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Japan and China Battle for Russia's Oil and Gas

by James Brooke

VOSTOCHNY, Russia - For now, Krylova Cape is not much to see: a spit of land between the Russian taiga forest and the Sea of Japan, its soil being graded a bit by a bright yellow bulldozer. But what is taking shape here is central to a pitched struggle between the two most important economies in Asia: the reigning titan, Japan, and its rising challenger, China.

Both economies are hungry for raw materials, especially energy - Japan because it has almost none of its own, China because its economic boom has fast outstripped what once were adequate domestic supplies. Both want to limit their dependence on oil from distant, politically volatile regions like the Middle East. And both see an attractive alternative in the little-tapped energy riches of the vast, vacant Russian Far East.

Getting oil to market from the remote East Siberian fields that Russia is ready to develop means spending billions on a pipeline. Japan and China are fighting hard over where that pipeline will go: either to China's northeastern industrial heartland, or to this stretch of Russian shoreline, where a new deep-water oil terminal will be just one day's tanker cruise from Japan.

With the choice Russia faces, the political and economic dynamics of Northeast Asia stand to be profoundly shaped for years to come.

"The Chinese will be furious if the Russians do not give them the pipeline," said Graham Hutchings, an Asian specialist with the British consulting group Oxford Analytica. And no one expects it to be the last time Japan and China collide over the resources they both need.

China has been talking to Russia about Siberian oil for a decade, and its need has grown acute. It is on a pace to overtake Japan next year as the world's second-largest oil consumer, and to catch the leader, the United States, sometime around 2030, by quintupling its current demand. Energy shortages plague the country, with 21 provinces experiencing rationing and blackouts so far this fall and winter, twice as many as last year. A Russia-China pipeline, Chinese officials say, would be a natural north-south marriage between Asia's largest oil exporter and what will soon be Asia's largest oil importer.

Japan, whose demand for oil is slowly falling because of anemic growth and a shift from manufacturing, came later to the game, making a serious alternative proposal only a year ago. But it has steadily sweetened its bid, while the financing of the Chinese plan remains fuzzy. Japan now is offering to put up $5 billion for pipeline construction and another $2 billion for oil field development, while holding out the prospect that a pipeline to the Sea of Japan could handle oil exports to America, too.

The pipeline rivalry offers a taste of more battles to come, as China moves aggressively to secure access to resources it needs to keep wheels spinning in "the factory to the world."

Moving around Asia, China is financing copper and coal mines in Mongolia, building another oil pipeline in Kazakhstan, negotiating over gas development in Turkmenistan, buying gas fields and signing long-term supply contracts in Australia and Indonesia and buying steel in South Korea.

So far, the biggest market impact has been on industrial commodities like coal, copper and iron ore. Many have reversed long declines and started rising, as Japanese, Taiwanese and South Korean manufacturers find themselves competing with China for supplies and bidding prices up. But in oil, Japan and China are competing over more than just price.

"We are about to enter an age in which Japan and China scramble for oil," Yoichi Funabashi, international affairs columnist for Japan's Asahi Shimbun, wrote recently. "China acts, and Japan reacts. Now, we are losing the oil race."

In Japan's rush to get in on Siberian oil development, it has all but ignored the inconvenient diplomatic fact that Japan and Russia never signed a peace treaty after World War II. For decades, the sticking point has been Japanese claims over four islands in the Kurile chain north of Hokkaido that Soviet forces seized in the autumn of 1945.

"Energy security, energy diversity, energy from across the Japan Sea is sufficiently important to move the Kurile Islands way down the list" of priorities, said Stephen O'Sullivan, head of oil and gas research at UFG, a Moscow-based investment bank.

Japan has quietly decided to deal with the island question separately and not let it block economic relations with Russia. "It is the issue which is being left aside," Vladimir I. Ivanov, a Russian economist, said by telephone from Niigata, Japan, where he researches regional energy issues. "Nobody wants to link the islands with the pipeline project."

In Moscow, advocates of a China pipeline say that binding Russia and China together in economic interdependence would be good for regional stability, on the model of Canada and the United States. Similar reasoning helped propel a $17 billion project to build a 3,055-mile natural gas pipeline from eastern Siberia to serve northeast China and South Korea, which won initial approval in November.

China's voracious appetite for energy is also lighting a competitive fire under Japan's conservative electric utilities, which have been slow to commit to new development projects. Exxon Mobil tried for years with little success to interest Japanese utilities in a 1,200-mile gas pipeline from its gas development on Sakhalin Island, Russia, to Tokyo.

Interest suddenly perked up when Exxon Mobil let it be known that it was studying an alternative 1,000-mile pipeline to Harbin, China. China has also plunged ahead with deals to bring in more liquefied natural gas from Indonesia and Australia, where Japan also buys gas.

