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“Central Asia and Energy”

* The co-host organizations -- the Japan Institute of International Affairs (JIIA) and the Konrad-Adenauer-Stiftung (KAS) – sought in this forum to clarify the points of discussion by limiting the scope of “energy” to petroleum and natural gas.

• **Masumi MOTOMURA: “Petroleum, Gas, and Multinational Pipeline Strategies in Central Asia”**

It is fairly common knowledge that resource development and investment from various countries has been expanding non-stop in Central Asia since the collapse of the Soviet Union and that pipelines play a major role in this landlocked region. However, there appears even today to be some misunderstanding of the “political nature of pipelines,” i.e., the view that international circumstances and political circumstances within the countries involved have an across-the-board impact on pipeline construction. This view is overly one-sided, however; characterized by high construction costs and long-term operations (on the order of several decades) and above all the need for bank financing (project financing) of construction and operation, pipelines are in fact developed in line with exacting calculations of their commercial viability. Taking advantage of the opportunity permitted me today, I would like to cite actual examples in illustrating the point that political conditions are in the end simply one premise and that ultimately it is economics that “drives” pipelines.

Looking at the overall trend in Central Asia’s petroleum production, volume fell to about half its peak level when the Soviet Union collapsed in 1991 but has been on the rise this century, recovering in 2010 to the level it had reached prior to the collapse of the Soviet Union (petroleum export volumes have a generally similar trend). Expanded production by Kazakhstan and Azerbaijan in particular have had a major impact in this process with the discovery and development of large-scale oil fields – the Tengiz (reserves: 9 billion barrels; daily production: 540,000 barrels) and Kashagan (reserves: 16 billion barrels; daily production: 1,500,000 barrels) oil fields in the former and the Azei-Chirag-Guneshli (ACG) (reserves: 5.4 billion barrels; daily production: 900,000

barrels) oil field in the latter. Foreign companies such as INPEX and Japan's Itochu and foreign capital enabled the operators to hit upon solutions to technical issues (exploring for oil fields, eliminating hydrogen sulfide from crude oil, digging oil wells in shallow sea areas, etc.) that were impossible with Soviet-era technology.

How are pipelines for exporting these petroleum built? Here I would like to take a brief look at the process using as an example the ACG oil field that started production in 1997.

With regard to the pipelines to be connected to the ACG oil field, it turns out that the BTC Pipeline (Baku-Tbilisi-Ceyhan) advocated by Turkey and the US has been adopted as the principal route after the "Northern Route" (Baku – Black Sea) generally supported by Russia gradually lost favor due to the immix of sulfur-rich Russian-produced petroleum (Ural blend) and after the "Western Route" (connecting to a line in Iran at Tabriz) passing through Iran was passed up due to political risks. Even after a construction agreement was signed among Azerbaijan, Georgia, Kazakhstan, Uzbekistan and Turkey in 1998, however, a consortium headed by the UK firm BP continued to object due to higher construction costs than for other routes and the drop in international petroleum prices, but the discovery of a promising gas field for the Turkish market in the vicinity of the ACG oil fields (Shah Deniz, July 1999) and a rise in oil prices ultimately confirmed this pipeline's profitability; construction began in 2002 and was completed in July 2006. In other words, it was not simply political factors – the US' intent to avoid intervention by Iran and Russia and Turkey's ulterior desire to be involved as a transit country – that buoyed the BTC line; rigorous pursuit of economic viability was thoroughly engrained throughout the entire process, and it was severalfold confirmation of the pipeline's profitability that ultimately led to its construction. There do of course exist examples such as the Kazakhstan-China pipeline (completed in 2010), long left untouched due to China's emphasis on a separate route via Siberia, despite China having reached a construction agreement in 1997 with a Kazakhstan seeking to diversify its petroleum export routes. It is obvious, however, that such pipelines were not established by political factors alone.

