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By Hisane Masaki

TOKYO - The imbroglio over the huge Sakhalin-2 oil-and-gas project in Russia's Far East involving two Japanese firms has cast a cloud over resource-poor Japan's new national energy strategy. It has also served as a fresh reminder that Japan's economic power seems to have lost much of its luster, at least in the eyes of the Russians.

In September, the Russian Natural Resources Ministry froze a key environmental permit for the project off the Coast of Sakhalin Island, citing problems with conservation. The decision drew immediate protests from Japan and the European Union. Prime Minister Abe Shinzo, then still chief cabinet secretary of the Koizumi cabinet, said a major delay to Sakhalin-2 could hurt diplomatic relations.

Map of Sakhalin's oil and gas projects and pipelines

Japan's ambassador to Moscow, Saito Yasuo, was blunter. He criticized the "unilateral" Russian decision as "lacking transparency". The British government said it was "deeply concerned".

The project is operated by an international consortium called Sakhalin Energy, in which Royal Dutch Shell has a 55% stake. Japanese trading firms Mitsui and Mitsubishi hold 25% and 20% shares, respectively.

Natural gas taken from two fields off the northeast coast of the island will be transported through an 800-kilometer pipeline to Prigorodnoye, in the island's southernmost part, where it will be liquefied and shipped to Japan, South Korea and the United States.

To be sure, even before Moscow began looking into the environmental problems surrounding Sakhalin-2, Russian and foreign environmental groups had raised strong questions about the project. But the stunning Russian move is widely believed to be a veiled ploy to pressure Sakhalin Energy to reshape the original 1990s deal to the Kremlin's benefit.

With prices for crude oil and other natural resources at high levels, the Russian administration of President Vladimir Putin has been promoting a strategy to place energy under national control. The major oil company Yukos, which was hostile to the government, was charged with tax evasion and eventually forced to dissolve.

Sakhalin-2 is the only wholly foreign-funded project among major resource development programs in Russia. There has been growing discontent in Russia over the project, with some saying it is based on an "unequal treaty" that bars Russian companies from taking part, and which severely restricts the country's share of the profits.

Sakhalin-2 offshore

Russia's gas-export monopoly Gazprom agreed last year to acquire a 25% stake in Sakhalin-2 in exchange for ceding to Royal Dutch Shell a stake in its big gas field in western Siberia. But talks stalled after the Sakhalin-2 operator announced it would double costs to US$20 billion because of higher steel prices and the weaker US dollar. There were also plans in effect for Mitsui and Mitsubishi to transfer a combined total of 5 percent of their stakes to the Russian company.

Putin acknowledged on Friday that the conditions of the contract, known as a production-sharing agreement, and increasing costs for Sakhalin-2 are disadvantageous for his country because Russia cannot receive any profits until the project operator recoups the investment cost.

In what appears to be the latest in a series of Russian efforts to take greater control of domestic energy resources, Gazprom said this month that it will develop the giant Shtokman natural-gas field in the Barents Sea near the Arctic alone. The move is disappointing for five foreign companies, including US oil majors Chevron and ConocoPhillips, that had been on a short list to partner with Gazprom on the $20 billion project, one of the world's largest undeveloped gas fields.

Optimism on both sides

In what was seen by some as a conciliatory tone, however, Russian Natural Resources Minister Yuri Trutnev gave Sakhalin-2's operator a month - until the end of October - to come up with plans to rectify what they called major environmental violations before a possible shutdown of the $20 billion operation. The plans are to be submitted to the minister in the final week in October.

Royal Dutch Shell's chief executive said that the company has fully addressed all ecological issues and is seeking dialogue with the Russian authorities. "Although the project has faced significant environmental challenges, we firmly believe these have been fully and transparently addressed," Jeroen van der Veer told an investment advisory council chaired by Russian Prime Minister Mikhail Fradkov.

"This project is 80% complete now with all LNG [liquefied natural gas] pre-sold under long-term contracts ... We are confident that all remaining issues can be resolved through our ongoing, constructive and fair dialogue with the Russian government."

Trutnev said that if the company's plan is acceptable, the development won't be stopped, and noted that he had received assurances from the Royal Dutch Shell head that the energy giant is working to resolve the problems. Trutnev praised the company for taking a constructive approach to Russia's environmental concerns.

"My meeting ... with van der Veer represents a 180-degree about-turn," Trutnev said. "He talked about existing violations, about ecological standards and how they have already started improving the situation." Trutnev noted, however, that "absolutely any sanctions" are possible if the proposals prove unsatisfactory. Trutnev's ministry will announce the results of its environmental probe into Sakhalin-2 as early as this week.

