

The Chinese threat

While the US and Europe compete for Shtokman gas, China is increasingly asserting as an attractive market for Russian energy. Yet, in the end, Russia will give Europe preference, expects Hans van Koningsbrugge, Director of the Netherlands-Russia Centre of the University of Groningen.

| by *Hans van Koningsbrugge*

In May and October of 2008 President Dmitri Medvedev of Russia visited Beijing – to be followed not long afterwards by the chairman of state-owned oil group Rosneft, Igor Sechin. It is symbolic that these were Medvedev's first state visits since being sworn in as president of Russia earlier that year. With these two visits in just six months' time he made it clear that the Kremlin considers it hugely important to have a good relationship with China. During his second visit in October this was expressly emphasized when in the presence of China's Premier Wen Jiabao and Russia's Prime Minister Vladimir Putin, the directors of the China National Petroleum Corporation

(CNPC) and Russian Transneft signed an agreement with respect to the construction of a new oil pipeline from the Siberian city of Skovorodino to the Russian-Chinese border. The pipeline will have a capacity of fifteen million tons (110 million barrels or almost 4% of China's consumption) and will be a part of the important East Siberian-Pacific pipeline currently under construction. Besides the agreement for the construction of the pipeline, another agreement was reached in principle for the supply of the fifteen million tons of oil.

Surprisingly, Russia, the second largest oil producer in the world, is only the fifth largest oil supplier of its neighbouring country China. Russian oil is currently

transported to China by rail only. Already in 2006 Moscow and Beijing agreed that Russian oil deliveries must have a larger share of the Chinese oil import. Negotiations on the new Russian-Chinese energy relations subsequently dragged on for over a year and only gained momentum when the global credit crisis broke out this year. The crisis, which caused oil prices to plummet, has driven Russia's state-owned oil group Rosneft into difficulties. Its share price has plunged, whilst the company is contending with major debts to foreign banks which it incurred to pay for its massive expansion during the past ten years. The necessity for Rosneft and Russia to sell oil abroad at a good price led to a breakthrough in the energy negotiations with China. The

The border between China and Russia near Manzhouli in northeast China. Photo: Liu Liqun/Corbis



question is what effect this will have on Russia's energy relations with Europe.

Stumbling block |

Russian-Chinese relations have improved significantly over the past few years partly because of the US's aggressive stance in Central Asia after the 9/11 attacks. The Kremlin and Beijing responded to the increased presence of the US in their Central Asian "backyard" by strengthening the collaboration within the Shanghai Cooperation Organisation (SCO). This organisation, established in 1996, now comprises Russia, China, Kazakhstan, Tajikistan and the Kyrgyz Republic. Uzbekistan, Iran, India, Pakistan and Mongolia have been admitted as observers. So the SCO counts four nuclear powers (Russia, China, Pakistan and India) and three major energy producers (Russia, Kazakhstan and Iran).

Up until 2005 the SCO focused on regional issues like terrorism, separatism and economic collaboration. In July 2005 during the annual summit in Astana, Kazakhstan, its tone changed. The SCO distanced itself in no uncertain terms from the 'unipolar and dominant American politics' and spoke out in favour of accelerated withdrawal of Western troops from the Kyrgyz Republic and Uzbekistan. Shortly thereafter the American army was ordered to leave Karshi-Khanabad air base in Uzbekistan.

The meeting in Astana represented a breakthrough in Russian-Chinese relations. 2006 became known as the 'Year of Russia' in China and 2007 became the 'Year of China' in Russia. In 2006 Putin and President Hu of China met five times whilst more than four hundred official Russian delegations visited China. However, this did not result in an exclusive Russian-Chinese alliance. The conflicts of interest between the countries, such as

from Siberia to Russia's administrative territory of Khabarovsk. In October and November 2008, Russia and China reached agreement to extend this pipeline to the Chinese network. Thus, for the first time, Russia and China are to be linked by oil pipelines.

What is Russia's strategic thinking behind this? Both Prime Minister Putin and Rosneft's chief executive officer Setchin

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with respect to Central Asia, are too great to make an easy political alliance possible. The countries did make some progress in their energy relations.

