleted market reforms. Economic stimulation and political stabilisation during Vladimir Putin's terms of office have led to the intensification of Russia's efforts to restore its former international position by, amongst other measures, the pursuit of an active policy within the Commonwealth of Independent States (CIS), a *rapprochement* with NATO, the USA and the UE (while, at the same time, trying to take advantage of existing trans-Atlantic differences), and growing activeness in relations with the People's Republic of China and with Japan.

In order to improve its international position, Russia increasingly makes use of energy policy as an important instrument in its relations with other countries. Taking full advantage of its abundant resources and of its strong position as an exporter, Russia is trying to compensate for its weaknesses in other areas. A sign of the increasing importance of the energy factor in Russian policy was the adoption, in August 2003, of the Energy Strategy of the Russian Federation to the year 2020. The authors of this document, which spells out the aims, tasks, and directions of the long-term energy policy of the state, openly declare that 'raw material resources and the fuel and energy complex which are the basis for the growth of the economy, at the same time constitute an important instrument of internal and foreign policy' and that 'the position of the state on world energy markets in large measure determines the geopolitical influence of the Russian Federation.'[9] These aspirations have been reflected in the latest public pronouncements of President Putin who, in December 2005, during a meeting of the Security Council of the Russian Federation, stated, amongst other things, that: 'Russia contributes significantly to ensuring global and regional energy security. At the same time, our country is in possession of a natural competitive advantage and of environmental and technological means to secure for itself a better position on energy markets. We should make use of our position in the interest of the entire international community without, at the same time, harming our national interests. Russia's present and future prosperity are directly dependent on the place we will occupy in the global energy sector.'[10]

Two months later, President Putin declared additionally that one of the strategic tasks of the G8 – of which Russia has taken over the yearly rotational chairmanship – should be the creation of a global energy security system.[11] Therefore, it seems that faith in the fuel and energy sector's ability to drive Russian growth remains unshaken.

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8 Siberia occupies an area that reaches from the Ural Mountains to the Pacific Ocean. Russian nomenclature divides this area into three parts: Western Siberia, Eastern Siberia, and the Far East. The first of these extends from the Ural mountains to the Yenisei river (the Western Siberian Plain); Eastern Siberia extends from the Yenisei river to the Lena river further east, including the area surrounding Lake Baikal (administratively this corresponds to the area of the Siberian Federal District); the Russian Far East includes the remainder of Russian territory extending to the Pacific Ocean coast (administratively this corresponds to the area of the Far Eastern Federal District).

9 *Энергетическая стратегия России на период до 2020 года*, www.minprom.gov.ru/docs/strateg/1.

10 Вступительное слово на заседании Совета Безопасности по вопросу о роли России в обеспечении международной энергетической безопасности, 22.12.2005, Москва, Кремль, http://president.kremlin.ru/text/appears/2005/12/99294.shtml.

11 В. Путин, *„Группа восьми" на пути к саммиту в Санкт-Петербурге: Вызовы, Возможности*, *Ответственность*, „Российская газета", 1.03.2006.

A glance at the relevant statistical data is sufficient to understand the cause of such a conclusion. At this time, Russia is the world's second largest producer and exporter of oil, after Saudi Arabia. In addition, Russia is in possession of the largest deposits of natural gas in the world. In the last few years, the export of petroleum, natural gas, and derived products amounted to about 50% of Russia's overall exports, earned 30% of the state budget revenue, constituted from 8.7% (according to Rosstat, the Russian statistical office) to 21% (according to the World Bank) of GDP, and represented a major source of budget surplus.[12] In January 2006, thanks to revenue generated by exports, Russian foreign currency reserves rose to over 180 billion USD, a sum almost twice as large as in 2005 at the same time. Crude oil production in 2004 amounted to 458 million tonnes (Mt), of which 330 Mt were sold abroad, with over 90% going to European markets. Proven Russian natural gas reserves amount to 48 billion m^3 (Bcm) and represent 26.7% of world reserves. Of that number, 72% is located in Western Siberia, 8.3% on the Arctic Sea shelf, and 7.9% in Eastern Siberia and in the Russian Far East.[13] Russia is presently the largest world producer (589 Bcm per year) and exporter (194 Bcm) of natural gas. Of the exported natural gas, 150 Bcm flows to non-CIS European countries and to Turkey, while the rest goes to Belarus, Ukraine, Moldova, Georgia and Armenia.

In spite of this enormous potential, Russia still remains a regional energy player, dependent above all on European buyers and, to a lesser degree, on CIS countries. Russia's main problem is the almost total lack of distribution infrastructure in the east of the country, a situation that reduces the number of directions in which oil and natural gas can be shipped (see maps Nos. 1 and 2). A necessary pre-condition for turning Russia into a world energy power, is its expansion to the East-Asian markets. Therefore, it is not surprising that the idea of diversifying export routes has been assuming an ever-greater economic and political significance in the past few years.

The growing importance of the external energy policy in Russia is due to the intensive development of the fuel sector after 1999, as a result of following factors: (1) the devaluation of the rouble and the increased profitability of fuel exports thanks to significantly reduced production costs; (2) the improved legal environment for business activity; (3) the growing strategic significance of fuel supplies from sources other than the potentially unstable Middle East, and (4) the sharp increase of world oil and natural gas prices, which has improved the investment capabilities of the Russian state and of Russian enterprises.

In addition, since 1999, the Russian energy sector has undergone a reorganisation characterised by the consolidation of oil companies (in the gas sector Gazprom has maintained an uninterrupted monopoly).[14] The state has become more active in regulating the energy sector. The most visible example of this has been the case of Mikhail Khodorkovsky, the president of Yukos (Russia's largest petroleum company until 2003), who was accused of funds embezzlement, tax arrears, and unlawful takeover of state property in the 1990's. Yet, political motives were also important. One such motive was the state's desire to gradually gain control over the energy sector.[15] The protection of the monopolist position of the state firm Transneft in the field of the construction and management of the oil pipeline network was another expression of growing centralization.[16]

The combined effect of the abovementioned factors, which stimulated growth in the energy sector, was a considerable increase in oil production (from 6 Mbd in the mid-nineties to over 9 Mbd in 2004), exceeding even the most optimistic forecasts presented in the governmental Strategy. Thanks to rising demand among the major importers, primarily in Europe, the production of natural gas also increased. In this situation, Russia began to strive for better energy cooperation with the USA and the UE – the potential

12 See: *Russian Economic Report 2004*. Word Bank specialists consider official Russian data to be imprecise and show that the methodology used reduces the real dependence of the Russian GDP on the fuel sector. See: www.worldbank.org.ru/ECA/Russia.nsf/ ECADocByUnid/0CF40EF2E501A275C3256CD1002B7D90/$FILE/RER7_eng.pdf.

13 Y.P. Batalin, and V.V. Slavyantsev, *Eastern Direction of Russian Oil and Gas Industries' Development*, Russian Oil and Gas Contractors Union, Norway, January 2005, www.intsok.no/PHP/index.php?id=3110&download=1.

14 In the last few months, Gazprom has aimed at diversifying its activities by taking over oil companies, and by investing in the electrical and nuclear power sector. At first, it was planned to merge Gazprom with the state petroleum company Rosneft, but the scheme was not realized. However, a few months later, in the summer of 2005, Gazprom acquired over 70% of Sibneft (the fifth largest Russian petroleum company) for 13 billion USD. At present, the state controls almost one third of the country's production of oil and the entirety of its oil and gas exports.

