
Chairman's Summary: Overview of and Update on the Pacific Pipeline Project

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The 2006 Energy Forum in Niigata was the third conference of this kind, following meetings held in 2004 and 2005.¹ Similarly to the 2005 Energy Forum, the 2006 conference was focused on the energy security interests, development plans and policy priorities of Japan and Russia. Naturally, the Pacific oil pipeline (abbreviated in Russian to VSTO) is attracting considerable attention as a mega-project important for both Russia and Japan.

The VSTO project is unique on several counts, including (1) its ultra-large scale; (2) its advanced technological level and the complexity of the engineering work required; and (3) its significant impact on regional development in Eastern Russia, as well as access to oil fields in Eastern Siberia and Yakutia, both those already discovered and those that have yet to be found. Last but not least, the oil pipeline project will allow Russian oil-producing companies access to new markets in the Asia-Pacific region, including Japan and China.

Since 2005, progress has been achieved in moving this

project towards implementation. Several very important events have taken place during the last 12 months, including (1) the issue on April 26, 2005 of a ministerial level order regarding the project plan;² (2) the completion in November 2005 of a detailed draft construction schedule for the project's first phase; (3) the approval of the environmental assessment on March 3, 2006 by the special expert-level commission under the auspices of the Federal Technical Oversight Agency "Rostechnadzor"; and (4) the approval of the first inland part of the project on April 4, 2006. On the other hand, on February 1, 2006, "Rostechnadzor" declined to approve the plan for the loading terminal in Perevoznaya Bay, citing the project's inadequate compliance with environmental requirements (Kozmino Bay has been proposed by the Federal Natural Resources Use Oversight Agency "Rosprirodnadzor" as an alternative option).

Moreover, in late March 2006, during the Russia-China summit meeting in Beijing, an agreement was reached to link the VSTO main pipeline with Daqing in

¹ Reports on these two meetings are available at <http://www.erina.or.jp/En/Ef/pub-f1.htm>

² Order #91, April 26, 2005 "About the phases of construction of the "Eastern Siberia - Pacific Ocean" pipeline system".

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Northeastern China via a branch pipeline. Finally, Transneft CEO Semyon Vainshtok announced that his company was ready to start construction of the pipeline from April 28. He was speaking in Tomsk, at a meeting dedicated to the economic development of Siberia. Towards the conclusion of this very meeting, President Vladimir Putin decided that the 60km section of the pipeline planned in the vicinity of Lake Baikal should be moved beyond the mountain range, to rule out any possibility of an oil spill reaching the lake.

These were just plans, proposals and concerns when Dr. Vladimir V. Saenko, Director of the State Energy Policy Division of the Department of Fuel and Energy Complex, Ministry of Industry and Energy made his presentation concerning the progress of the VSTO project. In a way, this was a follow-up report after the presentation he made in Niigata in March 2005.

In his speech, Dr. Saenko reiterated that Eastern Siberia and the Far Eastern region are strategically important for Russia's economic development. These two regions contain 40-50% of Russia's estimated oil reserves. The VSTO project will be followed by the development of oil fields in the area, contributing to regional development, as well as social and industrial advancement. According to Russia's Energy Strategy 2020, the regional production of oil should reach 100 million tons a year by 2020, including about 20-25 million tons extracted offshore from Sakhalin.

Phase One of the VSTO project includes the Taishet-Ust-Kut-Kazachinskoe-Tynda-Skovorodino pipeline with an annual capacity of 30 million tons, to be built by 2009. Additionally, an oil-loading rack will be built in Skovorodino to load the first oil into rail tankers and transport it to the oil loading terminal on the Pacific coast. This will be followed by Phase Two: the Skovorodino - Perevoznaya Bay stretch, with a capacity of 50 million tons, coordinated with the expansion of the capacity of the Taishet-Skovorodino section to 80 million tons, as well as a branch pipeline to China, which could be completed before 2009.

However, as a result of the implementation of the VSTO project, the energy security of Eastern Russia itself will be strengthened, while Northeast Asia will become the main export destination for oil extracted in Eastern Russia, as well as oil products. There are plans to build oil refineries attached to the pipeline, including one planned by Rosneft Oil Company on the Pacific coast.

As of today, economic exchanges with Northeast Asia are not sufficiently developed, partially due to Russia's limited capacity to supply energy resources and related goods. Energy demand in the region is growing fast. Russia's capacity to meet this demand will lead to long-term energy links, which could define the future "energy architecture" in the region, as well as the development path of Eastern Russia.

Obviously, the influence of the VSTO project on Russia's oil exports will be crucial. About 80 million tons of oil will be transported via the VSTO pipeline after the project is completed. This means that up to one-third of Russia's entire oil exports will be directed towards Northeast Asia and other markets beyond this area, primarily due to the introduction of the VSTO pipeline. This is important because the European oil market currently

dominates Russia's oil exports. In a way, the European market has been "saturated" with Russian oil and it is not expected to grow significantly, unlike neighboring markets in Northeast Asia.

