

A Discussion Paper on the Presentation of Mr. Yoshikazu Kobayashi

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My impression is that the presenter's view is rather cynical about the efforts of the oil and gas industries of Japan and Russia. Obviously this view and will not get support from them. Tremendous results have been achieved in Sakhalin and new business opportunities are being called for in Offshore Sakhalin and East Siberia by Japanese and Russian business entities.

It is quite often reported by diplomatic people that the political relationship between Japan and Russia is now rather smooth. In addition to that, the economic relationship has now reached a level unprecedented throughout the history of both countries. The amount of trade between the two was recorded at \$21 billion in 2007, which was a 55% growth compared with that of 2006 (Fig. 1).

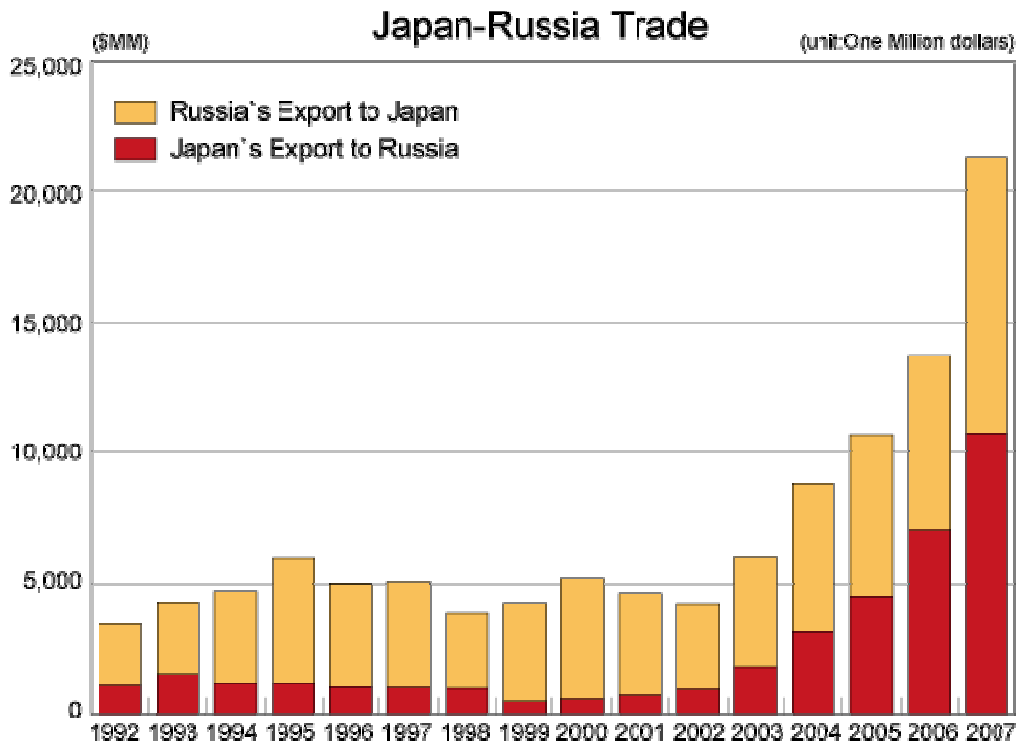


Fig. 1 Transition of the Amount of Japan-Russia Trade

The presenter raised four questions and developed points about the Japan-Russia relationship on energy. From now on, I would like to make comments on these points one by one.

1. How does the Japanese government position Russia for its energy politics?

The presenter said that Japan's interests in the Soviet Union were not strong and it was because of the progressive resource diplomacy of the administration of the Premier Tanaka that the Sakhalin's project was launched in 1974.

Actually the fact is that the relationship between Japan and the Soviet Union has existed for longer and been much stronger than the presenter reported.

