

IEEJ e-NEWSLETTER

No. 41

(Based on Japanese No. 130)

Published: July 14, 2014

The Institute of Energy Economics, Japan

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Summary

【Energy Market and Policy Trends】

1. Developments in Nuclear Power

Three months have passed since the decision to prioritize the reviews of Kyushu Electric's Sendai Units 1 and 2, yet the reviews are dragging on due to a delayed disclosure of the final safety report. The regulatory authority should clarify the decision criteria.

2. Developments in the Oil Market and Oil Policies

Worsening armed conflict in Iraq is causing prices to rise in the international oil market. In Japan, the government has begun to consider applying the Industry Competitiveness Enhancement Act, increasing the pressure for rationalization.

【Global Watch】

3. China Watching: China's Reaction to the China-Russia Natural Gas Deal

For China, the China-Russia gas deal will integrate Russian natural gas into China's medium- to long-term energy strategy and help promote gas price reforms, yet much remains to be done to ensure stable supplies.

4. ME Watching: Catastrophe in Iraq

As ISIS increases its presence in the civil war in Syria and puts pressure on Iraq's Maliki administration, the US is responding by seeking to cooperate with Iran, which is at odds with each other in the nuclear talks. Egypt is coming under increasing criticism for its oppression of journalists and the Muslim Brotherhood.

5. Russia Watching: Can Ukraine Find a Way Out?

The conflict between the new Poroshenko administration and pro-Russian forces is at an impasse without any prospect of being settled. All parties must prepare for growing volatility in Ukraine, since not only the West but even Russia has limited ability to solve the problem.

1. Developments in Nuclear Power

Tomoko Murakami, Manager
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On June 19, the Nuclear Energy Subcommittee of the Advisory Committee for Natural Resources and Energy held its first meeting for developing specific measures based on the nuclear policy indicated by the new Basic Energy Plan. The topics for discussion included reconstruction and revitalization of Fukushima, developing technologies and maintaining human resources for nuclear decommissioning and improving safety, the direction of the nuclear industry in a competitive environment, the handling of spent fuel, and the nuclear fuel cycle policy. The results of the discussions will provide a basis for future discussions on the energy mix.

On June 21, the Nuclear Regulation Authority (NRA)'s "expert team for investigating on-site crush zones at Tsuruga Nuclear Power Station" held its second additional investigation meeting. The Japan Atomic Power Company (JAPC), operator of Tsuruga Unit 2, once again stated that "the faults directly under Unit 2 is not active" citing evidence found in the additional investigation, and requested permission to have the experts from the JAPC's investigations attend the meeting. The NRA, however, refused to allow any experts aside from the expert team members to attend, or even to discuss the opinion statement of outside experts at the meeting, declaring that the JAPC's documents "do not sufficiently prove there is no possibility of activity", and cutting off the JAPC's explanation. After the meeting, the JAPC protested at the refusal to allow the experts to join the meeting, arguing that "the NRA itself acknowledges that it is a usual for an operator to bring an expert".

The discussion between the NRA and the JAPC on Tsuruga's on-site faults is entering its third year. One of the main reasons for the delay is that the NRA requires the operator to "prove that the faults are 100% inactive". Strictly speaking, 100% safety (zero risk) is technically impossible, and we believe that the NRA needs to base its decisions on scientific rationality and risk-based thinking. They must also listen to the opinions of a broad range of experts when making decisions.

On June 24, Kyushu Electric Power Company submitted an amended application for its Sendai Units 1 and 2, but the end is still nowhere in sight. As the reason for continuing the reviews, NRA cites "inadequacies in the operators' documents". However, with nearly 500 reviews for Sendai and more than 200 reviews for Ikata Unit 3 held so far, exactly why are there so many "inadequacies in the operators' documents"?

At the 119th review meeting held on June 17, the first compliance reviews were conducted for the JAPC's Tokai Unit 2 and Tohoku Electric's Higashi-dori Unit 1. At the meeting, a NRA member stated "it just won't do that the operators to apply with quick-fix documents, assuming that the issues can be solved through the reviews". However, with so many new issues being pointed out in the nearly 500 operator hearings and the dozens of review meetings held so far, "solving issues as they come up in the reviews" could be a realistic approach. The regulatory authority must clarify the decision criteria in advance.

2. Developments in the Oil Market and Oil Policies

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The greatest concern for the international oil market at this moment is the situation in Iraq. After seizing Iraq's second city Mosul on June 10, the Sunni militant group ISIS (Islamic State of Iraq and al-Sham) is heading toward the capital Baghdad, fiercely fighting the Iraqi government forces on the way. This is driving international oil prices higher as the high-demand summer season approaches, with the Brent futures price rising steadily to above \$110/bbl as of the end of June.

The armed conflict has yet to reach southern Iraq where the major oil fields lie, and so oil continues to be exported normally. However, the conflict could have a major impact on the international oil market.