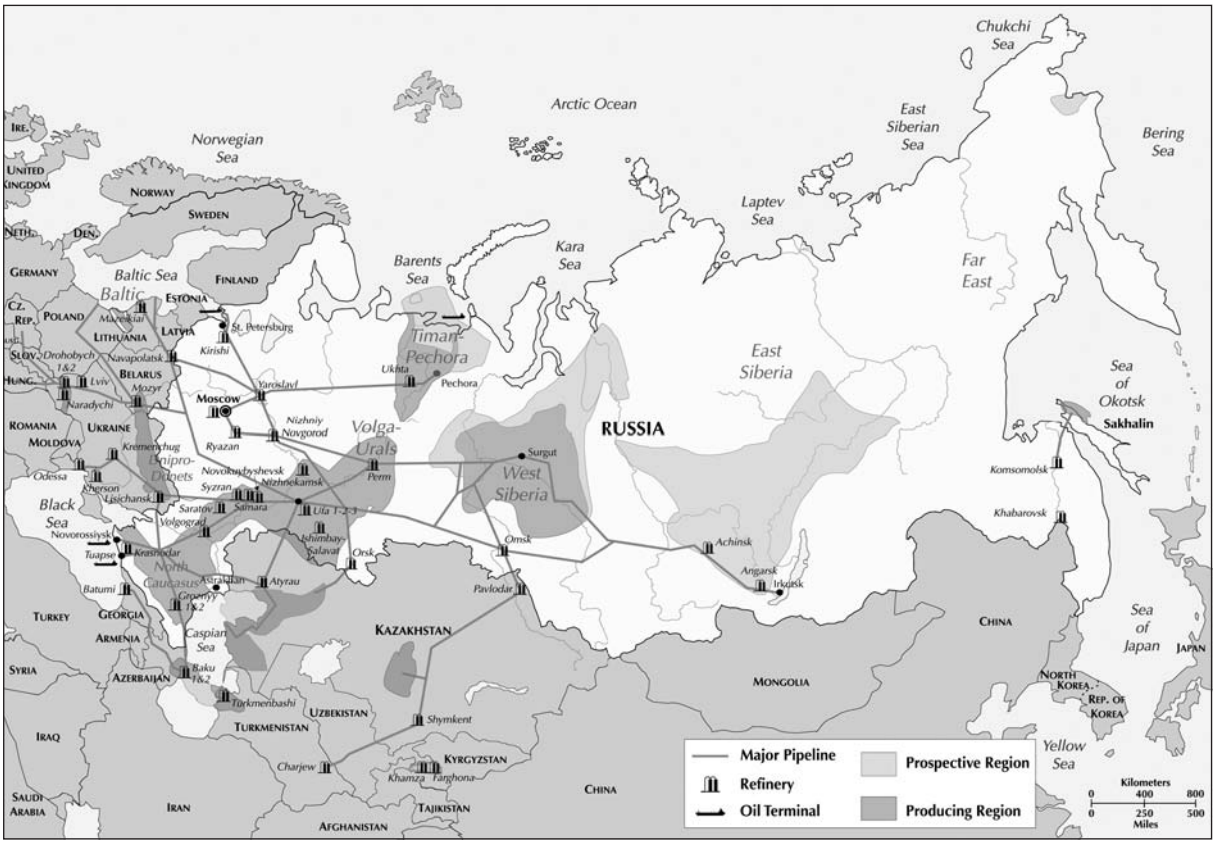
15 A. Robinson, *The Yukos Affair Part 1– Does Russia's President Putin Really Want To Turn the Clock Back?,* 9 January 2005; *item*, *The Yukos Affair Part 2– Yukos And The Future Of Gazprom*, 18 January 2005, www.oilbarrel.com/home.html.

16 Four years ago, Yukos, in cooperation with three other private companies, proposed the construction of a pipeline running from the Western Siberian deposits to Murmansk, from where the petroleum was to be shipped to, amongst other countries, the United States. These plans were blocked by Transneft. For more on the domestic aspects of Russia's energy policy, see: В. Милов, and И. Селивахин, *op.cit.*

sources of necessary investment funds. For the time being, however, its results are modest, as along with the rising revenues of the fuel and energy complex and the accumulation of domestic capital the day-to-day need for foreign investment has weakened, thus limiting the field for cooperation.[17] Last year's public listing of Gazprom shares and the removal of limitations in its acquisition by foreign entities improved the situation to a limited extent only, and served largely to cover the continued attempts by the state to extend its control over the energy sector.

Two major obstacles stand in the way of the realisation of the energy sector development plan contained in the Strategy: insufficient diversification of export routes, directed mainly to Europe and CIS countries; and the increasingly obsolete infrastructure, which might soon prove unable to handle Russia's growing export needs. Russia is still relying on old Soviet infrastructure, refineries, and already explored deposits – which, for now, makes it possible to increase production at little cost. In this situation, the state and energy companies are reluctant to invest. A greater awareness of the above-mentioned drawbacks is presently leading to the launching of projects for the rapid modernisation of existing infrastructure connections and the development of new ones, which are crucial in order to bring political declarations to life. In this context, the intensification of efforts to expand to Asian markets, primarily the Chinese and Japanese, takes on new weight.

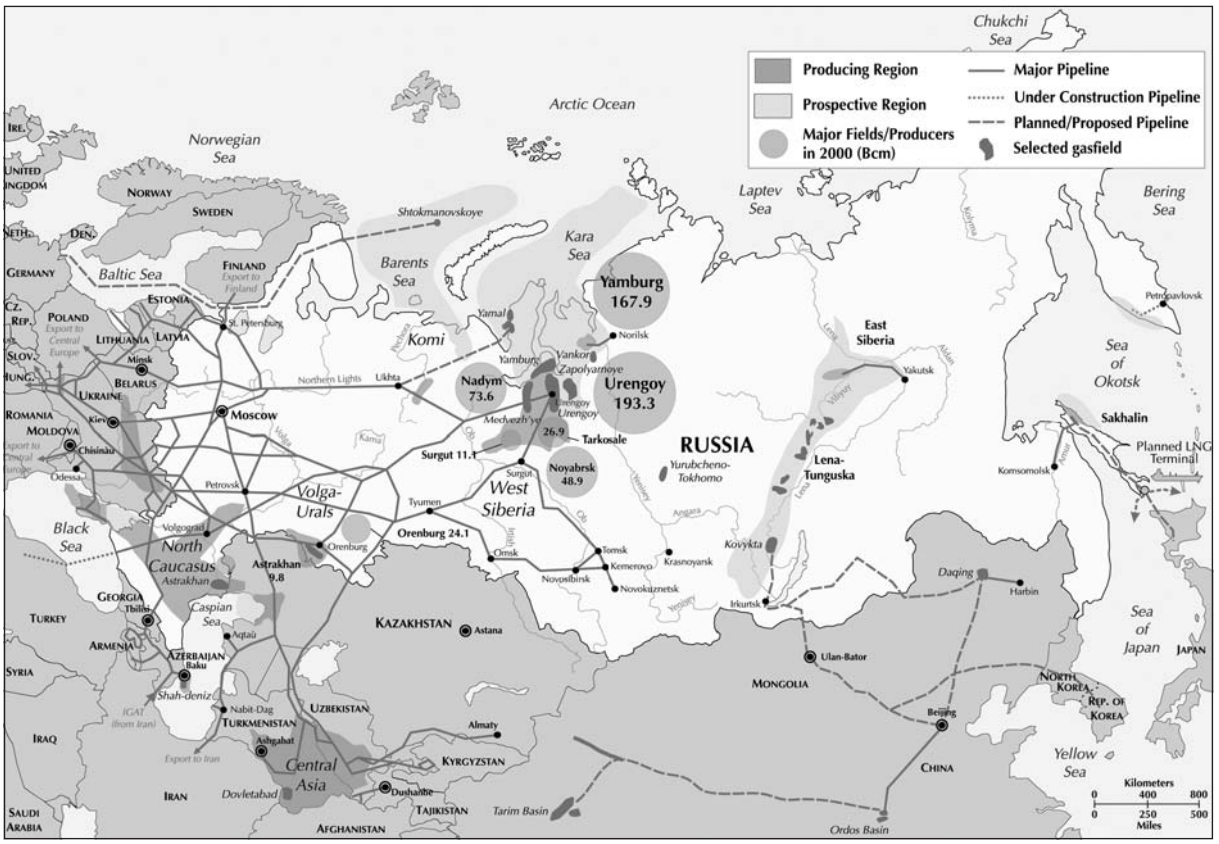
Map 1
Major Oil-Producing and Prospective Regions



Source: *Russia Energy Survey © OECD/IEA, 2002.*

[17] An expression of those measures was the cancellation, in February 2004, by the Russian government of the license to exploit the Sakhalin 3 deposits, which had been granted in 1994 to a consortium of the companies ExxonMobil, Chevron and Rosneft, in connection with insufficient investments. This made it possible to hand over the rights to the deposits to the Russian partner in the consortium, i.e., to the state company Rosneft. Gazprom is also interested in obtaining those rights.

Map 2
Major Natural Gas Producing and Prospective Regions and Pipelines



Source: *Russia Energy Survey © OECD/IEA, 2002.*

2.2 The People's Republic of China (PRC)

For the past 20 years the Chinese economy has been growing steadily thanks to ongoing reforms and a policy of openness to investments.[18] This economic growth has led to a sharp rise in demand for energy resources. Since 1993, China, which had been self-sufficient until then, has been an importer of oil. In 2003, it became the world's second largest consumer, after the USA.[19] In 2004, China used 308 Mt of petroleum, producing only 174,5 Mt of that amount.[20] The difference is imported from various sources (the Middle East, Africa, South America, Russia, Australia, and even the US). The importance of this import will continue to rise, not only on account of ever greater demand, but also of falling domestic production caused by the depletion of deposits, most of which have been exploited since the 1970's. In 2025, Chinese imports of oil could reach about 500 Mt, a quantity greater than Russia's entire production today.[21]

Given its strong dependence on fuel deliveries from the unstable Middle East by maritime shipping routes which are *de facto* under US control,[22] China is increasingly interested in, firstly, intensifying the exploration and development of new domestic deposits and the extension of existing infrastructure, and, secondly and more importantly in the international context, the diversification of supply sources, of which

18 According to World Bank estimates, Chinese GDP growth amounted to 9.3% in 2003, and 9.5% in 2004.The inflow of foreign direct investments amounted to 38.4 billion USD and 53.5 billion USD in 2003 and 2004, respectively, http://devdata.worldbank.org/external/ CPProfile.asp?PTYPE=CP&CCODE=CHN.