After World War II, a new economic relationship between Japan and the Soviet Union started in 1964, when the Soviet's First Deputy Premier Anastas Mikoyan visited Japan to appeal to Japanese industry to establish economic partnerships and diplomatic friendships between both nations. This is the time when Japan's legendary hyper-economic growth after World War II was just starting and Mr. Mikoyan predicted this new trend through observing Japanese industry in detail during his visit.

Business leaders of Japan answered the call of Mr. Mikoyan, and the first Japan-Soviet Economic Committee was held in Tokyo the next year. After discussion for several years, oil and gas projects of Offshore Sakhalin and Yakutia were agreed at the sixth Japan-Soviet Economic Committee meeting in 1974. It took almost ten years to start these projects, however it is a kind of proof that though there were many obstacles between Japan and the Soviet Union, like territorial disputes and memories of wartime, the industrial people of Japan and the Soviets at that time were very eager to establish an economic relationship.

As Sakhalin had been a familiar place for Japanese oil companies before World War II, it was rather easy to re-start business from this place again. This area has been one of the most important oil sources for Japan throughout the 20th and 21st centuries. So, the offshore Sakhalin Project was a kind of revival of Japan's activity in Northeast Asia.

I don't think the territorial dispute over the four Islands became an

obstacle in developing the oil and gas business in Sakhalin, since the principle of “separation of politics from economics” was established in the Japanese industrial society and in the government. An example of this is the case of Takeshima, which never casted a shade over the economic relationship between Japan and Korea. .

In regard to the ESPO (East Siberia-Pacific Ocean) Pipeline, it is true that the then Prime Minister Koizumi and the Japanese Government at first showed a great interest in this project but then seemed to lose momentum as this pipeline project did not make any progress two or three years after the “Japan-Russia Action Program” was signed.

The presenter pointed out three reasons why the project didn't make any progress:

- 1) First, the lack of Japanese companies' interest in East Siberia.
- 2) Second, a modification of Japan's resource diplomacy toward the Middle East.
- 3) And third, the influence of the territorial dispute between Japan and Russia.

These reasons do not stack up to the facts of the situation. JOGMEC and the Japanese oil companies have been making a dialogue for finding opportunities for investment in East Siberia. Now, JOGMEC has successfully established a joint venture with Russian oil company named Irkutsk Neft Company (INK) for the survey of the Sever Mogdinsky Block of the Irkutsk Oblast' in East Siberia (Fi.g 2).

It is well known that Middle East countries rarely propose business opportunities for International Oil Companies. And as I've said, the territorial dispute is a political amtter and not a business matter.

The main reason why Japan could not join the ESPO Pipeline Project was that Russia became rich and the national pipeline company Transneft could afford to raise sufficient funds for construction by itself. That is not a political but an economic reason.

