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Contents

Summary

【Global Watch】

1. **US Watching: State of the Union Address and the Energy Issue**

2. **EU Watching: China's Investments in Europe's Energy Industry**

3. **China Watching: Accelerating the Comprehensive Measures for Energy and the Environment**

4. **ME Watching: Death of the King of Saudi Arabia and Emerging Concerns**

5. **Russia Watching: Worsening Economic Situation and International Isolation**

Summary

1. US Watching: State of the Union Address and the Energy Issue

In his State of the Union Address, President Obama did not touch upon the plummeting oil prices and their impact. Meanwhile, drilling activities continue to decline and are starting to affect employment, although production will continue to grow this year.

2. EU Watching: China's Investments in Europe's Energy Industry

In view of the weak euro and structural transformation of the energy business, will Chinese companies ramp up their investments in the energy infrastructure of Europe?

3. China Watching: Accelerating the Comprehensive Measures for Energy and the Environment

The Xi Jinping leadership is accelerating the implementation of its comprehensive measures for energy and the environment as part of the "New Normal". China’s launch of the “Top Runner” system will positively affect Japan-China cooperation and yield business opportunities for Japanese companies.

4. ME Watching: Death of the King of Saudi Arabia and Emerging Concerns

Prince Salman succeeded to the Saudi throne. In Yemen, confusion is worsening. The murder of Japanese hostages during Prime Minister Abe's tour of the Middle East and the subsequent threat are a new challenge to Japan.

5. Russia Watching: Worsening Economic Situation and International Isolation

The Russian economy is being hit hard by the plummeting oil prices, and Russian companies are finding it increasingly difficult to obtain financing, yet the country's relationship with the West shows no sign of improvement.

1. US Watching: State of the Union Address and the Energy Issue

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The January 20 State of the Union Address by President Obama emphasized expanding domestic energy production, economic growth and jobs, and confidently announced that further job growth is expected in the manufacturing industry without insisting on the Keystone XL pipeline. He pointed to trade expansion as the policy for propping up economic growth, and called on both the Democratic Party and the GOP to pass the Trade Promotion Authority legislation needed to proceed with trade negotiations such as the TPP. The Republican chairman of the Lower House committee in charge of examining trade policies is putting top priority on trade negotiations, and is reportedly planning to visit Japan. In contrast, the Democrat minority leaders of both Houses have indicated their opposition to the Trade Policy Authority legislation, fearing that trade agreements would hurt middle-class employment and income while benefiting big business.

The President also highlighted the importance of infrastructure as a growth strategy, and called on Congress to pass long-term investment legislation. However, he did not mention the possibility of raising gas taxes as a means of funding roads. Since the beginning of 2015, several prominent lawmakers in the GOP have been quoted as saying that raising gas taxes will remain an option, while the Democrats also mentioned that the current low gasoline price provides a good opportunity to raise the tax. However, instead the President suggested tax reform to close overseas tax loopholes for businesses, and to spend part of the tax revenue on infrastructure. The GOP is resisting this proposal, with the Republican Chairman of the House Committee on Transportation commenting that the bill has little chance of being passed in 2015 as a transportation bill. As the public grows impatient with political stagnation, the President needs to prove that he can execute policies by working with the GOP. However, this is not easy given the present complex power structure and differences of opinion between Congress and the President on important policies. A reconciliation of interests is needed.

In his Address, the President also pointed out that lower gas prices and better fuel economy are reducing the fuel cost burden on households, but avoided commenting on the plunging oil prices since the summer of 2014 and its impact on domestic oil production, investment and jobs. A weekly report on the number of oil and gas drilling rigs shows that 1,633 rigs were in operation nationwide as of January 23, down 8% or 139 rigs year-on-year, the lowest since August 2010. One industry forecast estimates that the number of operating rigs will decrease by 30% in 2015 due to the slowdown in drilling activities. Nevertheless, US oil and gas production is expected to continue to grow in 2015, due to: (1) the lower break-even point for oil production due to lower drilling costs such as the rent for rigs and oil field services caused by the weakening oil market, and (2) lower production costs resulting from the wider use of re-fracking by upstream companies in existing shale gas fields as gas prices have slid since 2012, thus gaining know-how and improving the gas recovery rate.

