



## Siberian Nights: The East Siberia-Pacific Ocean Oil Pipeline

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*This is a guest post by Matt Stone. Matt is a student of international studies and economics at the University of Arizona, where he is finishing up his honors thesis on the geopolitical ramifications of the East Siberia - Pacific Ocean (VSTO) oil pipeline. Last year, he lived in Irkutsk and Vladivostok, Russia - roughly the two endpoints of VSTO. A 2007 Marshall Scholar, Stone will study next fall for a MSc in energy economics at the University of Dundee. He co-founded and writes for [The Global Buzz](#).*



As the 2008 Russian presidential election approaches, no one is more concerned about Russia's future policy direction than those that stand to benefit from Russia's energy largesse. In particular, China and Japan are very anxious about the final routing of the East Siberia - Pacific Ocean oil pipeline (VSTO - its Russian acronym), which is expected to be the world's longest oil pipeline (2,500 miles), originating in East Siberia at Taishet and extending to a Pacific port at Kozmino Bay. VSTO is Russia's first pipeline to East Asia, ultimately unlocking the [supposedly vast](#) oil reserves in East Siberia, an area that has been likened to the final frontier of hydrocarbons exploration. Whomever is elected (ie, appointed) president in 2008 will be the one who determines which country will benefit most from VSTO.

What makes VSTO so critical to the Chinese and Japanese is the changing energy and geopolitical landscape. In 2003, China surpassed Japan to become the world's second-largest consumer of oil. Chinese state oil companies (CNPC, Sinopec, and CNOOC) are pursuing a "going-out" strategy, where promises of Chinese investment in other sectors of a nation's economy secure guaranteed supplies of hydrocarbons, such as China's [good-will investment](#) in the Tehran subway system. The Chinese are rightfully worried about their dependence on Middle Eastern oil sources and the routes by which that oil is transported. China receives 51% of its oil from the Middle East. The vast majority of that oil is shipped through the Strait of Malacca, and therefore, is threatened by U.S. naval dominance. Thus, the Chinese are seeking to diversify their energy supply base, not only by increasing production of coal and hydropower, but by developing oil and gas pipelines with neighboring Kazakhstan and Russia.

More than any other region of the world, energy is seen in East Asia as something of a zero-sum game: Japan increasingly views China's positive gains in securing energy supplies as its own loss. Even though the Chinese still don't have a [ministry-level agency](#) to coordinate energy policy, Japan feels that it is a step behind. Eighty seven percent of Japanese oil is imported from the Middle East - an extraordinary amount that also must pass through the Strait of Malacca.

Hence VSTO begins to take on hues of geopolitical significance. While technically the routing of VSTO is not important from a market perspective (any oil purchased at world prices from VSTO by either Japan or China will simply free up oil supplies elsewhere), in light of the strategic chokepoints through which oil traverses - chokepoints that are critical to both the Chinese and Japanese economies (and subsequently, social stability in China) - Russia's ultimate decision is of paramount importance to both nations.

After years of Sino-Russian and Japanese-Russian memoranda of understanding, joint communiques, and declarations of intent, each ostensibly negating the one before, in 2005 the "final" route chosen by Moscow was the best (or worst) of both worlds. VSTO was planned to extend from Taishet to Perevoznaya Bay, just south of Vladivostok, with a branch line running from the Russian border town of Skovorodino to Daqing (Kozmino Bay would later be selected over Perevoznaya as the terminus). The road to that decision was more than circuitous.

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VSTO was originally vetted as an idea in the mid-1990s by the Yeltsin administration as a way to expand Sino-Russian economic ties. However, things didn't really get off the ground until the Putin presidency.

In May 2003, Chinese President Hu Jintao (in Moscow) signed a joint communiqué with Russian President Vladimir Putin endorsing a pipeline route from East Siberia to the Chinese oil-refining city of Daqing in Manchuria. At the same time, Yukos CEO Mikhail Khodorkovsky signed a 20-year agreement with a "Chinese state-owned oil company" (which later was reported to be CNPC) to supply China via some form of eastern oil pipeline. At the time, Yukos was viewed as the main proponent of a China-only route for any East Siberia oil pipeline. Japan was conspicuously absent from any plans.

However, during the second half of 2003, a pipeline feasibility study had still not been approved by the appropriate Russian agencies. Nezavisimaya Gazeta reported that the lack of a coherent framework for action by the Russian government was leading Russian oil companies - including Yukos - to act independently. Increasingly, it appeared that there was a behind-the-scenes struggle occurring between Yukos and Transneft, the state-owned pipeline monopoly, over the final route. Transneft, with everything to gain by constructing the longest route possible, was pushing for a pipeline to the Pacific, not China.

By October of that year, Mikhail Khodorkovsky had been arrested on charges of tax evasion and other unsanitary habits. The Chinese were miffed; their main man in Moscow was now behind bars and it appeared that the final route for VSTO was far from settled.

