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New Year Message from IEEJ Chairman & CEO Masakazu Toyoda

The Year to Finalize the Energy Mix

Masakazu Toyoda, Chairman & CEO
The Institute of Energy Economics, Japan

It is a great pleasure to welcome another year, with the macro economy showing signs of picking up in Japan thanks to Abenomics. We appear to be finally breaking out of the deflationary economy that has persisted for nearly two decades. The decision to host the 2020 Olympic Games in Tokyo has lifted the mood of the country. The seven years leading up to the Olympics is a critical period that will determine whether the economy can continue to drive the country; the so-called “six troubles” that have fettered the Japanese economy must be resolved one by one. The abnormal appreciation of the yen is being corrected, and the TPP negotiations, in which Japan is a late starter, are approaching the decisive phase. Japan’s unrealistic GHG emissions reduction target of 25% from 1990 levels by 2020 is also being revised. The normalization of labor regulations and corporate tax cuts are due to be addressed soon. And of course, a stable supply of energy at rational prices must be ensured.

December 13, 2013 was the last day of discussions of the Strategic Policy Committee, which was established in March 2013 within the the Advisory Committee for Natural Resources and Energy under the Abe administration. Various opinions were raised at the meeting regarding the draft report, and the Committee Chairman was asked to draw conclusions. With this, the marathon discussions extending over ten months and 17 meetings came to a close. Including the 33 meetings held during the 14 months under the former DPJ administration, Chairman Mimura led the discussions for more than two years. I greatly appreciate and respect his efforts.

The draft final report revises the report formulated by the Conference on Energy and Environmental Issues during the DPJ era that aims to achieve zero nuclear power by the 2030s, and declares that nuclear power is a “fundamental base source of electricity”, which “will be secured in necessary quantities determined with due consideration”. I appreciate this decision as a sharp shift from the former policy, which aimed to achieve zero nuclear power without rational grounds. The report is due to be approved by the Cabinet shortly, following the public comment period which is currently ongoing.

Unfortunately, however, the discussions on the energy policy have not yet finished, as the energy mix has yet to be decided. It is critical to decide on the energy mix within this year, and so the Advisory Committee for Natural Resources and Energy must promptly resume discussions this year. There are three main reasons.

The first is to secure the necessary investment for energy amid the complex crisis of the current energy situation. The second is to take an active role in establishing the framework to tackle global warming as the world’s third largest economy. The third is the need for a stable supply of energy at rational prices to enable Abenomics to proceed without hindrance. To meet all three goals, it is essential to gain public consensus on the energy mix.

The complex crisis, the first issue, is common knowledge for those of us working in the energy arena. However, the general public is not as aware of the crisis as it should be. At one of the Committee meetings mentioned above, one member stated that continuing to depend on nuclear power means forgetting Fukushima. Of course we must thoroughly examine the Fukushima accident, which is why an independent Nuclear Regulation Authority was established and is now reviewing 14 nuclear power plants based on the strictest class of safety standards in the world. However, there are other issues we should not forget: the oil crisis and the global warming crisis. In the 1973 Oil Shock, the oil price almost quadrupled. Similarly, oil prices have almost quadrupled again during the past decade, due to growing demand with the development of emerging economies such as China, and the supply instability in the Middle East triggered by events such as the Arab Spring. In addition, global warming is becoming increasingly serious. For example, the massive typhoon which claimed many lives in the Philippines and the frequent tornadoes that hit Japan were unimaginable in the past. Japan does not intend to commit to the Second Commitment Period of the Kyoto Protocol to 2020 because major countries such as the US, China and India have not done so. This, however, does not mean that global warming can be ignored. The international community is currently negotiating to build a framework beyond 2020 in which all major countries, including the US and China, will participate. Japan is now in the midst of a complex crisis that involves oil crisis and global warming, in addition to the safety crisis caused by the Fukushima accident. The market is not responding perfectly to this complex situation. In countries such as Japan, which has a low energy self-sufficiency rate of 4%, long-term investments in energy that are required to address such complex situation cannot be made without knowing the target energy mix.