19 *China Country Analysis Brief* (report from August 2005), Energy Information Administration, http://www.eia.doe.gov/emeu/cabs/china.html.

20 *BP Statistical Review of World Energy 2005*, www.bp.com/downloads.do?categoryId=9003093&contentId=7005944#1.

21 *China Country Analysis Brief… op. cit.*

22 Such fears are expressed by a considerable number of Chinese specialists and military figures, who see the United States as a threat to state security and as a potential rival. Opinions can also be heard to the effect that the US would not have the means to impede the flow of energy resources to China, and would not be inclined in any case to take measures being detrimental to their own interests as well. For more on the Chinese debate on the subject of energy security, see: E.S. Downs, *op. cit*.

two – Russia and the Caspian Sea region (more precisely, Kazakhstan, as a main source of energy and as a transit corridor for Caspian resources) deserve particular attention. It is worth mentioning that the problem of diversification has long-term significance. For the time being, the principal energy carrier used in the Chinese economy is coal extracted from domestic deposits (65% of the energy used).[23] It will remain China's most important energy resource for at least several more decades, although other sources of energy will become increasingly important (see Table 1).

Table 1

Share of fossil fuels in the energy balance of the PRC in the years 2000–2020 (forecast, in %)

	2000	2005	2010	2015	2020
Coal	67.0	62.7	57.1	53.2	47.8
Oil	23.6	24.9	27.5	28.9	31.3
Natural gas	2.5	4.8	7.4	9.4	12

Source: China National Petroleum Corporation (CNPC). Za: Keun-Wook Paik, *Geopolitics of Northeast Asian Gas Development*, An International Conference on Asian Energy Security and its Implications for the U.S., www.nbr.org/programs/energy/presentations/paik.pdf.

The awareness of China's growing dependence on imported energy in the last few years has led to the intensification of both its domestic and foreign energy policy. In 1998, China initiated the restructuring of its fuel industry, main part of which was the creation of two vertically integrated (i.e., uniting activities in the area of extraction, refining, transport, and distribution) companies, concentrated on given geographical areas: The China National Petroleum Corporation (CNPC) operating in the north and west of the country and the China Petrochemical Corporation (Sinopec) operating in the south. There are also two additional firms with smaller potential: The China National Offshore Oil Corporation (CNOOC) dealing mainly with extraction and investment expansion, and China Star Petroleum.

For the first time, the Five-Year Plan for 2001–2005 devoted much attention to the question of energy security, primarily to the assurance of uninterrupted and stable supplies in the long-term perspective.[24] The rising Chinese demand for petroleum, initially viewed as a short-term trend, has definitely become a permanent phenomenon and one of the most important factors shaping world prices. China is also increasing pressure on exporting countries through pursuing a very expansive policy. Chinese energy companies are more and more often striving not only for favourable long-term contracts, but also for extraction licenses and shares in deposits. The Chinese enterprises have already started doing business in, inter alia, Kazakhstan, Azerbaijan, Iran, Saudi Arabia, Angola, Sudan, Indonesia, Oman, Algeria, Syria, Venezuela, Peru, Canada, and Australia. In this context, it is worth recalling CNOOC's unsuccessful attempt to acquire the American corporation Unocal in 2005. Chinese expenditure for domestic investment rose as well. The most important of the latter is the construction, completed in September 2004, of the East-West gas pipeline running from the rich gas deposits located in the northwestern province of Xinjiang to Shanghai. Another important element of the domestic investment programme is the establishment of strategic reserves.

China's external expansion is fuelled by its strive for the widest possible diversification of supply sources. The share of major producers in China's oil imports in 2004 was as follows: Middle East – 45.4% (of which Saudi Arabia – 14%, Oman – 13.3%, and Iran – 10.8%), Africa – 28.7% (of which Angola – 13.2%, Sudan – 4.7%, and Congo – 3.9%), Europe and the Western hemisphere – 14.3% (of which Russia – 8.8%, Norway – 1.6%, and Brazil – 1.3%), and Asia and the Pacific – 11.5% (of which Vietnam – 4.4%, Indonesia – 2.8%, and Malaysia – 1.4%).[25] It is characteristic, that China penetrates the markets of states which do not favour US policy and which are accused of supporting terrorism or human rights violations. On the one hand this allows China to avoid a direct economic confrontation with the Americans, who have turned away from these markets but, on the other, China's involvement there, which comes down to a *de facto* financial sponsoring of states that are hostile to the US, generates more and more political tensions. Americans are

23 *China Country Analysis Brief…op. cit.*

24 Testimony Presented to the US-China Economic and Security Review Commission, October 30, 2003. Presentation by Kang Wu, *Outlook for Energy and Economic Developments in China,* Presentation by Kang Wu, *Outlook for Energy and Economic Developments in China,* www.uscc.gov/hearings/2003hearings/written_testimonies/031030bios/statementkwu.htm.

25 Figures from *China Oil, Gas and Petrochemical Newsletter* quoted by: D. Zweig, and B. Jianhai, *China's Global Hunt for Energy,* "Foreign Affairs", 2005, Vol. 84, No. 5, pp. 25–38.

also worried about the fact that China is getting into markets that have traditionally been linked with the US (such as Canada) or seen in a sense as being part of the American sphere of interests (such as Venezuela).[26]

2.3 Japan

For at least several years now, Japan has been aiming at securing such a political position in international relations which would commensurate with its economic potential. Japan is increasingly active abroad, taking part in peace-keeping operations and actions in the field of non-proliferation of weapons of mass destruction. It is openly vying for the status of permanent member of the United Nations Security Council. These developments are taking place in parallel with the growing strength of China and are leading to a qualitatively new situation in East Asia. Faced with growing competition from the People's Republic of China, the Japanese government has been concentrating on strengthening its alliance with the US and on establishing stable relations with other states in the region. In this context, the Russian Federation appears to be one of Japan's more promising political partners. From Japan's point of view, acquiring Russian backing for its efforts to secure permanent UN Security Council membership is also significant. For Russia, Japan counts as an important source of the investment necessary for the development of the backward regions of the Russian Far East. An important obstacle to the realisation of this scenario remains the two countries' unresolved dispute over the southern Kurile Islands (to use Russian nomenclature), or the Northern Territories (according to the Japanese), occupied by the Soviet Union right after the end of operations in the Pacific in September 1945, and the return of which the Japanese are demanding. This is a basic precondition for the signing of a peace treaty between the two countries and for the normalisation of their bilateral relations. Against this background, the development of energy cooperation, which has, until now, received little attention from either of the two countries, is becoming an increasingly important issue of strategic significance.

The economy of Japan – the fourth energy consumer in the world, the third world consumer of oil, after the US and the PRC, (241 Mt in 2004) and the world's largest importer of liquefied natural gas (76 Bcm in 2004)[27] – is almost entirely dependent on resources brought from abroad, primarily from the Middle East (oil) and Southeast Asia (natural gas). The energy mix of Japan is as follows: oil (49.7%), nuclear energy (13.7%), natural gas (12.7%), and coal (8.9%).[28] Japan has the lowest ratio of domestic production to consumption among highly developed nations and is most dependent on the Middle East for its oil deliveries.[29]

Following over a decade of economic stagnation, during which growth in consumption also came to a standstill, demand for energy is rising again, and so is the importance of energy imports. With the increasing international competition for access to energy sources, particularly growing pressure from China,[30] the Japanese government for the last couple of years has been stressing energy policy as an important element of national security policy. As part of its energy diplomacy, Japan has been focusing on the following measures: maintaining and enhancing emergency response capability (should an energy crisis arise) through the intensification of regional cooperation within organisations like ASEAN and APEC and the extension of its own strategic reserves; the development of friendly relations with Middle East countries and other important producers (including Kazakhstan, Uzbekistan, and Azerbaijan, to which Japan grants development aid; and where Japanese companies participate in energy consortia); diversification of oil supply sources, primarily through increased cooperation with the Russian Federation,

26 For a wider analysis of this process, see: *ibid.*

27 *BP Statistical Review..., op. cit.*

28 *Japan. Country Analysis Brief* (report from August 2004), Energy Information Administration, www.eia.doe.gov/emeu/cabs/japan.html.

29 Figures of the Japanese Ministry of the Economy, Trade, and Industry. From: K.A. Calder, *Japan's Energy Angst: Asia's Changing. Energy Prospects and the View from Tokyo*, National Bureau of Asian Research, September 2004, www.nbr.org/programs/energy/conferences/2004/presentations/calder.pdf.