One impact is on future global oil supply. According to the Mid-term Oil Market Report released by the International Energy Agency on June 17, 60% of OPEC's additional production capacity between 2013 and 2019 comes from Iraq. The conflict, however, will make it difficult to increase production capacity, and as the country's governance struggles to function properly, international oil companies are starting to pull out staff from even the heavily guarded southern oil fields.

The other major concern is the serious armed conflict emerging between the Sunni militants and the Shi'ite-supported Maliki administration. The conflict has a grave impact as it has exposed sectarian division as additional axis of confrontation in the Middle East with its complex, adversarial relationships. Sectarian issues lie beyond the framework of nation state by nature. Sectarian confrontation will continue to threaten the regional stability and thus its oil supply in the medium to long term.

In Japan, on June 10, METI Minister Motegi revealed plans to apply the Industry Competitiveness Enhancement Act to the oil industry to make it more competitive. The Act will require oil companies to submit and implement three-year rationalization plans for abolishing and consolidating refineries across corporate boundaries, premised on the assumption that a robust oil industry is essential for ensuring a stable supply of oil. The oil industry has been tested by deregulation and international competition ahead of other energy industries in Japan. To survive, oil companies have merged and reduced excess capacity at their own initiative since even before the Act on Sophisticated Methods of Energy Supply Structures was enacted. In implementing these policy measures for assistance, the voluntary efforts of the oil industry should be fully taken into account.

3. China Watching: China's Reaction to the China-Russia Natural Gas Deal

Li Zhidong, Visiting Researcher
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Regarding the China-Russia Gas Deal signed on May 21 (see the previous issue), the Russian side has released more information. President Putin and others revealed the total value of the contract which initially was undisclosed, and even mentioned the advance payment of 25 billion dollars and the confidential pricing scheme. In contrast, the Chinese side, government officials and operators gave only the official line. Recently, however, experts have begun to comment on various aspects of the deal.

China, which is highly dependent on coal, needs to increase the use of natural gas in order to maintain economic growth and reduce air pollution, while controlling CO₂ emissions. Natural gas consumption reached 167.6 billion m³ (123 million tonnes in LNG-equivalent) last year, of which about 30% was covered by LNG imports and natural gas imported from Central Asia and Myanmar. In the detailed guidelines on building an effective natural gas supply system prepared by the National Development and Reform Commission and released by the State Council on April 14, China set a goal of boosting its natural gas supply capacity to 400–420 billion m³ by 2020. According to the China-Russia deal, annual imports from eastern Siberia will be only 15 billion m³ in 2020, and rise to 38 billion m³ from 2023. Further, the deal is also expected to accelerate the pending negotiations for supplying 30 billion m³ of gas per year from western Siberia. In conclusion, Russian natural gas has finally been integrated into China's medium- to long-term energy strategy, which is the most important aspect of the deal for China. The deal is also anticipated to increase import routes and diversify suppliers, and help strengthen China's price bargaining power and eliminate the Asia Premium.

Also, we must note that the deal will promote pricing reform for natural gas. For structural reasons, Chinese natural gas importers tend to lose more money the more they sell, as the government has kept import gas prices as low as for domestically-produced gas, to tame inflation and maintain social stability. The main reason why CNPC has been insisting on an import price of less than 300 dollars per 1,000 m³ in the negotiations is to avoid running a deficit. Nevertheless, it eventually agreed to a so-called standard price of 350 dollars, probably because the government promised to carry out price reforms. Indeed, on June 13, President Xi Jinping expressed his resolve to reform energy prices and eventually let them be set by the market as part of the energy security strategy at the meeting of the Central Leading Group for Financial and Economic Affairs. Experts estimate that the price reform will be carried out by around 2018 when natural gas imports from Russia will start. If this happens, it should promote energy saving and the development of domestic natural gas including shale gas, as well as expand imports.

But there are risks. The recent deal is essentially a framework agreement, and much remains to be done for the gas to be supplied as agreed, including developing gas fields and securing supply sources, constructing pipelines, and achieving tax exemptions for both the Russian export tax and the Chinese import tax. Further, the sheer scale of supply would mean huge risks if price disputes and supply disruptions cannot be prevented effectively. Also, there are concerns about whether the long-awaited price reform may materialize or not.

Perhaps that was what the Chinese officials who remained silent were thinking. Even though they have high hopes for the deal, those directly involved might be feeling overwhelmed by the scale of the work ahead.

4. ME Watching: Catastrophe in Iraq

Koichiro Tanaka, Managing Director &
President of JIME Center

The spread of violence from Syria to Iraq, which had been feared for the past few years, is now a reality. As the US and the international community struggle to decide how to respond, the confusion is threatening to worsen in Iraq and Syria where the establishment of a caliphate order was announced by the ISIS.