Regarding the second issue, 2014 is an important year for tackling global warming in a responsible manner. The clock is running in other countries, even though it is not in Japan. The UN Environment Summit, in which the Prime Minister is scheduled to participate, is due to be held at the end of September 2014, and each country must submit its 2020 GHG reduction target in the first quarter of 2015.

As for the third issue, the smooth progress of Abenomics followed by the yen's depreciation should not be hindered by energy problems. It is crucial to keep energy prices as low and as competitive as possible while addressing the crisis, otherwise the manufacturing industry will not be able to stay in Japan.

From this spring onwards, the Nuclear Regulatory Authority is expected to complete its safety reviews of a few plants, and then the plants should be restarted accordingly. The IEEJ has postulated three scenarios, with the medium scenario predicting that up to 16 power plants will be restarted by spring 2015. Further, the pros and cons of renewable energies are becoming increasingly evident, not only in Germany and Spain but also in Japan. The conditions for the LDP's pledge, which is to restart the plants based on the judgment by the NRA and to assess the situation of energy conservation and renewable energies, are about to be fulfilled.

This year too, the IEEJ will continue to analyze, investigate, and make policy proposals on various energy issues, including the energy mix.

I would like to close by wishing the IEEJ members continued success and prosperity, and a Happy New Year.

Summary

【Energy Market and Policy Trends】

1. Discussions on the Review of the Energy Policies in the Basic Policy Subcommittee

This year will test whether Japan can make the necessary changes, firmly maintain its path based on a careful consideration of the domestic and overseas situations, and continue resolutely with its energy policies and climate change countermeasures.

2. International Oil Situation

Similar to last year, the international oil market is sustained by geopolitical risks while the physical supply-demand balance continues to ease. The Brent price for 2014 is estimated at around \$105/bbl, with the CIF price to Japan being around the same level.

3. Domestic Oil Situation

Accelerated by additional costs caused by the yen's depreciation, the domestic demand for petroleum products will weaken further. The business environment is expected to remain tight, even after March when the dismantling of refining capacity is completed.

4. Electricity Business

The risk of a supply-demand crunch caused by unplanned outages of overworked thermal power plants remains. With the revisions to the Electricity Business Act scheduled to be discussed in the regular Diet sessions this year, the electricity business system must continue to secure a stable supply of electricity even after the revisions are implemented.

5. Energy and Environmental Issues of APEC

Fossil fuel subsidies are attracting the attention of APEC. While the downsides are widely recognized and the APEC Leaders' Declaration calls for rationalization, it is actually extremely difficult to cut the subsidies due to various political barriers.

【Global Watch】

6. Middle East Watching

As the Middle East and North Africa struggle to restore calm, various political events in the first half of 2014 are expected to affect each other's outcome, increasing future uncertainty in the region.

7. US Watching

President Obama is in his last 3 years in presidency, and the Administration will push forward environmental regulations. In Congress, Tax Reform is considered, and the repeal of energy tax incentives will be disputed.

1. Discussions on the Review of the Energy Policies in the Basic Policy Subcommittee

Akira Yanagisawa, Senior Economist
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Following seventeen meetings of the Strategic Policy Committee of the Advisory Committee for Natural Resources and Energy, the “Draft Opinions on the Basic Energy Plan” document was finalized in December 2013. The document is due to be approved by the Cabinet in the new Basic Energy Plan following a public comment period and reporting to the METI Minister. The document contains no quantitative estimates or targets, and is called a “policy outline” by Chairman Mimura. Numerical figures are due to be presented soon for a feasible energy mix based on the progress of restarting the nuclear power plants and the expansion of renewable energies.

The roles of energy sources as described in the “Opinions” document are as follows. The descriptions give slightly more weight to electricity generation, and some of them may be self-explanatory. However, in building a realistic and responsible energy system, it is always important to be completely realistic rather than to pursue dreams. Oil: Despite declining demand, oil is an important energy source which will continue to be used due to its broad usage and high convenience. Natural gas: Natural gas is an important energy source whose role will grow as the price of natural gas becomes more competitive due to the Shale Gas Revolution and as the shift to natural gas accelerates. Coal: Coal is a base source of electricity with excellent stability and economic efficiency, and will continue to be used while efforts are made to reduce its environmental impact. LPG: LPG, which is now available also from North America thanks to the Shale Gas Revolution, is a clean, gaseous energy source with relatively low GHG emissions which will be useful in case of emergency. Nuclear: Nuclear will continue to be used, premised on safety, as a fundamental base source of electricity for the purposes of supply stability, cost reduction and global warming countermeasures. Renewables: Despite various issues in terms of supply stability and cost, renewables are a promising domestic energy source with no GHG emissions.