30 In the last three years, the dispute between China and Japan over the exploitation of the estimated 200 Bcm of natural gas in the East China Sea and in connection with China's attempts to gain control over the maritime shipping routes in the region has grown more acute. Tension has been mounting since 2003, when the planned common exploitation of the deposits fell through and China began drilling on its own. Japan alleges that China wishes to empty the deposits found in the Japanese zone by using their location in the vicinity of the boundary separating the two countries' respective exclusive economic zones. China rejects this argumentation and claims that its activities are limited to undisputed areas.

but also with Iran;[31] diversification of the types of imported fuels through enlarging the share of natural gas (mainly of Russian origin) and the development of international cooperation in the field of renewable and alternative energy sources.[32]

The Japanese government and the companies it supports, in their efforts to strengthen cooperation with Russia, are concentrating on two areas: participation in the exploitation of gas deposits on Sakhalin island, which, given its proximity, would constitute an excellent source of energy, and convincing Russia to build a pipeline linking the western and eastern Siberian oil fields with the Pacific Ocean coast, from where the oil could be shipped to Japan. Energy resources are not all that is at stake, however. Japanese firms expect that cooperation in energy would facilitate their investment expansion over the entire territory of Siberia when the implementation of Russian regional development programmes begins.

3. The dynamics of energy cooperation between Russia, China and Japan

3.1 Eastern Siberia and the Russian Far East as potential sources of energy

The significance of the Russian Far East and Eastern Siberia in Russia's energy balance is, as yet, small. Total proven oil reserves of Russia amount to 9.9 Bt (about 6% of world reserves),[33] of which the majority (55%) is located on the territory of Western Siberia. The petroleum potential of Eastern Siberia is modest. However, there are considerable deposits in the Russian Far East, primarily on the island of Sakhalin and the surrounding continental shelf (about 2 Bt). The exploitation of the Sakhalin oil fields is just in the early stage and, for this reason, the fields located in Western Siberia play the most important role in Russian production, for now. The production potential of both regions is used to a limited extent due to the absence of the infrastructure necessary in the circumstances when extraction sites are remote from processing centres and consumption areas. The abovementioned government energy strategy views the exploitation of Eastern Siberian and Far Eastern deposits and the development of new industrial centres as a long-term goal. Until 2020, the Russian government plans to achieve the production level of 50-80 Mt per annum (excl. Sakhalin), depending on the evolution of the international and domestic situation (the pessimistic scenario predicts an increase of only 3 Mt). Production on Sakhalin should at that time reach 25 Mt (16 Mt according to the worst case scenario).[34]

Assuming a favourable course of developments, the years 2010–2020 should see a significant increase of gas extraction in Eastern Siberia. It is there that some of the largest gas deposits in Russia are located (the Kovykta field in the Irkutsk District holds about 2 Bcm and Chayadinskoe in Sakha Republic – 1.3 Bcm). The significance of the gas deposits in Sakhalin (about 2.7 Bcm) is also expected to increase. Depending on the scenario, moderate or optimistic, the levels of gas extraction in 2010 should reach 30 to 50 Bmc, and in 2020 – 55 to 110 Bcm. These prognoses, largely confirmed by non-Russian sources, lead the governments of Japan, the People's Republic of China, and South Korea to believe that gas and oil supplies from Russia will constitute an important element of their future diversification policies.

Additionally, Russia is facing more and more serious political challenge of growing disproportions between the development of the Siberian and European parts of the country. Russia is struggling with, on the one hand, the problem of the spatial and administrative consolidation of the country,[35] and on the other, with an international challenge of its participation in the integration processes that are taking place in the Asia and Pacific region, a region that is becoming the principal economic competitor to both the US and the

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31 In 2004, the Japanese company Inpex signed an agreement with the Iranian government for the take over, for 2.8 billion USD, of 75% of shares in the large Azadegan oil field in Iran. However, the present situation with Iran makes the future of this cooperation highly uncertain – the Americans are quite staunchly against it whereas competition on the part of China is on the rise. These developments mean that other sources of petroleum, particularly those in Russia, are becoming increasingly important.

32 *Strategy and Approaches of Japan's Energy Diplomacy*, Ministry of Foreign Affairs of Japan, April 2004, www.mofa.go.jp/ policy/ energy/diplomacy.html.

33 Figures concerning proven reserves and production of oil and gas in Russia, China, and Japan come from the *BP Statistical Review of World Energy 2005,* available at www.bp.com. Deposits in Russia are probably several times larger, but inaccessible given the lack of appropriate technology and infrastructure (*International Energy Outlook 2005*). About 10% of these estimated deposits are located on the territory of Eastern Siberia and the Russian Far East.

34 *Энергетическая стратегия России..., op. cit.*

35 V.D. Kalashnikov, *National Energy Futures Analysis and Energy Security Perspectives in the Russian Far East*, Nautilus Institute, www.nautilus.org/archives/energy/eaef/Reg_RFE_final.PDF.

EU.[36] Fears associated with the weakening cohesiveness of the country – rising in parallel with the growing importance of China – explain the particularly careful opening of Russia to cooperation with Asian partners.

3.2 Cooperation in oil sector

Russian-Chinese cooperation in the field of energy began at the end of the 1990's, when the first signs of economic reinvigoration appeared in the Russian Federation and when a political *rapprochement* took place between the two countries. Initially, it was Russia that expressed its interest in pursuing common projects whereas China reacted to such proposals with considerable reticence.[37] The situation changed along with the rapidly rising Chinese demand for fossil fuels, particularly for oil. At the same time, the involvement of Japan, which was striving to diversify its sources of supply so as to diminish its dependence on deliveries from the Middle East, also grew. Both countries are facing a similar task of securing stable and uninterrupted supplies of energy for themselves. The geographical proximity of Russian deposits made the commencement of this rivalry only a matter of time, particularly as in addition to rivalry in the energy field came political and economic tensions, historical disputes, and both countries' mutually exclusive ambitions to play the role of a regional leader. Russia saw its chance not only to diversify its Euro-centric energy activities but also to strengthen its political and economic position in the region. An illustrative example of the nature of current cooperation between the three powers is provided by the story of the construction of an oil pipeline to the eastern markets, which brings together the most important factors defining both the present state of affairs and future prospects of regional cooperation in the field of energy.[38]

Initially, it was the private Russian company Yukos, which hoped for considerable profit from access to the growing Chinese market, that was the most active in pursuing the vision of selling oil to China. Towards the end of the 1990's, and as a prelude to closer cooperation, Yukos began exporting oil to China by rail (about 500,000 tonnes in 1999). As time went by, the concept of building a pipeline emerged. Nonetheless, both sides needed over two years in order to agree on the pipeline's route. According to initial plans, it was to run from Angarsk (Irkutsk Oblast'), site of the most easterly-located Russian refinery, to Daqing in North-East China, one of the most important Chinese oil extraction and processing centres. At the time, Yukos' plans were supported by the Russian president and government. Preliminary agreements in 2000 called for construction to begin as early as 2003. Soon however, the first problems appeared. In 2002, Transneft, the state petroleum transportation monopolist, which was concerned about the possibility of its position being weakened, proposed to build a pipeline to the port of Nakhodka, on the Pacific coast. In January 2003, the Japanese government declared its support for the project, by guaranteeing yearly purchases of 50 Mt, a declaration followed a few months later with an offer of capital backing of 7.5 billion USD.[39]

In the meantime, in May 2003, Yukos signed, in the presence of Russian government officials, a long-term contract with CNPC for oil deliveries by rail (20 Mt per annum in the years 2005–2010, and 30 Mt in the years 2010–2030) along with a letter of intent concerning the construction of the pipeline.[40] A few weeks following the signing of these documents, when the Japanese financial proposals became known, the Russian authorities declared that the agreement on the pipeline had been preliminary and non-binding

36 *Mapping the Global Future. Report of the National Intelligence Council's Project 2020*, www.foia.cia.gov/2020/2020.pdf.

37 The first proposal to construct a pipeline to China was made by Russia as early as 1994. For the next several years, Russia initiated feasibility and itinerary studies, but no specific decisions were taken, largely given the weak interest of the Chinese government in this issue.

38 For a detailed overview of Chinese-Japanese rivalry for access to Russian energy resources, see: N. Simonia, *Russian Energy in East Siberia and the Far East,* in: *The Energy Dimension in Russian Global Strategy*, The James Baker III Institute for Public Policy, October 2004, www.rice.edu/energy/publications/docs/PEC_SimoniaFinal_10_2004.pdf. See also a series of articles by Y. Bin in the quarterly "Comparative Connections. A Quarterly E-Journal on East Asian Bilateral Relations" (Vol. 5, No. 1 – Vol. 7, No. 3) published by CSIS as part of the Pacific Forum project. One can find in each issue a chapter devoted to an analysis and a chronology of events that have taken place in Russian-Chinese relations over the preceding three months. www.csis.org/pacfor/ccejournal.html.

39 Keun-Wook Paik, *Geopolitics of Northeast Asian Gas Development*, An International Conference on Asian Energy Security and its Implications for the U.S., September 2004, www.nbr.org/programs/energy/presentations/paik.pdf.

