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Goodbye Iran, Hello Iraq: Japan's and China's Oil Prospects in the Balance

Hisane MASAKI

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By Hisane MASAKI

Fresh from a serious setback in Iran, where it lost its controlling stake in the huge Azadegan oilfield, Japan has launched diplomatic efforts in earnest to secure petroleum in neighboring Iraq.

Recently, Tokyo invited Iraqi Oil Minister Hussain al-Shahristani to Japan and they issued a joint communique pledging Japanese assistance for improvements to the oil and gas infrastructure in the war-torn country. Japan specifically pledged loans of about 20 billion yen (US$170 million) to Iraq as part of the $3.5 billion aid package already committed.

Iraq is believed to have the world's third-largest oil reserves, after Saudi Arabia and Iran. Despite its huge potential, however, the country is relatively unexplored after years of sanctions and war. Only a quarter of its 80 discovered fields are pumping oil at present. By extending loans and increasing involvement in the reconstruction process, Tokyo is hoping it can acquire a good share of these massive oil reserves.

Japan imports almost all of its oil, and nearly 90% of that comes from the Middle East. In a significant setback for its energy-security policy, Japan agreed in October to give up its controlling interest in Iran's massive Azadegan oilfield - one of the world's largest, with an estimated 26 billion barrels of reserves - amid international tensions over Tehran's nuclear program.

After sustained discussions on the topic, Japan's Inpex Corp and Iran's National Iranian Oil Co reached a basic agreement reducing the Japanese developer's stake in the southwestern oilfield to 10%, down from 75%. Inpex is also to renounce its status as the operator. This development jeopardizes the Japanese government's aim of ensuring energy security through Japanese-own companies' increased foreign output.

At present, Iraqi oil accounts for a minuscule percentage of Japan's imports. To expand this, Japan is eying at least three Iraqi fields, including the giant East Baghdad oilfield, which has an estimated 18 billion barrels of reserves. The two other fields are Gharraf and Tuba, both in southern Iraq.

The Gharraf and Tuba fields have proven oil reserves of 1.1 billion and 1.5 billion barrels, respectively. Since returning to Baghdad, the Iraqi oil minister said Japanese firms have also shown an interest in the Nassiriya oilfield, in southern Iraq, which has proven oil reserves of between 2 billion and 2.6 billion barrels.

Meanwhile, two Tokyo-backed oil developers - Arabian Oil Co and the Japan Petroleum Exploration Co (JAPEX) - recently renewed, for another year, their respective agreements with the Iraqi Oil Ministry to provide technological assistance, hoping to secure a share of Iraq’s oil wealth in future.

Iraqi Oil Minister Hussain al-Shahristani during a news conference at the Foreign Correspondents
Club in Tokyo October 24, 2006.

Iraqi Oil Minister Shahristani's Asia-Pacific tour also took him to Australia and China. China and Japan are, respectively, the world's second- and third-largest oil consumers, after the US. In a report issued early this year, the government-affiliated Japan External Trade Organization (JETRO) warned of an ever-intensifying global competition for oil and gas. The report said China's oil consumption will nearly double by 2020 from the current level.

The setback in Iran came at an awkward time for Japan, which launched its New National Energy Strategy in late May. The new strategy sets specific goals to ensure the nation's long term energy security. In addition to importing almost all of its oil, Japan is the world's largest importer of liquefied natural gas (LNG). The new strategy reflects strong concerns about energy security amid high oil prices and an intensifying global rush for oil, gas and other resources, led by China and India.

The New National Energy Strategy calls for increasing the ratio of "Hinomaru oil" - oil developed and imported by Japanese companies - from 15% to 40% of total imports by 2030. But the draconian cut in Inpex Corp's stake in the Azadegan project has made this ambitious goal even more difficult to achieve.

Japan's invitation of the Iraqi oil minister came only two weeks after Inpex Corp was pushed out of the driver's seat in the Azadegan project in Iran, underscoring Tokyo’s desperation in wooing Baghdad.

Although Japan withdrew its troops from Iraq in the summer, it plays an active role in Iraq's reconstruction. Tokyo hopes its generous aid pledges - $5 billion of which $1.5 billion is in grants and the remaining $3.5 billion in soft loans - will be rewarded with access to Iraq's extensive oil reserves.

Japan's aid is the largest by any single nation, except the United States. The $1.5 billion portion has already been disbursed, and the $3.5 billion soft loan is to be fully allocated by the end of 2007, with the focus likely to be on energy-sector developments.

