

Energy Cooperation Between China and Russia: Uncertainty and Prospect of Development

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Abstract

This article considers the burgeoning natural gas alliance between Russia and China. It suggests that the two countries are committed to developing their cooperation on constructing new pipelines and expanding their energy trade relationship. However, some challenges still remain. They must also manage the impact of the decline in international oil prices, and work out how best to coordinate their energy cooperation within China's "one belt and one road" strategy.

On November 9, 2014, China National Petroleum Corp (CNPC) and Gazprom signed a new Memorandum of Understanding (MoU) about the supply of natural gas from Russia to China. Gazprom has committed to supplying 30 billion cubic meters per year (bcm/y) for 30 years from Western Siberia to North-western China through the proposed Altai pipeline (we will refer to this pipeline as the Western route), with a notional start date of 2019. This new memorandum comes in the wake of the agreement signed in May, 2014 on gas supplies along the so called Eastern Route, and which was hailed as a sign of the new level of Sino–Russian natural gas cooperation. Additionally, the CNPC also signed an agreement with Rosneft on the so-called Oil Cooperative project for the Vankor Oil Field in Eastern Siberia. With this agreement, the two sides have demonstrated their intension to cooperate on the exploration of this oil field, and at Russia's invitation, the CNPC has pledged to purchase a 10 per cent stake in the field from Rosneft; the agreement also sets in place the principles for trade between the two parties. It thus seems that China and Russia are entering into a new "natural gas cooperation alliance". In the context of the decline of the international crude oil price, alongside Western sanctions on Russia, some important questions have arisen: How will Chinese–Russian energy cooperation develop in this context? What will be the impact of such cooperation? And is there any uncertainty about the future implementation of these energy agreements?

Quality and Uncertainty of the Natural Gas Pipelines Along the Eastern and Western Routes

At the present time, China and Russia have different attitudes toward, and judgments on, the expectations, implementation and international environment with regard to the two routes.

First, the legal status of the two projects is quite different. As has been publicized, the protocol on the Western route is only an agreement, specifying the amount,

time-limit and routes of gas supply. It is not a contract that is legally binding. The protocol on the Eastern route, signed in May 2014, is, however, a formal contract, which confirms and guarantees the future implementation of the project, and outlines both parties' legal responsibility for its implementation. This is a fundamental difference to the protocol on the Western route.

Second, Chinese and Russian expectations about and prioritization of the two routes are different. Generally speaking, the Chinese side is more interested in the Eastern Route, while Russia is more interested in the Western one. In terms of the volume of supply, the Eastern Route will render 38 bcm/y, and a supply contract has been agreed for 30 years. Although many details of the supply contract have not been finalized yet—such as financing and advanced payment—the gas supply for the Eastern Route is guaranteed by the fact that all of this volume will come from the gas reserves from a new gas field in Siberia. By comparison, the protocol agreed on the Western route is nothing other than a framework agreement, with many uncertainties unresolved as to its future implementation and viability.

For the Russian side, however, the construction of the Western route pipeline is expected to bring more profit than the Eastern route. Since Western Siberia is a place rich in matured gas fields and shelves, and—given the country's mining capacity—the construction of a single pipeline would be sufficient for the task of supplying the agreed volume of gas. On the contrary, the construction of the Eastern route requires the exploitation of the Chayanda and Kovykta gas fields in Eastern Siberia—an undertaking that will require a significant amount of investment. This is pushing Russia to turn to the Western Route. At the present time, with the Russian economy facing a downturn owing to the sanctions applied by the West in response to the Ukraine crisis, the Western Route—as compared to the Eastern Route—seems preferable, as it requires less investment and a shorter time-frame for construction, and is thus expected to realize a stable cash flow quicker by exporting natural gas to China faster.

However, in a buyer's market the buyer is always keen on diversifying the sources of its imports. China's western provinces have already begun to import gas from Central Asia, and the import of Russian gas into western China via the Western route would not only impact on the current China–Central Asia gas trade structure and make China more dependent on a single supplier, but it would also increase pressure on the transportation capacity of “the West to East” gas pipeline network for delivering much needed energy to eastern China. Considering that both the center-of-economic-gravity and greatest market demand lie in the eastern part of China, there is no urgent need for China to build the Western route pipeline. In the meantime, Northeastern China is currently lacking LNG (Liquefied Natural Gas) import equipment and facilities, and thus Beijing would like to give priority to the construction of the Eastern route pipeline.

Generally speaking, then, both Russia and China have their own respective advantages to use within their negotiations over their energy cooperation: Russia is able to push for high pricing based on its abundance of energy resources; while China can also leverage significant pricing-power because of the huge market opportunities it can offer exporters, and because of its alternative existing gas supply arrangements with Central Asia (including LNG) and the exploitation of its own natural gas fields.