40 Interestingly, one of the signatories of this agreement was Transneft, which was already pushing for the concept of a pipeline to the Pacific coast. The sole point was to maintain full control over the course of the preparatory process and to prevent the realization of any project without the participation of the monopolist. In fact, the company's aim was to maintain its transport monopoly, which, at the time, entailed the necessity of weakening and undermining Yukos' proposal (Yukos being the most dangerous potential competitor).

in nature.[41] Soon, the arrest of Mikhail Khodorkovsky in October 2003 and the takeover by the state of Yukos' assets *de facto* deprived the latter of any say in the matter of the project. However, the question of oil deliveries by rail to China remained under the company's control. In the matter of the pipeline, the most important players now became the Russian government and the state-controlled companies Rosneft and Transneft. By the same token, its construction was transformed into a political undertaking – one of the many elements shaping Russian policy towards its Asian neighbours.

The possibility of bringing a pipeline to the Pacific was mentioned by many representatives of the Russian authorities at the beginning of 2003, when during a meeting of the government, a sharp disagreement emerged between various ministries as to the pipeline's itinerary. In the end, it was decided to merge the two projects into one, with priority being given to the realisation of the connection with China. Yet, shortly after, the redoubled efforts of Japanese diplomacy, backed by financial offers, led to a change of decision favourable to the Japanese. The first pronouncements made in connection with the project of building a pipeline to Nakhodka were made known to international community after releasing a common declaration of the prime ministers of Russia and Japan in December 2003.[42] Soon after, at the press conference of 25 December 2003, Russian Prime Minister Mikhail Kasyanov spoke of the need to pursue a two-pronged approach, with strategic/long-term significance given to the Angarsk–Nakhodka branch, and a tactical significance to the Angarsk–Daqing one. Within the first option, Russia would not only build the pipeline and sell the crude, but also could develop oil deposits in Eastern Siberia and expand its industrial facilities thanks to Japanese investments. On the other hand, Chinese project would mean only sending to Daqing – at first by rail and, in the future, by pipeline – the excess oil produced in Western Siberia, transport of which to the Pacific would be too costly.

In early 2004, everything seemed to point in favour of the Japanese variant. Transneft had even begun work on a feasibility study connected solely with the Nakhodka pipeline project. In addition, no Russian company, with the exception of the bankrupting Yukos, was interested in the route to Daqing. In order to defuse critical assessments from China and its anxiety about the consequences of the 'Yukos affair', President Putin authorised the Minister for Railways and transportation companies to increase oil exports to China from the 6 Mt planed in 2004 to 15 Mt in 2006. Just a few days later, during a press conference, the Chinese ambassador in Moscow called for Russia to accelerate the realisation of the Angarsk–Daqing pipeline project. At the same time, he stressed that a strong China does not constitute a threat for Russia, but only needs Russian oil, just as Russia needs the Chinese market, and the construction of the pipeline would be the best way to satisfy the needs of both states. Although China had intensified its efforts to secure other sources of oil accessible by land (Central Asia), it did not abandon the idea of the Angarsk-Daqing pipeline project.

Meanwhile, in the middle of 2004, although the final decision about the pipeline had not been taken yet, Russian companies began studying possible ways of powering relay stations and looking for appropriate locations on the route leading to the Pacific coast. Transneft also proposed a new itinerary, running to the north of Lake Baikal, from Taishet to Nakhodka, a more favourable route on account of its lesser environmental impact. The only unknown thing remained the question of the potential branch pipeline to China. In June 2004, the Russian authorities informed the Chinese ambassador that the feasibility study concerning the pipeline to Nakhodka had proved positive, and the final decision in the matter of its construction was to be taken by the end of the year. At the same time, the ambassador was assured that the issue of the branch pipeline to Daqing was still on the agenda. Nonetheless, the lack of clarity about final Russian aims, the endless expertises and environmental impact studies, and the absolute lack of decisiveness in the realisation of incurred obligations were very badly viewed in China, and this led to a number of counter-moves. For example, the gas company PetroChina did not grant – though it had previously promised to do so – participation rights in the construction of the East-West gas pipeline to the consortium made up of Gazprom, Shell, and ExxonMobil. This was a blow to the strategy of the Russian monopolist planning to expand onto the Chinese market.

Tensions in Russian-Chinese relations rose in September 2004, when Yukos declared that it would suspend oil deliveries by the end of the year, on account of the freezing the company's assets by the

41 Y. Bin, *Party Time!*, "Comparative Connections", July 2003, Vol. 5, No. 2, pp. 129–130, www.csis.org/media/csis/pubs/0302q.pdf.

42 Earlier, only press reports appeared, for example about the fact that during the meeting of the Security Council of the Russian Federation in January, President Putin announced that bringing the pipeline solely to China would constitute a threat to Russian interest. 'RFE/RL Reports,' 14 January 2003, Vol. 4, No. 2, www.rferl.org/reports/securitywatch/2003/01/2-140103.asp.

Russian authorities. China thus became a victim of an internal conflict in Russia. Thus, Russia's image as a reliable partner suffered further.[43] Wishing to tone down the dispute, in the very same month Russia assured China that it would consider the question of building the pipeline to China, that it would increase exports of fuel by rail, and would present a plan for cooperation in the gas field. Russia's position was also dictated by its reluctance to strain overall relations with China, as the talks about the final settlement of boundary were being finalised at the time.

Finally, on 31 December 2004, the Russian government issued a decision on the unified petroleum transportation system. It announced the development of the 'Eastern Siberia-Pacific Ocean' infrastructure, making it possible to export oil to the far eastern markets.[44] The project of the pipeline from Taishet to Perevoznaya Bay (near Nakhodka, which had earlier been presented as the destination point) was drawn in more details by the Minister of Industry and Energy in the executive act of 25 April 2005,[45] defining individual stages of the project's realisation. The first stage – the construction of the first leg with a flow capacity of 30 Mt from Taishet to Skovorodino, from where the petroleum originating from the Western Siberian fields would be shipped further along by rail – is to be completed by 2008. At the same time, an oil terminal is to be built in Perevoznaya Bay, with a transhipment capacity of up to 30 Mt per annum.[46] The second stage involves the construction of the second leg from Skovorodino to Perevoznaya, with a target flow capacity of 80 Mt, which would be supplied from Eastern Siberian deposits, developed simultaneously. Meeting the deadline for the completion of the entire project, planned for 2020, is dependent on the synchronization of these two processes. Without Eastern Siberian resources, the pipeline to the Pacific coast would be a faulty and unnecessary investment.

Significantly, enormous export revenues have allowed Russia to free itself from the necessity of attracting extensive foreign investments and have given it a wider margin of manoeuvre. Russian authorities began making declarations to the effect that Russia would finance the pipeline itself. This constituted a sort of show of force to precede negotiations with potential creditors and investors. It would seem that this tactic could prove successful. The Japanese, having stated that their country would not engage itself financially should a branch to China be built, then changed their minds and began talks about participating in the project.[47]

Although the abovementioned acts of law made no mention of building a branch to China, the issue would not go away.[48] In the second half of 2005, the project grew more popular again, in connection with Russia tightening relations with the PRC.[49] Political advantages prevailed over the relatively low cost of building a leg several dozen kilometres long running from the main line of the pipeline to the Chinese border. In September 2005, President Putin declared that the first stage of construction of the pipeline to the Pacific coast would include the construction of a branch to China. In November, the Russian Minister of Industry and Energy announced that the conceptual work on the pipeline branch to Daqing had begun.[50]

At present, the realisation of the combined variant (the construction of a line to the Pacific coast with a branch to China) seems the most probable option, as the most advantageous one for Russia, both in political and economic terms. According to Transneft, the realisation of the 'Eastern Siberia-Pacific coast'

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43 Interestingly, the Russian government did not intend to back down in the Yukos affair, even at the cost of periodic problems in relations with China. In the end, CNPC paid in advance for the fuel and for the transportation, wishing to avoid an interruption of supplies. Although it received payment, Yukos suspended deliveries, forcing the Chinese concern to take matters before the tribunals. In 2005, Yukos lost its dominating position in petroleum exports to China to the benefit of Rosneft and Lukoil.

44 Распоряжение Правительства РФ от 31 декабря 2004 г. N 1737-р „О единой нефтепроводной системе", http://govportal.garant.ru:8081/SESSION/S__35zyW7Gp/PILOT/doc.htm?skind=&pid=6152270&showcomments=1&page=1&sub=0&doc_type=3.

45 Приказ Минпромэнерго РФ №91 от 26 апреля 2005 г. (26.04.2005) www.transneft.ru/Projects/Default.asp?LANG=RU&ID=8779.

46 The obligation to simultaneously carry out both of these undertakings is Russia's main argument used to appease Japanese fears that petroleum will flow exclusively to China following the completion of the branch to Skovorodino.

47 В. Путин, *Нефтепровод Восточная Сибирь – Тихий океан открывает большие перспективы*, 21.11.2005, www.transneft.ru/press/Default.asp?LANG=RU&ATYPE=8&PG=4&ID=9701.