"Japan Inc. is thinking that there is no shortage of supply, that there will be another bus in a minute," Mr. O'Sullivan said. "China is building terminals."

The yellow bulldozer's grading work here will not be in vain, whatever Moscow decides. Krylova Cape is at the eastern end of the

Trans-Siberian Railroad. Next year, work will begin in earnest on the oil terminal, with plans for 140,000 barrels of oil a day to reach the port by rail for shipment to Japan and elsewhere.

"Krylova Cape is a good spot," Viktor S. Gnedzilov, mayor of Nakhodka, the municipality that oversees the cape and this port, said in an interview. "There is the railroad. The piers can be extended one kilometer. We expect that vessels up to 300,000 tons could come to the pier. It would be a colossal benefit for Nakhodka - jobs, businesses, development, foreign investments."

In Russia's thinly populated Far East, the Japanese pipeline is seen as a counterbalance to China, a partner Russians view with some misgivings.

"Many people here believe Japan is a more predictable country," said Alexei Kabanchenko, spokesman for Nakhodka, a Slavic outpost whose billboards proclaim: "Russia starts here."

Many Russian officials, including President Vladimir V. Putin, have also said that Russia would gain economic clout if East Siberian oil were to be sold on the world market rather than to just one customer, China.

"We had a cruel lesson with a gas pipeline to Turkey," Viktor V. Gorchakov, regional vice governor for economic affairs, said in Vladivostok, the regional capital. Once it was built, he said, the Turks reneged on earlier agreements.

"They told us, 'We don't need gas, cut the prices down,' " he said. "You get a lesson like that once. But not again."

For their part, Chinese officials say that the Russians risk hitching their future to a fading partner if they choose Japan. They express frustration that the question has not yet been decided.

"We really put high importance on that pipeline," said Yang Bojiang, Northeast Asian studies director of the China Institute of Contemporary International Relations, on a recent visit to Tokyo. "When we faced them at first, I thought they were sincere," Mr. Yang said of the Russian negotiators. "Now, I think they are probably playing a game. The Japanese have been promising to pay more."

President Hu Jintao thought he had won the pipeline last May when he visited Moscow and signed a communiquÈ with Mr. Putin endorsing the Chinese route. On the same visit, a Chinese state-owned oil company signed a 20-year, $150 billion agreement with Yukos, Russia's largest oil company, in which Yukos promised to supply China with 400,000 barrels of oil a day by 2005, and 600,000 barrels a day by 2010. The Russian national railway system also announced recently that it would expand sixfold its capacity for shipping oil to China.

But China lost an important advocate in Moscow on Oct. 25, when Mikhail B. Khodorkovsky, the chief executive of Yukos, was arrested on charges of tax evasion and fraud. Now political winds seem to blow Japan's way: the regional governors in the Russian Far East are lobbying hard for the Japan route. Mr. Putin's own representative in the region, Konstantin Pulikovsky, favors it so strongly that he once called himself "a Japanese ambassador."

Still, the decision may come down to economics, not politics.

The China route proposed by Yukos would be shorter, faster and cheaper: 1,400 miles long and about $2.8 billion and seven years to build, compared with 2,300 miles, about $5.8 billion and a decade to build the Japan route.

The Japanese pipeline would be larger - a million barrels a day rather than 600,000 - but many Russians from President Putin on down wonder whether enough oil can be produced in East Siberia to fill it. Advocates say that, given advances in oil exploration and production technology, building the pipeline would make it feasible to explore and develop new fields believed to lie east of Lake Baikal but not worth pursuing in the past.

Despite a strong showing by economic nationalists in Russia's Dec. 7 parliamentary elections, the energy minister, Igor Yosufov, is encouraging joint ventures with Japanese companies to explore eastern reserves now listed as probable rather than proven. Confirming their potential would add weight to the argument for a Sea of Japan pipeline. But disappointing results in Eastern Siberia could make a smaller pipeline to China the only viable choice.

Russia needs to develop oil exports to fulfill President Putin's promise to double the size of the nation's economy in this decade. It already produces much more oil than it needs domestically; bottlenecks in export pipelines, now straining at full capacity, have glutted the domestic market and pushed prices down to about $4.50 a barrel in Russia, only one-seventh of the world price. Transneft, the state pipeline monopoly, is working on projects to expand its export capacity to ports on the Baltic and White seas.

As for the Far East, all eyes are now on Mr. Putin and his choice of pipeline routes, as China and Japan each try to sway him.

Watching from a relatively neutral perch, Thomas U. Berger, a Boston University professor of international relations, said on a visit to Tokyo: "This is the great Asian oil game of the 21st century."

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