What about natural gas, another energy resource? Natural gas prices have fallen due to lower demand in Europe and increased production by Shale Gas (US) through technological innovation, and natural gas differs greatly from petroleum in enjoying overall a buyer's market (in light of which Turkmenistan, a major producer country, posted a 45% year-on-year decline in production in 2009). Let us first look at the Nabucco pipeline (scheduled to be completed in 2015), a well-known symbol of the rivalry between Russia and the EU. The political infighting has been regularly emphasized, exemplified by the initial agreement among the countries involved (June 2004) that this pipeline would extend a total of 3300 km from Turkey to Austria via Bulgaria and Rumania but would not pass through Russia, and Russia's reaction of

announcing the construction of a “South Stream” (Black Sea – Bulgaria – Italy) pipeline. What should be noted here, though, is that when a plan was ratified among the participating national governments in July 2009, the US Special Envoy for Eurasian Energy announced that 50% of this line’s capacity would be open to participation by companies from other countries – including Russia. The true implication of this case, therefore, is that even if political factors (e.g., bypassing Russia) thrust their nose in at the initial phase, decisions are ultimately made on an extremely “non-political” basis (it should be added that doubts have been regularly expressed about the profit potential of the South Stream). There is no end to other examples of energy policy being pursued on the basis of economic factors, among them the Altai Pipeline Plan (agreed upon by the leaders in March 2006 but whose status remains unclear) for the supply of gas from Russia to China that exacerbated the sense of crisis among EU countries; the conclusion of long-term supply agreements with Russia’s Gazprom in 2006 by companies from various countries; Turkmenistan’s efforts to gain a direct pipeline connection with the new market of China and avoid intermediate losses that would ensue by running the pipeline through Russia; and Russia’s countermove of raising its buying price and its growing price competition with China, which is seeking more advantageous supply conditions.

Let me move on. Looking at natural gas as an example, currently pursuing supplies in Central Asia are the EU countries seeking to diversify and stabilize their energy sources, China rushing to secure energy to maintain its economic growth, Russia utilizing the competition between the two to offer long-term agreements, and Turkmenistan competing with Russia for the China market. These actors are locked in fierce market competition, and there seems in fact to be extremely little room for intervention by the oft-cited political factors. While the aforementioned impact of the drop in gas prices merits continuing attention, “economics” will almost certainly continue to be the most important factor in energy and pipeline policy, whether petroleum or gas, and it is my conclusion that this viewpoint should be shared far and wide not only in the proposal and pursuit of policies but more generally.

- **Frank UMBACH: “Energy and Central Asia: Domestic and Foreign Policy Perspectives”**

To set out upfront the gist of my argument, my basic view can be condensed as follows: the decision-making process for energy policies should be interpreted from both a business and a political context. The “unification” of these two factors is deeper and more obvious when one considers the growing presence of state-owned companies in producer countries – in contrast to the 1970s when the petroleum majors (commonly known as the Seven Sisters) accounted for 80% of the market – the diversification of actors involved in this, and the manifestation of energy policies as negotiations between states as seen in the April 2010 summit agreement between Russia and Ukraine that featured a bartering of usage rights to bases for Russia’s Black Sea Fleet and a

reduction of gas supply prices. In this presentation, I will spotlight these current conditions by confirming the significance of the energy resources of the Caspian and Central Asia Region (CACR) and offering my views on the energy policies of Russia, China, the EU and the countries of Central Asia.

Let me begin with the importance of CACR as viewed from the perspective of global energy security. World energy demand is forecasted to increase about 36% over present levels by 2035, driven in part by economic development in China and India. At the same time, CACR production and exports of petroleum and natural gas are both holding firm, and it is anticipated that the CACR countries will endeavor to expand exports beyond the level of growth in domestic consumption. These points are exceptionally important not only in terms of simple supply-demand forecasts but in geopolitical terms as well. At the “heart” of the vast energy producing region known as “the energy ellipse” stretching from the Persian Gulf to the coast of the Caspian Sea and encompassing the unstable Iran and Iraq, to which risk the other countries of the Persian Gulf lie considerably exposed, the CACR’s relatively stable political circumstances and production will likely boost the stature of the region in global energy security strategy. I should also point out that, although foreign companies have relatively high shares in Kazakhstan and Azerbaijan, the vast majority of the energy production in the CACR countries is carried out by local state-owned companies, an example illustrating the greater weight being given to political factors.

What is the basis of other countries’ interest in the CACR and what stances are they taking toward the region?