Shahristani met with Japanese Minister of Economy, Trade and Industry Amari Akira and other officials in Tokyo. The Japanese side specified that about 20 billion yen ($170 million) in loans would be spent on upgrading an oil refinery and working on a fertilizer plant near the southern port city of Basra. The repayment period for these soft loans is 40 years and they carry a concessional interest rate of 0.75%. Japan and Iraq also agreed to hold energy talks at least once a year.

Japanese investment

"The oil industry is important for the reconstruction of Iraq," the Iraqi minister told Amari. "But investment is not sufficient," he continued. "We would like Japanese companies as well as Japanese official loans to come to Iraq. [We are] not short of funds [now]" thanks to recent high oil prices, but the country hopes to start "major construction [of oil facilities] next year, and we will need more funds", Shahristani said.

The two countries issued a joint statement calling for Japanese companies to work in Iraq's oil- and natural-gas-development projects. "Both sides welcomed that Japanese corporations have the intention to keep performing activities which aim at obtaining a secure energy supply, and contributing to the development of the oil and gas fields in Iraq in a positive way," the statement said.

The statement confirmed that "it is essential to explore Iraq's oil and natural-gas reserves … as well as to restore and expand Iraq's existing facilities and to develop related industry in the sector, in order to reconstruct Iraq".

Iraq's oil production rose to 2.5 million barrels per day (mbpd) in June, and Shahristani noted at the time that this was to increase to 2.7mbpd by the end of the year. Before the war, output was about 3mbpd, peaking at a record of 3.5mbpd.

In Australia en route to Tokyo, Shahristani expressed his confidence again that international investment would help Iraq more than double its oil output to 6mbpd by 2012-14. In Tokyo, he said Iraq hopes to export more than 4mbpd by 2010. "We are determined to go beyond that to 6 million [bpd] by cooperating with foreign companies," he said.

He said the oil sector, which accounts for about 70% of Iraq's gross domestic product (GDP) and 90% of its national income, would receive a boost after a new hydrocarbon law expected by the end of the year that will provide further guarantees for foreign investors.

Asia is seen as a major target market for Iraq once production and exports are increased. "Our increased production will be for the Asian markets," he said.

Security concerns

It is clear that Japan is interested in increasing its profile in Iraq's energy sector, but the main obstacle to ramping up investment remains the endemic violence that persists in the Middle Eastern country. While Tokyo's calls for the domestic private sector to pump more money into overseas oil and gas projects, investment in Iraq will be difficult as violence is unlikely to cease anytime soon.

Iraq's security condition is deteriorating.

Shahristani acknowledged that if it were not for the increasingly frequent attacks by saboteurs on northern pipelines, Iraq could be shipping about 400,000bpd more in crude-oil exports. "The pipeline that takes the oil through Turkey has been attacked more viciously in recent months," he said. "We are talking with the minister of defense to provide better protection."

China in Iraq

In addition to security concerns, Japanese officials and analysts worry that countries such as China might have an edge over Japan in gaining access to Iraq's energy resources, since it has more experience operating in inhospitable environments such as Sudan and Angola.

In fact, the new government in Baghdad has courted Beijing because Chinese producers have been willing to invest in countries that are considered dangerous or politically isolated. Beijing had previously been thought to be out of the running for major contracts in postwar Iraq, with the best deals going to the United States and its allies. But the upsurge in violence there has made the country less attractive to Western producers.

In Beijing, Shahristani and Chinese officials agreed to revive a 1997 deal worth $1.2 billion signed by China and Saddam Hussein's government to develop the al-Ahdab oilfield. Saddam awarded Al-Ahdab, with an estimated development cost of $700 million, to China National Petroleum Corp and Chinese state arms manufacturer Norinco. The deal was frozen by international sanctions and then Saddam's overthrow.

China’s aggressiveness

Meanwhile, in the latest development that highlighted China’s growing clout in Africa, Chinese and African leaders ended an unprecedented summit in Beijing on Nov. 5, signing deals worth $1.9 billion and pledging to boost trade and development between the world's fastest-growing economy and its poorest continent.

Chinese and African leaders held an unprecedented summit
in Beijing in early November.