Since 2001 Russia and China had been negotiating the construction of a pipeline to link Russia's West-Siberian oil fields with the Chinese oil fields around Daqing. Japan is interested in this oil as well. In 2005, then-President Putin cut the knot. The oil pipeline was to be laid to Daqing but would then be extended to Russia's Pacific coast to supply Japan. At the same time a pipeline is under construction

regard the economic development of East Siberia as a high priority. The Duma also has a strong oil and gas lobby aimed at opening up East Siberia by building new petrochemical factories to further refine Russia's oil and gas. But in order to realise this pipeline connections between West and East Siberia are vital. The advantage is that the West Siberian oil fields can be included in the Asian export without new and costly fields having to be exploited. At the same time East Siberia is being developed to a higher level, thereby thwarting the spectre of a Russia that exports raw materials only. The very



thinly populated East Siberia can thus also attract new inhabitants to counterbalance increasing Chinese immigration.

The current oil supply contract for 9.7 million tons per year which Rosneft and the Chinese oil company CNPC entered into in 2004, expires in 2010. A new 20-year contract for 15 million tons per year is currently being negotiated. The contract is to include petrochemical products as well. Rosneft is requesting a \$12-15 billion credit from China. The company desperately needs that money. It needs \$13.4 billion till the summer of 2009 for the construction of pipelines, and is already \$21.15 billion in debt. To ensure that production will be sufficient, the Russians have also sought cooperation with the Chinese in exploration and production of oil (and gas). In 2005 Rosneft and the Chinese company Sinopec agreed to explore the Veninsky block (which contains both oil and gas) within the Sakhalin-3 project in a joint-venture in which Rosneft has 74.9%.

Russia and China are also pursuing cooperation in gas. The countries are currently negotiating the building of two gas



Heads of state of the Shanghai Cooperation Organisation meet in Tajikistan. Photo: Mikhail Klementiev/EPA

this? The answer depends firstly on the time scale on which you look at it. As compared to Europe, China is still a small customer for Russian energy. This can change but that depends on the success of the projects that are now being pursued. It is also simply a matter of money. There is no doubt that the Russian government is faced with a major challenge. For six years Russian energy revenues grew at a much greater rate than those of imports.

economic zone. Moscow opposes this idea, believing that cheap Chinese goods could flood Russia's domestic market. Furthermore, Russia and China disagree about Central Asian oil and gas transport routes. For instance, both China and Russia have entered into agreements for the supply of Turkmen gas. Both countries are also rivals with respect to Kazakhstan. In December 2005 the Kazakhstan-China (Atasu-Alashankou) oil pipeline was opened. This pipeline will make both China and Kazakhstan less dependent on Russia.

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pipelines. The eastern pipeline is planned to enter China at Manzhouli, whilst the western pipeline is planned to reach Xinjiang at Altay. These pipelines are to have a capacity of 68 billion m³, which could double China's gas consumption. A major stumbling block is price. Gazprom wants to link the oil and gas prices. China is only offering \$100 per 1000 m³, presumably half of what the Russian domestic market will pay in three years' time. This is a sore point. It is one of China's weaknesses as compared to Europe. The EU simply pays better than China, which is constantly demanding discounts.

Alternative |

In discussions with the EU Russia often harps on the fact that China is an alternative market for its oil and gas. But how realistic is

However, the tide has turned. The Kremlin has based all its budget calculations on an oil price of around seventy dollars per barrel. Ural oil barely realises half that amount at this moment. Furthermore, the substantial inflation is weakening the position of the rouble. At this time of writing, government assistance to bail out the currency has already cost \$150 billion since August. At the same time a lot of capital is being routed out of the country. Many companies are finding it difficult to re-finance their outstanding debt. So it remains to be seen whether there are enough funds available to execute the pipeline projects.

Then there are other Russian-Chinese conflicts of interest. Beijing is very interested in forming one Central Asian

It is also significant that trade between Russia and Europe is many times greater than between Russia and China. Russia exported more than \$195 billion worth to Europe in 2007, whereas its export to China amounted to less than \$16 billion. Russia's import from EU countries amounted to close on \$87 billion, whereas it imported only \$24 billion of goods from China. Russia's economic centre of gravity still clearly lies in its relations with the EU.

The Russians have three primary markets for their oil and gas: the domestic, the European and the Chinese markets. For Russia's local situation to remain stable its domestic market must be supplied no matter what. If a further choice needs to be made, Europe will (still) have preference. This is compelled by economic interests as well as the fact that Russia does not wish to isolate itself from the EU. ■