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THE GEOPOLITICS OF ENERGY PROJECT



Pipeline Pivot:

Why Russia and China are Poised to Make Energy History

After a decade of false starts and impasses, Russia and China are on the cusp of a major energy agreement. The natural-gas deal, expected to be concluded during Russian President Vladimir Putin's visit to China starting on May 20, would have significant implications for relations between Beijing and Moscow, the European energy market, energy security in the Asia-Pacific, and even the pace of climate change.

The byzantine history and unique dimensions of this alliance are explored in a separate research report^[1]. The purpose of this policy brief is to explain the emergence of conditions that favor a breakthrough deal.

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This policy brief is based on "Booming Synergies in Sino-Russian Natural Gas Partnership: 2014 as the Propitious Year," published May 2014 by the Belfer Center for Science and International Affairs.

Introduction

Ever since the Crimean crisis, it has become commonplace to speak of a new global order, in which a declining West is giving way to an emboldened Russia tacitly supported by a complacent China. For more than two decades after the collapse of the Soviet Union, Moscow and Beijing agreed that the development of political relations had to be reinforced by improved economic relations^[2]. This corresponded closely with the increase in Sino-Russian oil trade. In 2013, Russia pledged to increase its oil export to China from the current 300,000 barrels a day to about 700,000 barrels a day. Yet a gas deal has remained elusive – until now.

Incremental agreements over the past decade have set the stage for the historic partnership. Between 2004 and October 2013, the China National Petroleum Corporation (CNPC) and Russia's Gazprom (and their governments) concluded no less than eight rounds of negotiations but did not reach a deal on actual gas deliveries. In March 2013, Gazprom and CNPC signed a memorandum of understanding for the delivery of 38 bcm of natural gas to China for 30 years starting in 2018 with the option of expanding deliveries to 60 bcm. At the beginning of September 2013, the two sides signed basic conditions for their long-term deal. The agreement terms cover the start date and volume of gas deliveries, the take-or-pay level, the amount of guaranteed payments, and the gas transfer point. Further details were settled in October, during Russian Prime Minister Dmitry Medvedev's state visit to Beijing. And as relations with the West deteriorated, Vladimir Putin resolved to exploit the Eastern Siberian gas fields deposits "as soon as possible" by looking East rather than to its traditional markets in Europe.

Past blockages

Despite this momentum, price has proved to be the main sticking point.

Until June 2013, the price gap was reportedly \$100 per 1000 cubic meters. Reports in early January 2014 suggested that Gazprom and CNPC were getting closer to agreeing on a base price, with a range of \$10-11/mmbtu^[3] at the Russian border. Industry sources have indicated that Gazprom may ease its price demands in return for billions of dollars in upfront payments. CNPC is reportedly considering an upfront payment of \$50 bl without any interest to finance the pipeline.

Price has not been the only impediment, however. Russia's resistance to China's equity investments, disagreements over the preferred route, the as of yet meager presence of natural gas in the Chinese energy mix, and enduring mistrust on both sides have all contributed to the deal's delay. It is the resolution of these other domestic conditions and energy realities on both sides – rather than the price per se – that makes the deal look so likely on May 23rd^[4].

Why the time is ripe for Russia

Four developments have converged to give Russia a strong incentive to reach an agreement.

1. The emergence of shale gas and friction with Europe

The first and most important reality shaping Russia's behavior is the crisis of its business model in Europe. The American shale revolution has provoked a gas glut in Europe, giving rise to a truly global gas market and disrupting Eurasian gas market governance. For 40 years, European energy companies and consumers were highly dependent on long-term, take-or-pay contracts with Gazprom. The rapid rise of US natural gas is giving Europeans genuine market options; many are opting out of the grip of Gazprom, which has been slow to respond. The result? Russia is looking for a new cash cow, turning its gaze East.

2. The equity stakes dilemma – two important precedents

Expanding energy trade between Russia and China depends on China's acquisition of substantial equity stakes in Russian energy projects. The Kremlin along with Gazprom has always feared that if the Chinese were to acquire a big stake in a Russian energy field, Russia's long-term geopolitical interest would be endangered. Knowing the limited possibility of overcoming mutual mistrust, China ultimately does not regard Russia as a reliable exporter and views involvement in Russia's energy upstream projects as a way to avoid relying on Russia's promises of good will. While rooted in deep-seated ambivalence, China's efforts to gain upstream are also driven by profit considerations; access to Russia's upstream would let CNPC mitigate the losses of sales on China's subsidized domestic market. Recently there have been two groundbreaking developments on this front: the Yamal LNG deal and the CNPC-Rosneft joint venture in Eastern Siberia. Significantly, both deals occurred in 2013, a year in which Russian energy-driven growth was virtually nonexistent. Earlier this year, subsequent to the Crimea crisis, a potential acquisition by CNPC of 25% of the Chayandinskoye gas field in the Sakha Republic was mentioned for the first time. If CNPC indeed proves successful in this endeavor, the likelihood of a breakthrough in the Sino-Russian gas linkage in May 2014 will be hugely increased.