The impact of the slowdown in drilling activities on jobs, however, is already starting to show. Since the turn of the year, Halliburton and Schlumberger, two major oil field service companies, have announced that they will shed 7,000 and 9,000 jobs, respectively, besides reports of cuts of hundreds of jobs. If the US oil industry continues to increase production without adding jobs in 2015, it is likely to face stiffer opposition to the energy policy than in the last three or four years.

2. EU Watching: China's Investments in Europe's Energy Industry

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On January 22, the European Central Bank decided to launch quantitative easing (QE) by purchasing bonds. It will purchase 60 billion euros of government bonds per month starting in March, and continue until the end of September 2016. More than one trillion euros will be newly supplied to the government bond market. This QE by Europe follows the end of QE by the US; similar to Japan where the yen is weakening against the dollar, the euro is also likely to weaken against the dollar.

Meanwhile, in Europe's electricity market, the rapid growth of renewable electricity driven by the FIT system is forcing conventional power plants including thermal power to close. Hit also by falling demand for electricity due to recession, power companies are continuing to struggle. Accordingly, Germany's largest power company, E.ON, has announced a drastic business restructuring plan. It will unbundle its core businesses of nuclear, coal, hydropower and gas departments into a new company, and E.ON itself will focus on renewable energies, operation of Germany's domestic transmission network, and customer services. E.ON is thus transforming itself into an entirely new company. Similar pressure on the energy industry to restructure is likely to intensify.

If the weaker euro and business restructuring proceed concurrently, China could strengthen its presence in Europe's energy industry in 2015. Chinese companies tend to prefer investing in infrastructure, as evidenced by the purchase of a 21.35% stake in Portugal's largest power company EDP by China's state-owned power company CTG in 2011 for 2.7 billion euros (380 billion yen). Further, State Grid Corporation of China has purchased a 25% stake in a transmission and distribution pipeline company, REN, for 390 million euros (54 billion yen). China's investments have so far focused on countries in need of financial reconstruction, but could in the future spread to the transmission infrastructure and power generation assets of major European countries such as Germany and the UK. While Europe is aiming to increase the use of renewable energies, this does not mean that thermal power will be phased out, as it is essential for stabilizing the grid and as a backup. Further, the recent fall in oil prices provides an excellent opportunity for Europe's thermal power to increase its low utilization rate and regain competitiveness, and hopefully deliver profits to buyers.

The energy industry is being liberalized in Europe, particularly in the UK, and it is no longer uncommon for energy infrastructure to be owned by another country. However, most buyers of foreign infrastructure have been Western companies who share the same set of values. If China, a country with a different social system, steps up its investments in Europe's energy infrastructure, it will truly test Europe’s commitment to liberalizing its energy industry. The developments must be closely monitored, as they may affect the future of Japan's energy system reforms.

3. China Watching: Accelerating the Comprehensive Measures for Energy and the Environment

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On January 20, China's National Bureau of Statistics announced that the country's GDP growth rate in 2014 was 7.4%, the lowest in 24 years. Meanwhile, energy-GDP intensity fell 4.8%, the largest drop since 2009. The primary energy consumption is yet to be announced officially, but can be estimated based on the GDP growth rate and energy-GDP intensity at 3.84 billion tonnes (standard coal-equivalent, 1 t = 7×10^6 kcal), up 2.2%. Compared to the government target, the GDP growth rate fell short by just 0.1 point while the reducing rate of energy- GDP intensity exceeded it by 0.9 points, and the primary energy consumption decreased by 40 million tonnes. The New Normal is appearing not only in economic development, but now also in the energy area.

Aspiring to establish the New Normal, the Xi Jinping leadership is accelerating its comprehensive measures for energy and the environment under the slogan "energy revolution" (see the November 2014 issue of this Newsletter).