It is important to note that the project would initially depend on oil extracted from existing sources in Western Siberia, with Rosneft supplying more than 40% of the crude oil to be transported by the pipeline. Phase Two of the VSTO pipeline project should involve the construction of feeder pipelines by Rosneft and other companies, linking newly developed oil fields in Eastern Siberia and Yakutia with the VSTO pipeline. The government's licensing policy will be modified for these green field projects, as will the tax regime, in order to reduce investment risks and facilitate investment returns.

Obviously, mega-projects such as the VSTO always involve complexities and problems. The first such problem is the environmental assessment of the project. Initially, the 60km stretch of the pipeline to be constructed near Lake Baikal became an issue that delayed the procedure for the pipeline's approval by a commission of independent experts. After approval was granted on March 6, 2006, the Transneft Company, which serves as the project's operator, reiterated its assurances of special precautions to be taken to alleviate the risk of the oil spills in vicinity of the lake, including (1) the number of safety valves; (2) tripling the thickness of the pipe wall and enhancing its quality; (3) real-time monitoring of the pipeline's operation; (4) security surveillance; and (5) the use of "pipe-in-pipe" technology for crossing rivers and streams, as well as many other special measures to prevent potential, but highly unlikely emergencies.

These assurances, however, were overruled by environmentalists, regional administrators, lawmakers, scientists and the general public, leading to a decision by President Putin to move the pipeline route about 40km to the north of the lake. This decision is intertwined with a second problem, namely the economics of the pipeline in terms of the competitiveness of the transportation tariffs with western transportation routes. Here, views and estimates differ. Oil companies that operate in Western Siberia could ship their crude oil via the new pipeline, paying about \$5.30 a barrel from Taishet to the Pacific coast terminal, with a tariff of \$2.90 per barrel for the west-bound Nizhnevartovsk-Primorsk route. However, the higher oil quality would influence its export price, which is likely to be higher than "Urals", the Russian oil mix predominantly used for exports.

According to Transneft, the tariff for the coastal oil terminal should not exceed the tariff for oil shipments to China, allowing supplies to react flexibly to market dynamics. Moreover, the economics of the VSTO project were initially calculated on the basis of international crude oil prices close to \$29 per barrel and without tax benefits for green field projects. With revised mid-term projections of international prices remaining at about \$40 per barrel or more, the project's economics could be sustainable.

However, among the options available to the government is the reduction of the transportation tariff to about \$31 per ton of crude by subsidizing the interest rates on the loans secured by Transneft for the project.

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The economics of the pipeline could be further improved through the concerted use of resources derived from the Stabilization Fund and federal programs, as well as by applying a preferential taxation regime. The estimated cost of the entire package of such support measures could amount to \$3-4 billion, requiring amendments to the tax legislation. In addition, the cost of tax holidays for key green field projects in Eastern Siberia and Yakutia proposed by the Ministry of Economic Development and Trade is estimated at \$4-\$9 billion.

On the other hand, interest in oil and natural gas projects in Eastern Russia on the part of foreign companies and governments is growing, resulting in cooperation agreements signed at the corporate and inter-governmental levels, including agreements with China. The ultimate goal of these steps is to make Eastern Russia a new “energy stronghold” linked to new markets in the Asia-Pacific region.

It should be added in conclusion that the proposal to combine the VSTO project with one or more high-capacity export-oriented oil refineries could also improve the economics of the VSTO project. Such proposals were initially advanced by Transneft, the Ministry of Industry and Energy and the Ministry of Economic Development and Trade. Recently, Rosneft's CEO Sergey Bogdanchikov revealed that his company is preparing a feasibility study for such a refinery located on the Pacific coast. Finally, on April 26, 2006, speaking in Tomsk, Vladimir Putin made explicit reference to this plan, instructing the government to provide support to such projects.

For Japan, including Niigata, an oil refinery built in the vicinity of the planned sea terminal on the Pacific coast could have significant implications for trade and investment links with Russia. In Niigata, for example,

there is a possibility of establishing a commercially viable oil product storage and distribution base with long-term contracts with an oil refinery in Russia and connected to major consumption centers by product pipelines. In such a scenario, the participation of Japanese companies in the oil refinery project would be indispensable.

In addition, Japanese companies could explore opportunities for investing in oil and gas projects in Russia, including those under the control of Rosneft, which is likely to be a leading oil and gas company in Eastern Russia. Specifically, a planned oil refinery on the Pacific coast could be an option for a comprehensive partnership, including the supply of equipment and technologies that will allow the output of products that conform to Japanese and other appropriate specifications.

This idea was among the issues discussed after Dr. Saenko made his presentation. It seems to be very much in line with the mainstream policy adopted by the government. Indeed, as the publication 2005 Energy in Japan put it, Japan still depends on oil for about 50% of its total energy supply, with 90% of this oil being imported from the Middle East. Efforts have been made to diversify the sources of oil to avoid over-dependence on any specific country or region. However, following the reduction of oil imports from China and other countries in East Asia, Japan's high oil dependence on the Middle East is expected to continue. In response to this situation, “the Japanese government is steadily implementing human exchange with oil-producing countries and actively engaging in joint research projects and technological cooperation in oil-related fields, such as the development of high-precision refining technologies.”³ A joint oil refinery project on the Pacific coast of Russia combined with a long-term supply scheme could be a step in this direction.