Japanese Minister for Economy, Trade and

Industry Amari Akira also expressed optimism recently about the fate of Sakhalin-2. Amari said he thought there would be a resolution between the Sakhalin Energy and the Russian government over the recent problems. "One way or another, Sakhalin-2 will be resolved," Amari said. "The basic contract hasn't been nullified." Amari said he thought Sakhalin Energy would be able to convince Moscow of its efforts to deal with the environmental issues.

The Sakhalin-2 project is expected to provide 9.6 million tons of LNG a year from 2008. Eight Japanese companies, including Tokyo Electric Power Co, Tokyo Gas Co and Chubu Electric Power Co, have agreed to purchase 4.73 million tons per year - equivalent to 8% of Japan's LNG imports in fiscal 2005. The initial impact on Japan of a delay in imports from the project might be limited. But the impact of a prolonged suspension could be far-reaching.

Molikpaq offshore platform currently used for producing oil at Sakhalin-2

Japan is the world's largest LNG importer, purchasing 58 million tons from abroad in 2005, of which 25% was from Indonesia. Most of Indonesia's long-term LNG supply contracts with East Asian countries, such as Japan, China, Taiwan and South Korea, start expiring from 2010. Indonesia is poised to cut in half its Japan-bound exports of gas when long-term contracts expire in 2010 to boost the availability of natural gas for domestic industries amid decreasing natural-gas production at home.

If imports from Sakhalin-2 are delayed for an extended period, affected Japanese companies would need to find alternative suppliers. It remains to be seen, however, whether Japan will be able to secure the same volume it has been importing up until now, as countries with large energy demands, such as China and India, are increasing their imports of LNG. In 2010, China and India are expected to need an additional 5 million tons and 8 million tons, respectively, above current levels.

The island of Sakhalin also started producing and exporting crude oil in 1999, with exports to Japan beginning in 2001. In 2005, the area provided Japan with 10.89 million barrels, accounting for about 1% of the country's crude-oil imports. The new pipeline, scheduled to start operating in late 2007, will allow crude oil to be exported year-round, instead of only in summer at present.

Headwinds against Japan's energy security

The Sakhalin issue has come at an awkward time for Japan, which this year adopted the "New National Energy Strategy". The new strategy reflects growing Japanese concern about energy security in the medium and long terms amid high oil prices and an intensifying global rush for oil, gas and other resources, led by China and India.

Japan imports almost all of its oil, about 90% of which comes from the volatile Middle East. Japan is also the world's largest LNG importer. Japan is struggling to diversify the suppliers of oil, gas and other energy resources. The new strategy, adopted in late May, also calls for, among other things, increasing the ratio of oil developed and imported by domestic companies - from 15% to 40% of total imports by 2030.

But this 40% target for "Hinomaru oil" has become even more difficult to achieve following Japan's recent agreement to give up its controlling interest in the $2 billion development of Iran's massive Azadegan oilfield amid tensions over Tehran's nuclear program.

After hectic haggling, Japan's Inpex Corp, a core firm of Inpex Holdings Inc, and National Iranian Oil reached a basic agreement early this month on a major cut in the largest Japanese oil and gas developer's stake in the oilfield, in southwestern Iran, to 10% from 75%. Inpex Corp will also return its status as operator of the project to the state-owned Iranian oil company. Still, Inpex Corp is expected to maintain the right to import crude oil from the field in the future with the 10% stake.

Meanwhile, Russia's energy-resource nationalism could spill over into another major project on Sakhalin - the $12.8 billion Sakhalin-1 project, managed by an international consortium led by US oil major ExxonMobil. The project cost is now said to have increased to $17 billion.

Russia's environmental watchdog, Rosprirodnadzor, reportedly plans to check to determine whether the project complies with environmental-protection laws after finishing such a check on Sakhalin-2. Other consortium participants include Tokyo-based Sakhalin Oil and Gas Development Co (SODECO), owned by the Japanese government and private sector, and Russia's state-owned oil firm Rosneft. The Russian firm has a 20% stake in the project.

Last year Sakhalin indigenous people protested the project.
The banner reads, "I am not a guest here. I am the returning
son. Here, for me everything is both beloved, and holy."

In yet another blow to Japan's energy security, exports of natural gas from Sakhalin-1 could all go to China. ExxonMobil, which holds the right to decide which parties receive natural-gas exports, reportedly concluded in October a provisional contract with China's state-run China National Petroleum Corp (CNPC) on the import via a pipeline of about 6 million tons (in liquefied conversion) of natural gas to be produced at Sakhalin-1. ExxonMobil and CNPC reportedly plan to conclude a formal contract a year later.

The Sakhalin-1 development started on the condition that all of the 6 million tons of natural gas for export purposes - the amount excluding that to be taken by Russia - would be exported to Japan. SODECO reportedly agreed to the provisional contract on the condition it receives 30% of proceeds from exports to China. SODECO is jointly funded by Japan Petroleum Exploration, Japan National Oil, Itochu and Marubeni. SODECO owns the right to acquire 30% of resources available from the project. Japan's imports of oil from Sakhalin-1, which began in October, will not be affected, but no natural gas may be exported to Japan.