48 The possibility of using the branch leading to Skovorodino for petroleum exports to China was mentioned at the end of May 2005 by Viktor Khristienko, the Russian minister of industry and energy. *Условия для поставок нефти странам АТР будут складываться синхронно*, www.transneft.ru/press/Default.asp?LANG=RU&ATYPE=8&PG=14&ID=8540.

49 In July 2005, during a meeting of presidents Hu Jintao and Vladimir Putin in Moscow, documents were signed that were to cement the Russian-Chinese strategic partnership, including a common declaration about the international order in the 21st century. (*Совместная декларация Российской Федерации и Китайской Народной Республики о международном порядке в XXI веке*, www.kremlin.ru/interdocs/2005/07/01/1728_type72067_90623.shtml?type=72067). Another important event was the first military manoeuvres conducted in August of the same year.

50 В. Христенко, *«Транснефть» готовит обоснование инвестиций ответвления на Китай Восточного нефтепровода*, www.transneft.ru/press/Default.asp?LANG=RU&ATYPE=8&PG=5&ID=9583.

project commenced in April 2006.[51] One of the last remaining obstacles to the realisation of this undertaking was removed in March 2006: the Russian Technical Supervisory Authority approved the environmental impact study and authorised the beginning of work.[52]

Both variants, the Chinese and the Pacific one, have their advantages and disadvantages. The former offers better short and medium term earning possibilities on account of the much lower approximate construction costs (2 to 4 billion USD for 12 to 16 billion USD in the case of the Japanese variant).[53] The receptive Chinese market would also provide a ready market for oil presently available to Russian producers. From the political point of view, the situation is not so clear-cut. On the one hand, the establishment of a true energy partnership between Russia and the PRC would also favour the strengthening of political ties and the diversification of economic relations, which are, at this time, mainly centred on the export of Russian armaments and military technology and trans-border trade. On the other hand, bringing the pipeline solely to China would reduce the chances for a further diversification of easterly export options for Russia, leading to dependence on one client, who could one day make use of such a privileged position to change contract terms to the detriment of Russian producers. In such a situation, the Taishet-Perevoznaya variant offers more benefits, as it makes it possible to reach a larger number of consumers, primarily Japan, South Korea, China, Southeast Asia, and also the US (west coast). In domestic Russian context, the realisation of that variant could constitute a strong stimulus for the underdeveloped regions of Eastern Siberia and the Russian Far East, where it would, furthermore, slow down de-population trends, speed up industrial development, have a positive long-term impact on the reinforcement of the territorial integrity of the State, put an end to the yearly energy shortage crises that take place in these regions, and initiate the exploitation of oil deposits.

As can be seen, the Russian government decided to give up playing the zero sum game and to merge the two projects. The decision to build the pipeline to the Pacific coast with a branch to China is an attempt to secure the maximum political and strategic advantage, whereas economic matters, although important, have taken a back seat. It remains to be seen if this political project will stand up to the economic and environmental realities or, to put it in other words, whether minimal economic viability conditions will be fulfilled and whether geologically confirmed reserves will really prove sufficient to achieve the planned level of sales.

3.3 Cooperation in natural gas sector

Talks about possible construction of a gas pipeline to the PRC since the mid-1990's have been conducted in the shadow of the controversy surrounding the oil pipeline. Towards the end of President Yeltsin's tenure, the idea was voiced of building a gas pipeline from Irkutsk Oblast', through Mongolia, to China.[54] Soon, under pressure from the Chinese government, Mongolia was excluded from the project as an additional risk factor. Simultaneously, the question was also debated of exporting West Siberian gas to the province of Xinjiang, from where it would be transported further to Shanghai through the Chinese East-West pipeline, which was being planned then. At the end of 2000, the prime ministers of Russia and China signed an agreement on the preparation of a feasibility study for the gas pipeline running from the fields of Kovykta to China, with a flow capacity of 30 to 35 Bcm per annum, at an estimated cost of 10 billion USD.[55] Representatives of South Korea were invited to the discussions devoted to this undertaking by the Russians and the Chinese, who expected that access to Korean market, whose needs are estimated at 10 Bcm per annum, would increase the viability of the entire project. In November 2003, work was completed on the study and a preliminary agreement on the construction of the gas pipeline and gas supplies to China and South Korea was signed. The realisation of this project was not hampered, this time, by geopolitical considerations (Japan does not compete with the PRC in this case, because it is interested in the Sakhalin gas fields), but by rivalry between different Russian companies with state being actively involved.

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51 *28 апреля начнется строительство ВСТО, 26.04.2006,* http://www.transneft.ru/press/Default.asp?LANG=RU&ATYPE=8&PG= 7&ID=10861.

52 *ТЭО первой очереди ВСТО утверждено – Ростехнадзор*, www.transneft.ru/press/Default.asp?LANG=RU&ATYPE=8&PG=0&ID=10521.

53 The difference in costs originates primarily in the length of the planned routes. Its scale, however, depends on the information source. Manipulation of the estimated costs of both investment projects has also become an element of negotiations and political rivalry. The semi-covert nature of the entire process makes it impossible to indicate reliable sources, thus the figures cited are estimated costs at their most extremes.

54 Y. Bin, *China-Russia Relations: Back to the Future*, "Comparative Connections. A Quarterly E-Journal on East Asian Bilateral Relations", January 2000, Vol. 1, No. 3, p. 77, www.csis.org/media/csis/pubs/9904q.pdf.

55 Y. Bin, *Putinism in Its First Year*, "Comparative Connections", January 2001, Vol. 2, No. 4, p. 96, www.csis.org/media/csis/pubs/0004q.pdf.

The license for the exploitation of the largest deposit in the region, that of Kovykta, is owned by Russia Petroleum, a company controlled by the private corporation TNK-BP. However, no undertaking can be successful without Gazprom's approval, which has the exclusive right for the export of gas. The talks held about the construction details of the gas pipeline have been inconclusive yet. TNK-BP also announced its interest in investing up to 5 billion USD in the Kovykta, provided that export-related issues were settled – only then would profits make up for the initial outlays. Meanwhile, Gazprom is concentrating on other projects in Europe (the construction of the Northern Gas pipeline through the Baltic Sea) and on Sakhalin, and has adopted a wait-and-see attitude. It has no intention of allowing its export monopoly to be curtailed. In this matter, Gazprom enjoys the support of the state, which exerts pressure on TNK-BP.[56] Gazprom is probably planning to convince TNK-BP to develop the deposits, without Gazprom's expending its own funds, in order to take over a portion of shares later in exchange for authorisation for export.[57] Gazprom has an important trump card in the form of an alternative course of action: it has the possibility of securing for itself a license for the exploitation of the gas deposits of Chayadinskoe in Sakha Republic. These amount to 1.3 Bcm and could replace the gas of Kovykta.

On the other hand, Gazprom has nothing against the use of Kovykta gas for domestic consumption. This is consistent with TNK-BP's assumptions about the first stage of the investment.[58] TNK-BP plans call for the deposits of Kovykta to supply the domestic market as early as 2006, and China only in the following decade. In the fall of 2005, Gazprom held talks with TNK-BP about cooperation in exports. The parties have not reached an agreement as of yet. However, Gazprom is clearly modifying its previous strategy of limited involvement in the regions of Eastern Siberia and the Russian Far East. It is working closely with the local authorities in order to secure for itself better access to deposits and to create conditions for the development of infrastructure. Furthermore, in October 2005, Gazprom signed a strategic cooperation agreement with CNPC, which can be seen as a form of compensation for Russia's lack of decision in the matter of oil deliveries. In March 2006, during President Putin's visit to China, both companies signed a protocol about natural gas supplies from Russia to China, in which conditions for cooperation in gas sector were laid out. The two parties announced the construction of two gas pipelines. The first is to run from the deposits of Western Siberia, over the Altai Mountains to China, whereas the second is to run from Eastern Siberia. Their combined target flow capacity is to be 80 Bcm per annum (from 30 to 40 Bcm each). According to information agencies, the gas should start to flow in five years, whereas the cost of the investment could come to about 10 billion USD.[59] The agreement is rather vague and gives both parties a wide margin for manoeuvre for the negotiations, yet it is of considerable symbolic significance. Given the anticipated growth of Chinese demand for Russian gas (see Table 2), the construction of the gas pipeline seems a foregone conclusion, although it is still too early to speak of specific parameters and definite destinations.

Table 2
Chinese demand for Russian gas (Forecast, in Bcm per annum)

	2005	2010	2020
Eastern Siberia	0.0	12.0	30.0
Western Siberia	0.0	0.0	30.0
TOTAL	0.0	12.0	60.0

Source: China OGP 2003, in: Keun-Wook Paik, *op. cit.*

56 In 2004, the Russian Minister for Natural Resources announced that there was a possibility of cancelling the TNK-BP license on grounds of the company's neglect of its obligation to develop and modernise local infrastructure. *Russia's Kovykta Project: Dire Consequences*, September, 2004, www.stratfor.com/products/premium/read_article.php?id=236403.