Furthermore, during the run-up to Khodorkovsky's arrest, the governor of Primorye, Sergei Darkin, lobbied heavily for a Pacific route - one that would clearly terminate in his home region. Darkin went to Tokyo to meet with the Japanese foreign minister, and he accused Yukos of deliberately underestimating East Siberia's resources to promote the Daqing route. In July 2003, during a meeting between Putin and Darkin, the governor urged the president to help integrate Primorye into the East Asian economy. Darkin implied that VSTO - and specifically the Pacific route - would be the perfect candidate for immediate economic integration with the region.

The momentum seemed to be turning in Japan's favor. In February 2004, Russian Deputy Foreign Minister Aleksandr Losyukov told reporters that the government was considering multiple options - presumably not mutually exclusive - and would "give priority to its own interests when selecting which option to follow." On December 31, 2004 - not two weeks after

Yuganskneftegaz was sold in a rigged auction to Baikal Finans Group and later state-controlled Rosneft - Russian Prime Minister Mikhail Fradkov approved the Transneft-endorsed route from Taishet in Siberia to Nakhodka on the Pacific coast.

A branch to China was not included in the approved plan.

But, in typical Russian teeter-totter fashion, by April 2005, the [Kurile Island dispute](#) between Russia and Japan had impeded forward progress on the pipeline plan. This hang-up was indicative of the fact that Russia was using VSTO as a bargaining chip in the Kurile Island dispute. It is important to note that a Pacific terminus would allow any country to import East Siberian crude - both China and Japan, and possibly America. Pipeline length notwithstanding, it would seem to be in Russia's interest to build to the Pacific in order to export to any number of markets rather than just one under the China plan. However, Russia wanted to use that potential route as leverage over the Japanese in its territorial claims.

That same month, the Russian government announced that the two original plans - (1) Taishet-Daqing and (2) Taishet-Nakhodka - would be integrated, thereby giving Russia leverage over both nations during the construction process. The first stage of VSTO would originate at Taishet and end at Skovorodino, a town that borders China; a branch line to Daqing would be built. The second stage would continue on from Skovorodino to Perevoznaya Bay, just south of Vladivostok. The Japanese immediately threatened to terminate funding for VSTO because the pipeline would start pumping oil to China before terminating on the Pacific.

Oil would flow to Skovorodino by 2008 and Perevoznaya by 2012. VSTO was announced to have a capacity of 1.6 million b/d, although a debate rages as to whether East Siberia has enough accessible oil reserves to fill VSTO to capacity. In July 2006, Transneft declared that Kozmino Bay, closer to Nakhodka, would be the ultimate terminus for VSTO.

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While VSTO has been the subject of much [environmental controversy](#), especially with regards to the World Heritage Site of Lake Baikal, it is its geopolitical significance that motivates the most pressing questions. Even more important, however, is what VSTO says about Russia's future policy direction in the spheres of energy and foreign relations.

Immediately clear is the fact that Russia (rightly) considers its energy resources as a strategic asset rather than a purely economic one - and consequently leverages those resources for strategic gain. But Russia also worries quite a bit about competition. When Kazakhstan's Atasu-Alashankou oil pipeline to China began pumping oil in May 2006, the Russian government hit the accelerator on VSTO construction. With Atasu-Alashankou pumping, Russian oil firm Lukoil announced its intention to ship oil via that pipeline in lieu of any Russian alternative.

A Russian alternative was clearly a strategic imperative for the Kremlin. State-controlled Rosneft plans to double its investment in the East Siberian Vankor oil field to \$1.5 billion in 2007. The company is also making noises about building an oil refinery in Nakhodka, near VSTO's terminus (a project Lukoil wants to get in on). One of Yukos's last units, Tomskneft, is slated to be sold off in a couple months' time. (Interestingly enough, Chevron is trying to reverse its bad luck in Russia by [partnering](#) with Gazpromneft, the oil-producing subsidiary of state-controlled Gazprom, to purchase Tomskneft ... Stupid or genius? I give it 80/20.) Tomskneft is actually not in East Siberia, but rather the far eastern part of West Siberia.

Here is where it gets interesting. While Tomskneft doesn't seem to be immediately important to

the success of VSTO, many analysts are predicting that East Siberia will not have enough oil to fill the pipeline, and therefore, Russia will instead "borrow" from West Siberia - adding roughly 1,250 miles to the distance of transport. According to [Leon Aron](#) of the American Enterprise Institute:

Even with all of the currently known major oilfields in eastern Siberia coming fully 'on stream' by 2015, production will be no more than 287 million barrels per year - or less than half of the planned amount.

Thus, what would cost between \$6.40 and \$9.80 per barrel in transportation costs from East Siberia, the oil being shipped from West Siberia would cost well over \$12 per barrel just for transport.

It becomes immediately clear that the Russian government doesn't view VSTO from a purely economic perspective, but rather from a political and strategic one.