Regarding nuclear in which the public is particularly interested, the “Opinions” document states that “dependency on nuclear will be minimized by conserving energy, introducing renewables, and improving the efficiency of thermal power stations. Based on this policy, and considering the limitations on energy in Japan, nuclear will be secured in necessary quantities determined in view of supply stability, cost reduction, global warming countermeasures, and the technology and personnel needed for ensuring safety.” This is a complete shift in policy from the “Innovative Energy and Environmental Strategy” of the former DPJ administration which pledged to “mobilize any and all political resources to achieve zero nuclear by the 2030s.”

Once set, these policies need to be put into action without delay. Written strategies and plans will not help Japan surmount the various difficulties it is facing. This year will test whether Japan can make the necessary changes, firmly maintain its path based on a careful consideration of the domestic and overseas situations, and continue moving steadily forward. This applies also to climate change countermeasures, which are closely tied to energy.

2. International Oil Situation

Yoshikazu Kobayashi, Senior Economist, Manager
Oil Group, Oil Sub Unit
Fossil Fuels & Electric Power Industry Unit

Similar to last year, the international oil market is sustained by geopolitical risks while the physical in 2014 will see the supply-demand balance continues to ease as a result of geopolitical risks.

In 2014, the global demand for oil is expected to increase by 1 million B/D year-on-year. While the increase will continue to be driven by emerging countries such as China and the Middle East, developed countries such as the US, where demand has turned positive for the first time in three years due to the robust economy, and Europe, where signs of economic recovery are starting to show, could also support the global demand growth for oil.

On the supply side, a supply increase of 1.5-1.7 million B/D, much higher than the increase in global demand, is expected in non-OPEC countries alone, due to the increase in output in the former Soviet countries, South America and Canada as well as the US where production of shale oil continues to grow. The supply surplus could increase further if exports increase from countries such as Libya, whose production is currently drastically restricted due to the oil plant strikes, Iraq, where a series of new oil fields are being developed, and Iran, which has agreed a temporary accord on its nuclear development, adding to the estimated increase in NGL production of 200 thousand B/D from OPEC.

Under this supply-demand situation, Saudi Arabia holds the key to the market trend. We must closely monitor whether, if oil prices drop due to easing demand, Saudi Arabia will take the lead in cutting production to tighten the supply-demand balance, or let the market weakened to some extent in order to check the development from non-OPEC countries.

The situation in Iran, which so far has been the greatest geopolitical risk to the international oil market, will need to be monitored for at least six months to determine the impact of the recent Geneva Accord. However, it is not clear whether tensions will continue to ease, as the Accord is facing strong opposition from other Middle East countries and also from some congressional members in the US. Besides, there are many other geopolitical risks that may result in higher oil prices in 2014, such as the civil war in Syria and the threats to political stability in Libya and Iraq.

In terms of financial factors, speculators have reduced their long positions in the futures market. The close link between share prices and oil prices seen until last year has almost vanished, and this year, supply and demand (including future prospects) factor could have a more influence in the oil pricing makings. The market driver could change depending on the developments in the recently announced tapering of QE3 and monetary easing measures.

Based on these factors, the Brent price for 2014 is estimated at around \$105/bbl, slightly lower than the annual average for 2013 (\$109/bbl), and the CIF price to Japan is estimated at around the same level.

3. Domestic Oil Situation

Ikuo Hamabayashi, Secretary General
The Oil Information Center

In June last year, the Agency for Natural Resources and Energy released a five-year forecast for oil demand for the first time since the Great East Japan Earthquake. According to the forecast, the demand for oil will continue to decrease by 1.8% each year for the next five years, reaching 182 million kl (FY 2012 value is used for Bunker C for electricity generation) in 2017, the final year of the five-year forecast, down 8% from FY 2012.