57 In February 2006, rumours surfaced to the effect that TNK-BP intended to sell its share of RussiaPetroleum to Gazprom, as it could not see any export prospects. These rumours were not confirmed by either party.

58 According to TNK-BP, the exploitation plan of this gas potential were to take shape as follows: first stage (2005-2010) – the gasification of Western Siberia and the Russian Far East and the commencement of gas exports by pipeline to Asia and the Pacific coast, and of liquefied gas from Sakhalin; second stage (2011-2030) – significant increase of exports and linking with the Unified Gas Networks. See: В. Вексельберг, *Нефтяные и газовые ресурсы Восточной Сибири и Дальнего Востока как основа регионального развития*, 05.12.2005, Москва, Совет Федераций, www.tnk-bp.ru/common/ru/press/events/DumaVF_291105_rus.

59 *Великая китайская труба,* „Ведомости", 22.03.2006, № 49 (1576), www.vedomosti.ru/newspaper/article.shtml?2006/03/22/104270; *Об итогах визита делегации ОАО «Газпром» в Китайскую Народную Республику*, 21.03.2006, www.gazprom.ru/news/2006/ 03/211840_19126.shtml.

At present, more advanced actions have been initiated on Sakhalin Island and the nearby continental shelf, which contain considerable deposits of oil and gas. A characteristic trait of these undertakings has been, until recently, the preponderance of foreign investment capital over the Russian one. However, for about two years, the state, by using companies subordinated to it such as Gazprom and Rosneft, has started to increase pressure on foreign investors with the aim of strengthening the role of the Russian enterprises.[60]

The state policy carried out by Rosneft and Gazprom is aimed at securing the greatest possible degree of control over the undertakings under way. Examples from the past few years include the already-mentioned cancellation of licence for the realisation of the Sakhalin 3 project, the takeover of a majority stake in the Sakhalin 4 and 5 projects, and lastly, Gazprom's attempts to gain access to the Sakhalin 2 project, the construction of the first gas liquefaction facility in Russia. Last year Gazprom signed a preliminary agreement with Royal Dutch/Shell for the takeover of a 25% stake in the project. In exchange, Shell obtained a 50% stake in the project to develop the Zapolyarnoe fields in the far north of Russia. The finalisation of the agreement is to take place in 2006. In this manner, Gazprom wants to both enter the world LNG market, which has been growing very rapidly in the past few years, and to be able to influence the export of gas from the region, which is expected to become one of the largest suppliers for East Asia in the next years. The deposits on Sakhalin and the surrounding continental shelf should become a source of supply for China, Japan, and South Korea in the not too distant future, beginning in 2008.

Table 3
State-of-affairs of the Sakhalin projects as of the end of 2005.

At present, 5 projects are being carried out on Sakhalin based on licenses granted in the 1990s:

- *Sakhalin 1 (deposits: oil – 307 Mt., gas – 485 Bcm), carried out by a consortium directed by the American company Exxon Mobil (30%) with the participation of the following companies: the Japanese SODECO (30%), the Indian ONGC (20%), and the Russian Rosneft (20%). Until now, the invested funds have amounted to over 4.5 billion USD (for a planned total of 12 billion USD). In October 2005, oil production began, which from the end of 2006 is to be sold on the world market. Production of gas is to begin in 2006, initially for the local Russian market solely. The commencement of gas exports to Japan is scheduled for 2008.*
- *Sakhalin 2 (deposits: oil – 185 Mt., gas – 800 Bcm), carried out by a consortium under the direction of Royal Dutch/Shell (55%) with the participation of the following partners: Mitsui (25%) and Mitsubishi (20%). The project includes two stages, of which the first (development of oil deposits, start-up of seasonal production – given the port's being iced over in winter – and oil exports) was completed in 1999 with an outlay of 1.5 billion USD. At present, the project's much more important second stage is being carried out. It entails the construction of a pipeline from the north to the south of the island – allowing for all year production and several times greater exports of petroleum – up to 6 to 9 Mt per annum – and the construction of Russia's first LNG terminal making it possible to process nearly 10 Mt of gas per annum. The cost of the second stage amounts to 20 billion USD, making the Sakhalin 2 project the largest foreign direct investment in Russia. LNGs exports are to begin in 2008. Japanese buyers have already contracted almost 4 Mt per annum, and almost 2 Mt is to be shipped to South Korea. In addition to supplies to Asian countries, it is planned to ship gas to the United States.*
- *Sakhalin 3 (deposits: oil – 800 Mt., gas – 1,4 Bcm) is in the preliminary stages of realisation, although the consortium under the direction of ExxonMobil (33,3%), with the participation of Texaco (33,3%) and Rosneft (33,3%) has won the relevant call for tenders in 1993. For the time being, only several dozen million dollars have been invested, which led to the Russian government cancelling the results of the call for tender in February 2004, and announced the organisation of a new one. In October 2005, the company Rosneft announced the granting of a 25% stake in the project to the Chinese Sinopec.*
- *Sakhalin 4 and 5 – both are under the control of the consortium of BP (49%) and Rosneft (51%) and, for the time being, are in the very early stages of either realisation, geological studies, or the first drillings.*

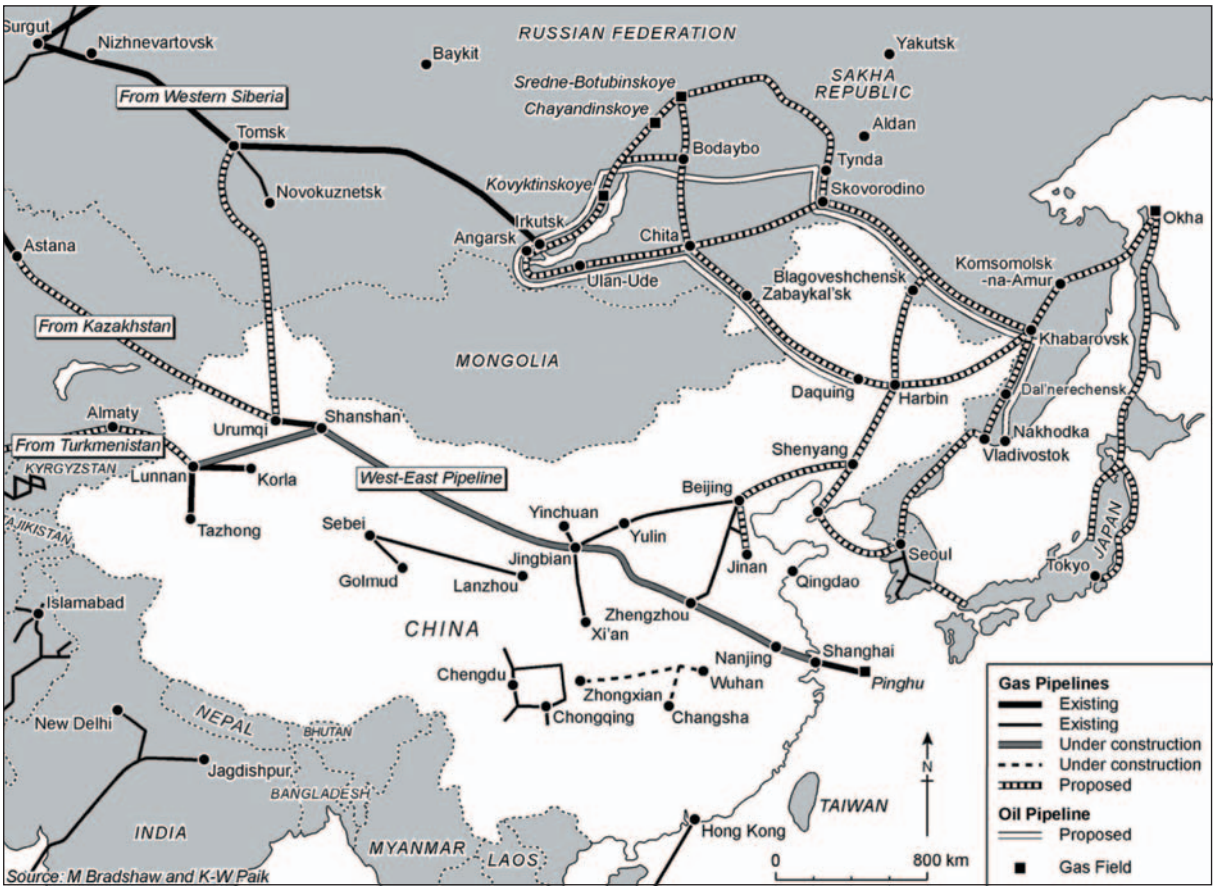
The cited data comes from the following websites:
Sakhalin 1 project – www.sakhalin1.com/index.asp,
Sakhalin 2 project – www.sakhalinenergy.com/project/prj_overview.asp
and the Energy Information Administration – www.eia.doe.gov/emeu/cabs/Sakhalin/Background.html.
See also: Keun-Wook Paik, *op.cit.*

[60] See footnote No. 19.