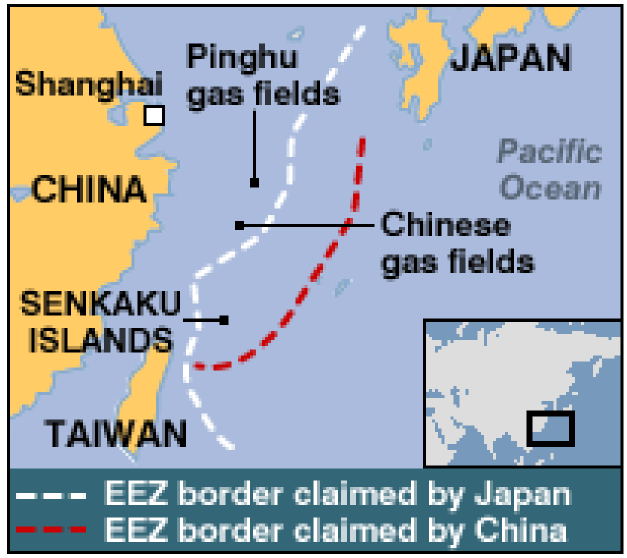
Chinese President Hu Jintao told the Forum on China-Africa Cooperation that China will double its aid to Africa from its 2006 level by 2009, although he gave no figures. Hu also promised the provision of $3 billion in preferential loans and $2 billion in export credits over the next three years and the establishment of a $5 billion fund to encourage Chinese investment in Africa. These pledges are part of Beijing's strenuous efforts to strengthen ties with Africa as it continues its aggressive search for new oil and other energy sources and export markets.

Human rights activists accuse China of supporting governments such as those in Sudan and Zimbabwe that are accused of chronic abuses. Critics say that Beijing's aggressive foray into Africa is driven by self-interest and that it is prepared to ignore political, environmental and humanitarian considerations in its aggressive search for energy resources. They contend that oil wealth could entrench corruption in countries whose elites control natural resources.

Competition for gas

Concerns about tougher competition for natural-gas supplies in the medium and long term are also growing in Japan as many countries, led by China, step up liquefied natural gas purchases.

China began to import LNG in May. The LNG shipment to China came from Australia. China's LNG imports have also come at a time when Japan and China - the two Asian giants - are locked in the simmering territorial dispute over gas resources in the East China Sea. Japan is now the world's largest LNG importer, accounting for more than 40% of total global imports. But China is expected to catch up with and possibly overtake Japan as the world's largest LNG importer in 2020.



Japan and China are locked in a dispute over gas reserves in the East China Sea.

Malaysian national oil company Petroliam Nasional Bhd (Petronas) at the end of October announced a deal to supply LNG to Shanghai for 25 years, starting in 2009. In other recent developments, China National Offshore Oil Corp (Cnooc) signed frameworks with Suez SA, Total SA and Shell Eastern Trading Ltd to buy spot shipments of LNG to make up for any supply shortfalls.

ExxonMobil Corp also reached a preliminary agreement recently to sell natural gas from the Sakhalin-1 oil and gas project in Russia's Far East to China – rather than Japan as originally planned. That deal faces hurdles, however, including the economics of building a very long pipeline and getting the cooperation of OAO Gazprom, Russia's natural-gas-distribution monopoly.

Other participants in the Sakhalin-1 project include Tokyo-based Sakhalin Oil and Gas Development Co (SODECO), jointly owned by the Japanese government and private sector, and Russia's state-owned oil firm Rosneft. SODECO has a 30% interest in the project, while the Russian firm has a 20% stake. ExxonMobil holds the right to decide which parties receive natural-gas exports.

Japan purchased 58 million tons of LNG 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 in order to increase availability of fuel for domestic industries amid decreasing natural gas and oil production at home.

Despite being a member of the Organization of Petroleum Exporting Countries (OPEC), Indonesia became a net importer of crude oil in 2004. Qatar is expected to replace Indonesia as the world's largest LNG exporter in 2010.

Meanwhile, China's Cnooc recently finalized a deal to buy LNG from the Indonesian Tangguh gas project for its LNG terminal in the coastal province of Fujian. The Tangguh project, under the operation of BP, is set to supply 2.6 mm tons of LNG annually for 25 years to the Fujian terminal starting from 2009. The Tangguh project, located in Papua of Indonesia, is scheduled to come on stream by late 2008, drawing gas supplies from six fields in the Bintuni area. CNOOC is the first company to sign a supply and purchase agreement with the project.

The report by JETRO, released early this year, predicted that the percentage of oil as an energy source will level off in China at about 26% by 2020 while that of gas will sharply grow to nearly 9% with increased imports from Indonesia and Russia.

As China - and to a lesser extent India - demonstrates a willingness to pay higher prices to ensure gas supplies, producers are likely to push ahead. Still, most industry observers expect the Asian LNG market to remain tight in coming years, keeping prices high.

Hisane Masaki is a Tokyo-based journalist, commentator and scholar on international politics and economy. This is an updated and slightly expanded version of an article that originally appeared in Asia Times. Posted on Japan Focus, Nov. 13, 2006.