To cope with the shutdown of the nuclear power plants after the Great East Japan Earthquake, the power companies ran their thermal power plants to the maximum, and oil-fired thermal power was no exception. As a result, the consumption of Bunker C for electricity generation increased by as much as 60% from FY 2010 levels in FY 2012. Subsequently, however, Bunker C consumption has been falling year-on-year since February 2013 as the power companies gained access to LNG from various parts of the world and increased the use of coal-fired thermal power which is cheaper. This trend is expected to accelerate in 2014. In addition, the consumption of gasoline and heating oil is also facing a structural drop due to changes in living patterns, as is the consumption of ~~light~~ gas oil which is likely to start to fall in FY 2014 after growing year-on-year following the earthquake disaster and the demand generated by recovery work.

Under such circumstances, the scrapping of refining capacity based on the Act on Sophisticated Methods of Energy Supply Structures will end in March 2014. The oil companies have almost completed this scrapping, which will cut more than 1 million B/D of refining capacity. Based on the oil demand forecast above, however, production will remain in surplus even with the new refining capacity, and as a result, additional scrapping will likely be needed.

This structural decline in demand is accelerating due to higher costs caused by the yen's depreciation. Unlike American oil which was affected by the easing domestic supply due to the Shale Gas Revolution, the dollar-based price of Middle East oil remained relatively stable in 2013. However, as the yen weakened past 100 yen/dollar due to Abenomics, the cost of imported oil rose by approximately 12,000 yen (more than 20%) per kiloliter year-on-year, reaching 70,000 yen in October for the first time in over five years. Accordingly, the prices of domestic petroleum products are high, affecting consumer behavior.

Amid this environment, the oil industry of Japan must continue to raise the profitability of domestic petroleum products as its core business, while diversifying and expanding its business areas including upstream and overseas businesses, although this will not be easy.

4. Electricity Business

Junichi Ogasawara, Senior Economics, Manager

Electric Power Group

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Fossil Fuels & Electric Power Industry Unit

The nuclear power plants that were shut down following the Great East Japan Earthquake have not yet been restarted, and so thermal power plants are being fully operated to make up for the lost capacity. As a result, a significant number of plants have not undergone the required periodic inspections, maintenance or repair, resulting in a rising number of unplanned outages during the peak season. In the winter of 2013, none of the power companies were required to restrict electricity consumption, except for Hokkaido Electric which imposed a 6% electricity saving target within its area. The supply-demand situation of electricity, however, must be closely observed. If the restarting of nuclear power plants remains uncertain and the power companies cannot secure enough supply capacity in the summer of 2014, some areas may be asked to reduce their electricity consumption. Particularly for those power companies that have relatively small grids, the shutdown of one thermal plant would have a significant impact on the overall supply-demand balance, and therefore wide-area collaboration is important. Toward the summer, the balance between eastern and western Japan, as well as the supply margin of each company, must also be monitored closely.

Based on the Reforms of the Electric Power System finalized in February 2013, the Act on Electricity Business was revised in November that year with the first set of system reforms, which stipulate the setting up of an organization for promoting wide-area operation in 2015. This organization will be an important body responsible for (1) finalizing the supply-demand and grid plans, (2) wide-area operation of supply, demand and the grid, (3) wide-area adjustment of supply and demand in an emergency, and (4) accepting connections of new electricity sources and disclosing grid information. With the policy for establishing the preparatory task force for the organization established only this December, the task force must act quickly as time is limited until the organization commences operation in 2015.

In 2014, the revision of the Electricity Business Act with the second set of system reforms will be discussed in the ordinary Diet session. The highlight of the second phase is that it expressly addresses not only the implementation of the overall liberalization of electricity retail, but also the transformation of the current electricity business system, centered around the general electric utilities, into a business segment-based licensing system comprising the electricity generation business, transmission and distribution business, and retail business.

Conventionally, the stable supply of electricity of the region has been ensured by the general electric utilities which serve regulated, low-voltage consumers, including the residential segment. With the migration to the licensing system, however, supply stability will be secured through collaboration between the transmission and distribution segments on the one hand, and the generation and retail segments on the other. So far, discussions on the roles of the respective segments have been held in the working group. As collaboration between various market players is essential for the new system, the working group must engage in realistic discussions, referring to the examples of Europe and the US.