The most remarkable move was that the energy-related tax system reforms were immediately brought forward as the fossil fuel market stagnated and international oil prices plummeted. The falling oil price brings great benefits to China, which imported 308 million tonnes of oil in 2014. Meanwhile, the consequences of the price drop are mixed for oil production and energy conservation, as it could accelerate cuts in production at high-cost oil fields such as Daqing, delay oil consumption reductions derived from energy conservation and oil substituting. Faced with this situation, on January 13 the government raised the consumption tax on petroleum products for the third time following November 29 and December 13 last year. The tax rate was raised by 52% for gasoline from 1 yuan (approx. 20 yen) to 1.52 yuan, and by 50% for diesel oil from 0.8 yuan to 1.2 yuan. Consequently, despite falling oil prices, the gasoline price (Beijing, highest price for No. 90) dropped only 10.3% from 6.07 yuan/liter before the tax raise to 5.44 yuan. Meanwhile, the tax hike will at least generate additional revenues of 148 billion yuan (based on consumption for 2013) from just these two oil products alone, which will be used solely for funding pollution and global warming countermeasures, energy conservation and the promotion of new energy vehicles. For coal, the various municipal surcharges and taxes were unified into a resource tax, and the tax system was switched from a specific tariff to an ad valorem duty. To address the prolonged weak demand in the coal market in the future, this reform attaches more weight to maintaining the coal industry rather than securing funds. For instance, for Shanxi Province, China's greatest coal-producing area, the corporate tax burden was lowered from an estimated 14.6% to 8%. In addition, import duties were raised to discourage coal imports.

The government also launched the long-awaited reforms of the power grid. In Shenzhen, where a pilot project is being implemented, from January 1 the revenue system was switched from the conventional "sale-purchase price difference" (difference by subtracting the purchasing price from the sale price of electricity) to a new transmission fee determined based on the "government-determined cost + appropriate profit margin". The transmission fee, currently 155.8 yuan per 1 MWh, is estimated to fall to 143.5 yuan this year, 143.3 yuan in 2016, and 142.8 yuan in 2017.

Meanwhile, the highlight of institutional reforms is the introduction of China’s version of the Top Runner system starting this year, based on the successful experience in Japan and the national circumstances in China. The system will be applied not only to home appliances such as air-conditioners but also to energy-intensive industries such as thermal power generation, steel manufacturing and cement, as well as public institutions such as schools and hospitals. The names of Top Runner products, companies and other organizations will be announced. The launch of this system is expected to offer big business opportunities for Japanese companies whose products are highly energy efficient, and to encourage Japan-China cooperation on the field related energy and environment.

4. ME Watching: Demise of King of Abdullah and Emerging Concerns

Koichiro Tanaka, Managing Director &
President of JIME Center

On January 23, Saudi Arabia's King Abdullah died at age 91, after reports of deteriorating health since the beginning of the year. Prince Salman succeeded to the throne as the seventh king of Saudi Arabia, and Prince Muqrin became the new crown prince, as expected. Meanwhile, Interior Minister Prince Muhammad, the son of former Interior Minister Nayef, became Deputy Crown Prince, marking the start of succession to the throne by the third generation of the dynasty. As the Middle East and the Persian Gulf Region closely watch the progress of the nuclear talks with Iran and are shaken by the ISIS situation, the world is waiting to see the actions of the new leadership of Saudi Arabia, which has taken a firm stance on the oil strategy in OPEC and is willing to risk low oil prices if needed, and the country's counterterrorist policies which are a pressing issue. The new King has already embarked on an aggressive reshuffle of the cabinet which is an indication that significant policy changes may follow. With international oil prices dropping to the 40 dollar range, even the Gulf Countries face slow growth in 2015 and are starting to feel the consequences.

In Yemen, where the conflict between the government, the southern separatists and Al-Qaeda in the Arabian Peninsula (AQAP) continues, the dissident Houthis began to step up military pressure on the capital Sana'a, resulting in the resignation of President Hadi. This means the failure of the mediation by the GCC led by Saudi Arabia in 2012, which ended the 33-year rule of former President Saleh. The de facto seizure of power by the Houthis, who are considered to be close to Iran, is causing concern among Sunni Arab States and will alarm the Saudi government, in particular, which is wary of threats on its southern border. This is likely to fuel Saudi Arabia's distrust toward Iran.