I have previously pointed out the risk that the ISIS (Islamic State of Iraq and Syria), which has extended its influence to Syria, could intensify its attacks on Iraq, where the organization was originally based. In early June, ISIS quickly widened the battle lines with bold, coordinated attacks, winning battles through military operations with better trained troops than mere terrorist and rebel groups. The tide changed in favor of ISIS after it took Iraq's second city Mosul on June 10. ISIS is now encircling the capital Baghdad from three directions, routing the Iraqi forces and gaining control of most of Sunni inhabited provinces. By end June, ISIS declared the establishment of a caliphate and rebranded itself as the "Islamic State."

The expansion of power by the terrorist group and the outbreak of civil war have alarmed the US, which has been helping Iraq "democratize", but the US has not yet decided on any effective, specific measures. Some Sunni citizens are welcoming the ISIS attacks due to strong discontent and suspicion toward the Shi'ite-biased Maliki administration, causing the US to hold back and stay out of the sectarian conflict. In his unannounced visit to Baghdad, Secretary of State Kerry urged all political leaders of Iraq, regardless of religion or ethnicity, to build a unified national government by July 1. However, as shown by the Kurdish autonomous government which capitalized on the chaos and took control of the contested city of Kirkuk, there is no sign of order returning to Iraq, but there are signs of a general desire to oust Maliki.

Struggling to deal with the civil war in Iraq and ISIS, the US has contemplated to seek cooperation from Iran, with which last-ditch nuclear negotiations have begun on July 3. Although President Rouhani has mentioned the possibility, the two countries are unlikely to develop military ties, as Ayatollah Khamenei has strongly opposed President Obama's decision to send US military advisers to Iraq. Meanwhile, the nuclear talks have entered the drafting phase of the comprehensive long-term agreement, yet the differences between the West, which wants to heavily restrict Iran's nuclear development, and Iran, which is determined to defend its right to use nuclear technology for peaceful purposes, remain unresolved.

In Egypt, President Sisi was inaugurated, and was congratulated by King Abdullah of Saudi Arabia who had publicly supported the president since the coup last year. Egypt, however, is being strongly criticized by the international community for the mass death sentences handed down to Muslim Brotherhood supporters by an Egyptian high court, as well as the prosecution of foreign journalists of satellite broadcaster Al Jazeera for allegedly cooperating with the Brotherhood, which the authorities consider as a "terrorist organization". Meanwhile, OPCW (Organization for the Prohibition of Chemical Weapons) has announced that Syria's declared chemical weapons have now been completely removed.

5. Russia Watching: Can Ukraine Find a Way Out?

Shoichi Itoh, Manager, Senior Analyst
Global Energy Group 2, Strategy Research Unit

The turmoil in Ukraine is worsening without any prospect of finding a solution. On June 18, the UN Refugee Agency (UNHCR) headquartered in Geneva announced that armed clashes between the Ukrainian government forces and pro-Russian insurgents have claimed the lives of more than 350 Ukrainian soldiers and civilians since the violence intensified in mid-April, and expressed strong concerns about the worsening chaos in eastern Ukraine. The death toll could rise dramatically when the number of deaths of pro-Russian militants and civilians is finally announced.

At the inauguration ceremony on June 7, the new President Petro Poroshenko (elected on May 25) emphasized his pro-Europe stance and goal to join the EU, while stressing the need to promote dialog with pro-Russian forces while firmly maintaining the integrity of Ukrainian territory. On June 4, the G7 group of advanced economies released the Leaders' Statement, suggesting possible additional sanctions depending on how Russia acts, and announcing that the G7 will not tolerate the use of energy supplies as a political tool or security threat. Meanwhile, President Putin visited France to attend the 70th anniversary of D-Day, and held separate talks with the leaders of the UK, France and Germany on June 5-6. He also talked with President Obama, though unofficially, for the first time in nine months. Russia steadily establishes Crimea as de facto Russian territory, while the G7 cannot tolerate the annexation but is yet to find a solution.

On June 20, President Poroshenko announced a peace plan that includes a temporary ceasefire and amnesty. President Putin expressed support for the plan on the 21, and on the 23, talks commenced between the leader of pro-Russian forces in eastern Ukraine and the Ukrainian government. President Putin has already criticized the one-week unilateral ceasefire by the Ukrainian government forces as too short, but is he ready to commit to ending the conflict? Ukraine also has not paid its bill for Russian gas in arrears (see "EU Watching" of this issue). As the West remains incapable of reconciling the parties, President Putin may have an intention to sit back and wait for political and social instability in Ukraine to worsen until more people both inside and outside Ukraine ask Russia to solve the issue.

One of the worst possible scenarios is that the violence between the Ukrainian government and pro-Russian forces worsens, while even Russia loses full control over pro-Russian forces. Considering that the support base for pro-Russian forces in the provinces in eastern Ukraine is not necessarily thoroughly solid, it is necessary to prepare for such an eventuality. However, halfway commitment in the Ukrainian affairs without a specific roadmap, whether by the Western countries or Russia, could further destabilize the country.

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