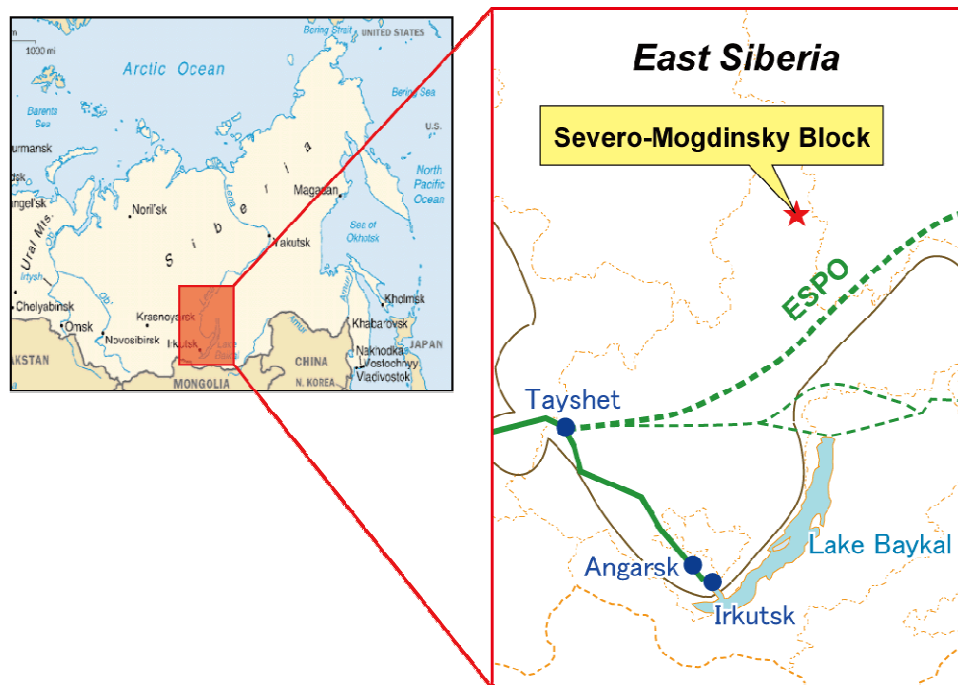


Fig. 2 Severo-Mogdinsky Block in East Siberia

2. How does Japan interpret Russian intentions towards energy exports to Japan and NEA?

It is obvious that Russia has a strong intention to export oil and gas to the Northeast Asian market. However, the presenter's view that the severe tax system discourages Russian oil and gas sectors to make a new investment is out of date.

I would like to point out a recent incentive in East Siberia. The incentive is a tax holiday for Natural Resources Extraction Tax (NRET) in East Siberia. This is to reduce 70% of NRET for fields which have produced more than 80% of reserves and to impose no NRET upon new fields, which have produced less than 25 million tons of crude oil.

In addition to that, the Finance Ministry decided to raise the threshold of NRET for oil price to \$15 from \$9. This is another tax incentive.

Oil and gas income is the most crucial issue for the Russian economy. The Russian Government understands that current oil production has

almost leveled off and will not increase without tax incentives.

3. What does Japan think of the outlook for future Russian energy exports to Japan over the next decade?

It is well known that the Siberian crude is sweet with its sulfur content almost 0.5%, while Japanese refineries are designed to convert high sulfur crude from Middle East which contains around 2% of sulfur.

In this section, the presenter pointed out that there is a mismatch of Siberian crude quality and the Japanese refining system, which means that sweet crude oil is rather expensive for Japanese refineries because the specification of Japanese refineries is too high for it. The presenter concluded that Japanese refiners will prefer Middle East crude on a commercial basis and Chinese refiners may evaluate Siberian crude oil higher and purchase it more than Japanese refiners.

I would like to show one example of importing sweet crude, so-called Vityaz crude from Sakhalin-2, which is very sweet and contains 0.1% of sulfur. As the presenter said, the Japanese refiners showed no interest when it started production in 1999. It was only the third year when Japanese refiners began to import in small amounts, however the portion of Japanese refiners kept on increasing after that and 80% of crude oil began to be exported to Japan after five years. Sakhalin's crude was finally welcomed by Japanese refiners (Fig. 3).

The reason why the Sakhalin crude was welcomed is its close proximity. It takes 20 days to ship Middle East crude to Japan, while it takes only three or four days for Sakhalin crude to be brought in to Japanese refineries. There are no choke points in between like the Hormuz or Malacca straits.

Japanese refiners realized that the proximity of an energy source is the crucial element of energy security.

From 2007, Sakhalin-1 started crude oil exports from the DeKastri terminal at the level of 250 thousand bbl/d. From June 2008, with the completion of the Trans-Sakhalin oil pipeline the Vityaz crude will be exported year round, which will be 80 thousand bbl/d for the time being and in near future its will increase to more than 100 thousand bbl/d adding the production from the Pil'tun Astokh-B platform. Needless to say, LNG will be started to export at level of 9.6 million tons/year from 2009.