3. Domestic budgetary troubles

The implications of Gazprom's deteriorating relations with many European partners – namely lower budget revenues, reduced geopolitical influence in Europe, and partial loss of status in the European energy economy – all make the deal with China extremely critical for Gazprom. And even though oil prices are well above their 2008 lows, the Russian economy hasn't rebounded. To compensate for the declining returns in Europe, rather than

enacting unpopular reforms that would impinge on the fortunes of Russia's super-wealthy and on his own fate, Putin is willing to do whatever he thinks is necessary to keep the state and the economy strong. Finding another energy market that pays seems the less disruptive and painless option. The answer is China.

4. A last-minute concession: the Eastern route

Since talks began, Russia had prioritized the Altai route to connect Eastern and Western Siberia, enable Gazprom to divert its surplus European volume to China, and increase its ability to use gas as a political bargaining tool. CNPC, aware of the dangers implied in Gazprom's arbitrage opportunities between the European and the Chinese market, has from the outset pushed for the Eastern route. In March 2013, when Xi Jinping chose Moscow as his first inaugural visit, Putin surprised everyone by expressing support for China's favored Eastern route. His concession on the Altai pipeline was a major setback for Russia's ambition to become a "swing supplier," and a significant step in China's direction.

Why the time is ripe for China

Although from a strictly bargaining position, China can comfortably afford to wait and leverage its position, four factors suggest that the political will in China to come to an agreement is very strong.

1. A projected gas shortage

Promoting natural gas is a top priority in China's Twelfth Five-Year Plan (2011-2015). China's aggressive pursuit of natural gas is being driven by Beijing's intensifying efforts to displace coal in favor of natural gas for greater environmental sustainability. However, China's ability to replicate an American-style natural gas boom appears dim. At the same time, China is set to import more gas than ever. Indeed, China's projected gas shortage is a leading factor in setting the stage for a breakthrough in Sino-Russian gas cooperation. In 2015, China's total domestic production is expected to reach 172.5 bcm (including shale gas). But total demand will exceed 230 bcm. Even with China's alternative import options (the Central Asian Republics, Myanmar, and LNG imports) as well as the potential to expand domestic production, there will be a substantial gap. Russia's gas is well suited to fill the gaps at an affordable price. On the flip side, if CNPC fails to strike a price deal with Gazprom soon, competition between Japan, Korea, and China to secure LNG supplies will intensify due to China's growing gas demand. As a result, the Asia-Pacific LNG market will tighten. This will in turn push spot prices up, which is good news for LNG producers, but not for China's government or Chinese consumers.^[5] It means that ultimately, for China, Russian gas could be cheaper than LNG from Qatar and Australia.

2. Domestic imperatives: raising prices and reducing the Asian LNG premium

China is acutely aware that additional expensive foreign gas will soon be needed to meet demand. In anticipation, the government has taken several steps toward linking the price of gas to fuel oil and LPG (liquid petroleum gas), as a way to increase domestic prices and "prepare" for additional foreign supplies. Currently, subsidized gas prices are still very low in China even compared to Chinese salaries, which means that the profit margin for Chinese NOCs^[6] at home is very thin and they have been losing a lot of money on expansive gas bought at the international markets. In short, we may be reaching a tipping point where every effort will be made to accommodate Russian supplies as quickly as possible, including a deeper gas-pricing reform.

3. Enhancing energy security

Two factors explain China's eagerness to decrease its dependence on LNG: 1) LNG is more expensive than piped gas; and 2) Beijing has a geopolitical aversion to excessive dependence on sea lanes dominated by the U.S. Navy (and on supplies coming from the unstable regions of the Middle East and East Africa). China hopes to reduce its dependence on LNG with a highly diversified supply combining gas from Central Asia, Russia, domestic shale,

and LNG – while avoiding relying excessively on one single region. China’s motivation to seek international pipeline access to its overland borders in line with its “March West”^[6] doctrine will intensify pressure to reach agreement with Russia.