5. Energy and Environmental Issues of APEC

Takato Ojimi, Managing Director
President, Asia Pacific Energy Research Centre

One of the most contentious energy issues in APEC currently is fossil fuel subsidies. In some APEC countries (called “economies”), fossil fuels such as gasoline and heating oil are subsidized to keep the cost below regular market prices. These subsidies often have a historical background or political considerations, and thus are not only an energy issue but also economic and social issues.

According to the Service Station (SS) retail price of gasoline released by The Oil Information Center in late November, gasoline costs 156.9 yen/L in Japan, yet only 86 yen/L in Malaysia and 65 yen/L in Indonesia where it is subsidized. Each economy has its own oil procurement system, refining costs, and tax system, and many economies do not disclose the details of the subsidies.

What are the problems of such subsidies? If fossil fuel prices are kept abnormally low, then: (1) fuels will become available at cheap prices, inducing wasteful consumption and in turn increasing the environmental burden through the unnecessary increase of CO₂ emissions. (2) Subsidies increase the burden on state finances: according to the IEA, the world paid over 400 billion US dollars as subsidies in 2010, equivalent to the GDP of South Africa. (3) Despite being regarded as essential to tackle poverty, in fact subsidies only benefit 8% of the poverty group which comprises 20% of the population. (4) Subsidies discourage investment in low-carbon energies, particularly for the development of new alternative energies, possibly threatening energy security.

Recognizing these downsides, APEC leaders stated in the Leaders’ Declaration of APEC 2009 Singapore that they will “rationalize, and in the medium-term abolish, the subsidies for fossil fuels, with due consideration to those who are in need of basic energy services.” In the Declaration of APEC 2011 Honolulu, the leaders went further, requesting economies to make voluntary reports in order to be able to annually review the progress of rationalization, and at the Leaders’ Declaration in Jakarta last year, recommended the introduction of a peer review system.

While agreeing on the need to cut fossil fuel subsidies, the economies face many barriers to doing so. The authorities often face strong opposition against subsidy reforms from numerous stakeholders, including the entire public. Based on this political reality, the economies should start by: (1) fully educating the public of the costs and downsides of fossil fuel subsidies; (2) taking measures such as compensating for the disbenefit resulting from rationalizing subsidies with an equivalent level of tax breaks, income compensation, and improved government services; and (3) giving political consideration to the low-income bracket. It is important to remember the reality that everyone loves Santa Claus.

The APEC Economic Leaders’ Meeting will be held in China this year. The agenda has not yet been released, but I hope that the leaders will hold effective discussions for solving the important energy issues that are shared by the APEC economies.

6. Middle East Watching

Koichiro Tanaka, Managing Director &
President of JIME Center

It is becoming evident that the Middle East and North Africa situation following the Arab Spring will not regain calm for some time. With a series of political events scheduled for the first half of 2014 which are likely to affect each other in the area, the future is becoming even more uncertain.

The provisional accord on Iran's nuclear development will likely continue to be swayed by the domestic situation of the countries involved, in both its short-term execution and the negotiations for a comprehensive accord aimed at ultimate resolution. The negotiations will remain fraught as Iran could become skeptical of them as dissatisfaction with the limited easing of sanctions grows, while in the US and Europe, the hard-line stance to gain further concessions by imposing stronger sanctions on Iran will remain strong. Meanwhile, the Middle East countries, particularly the Gulf countries, will grow increasingly distrustful of the US as it continues to interact with Iran.

In an effort to end the civil war in Syria, the Geneva II Middle East peace conference is scheduled to be held in January 2014. The conference, however, could easily be cancelled depending on the response of the National Coalition for Syrian Revolutionary and Opposition Forces, which refuses to negotiate with representatives of the Syrian Government. While the anti-Assad forces and supporting countries continue to oppose including Iran, which supports President Assad, in Geneva II, there is an imbalance in the framework caused by leaving out a major stakeholder. In any case, as matters currently stand, it is difficult to ensure that any agreement will be actually implemented even if it is agreed on. Meanwhile, prolonging the civil war could strengthen the jihadist forces, which could become a major threat to neighboring countries.