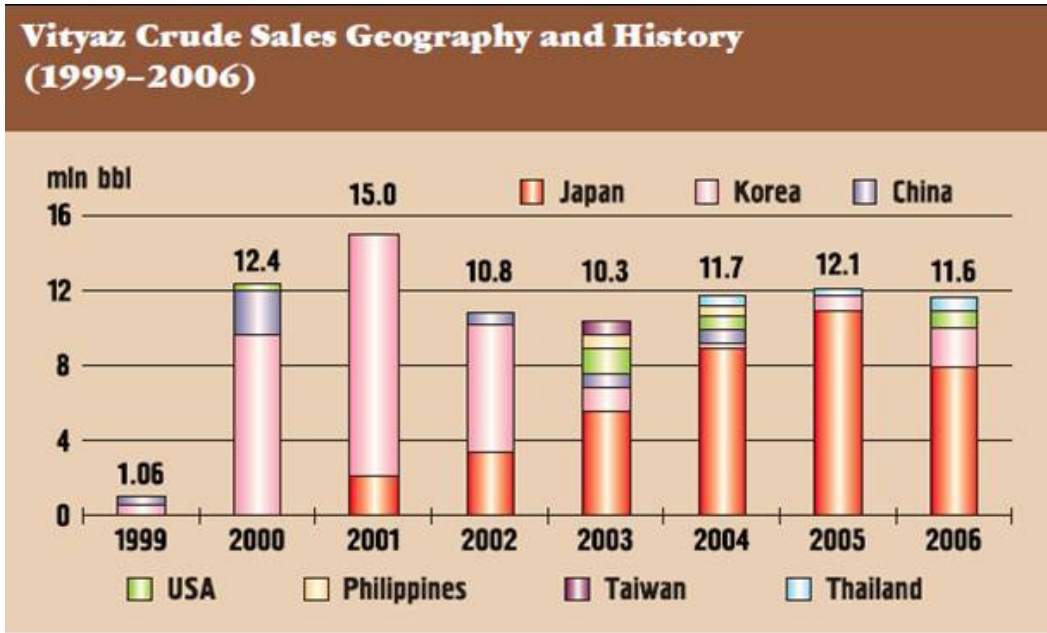


Fig. 3 Vityaz Crude Sales by Geography and History

This is all good news for Japan and the Northeast Asian countries since such a volume of oil and gas is to be exported from such close locations.

So, why not for Siberian crude? In 2009, after the completion of Phase 1 the ESPO will start transportation of the Siberian crude at the maximum level of 30 million tons or 600 thousand bbl/day (Fig. 4). How much oil can be exported from the Kozmino Terminal will depend on if the Daqing Spur will be constructed or not. If the Daqing Spur is constructed, only CNPC will be able to access the Daqing terminal to purchase Siberian crude oil. However, I would like to stress that the Kozmino terminal is open to the international market and any oil company can make an access, including Sinopec, CNOOC and CNPC.

Traditionally, China has used land transportation in the Eurasia Continent by rail and pipeline, and is reluctant to rely on open sea transportation. However, as I said, there is no choke point in the Sea of Japan and CNPC can transport crude oil from Kozmino to the Dalian terminal without any hazard. The most important thing is to trust the international trade system and to respect the people's will who join the market.