4. Prospects

The rapidly increasing world demand for energy resources and the growing importance of Asian consumers will probably lead to increased competition for access to sources of energy. Cooperation in the field of energy is taking on strategic significance these days. This is reflected in the intensification of the so-called energy diplomacy in states' policies. The developments of the past few years in Northeast Asia are a result of these processes. On the one hand, Russia is striving to make use of its energy potential as an instrument of bilateral policy and as a mean to become a "global energy power," while, on the other hand, access to Russian resources is becoming a way of improving energy security for China and Japan.

Map 3
Various options for gas and oil pipeline routes from Russia to East Asia



Source: Keun-Wook Paik, *op. cit.*

The development of infrastructure links in Northeast Asia seems unavoidable. According to one of the models of long-term gas market development,[61] during the next 20 to 30 years, Russia, due to its strategic location, will become an inter-regional link, providing considerable quantities of energy not only to China, Japan, and South Korea, but also to the United States. Russia's possibilities for using the energy factor as a tool of foreign policy are thus increasing, both in the regional context and on a global scale. In the case of the former, the use of the growing economic interdependence between the Asian powers to increase cooperation in Northeast Asia and initiate integration processes, such as, for example, the creation of an East Asian energy resources market and a regional oil fund. For Japan and China, each of which is almost entirely dependent on imports by sea, the Russian deposits in Siberia and the Russian Far East could become a form of strategic reserve.

Closer energy cooperation between Russia and its Far Eastern neighbours will indirectly affect its relations with the EU and the US. In the long-term, Russian dependence on European oil and gas purchasers will decrease. The pressure to send the resources of Western Siberia, now directed to

61 P. Hartley and K.B. Medlock, *The Baker Institute World Gas Trade Model*, www.rice.edu/energy/publications/docs/GAS_BIWGTM_ March2005.pdf.

European markets, eastward, will increase. If new deposits are not developed, increased rivalry between the consumers for access to Russian oil will be inescapable. For the United States, it is more significant whether Russia, guided by geopolitical criteria, will choose China as its basic partner, or whether it will pursue a policy of balance between the PRC and other countries of the region. From the point of view of the US interests, the latter option would be preferable. Firstly, and most importantly, the US would be interested in containing the growing power of China. The possibility of China gaining the status of chief importer of Russian energy resources in Asia would considerably reinforce China's position while reducing the influence of the US, controlling the major maritime shipping routes now. Secondly, choosing the Japanese option would make it possible to increase the quantity of Russian energy supplies (primarily oil and liquefied gas) to the US.[62]

It is interesting to note that Russia, in spite of its minimal export possibilities to the East, is already shaping the image of Asian (and American) markets as an alternative to Europe. In April 2006, representatives of Gazprom announced the possibility of redirecting Russian gas exports from the West to the East, if European countries are to continue blocking Gazprom's expansion on their energy processing, transport, and distribution markets (this is one of the elements of the company's export strategy).[63] The chairman of Transneft has made similar pronouncements in connection with petroleum exports.[64] In the European Union, such statements have been correctly assessed as a political subterfuge, given that Europe, for at least another 10-20 years, will definitely be the largest buyer of Russian energy resources. Nonetheless, and leaving day-to-day considerations aside, such measures provide a ready example of the methods the Russians may resort to when the rivalry for access to its energy resources becomes a fact. The Russian authorities will most probably make even more overt use of Russia's energy potential as an instrument of foreign policy, and as a method of exerting pressure.

Geopolitical criteria already play an important role – mainly in the development of closer energy cooperation between Russia and the PRC. An important element of this collaboration is curbing US influence in the region. Previous experience shows, however, that the complementary nature of both countries' aims – all too often stressed in Russo-Chinese declarations – is only partially true. Their respective policies regarding energy resources show a strong asymmetry in terms of the two countries' aspirations. Both countries place this policy in a wider context, but give it different functions.

The situation looks different in the case of Russian-Japanese relations. Japan is not striving to shape a long-term political strategy on the basis of relations with Russia, as the United States remain Japan's most important partner in that respect. Japan's aims are quite legible: diversification of supply sources in order to reduce Japan's dependence on the Middle East, and the creation of conditions for investment activity.

For Russia, presence on Far Eastern markets has a decisive long-term significance for the realisation of its plans to become an energy power on a global, as opposed to a regional, scale. Russia's choice between different expansion options entails a review of its most important aims of foreign and domestic policy, economic interests of the state and energy companies, and of its future role on world oil and gas markets. Russia wants to be perceived as an active player and not merely as a subject of the policies of other actors. But this growing 'energy assertiveness' hides an anxiety about the challenges brought about by the increasing significance of China. Russia's lack of decisiveness in the matter of choosing the pipeline route is an excellent example of the ambivalent attitude of the Russian authorities with regards to their country's increasingly powerful neighbour. Questions are being voiced about the possible consequences of China's economic expansion, which is visible primarily in Central Asia. This region is increasingly becoming a field of Russo-Chinese rivalry. Differences in perception of the Shanghai Cooperation Organisation, which brings both powers together with Uzbekistan, Kirghistan, Kazakhstan, and Tajikistan, are a case in point. For Russia, membership in this body was to be one of the means of limiting or controlling the process of China's economic and political expansion in the region, whereas for China, this organisation is the

62 The shipment of liquefied gas from deposits located on the continental shelf around the island of Sakhalin, the site of the largest foreign investments in Russia, to Mexico and from there to the USA, should begin as early as 2008. It should be remembered, however, that in this case, for the time being, the largest role is played by private investors not the Russian state, although in the last few months Gazprom has been voicing its interest in participating in the realisation of the Sakhalin projects.

63 See further: А. Полухин, *К чему приведет обмен ультиматумами между «Газпромом» и Евросоюзом*, «Новая газета», No. 30, 24.04.2006 г., http://2006.novayagazeta.ru/nomer/2006/30n/n30n-s05.shtml; *Дезактивация Европы. «Газпром» предъявил ЕС ультиматум*, «Коммерсантъ», No. 70, 20.04.2006; P.K. Baev: *Europe Calls Gazprom's Bluff and Ponders its Threat,* 'Eurasia Daily Monitor – The Jamestown Foundation', Vol. 3, Issue 79, 24.04.2006.

64 Семен Вайншток, *Россия перекормила Европу нефтью,* «Независимая газета», 24.04.2006, www.ng.ru/economics/2006-04-24/ 1_vainshtok.html.

institutional platform furthering this very expansion. It is no wonder, therefore, that common declarations about strategic partnership are, in fact, a smokescreen for Russia's fear of being, in the not too distant future, reduced to playing the role of China's junior partner.

For China, awareness of impossibility of self-sufficiency inclines it to develop energy cooperation with many countries and organisations. On the supra-regional level, the most significant element in this respect is the development of the cooperation with the International Energy Organisation, initiated in 1996.[65] On the regional level, importance is given to the energy partnership with the ASEAN+3 (the three being China, Japan, and South Korea) launched in June 2004 for the purpose of establishing closer relations between countries of East Asia in the field of, for example, the exchange of information, common projects for the improvement of energy security in the region, and the development of the gas market. China's cooperation with Russia is an element of policy of establishing closer bilateral relations with the largest energy producers, amongst which an equally – if not more – important role is played by countries of the Middle East and Central Asia (primarily Saudi Arabia, Iran, and Kazakhstan). If China manages to maintain a high economic growth rate for the next 10-20 years, it will become, as an increasingly significant importer of energy, a strong player on energy resource markets and the initiator of energy alliances established for the purpose of ensuring the reliability of supplies or the development of transportation infrastructure. In this context, the growing cooperation with Russia, unquestionably significant as it is, is not absolutely necessary to provide China with energy security, as it is only one of several components of a much wider strategy. China is pursuing a more active, and, for now, a more successful, campaign in Central Asia.[66]

The Russian authorities, being fully aware of the fact that the centre of the world economy is slowly moving to the Far East, wish to occupy the best possible position on the growing Asian markets. The energy industry is seen by Russia as the principal factor unifying the entire region economically and giving Russia the chance to play a major role in it. This model scenario, in Russian eyes, will probably be impossible to realise if Russia does not fully develop other branches of its economy. Although Russia's Asian neighbours truly need Russian oil and gas, this need is not an existential one. For the time being one can only speak of large potential for cooperation in the field of energy in the region of Northeast Asia, whose realisation will be dependent on many factors of a domestic and international nature.

65 The IEA is a mechanism created by OECD member states and, for this reason, China can not fully participate in its work. Nonetheless, cooperation has been growing, especially in the last few years.

66 This latest, and rather spectacular, example of this campaign is the acquisition, in August 2005, by CNOOC, of PetroKazachstan, one of Kazachstan's largest petroleum enterprises, for 4.2 billion USD.