4. Slow shale production

China ranks first in the world in technically recoverable shale gas reserves, estimated at 25.1 trillion cubic meters. But will China use its bountiful reserves? Two scenarios are likely – one positive and one negative-with Russia at the center of both. In the case of the former, the specter of a Chinese shale gas revolution is already spurring Sino-Russian gas cooperation. In the latter case, in which China’s shale revolution fails to materialize over the next decade, Russia becomes an essential partner to fill China’s gaps.

Ukraine: collaboration toward a New World Order?

The Ukraine crisis, too, works in favor of a deepening Sino-Russian gas relationship. As a result of Russia’s stand-off with the West, Russia may be more willing to compromise on the gas price, with China boosting its leverage. Although China has not explicitly taken Russia’s side, Russian’s annexation of Crimea has already been playing into China’s hands. While Putin remains distracted in Ukraine, China can use this moment to cement influence in Central Asia. Moreover, Obama’s pivot to Asia will suffer as a result of Ukraine, another clear win for Beijing. Western sanctions imposed on Russia have boosted both China’s negotiating position and the likelihood of a deal, as Russia is increasingly desperate to look for gas markets outside Europe.

Contours of a potential deal

Russia’s need for new customers means that it will insist on a deal, even if that means being more flexible on the price. Gazprom is hoping for a price of \$10-\$11/mmbtu from China. China is believed to pay \$9/mmbtu to Turkmenistan. Industry sources have indicated that Gazprom may ease its price demands in return for billions of dollars in upfront payments. In practice, CNPC is considering an upfront payment of \$50 bl without any interest to finance the pipeline. Gazprom is aware that accepting a loan of this magnitude will most likely only occur in exchange for equity in (particularly) the upstream part of the project. Politically, it is important for Putin to show that “the Great Russia” is back on the international scene and that it has other, non-Western options to restore its rightful place.

Looking ahead: global policy implications

The most conspicuous long-term impact of a Sino-Russian gas deal will be on global climate change. Progress in combating climate change depends on a rebalancing of China’s energy mix. The more China can shift its energy consumption from coal to cleaner natural gas, the better.

Conventional wisdom holds that a potential Sino-Russian deal could raise the impulse on both sides to form a robust Eurasian continental energy-centered entente. However, the potential emergence of such an alliance is unlikely for two crucial reasons. First, the prospects of a Russia-China consortium outside of energy are not particularly strong, unless they are set on specific issues, like Syria. Second, even as the potential for Sino-Russian gas cooperation grows, their rivalry remains conspicuous as Russia worries about Chinese naval intentions in the northern Pacific and Arctic region. China is wary that new clients, such as Vietnam and the Philippines, have become loyal buyers of Russian weaponry. In addition, Russia does not support China’s extensive maritime claims in the South China Sea. With Moscow increasingly balancing China’s presence in East Asia, there is neither the commitment nor the ability to act in concert against Western interests. The driver of Sino-Russian energy cooperation is emphatically economic benefit, not a desire to counterbalance American global influence.

Notes

- [1] This piece draws on my study Booming synergies in Sino-Russian Natural Gas Partnership: 2014 as the propitious year that will be published by The Geopolitics of Energy Project at the Belfer Center for Science and International Affairs at Harvard's Kennedy School.
- [2] For example, total trade between Russia and China has grown from 6,181 billion \$ in 2000 to 78,031 in 2011 and trade volume is expected to hit 100 billion U.S. dollars in 2014.
- [3] million British thermal units
- [4] Putin is visiting May 20-23 but observers expect a deal to be announced on May 23rd
- [5] If we look at the global growth in LNG in the last few years, China seems to have a lot of more options. Directly or indirectly, if we factor in East Africa and the East Mediterranean, overall there will be more competition in the LNG market. However, the rate of gas demand growth in China will most likely outpace new increases in LNG supply. For example, high costs of liquefaction and shipping in East Mediterranean gas make investors hesitant. East Africa's LNG supplies are expected to come on stream no earlier than 2020. In line with the tightening market, new producers will be able to exploit a gap in global supply that is expected to open up by 2020. However the price will inevitably increase, which means that for China a gas pipeline from Russia will be the cheapest new option.
- [6] National Oil Companies
- [7] Wang Jisi, China's most prominent and influential international relations scholar articulated the strategy in 2012. As Washington rebalances to Asia, the relation between the U.S. and China has become increasingly contentious and "zero-sum." If China continues to push forward in the Asia-Pacific, Beijing sees more problems, even a possible head-on military confrontation with the U.S. In comparison, the region to the west of China, including Central Asia, South Asia and the Middle East, bears no such risks.

For the full paper, see:

<http://belfercenter.org/RussoSinoGas>