Various events are scheduled for the first half of 2014, including presidential elections in Syria and Afghanistan, and national elections in Iraq and Lebanon. We must closely monitor whether the election in any country, such as Egypt, which is currently drafting its Constitution, and Libya, which could become a failed state, will result in confusion, or will become a turning point for the situation to stabilize.

While the Obama administration has set a major goal of concluding a comprehensive peace agreement by the summer of 2014, only Israel and Palestine have endorsed the resumption of the negotiations, and the prospects remain unclear. The administration has also been taken aback by the political intentions of Afghanistan over the urgent issue of signing a bilateral security agreement with the country, which is a prerequisite for the US troops to remain in the country beyond 2014. This could cause the US troops to be withdrawn from the area faster than intended by the US; fueled by the motives of the related countries that are sensitive to the change in power balance within the region, tensions could rise and continue in the surrounding countries and the entire Middle East in 2014.

7. US Watching

Ayako Sugino, Senior Researcher
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2014 is the year of midterm elections in the United States, in which all seats of the House and a third of the Senate will be contested in November. According to the Washington Post Poll dated December 17 2013, the popularity of President Obama was 43%, while those of the Congress Democrats and Republicans were 34% and 24%, respectively. The Republicans are under pressure to rebuild their support base after losing two consecutive presidential elections, but voter confidence in Republican lawmakers has plunged since the government shutdown last October.

Disapproval is particularly high for the conservative Tea Party lawmakers at 51%, with even 28% of Republican party supporters expressing disapproval. This is mainly because they are held responsible for causing repeated default crises and the government shutdown. Meanwhile, this situation poses a dilemma for the Republican party executives, as these lawmakers have a rock-solid support base in their constituency and helped secure seats in the House elections in 2010 and 2012.

This situation, however, does not necessarily mean that the Democrats have the upper hand. A series of Democrat incumbents have declared retirement in 2014, including senior members such as Sens. Baucus, Levin, and Rockefeller. It should be noted that many of these lawmakers are elected from conservative regions, understand the need for a stable investment environment in the energy industries, and take realistic policies. Consequently, there are concerns that as the doves retire, the Congress Democrats could become more liberal. Meanwhile, President Obama has appointed as his special assistant John Podesta, former chief of staff for President Clinton, who led the drafting of “Green Recovery” , President Obama’s campaign pledge during the 2008 presidential election. Mr. Podesta is expected to strongly drive pro-environment policies, including GHG emissions controls on power stations by the Environment Protection Agency (EPA).

Another major agenda for 2014 is the start of full-scale discussions on tax reforms. For corporate tax, the reforms highlight: (1) reducing the corporate tax rate to international level, (2) abolishing as many of the current industry-based tax breaks as possible, in order to (3) reduce the paperwork by simplifying the tax system; and (4) improve the international competitiveness of the US. Last December, a draft revision proposal was released to merge the currently 42 energy tax preferences into assistance for clean energies and alternative autofuels to oil, and to eventually phase them out as the GHG emissions intensity is gradually reduced.

As a result of the tax reforms, relative price of each energy source may change and it will result in the change in energy supply and demand. However, if the discussions on the reforms are prolonged, the reforms themselves could become a destabilizing element for investment. This could then cancel out the benefit of lower energy prices, which is a positive effect of shale development. In this sense, the impact of the appointment of Sen. Max Baucus, the leading tax writer as the new ambassador to China, announced last December, is also a concern. When the Montana senator takes office as ambassador, Sen. Wyden, the chairman of the Energy and Natural Resource Committee will succeed him as the Chairman of the Senate Finance Committee, and Sen. Landrieu of Louisiana will fill the ENR seat. These personnel matters may affect the direction of energy policy discussions.

The Annual Energy Outlook 2014 released by the Energy Information Agency (EIA) last December revised the domestic oil production upward and delayed production peak. However, the sustainability of production from shale resources remains uncertain, and there is likely to be much debate as the pattern of output decline becomes clearer and as investment in transportation infrastructure proceeds. Congress is due to start studying the lifting of the crude oil exports ban, and two senators from oil-producing states will lead the study in the Senate is not insignificant. It is necessary to objectively analyze the various discussions on domestic oil production in the US in near future.

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