Meanwhile, Japan and China have lobbied for alternative routes for a pipeline from eastern

Siberia's oilfields to Pacific Rim nations. Russia has played the two energy-hungry Asian nations against each other. Japan failed to gain a guarantee that Russia would give priority to building a "Pacific route" from Taishet near Lake Baikal to Perevoznaya Bay near Nakhodka on Russia's Pacific coast via the halfway point at Skovorodino, near the Russia-China border, rather than to building a "China route" heading to Daqing, northeastern China, from Skovorodino.

Russian state pipeline monopoly Transneft is building the pipeline in two stages. It expects to finish the first stage at Skovorodino in 2008. Construction work on the first stage linking Taishet and Skovorodino began in late April. No date has been set for the second stage. There are strong expectations that imports of oil from eastern Siberia through the proposed pipeline to Russia's Pacific coast, if and when they go into full swing, will help diversify oil sources and contribute to stable oil supplies to Japan in the long term.

Tokyo has been asking the Russian government to sign an intergovernmental agreement pledging that it will build the entire route of the projected 4,188km pipeline. But Moscow has rejected the Japanese request and said its priority now is to explore and develop the untapped reserves of eastern Siberia to provide the oil to fill the pipe. Although Inpex and trading houses have been considering joining the Siberian project, they are waffling in view of the lack of a government guarantee that Moscow will build a pipeline that could deliver oil up to the Russian Pacific coast - and then to Japan.

Japan on the diplomatic defensive

Japan once controlled the lower half of Sakhalin Island. After World War II this territory, and the string of islands to the south called the Kurils, was ceded to the Soviet Union. Tokyo no longer has claims on Sakhalin, but sovereignty over the Kurils has been in dispute for decades.

Not long ago, it was thought that Japan's trump card in the ongoing negotiations was its ability to develop the rich resources of the Russian Far East. However, what Japanese government officials have long taken for granted as a negotiating chip - Japan's economic power - seems to have lost much of its luster, at least in the eyes of Russian leaders. For Russia, Japan’s strategic significance has declined.

The current situation is a stark contrast with just about a decade ago when Putin's predecessor Boris Yeltsin made what the current Russian government now thinks were too many concessions on the territorial dispute, driven by the need to seek Japanese help in turning around the then ailing Russian economy.

While Japan's economic power has been relatively on the decline after the burst of the asset-inflated "bubble economy" of the late 1980s, the Russian economy has been barreling ahead in recent years, thanks to high prices of crude oil, the country's main export item. Russia, which overtook Saudi Arabia in 2006 as the world’s largest oil producer, has posted robust economic growth, and its gold and foreign-currency reserves have hit record high levels.

These days, the attraction of the Russian economic magnet for Japan seems even stronger than that of the Japanese one for Russia. Japan's direct investment in Russia jumped more than sevenfold in fiscal 2004, which ended in March 2005, to $51 million, from fiscal 2003, although the figure represented a still minuscule 0.1% of the country's overall direct investment abroad.

The two biggest Japanese auto makers, Toyota and Nissan, have decided to build assembly plants in St Petersburg. In the energy sector, too, Japanese companies are investing billions of dollars to help extract oil and natural gas in nearby regions of Russia, including the Sakhalin-1 and Sahkalin-2 projects.

Many analysts say, however, that if Russia courts foreign capital in rough times but then twists the law to its own ends in good times, foreign companies, including Japanese ones, will become reluctant to invest in the country. It will not be in the interests of Russia in the long term, they say.

There is growing international distrust of Moscow, particularly with regard to energy security. At this July's Group of Eight summit in St Petersburg, where energy security was high on the agenda, Putin failed to dispel the distrust. In January, Russia temporarily stopped gas supplies to Ukraine in a price dispute. All of this has stirred alarm among European countries that depend heavily on oil and natural gas supplied by Russia.

In St Petersburg, the G8 leaders agreed on an action plan to bring greater stability to energy markets. The program will promote development of more transparent and predictable energy markets and support energy-saving programs. If Russia wants to attract more foreign investment in its energy sector, it needs to win the confidence of potential investors, many analysts say.

On the oil pipeline linking eastern Siberia with Russia's Pacific coast, some Japanese government officials, concerned about the future possibility of a sudden halt to supplies as happened to Ukraine, have begun to ask: Will the pipeline actually contribute to ensuring Japan's energy security?

Prime Minister Fradkov is expected to visit Tokyo by the end of 2006. Topping his agenda will be energy issues, including Sakhalin-2 and the Pacific-route oil pipeline. The visit will be preceded by a meeting of the trade and economic committee between the two governments, co-chaired by Japanese Foreign Minister Aso Taro and Russian Energy and Industry Minister Viktor Khristenko.

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