What does that mean for Japan? By most indications, it increasingly appears that VSTO will not extend to the Pacific, but rather dive south via Skovorodino into China. It would not be surprising if sometime in 2008 or soon thereafter the Russian government announces that production in East Siberia does not merit an extension of VSTO to the Pacific.

Yet, at the same time, the Russian government fears being tied into a single-buyer relationship with China a la [Blue Stream](#) in Turkey. Granted, the natural gas market is fundamentally different from the oil market, but after getting burned by the Turks in 2003, the Russians are afraid of China using its monopsonistic market power to force prices down for East Siberian crude.

Can Russia sustain its energy largesse in the Far East? It would be easy to claim that Russia is on a collision course with reality - that oil prices will fall from their historic peaks in due time, that state intervention in the Russian oil, natural gas, and pipeline sectors will eventually decimate oil production increases, thereby decimating rents, thereby causing the Russian government to wake up to the fact that less state control, not more, is what is needed to infuse new vitality into the industry. But such claims are standard Western boilerplate and avoid the fundamental shifts occurring in the global oil market.

As the Chinese economy continues to grow at breakneck speeds, its people will continue to consume more and more oil. Despite all the talk of biofuels and alternative energy sources, the United States is not going to transition into a post-petroleum economy in the near or medium term. And as long as the Russian government enjoys the support of its populace as well as positive media coverage - both a near certainty - the Russian government can continue to funnel money into giant, state-sponsored industrial projects.

Moreover, we face a world where the oil majors are desperately in need of access to acreage. Less and less oil is available to the ExxonMobils of the world to develop. Thus, investors are increasingly pleased to invest in state-owned (yet inefficient) energy ventures like Gazprom and Rosneft. Capital is not hard to come by. Because of this, Russian state-controlled energy companies have little incentive to bring Western oil majors on board any major projects, thus decreasing the likelihood that these projects will be done well with the maximization of return to investment for shareholders. With the full backing of the Russian state on specific pipeline projects like VSTO, Transneft does not need to worry about the economics of any project. The subsidization of the industry - and associated diversion of resources from other, more efficient

sectors - does not stir any outrage in the Russian media. There is little reason to expect a change in the fundamental conditions that foster the corporate-energy state that Russia has become. This is a road paved with \$60+ oil and VSTO is just one of many manifestations of Russia's state-sponsored largesse.

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So.

Who wins?

**The Russian state for one.** It gets a new export market in China - and potentially other markets in East Asia. No longer will Russian oil revenues be based solely on European demand. Europe is certainly worried that Russian exports to China will either reduce Russian exports to Europe or allow Russia to threaten a cutoff like the one that occurred with Belarus this January. The first worry is a red herring: the nature of the global, fungible oil market implies that less oil exports from Russia simply means more oil imports from other regions. Furthermore, it is prohibitively expensive, even for the Russian government, to ship oil being produced west of the Urals to China.

The second concern is more reasonable. A cutoff in Russian oil exports to Europe or a threatened cutoff would cause global oil prices to spike in the same way a shutdown of the Strait of Hormuz would. Western governments must mitigate any diplomatic rows with Russia to avoid this contingency.

**China wins in some sense.** Because VSTO is viewed in China as a strategic asset as well, its completion will allow Beijing to breathe a bit easier. The Chinese fear of an energy cutoff actuated by the U.S. navy in the Strait of Malacca cannot be overstated. Diversifying their oil supplies is a significant boon. Furthermore, the Chinese can hope that in any potential conflict with the United States over Taiwan, the U.S. will avoid bombing VSTO for fear that such an action would draw Russia into the conflict (on China's side).

However, the Chinese will never achieve full energy independence or even diversify energy supplies to the extent that an energy cutoff will be entirely impossible. Thus, the onus is upon China, the United States, Russia, and other energy consumers and producers to forge a consensus enshrining the [preeminence of the market](#) as the key purveyor of energy security.

**Everyone wins.** This is less talked about but possibly the most important element of VSTO. This is not a strategic threat to the United States or Japan or the European Union. VSTO is but one way of further liberalizing the energy trade by opening new corridors of exchange. East Siberian crude would not be exported without a pipeline - even an expensive and ill-planned one like VSTO (Deutsche UFG recently estimated a total price tag of \$20 billion). Thus, the introduction of new sources of supply on world markets will only help in a time of demand outstripping supply. Indeed, even if VSTO dumps its oil into China, that will theoretically free up oil supplies elsewhere to be consumed by other nations, thereby dampening world prices.

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Given the strategic and economic nature to VSTO, Russia's vast undertaking represents the best and worst possible worlds. Like Churchill's famous utterance, it is a "puzzle wrapped inside of an enigma," jointly meeting the sovereign needs of multiple nations, but doing it in a way that is overly costly and overly politicized. Even though construction has already commenced, the

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conclusive route of VSTO is never a certainty - not until the pipeline is buried and oil is flowing.  
The Japanese and Chinese will be eagerly watching what the Russians ultimately decide to do.



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