

## Friction and Reconciliation: the Path of Contemporary Sino–Russia Energy Cooperation

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### Abstract

This article analyses the likely trends and limitations of Sino–Russian energy cooperation. Moscow and Beijing are interested in mutual cooperation on oil and gas. This interest in cooperation is based on common interests for which neither side would have to give anything up. At the same time, a number of restrictions on the development of cooperation exist.

China's energy demand has doubled since 2000 and recently the country overtook the US to become the world's largest energy user, according to the International Energy Agency. Even after three decades of rapid economic growth, during which it became the world's leading exporter and second-largest economy, China continues to import just 10 per cent of its annual oil requirement. That is thanks primarily to vast domestic reserves of coal, which supply 70 per cent of China's energy. At the same time, China's dependence on imported energy has continued to increase. In 2009 China was dependent on foreign oil for more than 50 per cent of its domestic crude oil consumption. Given that in 2020 this proportion is expected to rise to 60% or 70%, China needs to maintain economic cooperation with Russia and other global energy suppliers. Currently, China mainly relies on oil imports from the Middle East and Africa, with nearly 60% of China's imported oil coming from those two places. However, China has sought to diversify its pattern of suppliers, and the parameters of its energy diplomacy can be clearly seen in efforts to strengthen oil and gas cooperation with Central Asia, Russia and ASEAN countries.

In light of the Sino–Russian strategic cooperation partnership, energy cooperation between Russia and China looks set to become an important element of both countries' energy policy. Russia's plan to reorient its energy trade towards the East has taken a leap forward with the start of oil exports through a new pipeline to China. The pipeline, running from Skovorodino in Eastern Siberia to Daqing in Northern China, is an offshoot of a new oil export route that Russia is building to the Pacific Ocean, providing the world's top oil producer with a strategic window on the energy-hungry markets of Asia. When it is completed in 2013, the 4,070km pipeline will be able to carry up to 1.6m barrels of oil a day, about one third of Russia's current exports. Russia began commercial oil deliveries through the new pipeline to China on New Year's Day in 2011 consolidating its energy ties with the world's fastest-growing oil consumer. It is clear that Moscow wants to diversify from its currently European-oriented network—politi-

cally as well as economically—and building links with China is the best way to do it.

### The Foundations of Russian–Chinese Energy Cooperation: Supply and Demand Potential and Competitive Advantage

Several factors point to Russia–Chinese cooperation in the energy sector as being mutually advantageous: the resource potential of Russian oil and gas, its export capacity and both sides willingness to cooperate.

The potential of Russia's natural resources has been extensively and systematically demonstrated by Russian and foreign experts. According to experts from major research institutions in Russia, the country has proven oil reserves of about 130–160 million tons, accounting for 13% of world reserves. Natural gas reserves stand at around 46.8 trillion cubic meters, accounting for one third of world reserves. One expert from the Russian Ministry of Natural Resources, states that 1300–1360 million tons of oil and gas resources exist in Russia's northern sea, the Barents Sea, Marmara and Karra Sea, which accounts for 66% of all long-term reserves in the Russian continental shelf. It is important for its long-term viability as an energy exporter, however, that Russia does not remain satisfied simply with consuming these existing resources, but also actively tries to find additional resources. To this end, it is both committed to an expansion of a plan for a 200-nautical-mile economic zone on the Arctic continental shelf, and has also continued to seek outside resources for oil and gas from Iraq and from the contract for the Sikurna-2 field in Africa, from which it has received about one billion tons of oil reserves for exploitation. As a major Eurasian power, Russia has also not given up its possessions in Central Asia, where it has access to huge gas and oil resources through geographic advantage. In addition, working actively in other parts of the world with oil and gas reserves-rich countries (such as Venezuela, Algeria and Colombia etc.), Russia has engaged in widespread global oil and gas exploration and exploitation, expanding its own oil and gas resources and opening up new sources.

Russia's strategic concept on energy is called 'Go East'. The plan is to raise the percentage of oil that is exported to China, Korea and other East Asian countries from 3% to 30% by 2020, and from 5% to 25% in terms of natural gas. Within this programme, Russia is trying to build a new cooperative framework between itself and China, as indicated by Russia's construction of an Eastern Siberia–Pacific Ocean oil pipeline as part of its plans to develop its presence in the Asian energy market. Under the Skovorodino–Daqing pipeline agreement, Russia has agreed to supply China with 15 million tonnes of oil (300,000 barrels per day) each year for 20 years in exchange for a loan worth US\$25 billion to Russian companies Transneft and Rosneft for the further development of its eastern pipeline and oil fields. Russia is also committed to the development of Eastern Siberia's natural gas resources, something that is dependent on favourable conditions for exporting to China.