Prime Minister Abe visited four Middle East countries with an economic delegation, and delivered a speech on Japan's Middle East Policy in Cairo, Egypt, where he promised aid worth 2.5 billion dollars to Middle East countries that are directly threatened by radicalism, particularly ISIS. Israel, one of the Prime Minister's destinations, launched a cross-border attack on the Syrian side of Golan Heights, and assassinated Hezbollah commanders along with a former commander of the Iranian Revolutionary Guard who had been in Syria. Hezbollah, which announced its readiness to retaliate anywhere and at any time, subsequently launched several rocket attacks against Israeli positions in Sheba farms. However, international attention immediately shifted from Hezbollah to ISIS when the latter group demanded a ransom for two Japanese hostages who had gone missing in Syria.

Following the terrorist gun attack on the French satirical magazine *Charlie Hebdo*, the Middle East countries are divided between condemnation of radicalists who resort to violence, and indignation over blasphemy against Islam and other faiths under the cover of freedom of speech and expression. US President Obama proclaimed in his State of the Union Address that the military operation by the Coalition Forces is stopping the expansion of ISIS, but in reality the war is at a stalemate. The President acknowledged that the future of the nuclear negotiations with Iran is uncertain, but indicated his intention to veto Congress' bill for stronger sanctions which could hamper the negotiations.

5. Russia Watching: Worsening Economic Situation and International Isolation

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According to Russia's energy ministry, the country's crude oil production for 2014 (including NGL and condensate) was 10.58 million bbl/day, the highest since the fall of the Soviet Union. Nevertheless, falling oil prices are starting to seriously damage the Russian economy, as oil accounts for the majority of exports. This, combined with the economic sanctions by the West over the Ukraine crisis, is rubbing salt into Russia's wounded economy.

On January 16, rating agency Moody’s Investors Service announced a downgrade of Russia's government bonds from "Baa2" to "Baa3", just one level above "unsuitable for investment". In January, the World Bank and IMF estimated the country's real GDP growth rate at minus 2.9% and minus 3.0%, respectively. The European Bank for Reconstruction and Development has expressed an even tougher view, cutting its forecast from minus 0.2% (as of September 2014) to minus 4.8%.

With foreign reserves of 385.7 billion dollars (including gold, as of end 2014), the Reserve Fund of 88.9 billion dollars as a buffer against sudden oil price drops, and the National Welfare Fund for domestic infrastructure of 88 billion dollars (both as of December 1, 2014), Russia is not likely to default on its debt in the near term as it did in August 1998. However, Finance Minister Anton Siluanov warns that if oil prices remain in the $50/bbl range, the country's revenue for 2015 will be 45 billion dollars less than at $100/bbl, and the national treasury could run out by 2017.

Last December, the Russian government spent 1 trillion roubles (16.7 billion dollars, $1 = 60 Rb) to bail out the country's finances, including 100 billion roubles for its foreign trade bank VTB, in addition to spending 39.95 billion roubles from the national welfare fund for purchasing preferred stock of Gazprombank. Unless oil prices recover, major cuts in national spending will be inevitable. How long can the government continue to support Russian corporations which can no longer obtain financing on international markets due to the West's sanctions? The government is running out of time.

As President Putin continues to confront the West, domestic public opinion is starting to waver. Some see a split in public opinion, in which more than 70% of the population reportedly support the Western conspiracy theory, which the President emphasizes, while others acknowledge fundamental problems rest in Russia, including its domestic economic system. Currently, about 80% of the population are pessimistic and think that the economic crisis will continue.

In response to the terrorist attacks in Paris on January 7, at the EU Foreign Ministers' meeting held on the 19th in Brussels, High Representative of the Union Federica Mogherini tried to initiate discussions on reconsidering the sanctions against Russia, but was rebuffed by strong opposition from the UK and other countries; her attempt to solve the stalemate with Russia in the name of counterterrorism failed. Russia's sense of isolation from the West is likely to exacerbate. Meanwhile, Japan must be extremely careful in its relationship with Russia and consider its responsibility for international cooperation as a G7 member.

Past IEEJ Events

Energy Indicators of Japan

IEEJ Homepage Top

Back Numbers of *IEEJ e-Newsletter*

Back Numbers of *IEEJ Newsletter* (Original Japanese Version - Members Only)