Let me start with Russia (under President Medvedev), which regards the CACR as falling within a “special sphere of influence.” A notable characteristic of Russia is its clear-cut policy intentions of furthering its own national interests by “utilizing” its influence in energy exports and markets. One example of this is Russia’s efforts to divide the EU, which is moving to diversify its energy supply sources, by arbitrarily setting separate natural gas supply prices for each country (2007-2008). However, this has led at times to policies that go beyond economic rationality (e.g., resulting in a nearly threefold difference in prices).

Russia, too, is confronting a variety of difficulties, though, among them being the aforementioned EU diversification strategy, reduced gas consumption and a drop in international prices due to increased US production. In particular, it should be borne in mind that the continuing rise of the CACR countries as competitors in the Chinese and EU markets is greatly undermining Russia’s status as a monopolistic supplier.

Next, I will discuss China, whose energy demand is expected to double from the present level by 2035. Problems for China include not only a surging demand for energy but

also an overdependence on sea lanes passing through the Persian Gulf and the Malacca Straits, and prompting growing interest by China in the CACR's energy resources is showing that China is considering CACR as means of resolving these problems. The economic cooperation projects being pursued by China in this light garner frequent attention due to China's firm adherence to a policy of non-intervention in the domestic politics of its partner countries but, besides swift decision-making and short construction periods, the most prominent characteristic of these projects is their orientation toward comprehensive infrastructure improvements combining pipelines, railways, roads and port/harbor facilities. Indeed, a look at the projects underway across the Eurasian continent makes it clear that China is seeking to build what might be termed a "regional corridor." With further enhancements to energy transport routes from the CACR, the competition between Russia and the CACR as suppliers to the Chinese market and the competition between China and other consumer countries to secure energy resources will undoubtedly grow fiercer.

What of the EU, which is similarly dependent on importing energy? The CACR's energy resources have garnered EU attention since 2005, with the gas crisis between Russia and Ukraine having been a major catalyst. The EU's interest in energy security is clearly and primarily reflected in its adoption (March 2007, European Council) of the strategic objective of achieving "the three 20%*s*" – lowering energy consumption by 20%, reducing greenhouse gas emissions by 20%, and increasing the ratio of renewable energy to 20% (*vis-à-vis* 1990 levels) by 2020 – that have become a focus of environmental policy. Natural gas became an issue of special importance, and the need for improvement was strongly highlighted by the EU's dependence on Norway, Algeria and Russia for more than 90% of its supply and the reliance of the three new EU member Baltic states on Russia (most of all Gazprom) for 100% of its supply.

These factors were behind the construction of a number of pipelines not passing through Russia, with the Nabucco pipeline particularly symbolic in this regard. The South Stream Pipeline Plan put forth by Russia as a means of countering these moves faces difficulties in terms of cost (maintenance fees are estimated to be triple those of Nabucco and there has been no announcement of assistance from financial institutions) and supplier countries (Turkmenistan has avoided South Stream and given priority to supplying China), and both Nabucco and the EU's diversification strategy continue to enjoy success. EU demand for gas has declined, in part due to progressively greater efficiency and, in light of an overall downtrend in gas prices, the EU countries have hesitated to conclude long-term purchasing contracts. Russia, too, is seeking out other export destinations, giving one the sense that national energy policies have moved on to the next step. Nevertheless, the fundamental policy of diversifying supply routes – namely shifting from Russia to the CACR – will likely be maintained in future.

Finally, let me discuss the CACR itself. As I have touched on in part thus far, even as

Russia is attempting to diversify its exports and the Asian (especially the Chinese) market is on the rise, the CACR continues to establish itself as an independent actor securing benefits from other countries using its own energy resources and at times engaging in competition with Russia in the EU and Chinese markets. It is characteristic of the region's countries that this aspect has surfaced primarily in the form of pipeline policy, but this trend should over the short to medium term promote intra-regional cooperation in the construction, maintenance and management of pipelines directly connected to their status as energy exporter countries. Over the long term, the CACR will likely serve as a hub for energy/goods transport infrastructure on the Eurasian continent.