Due to its rapid economic growth over the past 10 years, China's energy consumption has been growing rapidly and become more dependent on imports. More than half of the country's petroleum and iron consumption—about 70% of its copper consumption and 64% of its sylvite consumption—now rely on imports. New resources in China, detected in the past 10 years, account for about half of all resources found in the past half century, and the amount of new resources found each year has surpassed annual consumption. However, China will still experience resource bottlenecks in the future. As a big developing country, China must make greater efforts to exploit domestic supplies to ensure energy security, as well as reach out to neighbours rich in natural resources. Energy cooperation with Russia will help quench China's growing thirst for hydrocarbons, and will therefore mean that energy co-operation advances the respective interests of China and Russia. Russia needs money in order to insure itself against the loss of income due to the world economic recession and falling energy prices, and to this end Russia built the Eastern Siberia Pacific Ocean (ESPO) pipeline to expand its eastern market potential, but also to spur the economic development of Russia's Far East. Russia in particular stands to benefit from China's growing energy need given its geographical proximity, and consequently good relations between the two are going to be an important feature of international relations in the near future.

Sino–Russian cooperation in the field of oil and gas has a number of advantages: firstly, the scale and huge potential for cooperation. Cooperation on both sides includes several million tons of oil supply and 10 billion cubic meters of potential demand for natural gas. Secondly, reliability. Both the supply side has enough capacity, and the other party has the money to

pay. Thirdly, energy security. For Russia, with large oil and gas resources, it is important that it effectively develops its capability and export markets so that it can benefit from the high economic growth rate that flows from hydrocarbon exports. For China, importing oil and gas from Russia will ensure a relatively stable supplier, and will reduce transportation risks.

### **The Dilemma of Energy Cooperation Between China and Russia**

Although Sino–Russian energy cooperation has great potential, there are also frictions between the two countries that require constant management. The main friction in developing energy cooperation between China and Russia remains both sides firm stance on the terms of contracts, above all on price. In the case of gas contract talks, Russia seems to feel that its negotiating position has been strengthened by Germany's decision to abandon nuclear energy, and the consequent expected increase in Russian supplies to Europe. Russia's efforts to build a gas pipeline to the two Korean states are also part of the negotiations. China, in turn, is putting pressure on Moscow by making more agreements with Central Asian countries (Turkmenistan and Kazakhstan) to increase the supply through the gas pipeline from Turkmenistan.

Also Sino–Russian energy cooperation involves the interests of relevant energy companies and even if the two governments have a strong intention to cooperate, the companies are not necessarily always willing to play along. For Chinese enterprises in the middle of a "going out" strategy aimed at seeking out greater profitability abroad, the difficulties of Russia's investment and financial environment means they may be obliged to undertake "gray swap" deals instead of following an internationally transparent standard and then also face restrictions on local employment. On the other side, Russian companies and government are afraid of China's consumption of Russian resources, and are also fearful of the rising development gap between the two countries.

Russia has acquired a large number of resources and energy companies in Central Asia, such as Russia's Lukoil's agreement with an Uzbek oil company, which will give the Russian firm a controlling stake in Uzbekistan's South-West oil and natural gas fields. Lukoil has succeeded where natural gas exporter Gazprom failed, supplying fuel to China. Gas from Lukoil's fields in Uzbekistan, where output generates more profit per barrel of oil equivalent than Western Siberian crude, is flowing to China under an agreement with its Uzbek partners. Meanwhile, this trend also increases the difficulties for Chinese enterprises in handling their overseas strategy of mergers and acquisitions.

Finally, Russia's long-term suspicion about its relationship with China creates an unfavourable structure of trade between the two countries, with the main principles of their energy cooperation a central problem. The countries have been unable to conclude several years of negotiations on constructing a pipeline and a long-term contract on gas supplies to China because of a dispute over gas prices. Gazprom signed an agreement to signal its intent to supply oil and natural gas to China, but as prices have gone up, the intention of the contract has not been implemented. The absence of a specialized framework for strategic energy cooperation between China and Russia means that such issues cannot be resolved as tidily as they were recently between Russia and Belarus as a result of the special offers made by Moscow after Belarus joined the Russia-led Customs Union.

### Conclusion

With conflicts in the Middle East and North Caucasus, Sino–Russian oil and gas cooperation would seem likely to grow, while continuing to face a series of new challenges. China is facing increasingly serious constraints due to growing anthropogenic environmental pressures, which are largely linked to the expansion of coal production and use. Over 80% of all freight traffic in China is

coal. As a result, the Chinese leadership are seeking to encourage the redevelopment of their oil and gas industry, including facilitating supply routes from various regions of the world. Against this backdrop, compromise on pricing disputes would appear to be a win-win situation for both Moscow and Beijing, so that Russia can continue to supply much needed oil and gas resources to the Chinese market, while China may open up its internal market allowing Russian energy companies to become involved. Russia needs big oil and gas markets, such as China and the EU, but will face growing challenges from Central Asia, from where it imports oil and gas and has developed commercial interests.

The most optimistic scenario for energy relations between China and Russia is one in which both sides approach this for mutual benefit, coexistence and win-win cooperation. The opposite is a return to the zero-sum politics of the past. The optimistic scenario would develop if trends continue that enable Russian oil and gas investors to further enter the Chinese market as sellers, while China continues to provide FDI to Russia to help develop their natural resources, so that they are then able to sell them to China. In this way, the links between the Russian and the Chinese economies would structurally complement each other.

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