The Decline of the International Oil Price and Its Impact on Energy Cooperation Between China and Russia

In 2013, revenues from oil and gas exports accounted for 68% of Russia's total export revenues. According to Russia's financial forecast for 2014, oil and gas was expected to account for 48% of the total export revenue. Morgan Stanley has estimated that should the price of crude oil fall by \$10/cubic meter this equates to a loss of \$32.4 billion in oil and gas revenue for Russia, which would represent 1.6% of Russia's GDP. Calculating by this ratio, Russia's GDP for the last few months of 2014 suffered a loss of around 4.8% as result of the decline in oil prices, which equates to a \$60 billion decline in the government's budget revenues. Recently, the Russian federal government submitted a draft budget for 2015 to parliament, stating that the governmental budget can only be balanced if the international oil prices returns to \$96 per barrel or above.

Meanwhile, the decline in the price of crude oil has reduced the cost of raw materials for Chinese manufacturers, enlarging their gross profit as a result, with the first batch of such beneficiaries likely to include companies dealing with aviation, cruises, consumer goods,

shipping and manufacturing. However, the decline in global oil prices is not likely to be a long-term trend, and Chinese enterprises should continue to extend overseas business by investing in the upstream industry abroad. In addition, the fall in oil prices will stimulate the depreciation of other energy prices, such as iron, ore and coal, which means that the cost of economic operations will also be reduced. The decline in international oil prices has led to reduced investment in oil production and pipeline construction worldwide, which is unfavorable for Chinese companies seeking to pursue a “going out” strategy, especially for those focused on the Russian mining business. Therefore, Chinese oil or gas companies should take measures to maximize profit based on their respective conditions in face of the current downward trend of international oil prices that is expected to last in the near future.

Historically, China has lacked a mechanism for anticipating energy price fluctuation, as well as substantive oil storage facilities. In July 2008, the international oil price soared to \$140/barrel and China misjudged this pricing trend. It believed that the price would keep rising as oil was considered a non-sustainable source of energy. As a result, when it then sharply fell, China lost a lot of foreign reserves, and as a result of the depreciation of the dollar (the currency in which oil is traded) during the past 10 years and China's huge investment in the government bonds issued by Western countries, much of these losses will never be recouped. Taking this into account, China can benefit from Russia's experience in early forecasting of critical moments in the trajectory of international price of oil.

In the current period of low oil prices, China has gained more influence within the international market as the largest buyer of oil and gas products. The next stage for China–Russia negotiations, in our opinion, is for Russia to take a more positive approach towards the construction of the Eastern route pipeline, paying particular attention to matters such as prepayments and cooperation modes. Considering that China has been a loyal partner within the Sino–Russian strategic cooperative partnership, energy cooperation between China and Russia is very unlikely to come to a stop in the near future due to any minor disputes. Indeed, China does not want to exclude the possibility of further cooperation with Russia in the exploration of energy resources in the Arctic region and the deep-processing of such energy products. While for Russian energy enterprises, the huge investment capital available via the Chinese-driven and supported Silk Road Fund—created last year to support connectivity across Asia and Eurasia—offers significant opportunities to realize the “dream” of Russian revival.

How to Promote the Sino–Russian Energy Cooperation Along the Silk Road Economic Belt

Russia largely holds a positive attitude towards China's "one belt and one road" proposal, on which China's new foreign policy conception of a New Silk Road is based: this is the Silk Road Economic Belt and the Maritime Silk Road. This policy focus includes cooperation with Russia on energy exploration and infrastructure construction, because this is considered of strategic importance to both countries and their relationship to the international energy market. For Chinese–Russian energy cooperation to further develop within the context of the New Silk Road project, the two states should focus on three areas:

Firstly, the full implementation of their existing agreements, and a further expansion of bilateral energy trade. With the significant agreements reached on bilateral trade of energy products during the last year, it is necessary for both states to promote the construction of the two agreed major pipelines by tackling the technical and financial problems related to their realization as soon as possible, in order to guarantee the start of gas supplies in 2018 and then a gradual increase in the volume of gas flow after that.

Secondly, enhance the connectivity between the two states' energy industries within the framework of Silk Road Economic Belt. Both sides should concentrate on

speeding up the construction of the Western route pipeline and promote agreements on the construction of new pipelines, in order to substantially improve the capacity for energy transportation between Russia and China, diversify the modes of energy transportation between them, conduct research on offshore oil and gas transportation opportunities, reduce pressures on the security of energy transportation, and build a new pipeline to the Indian Ocean aimed at enhancing transporting capability in the future.

Thirdly, deepen Sino–Russian cooperation on energy technology. There is great potential for Sino–Russian cooperation on the exploration of non-conventional oil and gas, and the development of new energy technologies, including cooperation on their utilization. For example, Russia plans to upgrade its public transportation system by substituting gas for oil and applying zero-tariffs on electric vehicles, and would likely be interested in investing in the relatively developed new energy vehicle technology that has been developed in China. At the present time, cooperation between Chinese and Russian enterprises on new energy fuelled automobiles is gradually taking shape, and successful cooperation between the two countries' on such new energy technologies and their utilization could then be used as an example for similar cooperation among other countries rich in gas reserves located along the Chinese "One Belt and One Road" New Silk Road route.

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