As noted earlier, the CACR's emergence has prompted the development of CACR/energy policies in the EU, Russia, China and the CACR that blend energy security, market competition, foreign policy and domestic policy interests, and it is my conclusion that this trend will continue, albeit transforming along the way, over the medium to long term. Leading this "trend" toward the consensus on the whole contributing to the stability and development (creation of the aforementioned 'hub') of the CACR will no doubt constitute the next issue to be addressed by the international community.

[Comments]

• **Axel BERKOFISKY (Professor, University of Pavia, Italy):**

Rather than making comments, I would like to pose some questions that came to mind while listening to the presentations by Mr. Motomura and Mr. Umbach.

First to Mr. Motomura. You emphasized the fact that economic rationality and viability are the dominant factors in pipeline construction, but in situations in which a producer country intentionally suspends supply – memories of the 2005 gas crisis between Russia and Ukraine are still vivid within the EU – I think that energy policy not infrequently should be seen as having become a political issue. Taking for example the Iran route, which should by all rights be the most attractive option for petroleum importer countries because of the shorter transport distance, the failure to establish such a route hints at the intervention of political factors.

In addition, I would like to ask for elaboration on some points not covered in detail during the presentation. First, the low share held by Japanese companies in the various oil fields in the CACR (at least as far as your mention) seems quite strange given that Japan relies almost entirely on imports for its energy; what is the actual situation in this regard? With electric power companies in the EU avoiding long-term import agreements and with gas prices in an overall downtrend, can long-term agreements in fact be easily concluded? What prospects do you see for the future development of "market competition"?

Next, I would like to briefly check on several points with Mr. Umbach. First, can the diversification of energy supply sources being pursued by the EU be seen entirely in the context of its Russia policy? Second, you mentioned that the current trend is increasingly toward state-owned companies in energy producer countries, so why are there disparities between countries within the CACR in this regard? And third, what is the present status of China's efforts to improve energy efficiency and expand imports, which are like the "two wheels of one cart"?

I would be grateful for explanations from the two gentlemen on these points.

• **Tomohiko UYAMA(Professor, Slavic Research Center, Hokkaido University):**

My understanding of Mr. Motomura's argument is that he does not reject the "political nature of pipelines" in and of itself but asserts that economic factors are given highest priority in their operation. I would like to make a few additions to Mr. Motomura's presentation touching primarily on conditions in the lead-up stage (i.e., up to pipeline construction).

The variance between the generally accepted notion that "economics should not be subordinated to politics" that is common currency throughout Japan and the realities of international affairs is regularly made clear by the difficulties confronting Japanese companies seeking to export nuclear power plants and high-speed railways in the face of summit diplomacy with competing countries. This is all the more notable in the CACR, where state-run companies have a high share and where the state frequently intervenes in the contracting process. As shown by the sudden arrest in May 2009 of the president of state-owned Kazatomprom for "improper sale of uranium concessions" in the Kazakhstan uranium mine development project planned with the help of Japanese companies, the impact of political factors on the project decision-making process can no longer be ignored. If multiple routes for a given pipeline offer about the same profitability, the utmost preference is likely to be given to that route offering political benefits as well, and the idea of politically "utilizing" economic infrastructure naturally comes to the surface. Even when economic rationales are cited, consideration should always be given to the possibility that political rivalry between the countries involved has taken on the guise of an economic issue.

In addition, instances frequently emerge in international politics in which the perceptions of the parties involved are more influential than the realities of the situation. Taking the energy policies of the EU and Russia as examples, it should not be forgotten that the concerns of the EU about a Russian monopoly on the supply of natural gas and the "groundwork" of the EU interpreting Russia's intentions in this way impacted practical policy decisions even if Russia itself did not have such intentions.