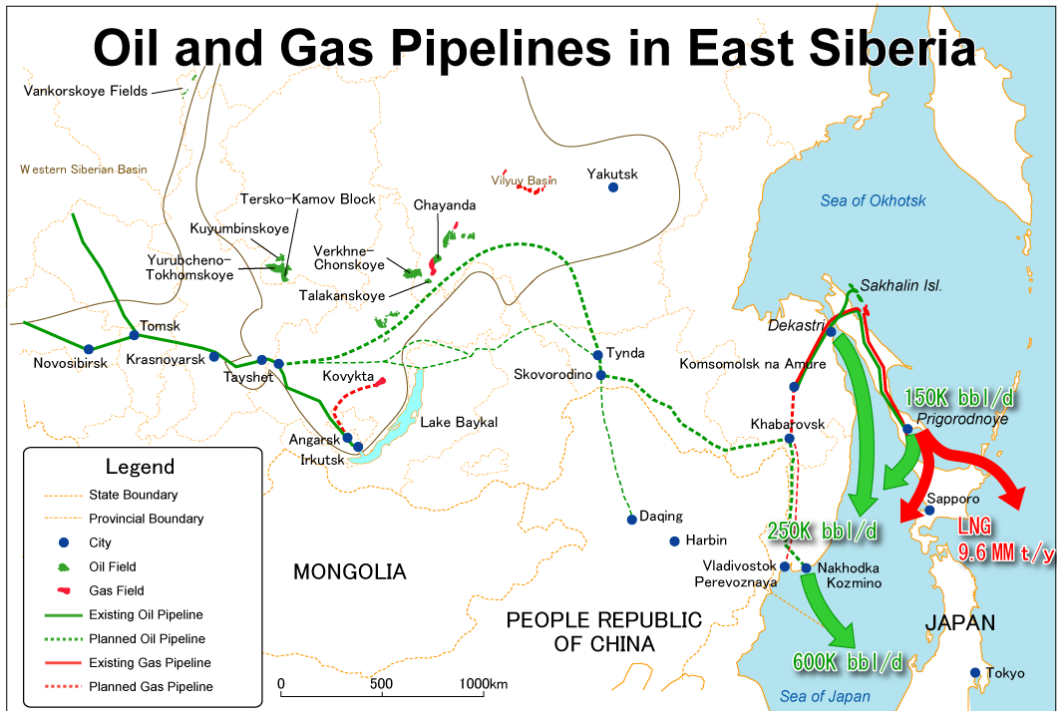


Fig. 4 New oil and gas sources in Northeast Asia

4. What factors are likely to drive these energy exports

Finally, the presenter proposed four driving factors which will increase Japan's investment in the Russian energy business:

- 1) Establishing an investment framework
- 2) Eliminating political risks
- 3) Building Japan's risk absorption capacities
- 4) Improvement of Japan-Russia diplomatic relationships

These are all reasonable assertions, however they are at a general level.

Regarding the Russian investment framework, all the oil majors join in Russian projects because the investment climate of Russia is not so bad as often reported. Of course, it may be worse than those of Australia and the North Sea. But it is far better than that of Venezuela.

Political risk is still a big problem in Russia. I would like to introduce a recent paper from the Oxford Institute for Energy Studies by Dr. Jonathan Stern, which describes a survey of gas industry opinion from the FLAME Conference, Amsterdam, March 4, 2008. Being asked which region is the

most reliable supplier of gas in Europe in the next five years, European gas companies think the most reliable gas supplier is: 59% for Russia, 13% for Caspian and the Middle East, 9% for North Africa and 20% for LNG. The result is quite persuasive. The industry's opinion is completely different from those of politicians. What we see on the newspaper is just the politician's views, while the industry's view is hardly seen through media. To analyze the investment climate of Russia, we should be very discreet. We need to consult with professional people and should not rely on newspaper nor political propaganda.

As the presenter said, it is true that there is a problem of "who decide what" in Russia. In the Sakhalin-2 case in 2006, the Minister of Natural Resources Turtnev asserted the unfairness of the PS Contract, and he said the purpose of environmental investigation against Sakhalin Energy is to change to term of the PS Contract. The Ministry of Industry and Energy claimed that the PS Contract is the matter of the energy ministry and sent an official letter of claim to Mr. Turtnev. After that, Mr. Turtnev became silent. This was the situation in Russia. The Russian government has to notice how such confusion created distrust internationally.

Finally, JOGMEC's task is to support private sectors capacity of investment. Of course we understand that the Japanese Oil Industry is still not well established. However, we would like to continue our effort and make it step by step.

In conclusion, there will be some difficulty in oil and gas business in Russia, however its investment climate is not the worst compared with other oil producing countries like Venezuela or Nigeria. What JOGMEC has to do from now on is to cast aside such a kind of skepticism about the investment climate of Russia and to encourage investment by the Japanese Oil Industry.