Accordingly, we must examine a broader background even when looking at the latest energy policies. For instance, Russia's announcement just prior to the political turmoil in Kyrgyzstan in April 2010 that it would be raising petroleum duties toward that country was seen as a statement of Russian dissatisfaction with President Bakiyev that gave momentum to opposition forces within Kyrgyzstan and helped "push" the collapse of the Bakiyev administration. This clearly should be regarded as part of an attempt by Russia to strengthen its control over the CACR countries, and it has been suggested that the sense of crisis in Russia following the conflict with Georgia (Russia was ultimately unable to topple the Saakashvili regime) was behind this effort. And, looking back at history on a more extended timeline reveals that Russia has traditionally been more flexible than China on territorial issues and, in the CACR, Russia has leaned heavily toward exercising its political and economic influence, in contrast to the British Empire's great reliance on its economic influence. These "historical characteristics" also suggest that Japanese companies considering expanding their business to these lands should be prepared for the possibility that Russia will aim to exert its influence. While I agree wholeheartedly that exacting profitability and cost calculations are essential for corporate activities, utilizing a "more in-depth" approach is needed to ensure business success and expand Japan's presence.

[Debate]

(Political factors in pipeline policy)

- **Motomura:** My basic view is that the period leading up to an agreement between governments is "political territory" and the period thereafter "economic territory." While I had no choice but to omit it in the interest of time, I would like once again to point out that I by no means completely filter out political factors.

(Gas crisis between Russia and Ukraine)

- **Motomura:** It should be recalled that, in the dispute between the two countries, Ukraine also objected to Russia's demand for a higher supply price in the context of a worldwide surge in energy prices at the time; Russia was also reconsidering its subsidy system supporting cheap exports. In addition, I should point out that Gazprom's "aggressive" insistence on participating in Sakhalin 2, something that became a topic of considerable debate in Japan, was not nearly as forceful as it has been popularly portrayed, at least judging from the share purchase conditions.

(The Iran route)

- **Motomura:** There can be no doubt as to the economic rationality of this route by which petroleum from Kazakhstan and Turkmenistan is to be shipped by tanker to Neka (Mazandaran Province, Iran) on the Caspian Sea coast for purchase by Iran, while an equivalent amount of petroleum will be exported from Kharg Island in the Persian Gulf. The key reason for this plan not making headway is that the conditions presented by Iran are far too expensive.

(Japan's shares in the CACR countries)

- **Motomura:** The disparity apparent in the shares of Japanese companies in the various

oil fields discussed earlier can be attributed in great part to the differences in the business strategies of these companies. Withdrawals from these countries, sales of these shares, and increases in shares due to withdrawals by companies from other countries are frequent occurrences.

(Long-term agreements)

- **Motomura:** As was mentioned in the presentation, long-term agreements are presently the consequence of market competition between China and the EU. Should a similar competitive relationship arise in future, similar long-term agreements could be concluded.
- **Umbach:** I think the downtrend in gas prices will continue for the time being, so new long-term agreements are not likely to be signed anytime in the immediate future.

(Future trends in markets and “price competition”)

- **Motomura:** China as a consumer country and Russia as a wholesaler are engaged in price competition to secure CACR energy resources; Russia is currently offering the higher price and keeping China at a distance. However, China is engaging in parallel efforts to gain indirect access by providing large-scale loans, so this competition cannot be assessed based on simple price comparisons.

(Background to the EU's energy policies)

- **Umbach:** It is obvious that the dispute over gas between Russia and Ukraine served as a major impetus for the EU to draft its common energy policy (March 2006 EU Summit). What is more important, though, is that this policy brought unity to the energy policies of individual EU countries, and the presence of such factors helped EU members to settle on the bold “three 20%” objectives.

(Energy supply/demand forecasts for 2020)

- **Umbach:** Because the EU's import demand and production capacity (North Sea oil fields) are both expected to decline, it is anticipated that overall demand in the EU will not change greatly. Nevertheless, it is difficult to deny the possibility of significant fluctuations in global prospects depending on the success of efforts by China and other emerging countries to increase efficiency. Trends in the development of renewable energy and shale gas and, above all, views on energy – for instance, the construction of new nuclear power plants being rejected by a national referendum – will also have a major impact on energy supply and demand.

(The three Baltic countries and the EU)

- **Umbach:** The Nabucco Pipeline will not directly relieve the complete dependence of the three Baltic countries on Russia for natural gas, but diversification similar to that being pursued throughout the EU – implementing domestic nuclear power programs, importing electrical power from Sweden via seabed electric power cables, connecting to power transmission lines in Poland and elsewhere, and using alternative energies – is likely to proceed over the long term.

End