

The “Power of Siberia”

NO LONGER A PIPE DREAM

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After two decades of discussion, China and Russia finally agreed this year to share the \$77 billion cost of building the “Power of Siberia” gas pipeline from Russia to China. On May 21, 2014, the two countries signed a \$400 billion deal to ship 38 billion cubic meters (bcm) of gas to China beginning in 2018. Although the timing of the long-awaited gas pipeline agreement from Russia to China highlighted the changed geopolitical context in the midst of the Ukrainian crisis, this was not what broke the deadlock between the two countries over pricing, routing, and upstream investments. The drivers were largely economic, though there are important geopolitical consequences.

Russia’s position: Russia initially hoped to build the pipeline from the Altai region to western China, thereby enabling Russia to supply China from the same fields in Western Siberia that provide gas to Western Europe. Russia could then play the role of “swing producer” and acquire maximum political and economic leverage in adjusting gas flows between Europe and Asia. Russia also demanded the same price that Europeans paid for gas, which is higher than what China now pays Turkmenistan.

China’s position: China insisted on a Siberian routing to Northeast China. China already has a gas pipeline from Turkmenistan to Xinjiang in western China and needs the gas more urgently in its populous and developed eastern provinces. To ensure security of supply, China wanted its own dedicated source of gas from eastern Siberia, not one shared with Europe. As Keun-Wook Paik observed in the *Oxford Energy Forum*, the “Chinese planners did not want to be blamed for ‘robbing’ the Europeans of their gas....” Moreover, Chinese energy companies have to make up for their losses on the domestic market (where price controls remain in force) through upstream investments. Consequently, China sought as low a price as possible to minimize domestic losses and hoped for upstream investment opportunities.

Russia and China were able to narrow their differences because of changes in both countries, as well as in European and Asian gas markets. New leadership in both countries gave new impetus to the long-stalled talks. In 2013, during Chinese President Xi Jinping's inaugural visit to Moscow, President Vladimir Putin agreed to the Siberian routing. Over the next year, Gazprom and China National Petroleum Corporation (CNPC) continued to discuss the remaining stumbling blocks, particularly pricing, as domestic politics in the two countries shifted in ways more conducive to a deal.

Although the exact price of gas China is paying Russia has been kept secret to avoid unsettling other gas partners, in the end most experts believe that China negotiated a price of approximately \$350 per thousand cubic meters (tcm) (\$9-\$10 per million British thermal units), slightly less than the \$380 per tcm average for Gazprom sales to Europe (\$10.60 per mmBtu), according to Reuters. Some Russian officials told Bloomberg News that China's base price was \$360 per tcm, just slightly less than Germany pays (\$366, among the lowest prices in Europe), so that Russia could maintain price parity between Europe and Asia (\$9 per mmBtu). China pays considerably less—about \$322 per tcm for gas from Turkmenistan—but the Russian price would still be much less than the \$501 per tcm (\$14 per mmBtu) the Chinese pay on the Asia Liquid Natural Gas (LNG) spot market, as an analysis by the U.S.-China Economic and Security Review Commission pointed out.

Gas Imports and China's "War on Pollution"

China's renewed interest in Russian gas reflects the greater political urgency of addressing the country's environmental problems. Responding to unprecedented smog and growing public dissatisfaction with poor air quality, Prime Minister Li Keqiang called for a "war on pollution" in a March 2014 speech to the Chinese legislature. According to the U.S. Energy Information Administration, China plans to double its use of gas from 4 percent of its energy mix to 8 percent by 2015, the end of the current 5-year plan cycle.

To make domestic gas sales more profitable for Chinese energy companies, the Chinese government has been gradually raising the price of gas at home. In July 2014, China's National Development and Reform Commission raised natural gas prices by 15.4 percent, which meant that the average price for a non-residential consumer was \$8.90 mmBtu, according to Platt's McGraw Hill Financial. By the end of 2015, natural gas prices will be increased further for non-residential customers and high-volume residential customers. These changes made it possible for CNPC to accept a higher price than they previously demanded in gas negotiations with Russia.

Beginning in 2007, China became a net importer of natural gas and by 2013 it became the world's third largest user. According to CNPC, China used 167.6 bcm of gas in 2013, a 13.9 percent increase from the previous year. Turkmenistan has been piping in nearly

half of the gas China imports (46.5 percent) and the rest comes from liquid natural gas (LNG) imports from countries such as Qatar (17.8 percent), Australia (9.3 percent), Malaysia (6.7 percent), and Indonesia (6.6 percent). Due to concerns over the possibility of the U.S. Navy denying China access to energy imports arriving by sea, the Chinese government has been seeking additional land-based gas supply routes, from Myanmar and now from Russia. The development of Sino-Russian gas cooperation will also help China negotiate a better price for LNG with other suppliers.

Russia (Finally!) Marches East

Five years ago, Russia's Energy Strategy to 2030 envisaged that one quarter of Russian gas exports (75 bcm) would be to Asia in coming decades. John Henderson and Jonathan Stern of the Oxford Energy Institute note that despite this goal and the location of Russian gas fields in the eastern part of the country, surprisingly Russia thus far has sold very little gas to Asian markets—just 16.6 bcm from the Sakhalin 2 offshore gas project. According to Henderson and Stern, Gazprom hoped to increase its bargaining power with China by building an LNG plant in Vladivostok that could sell to other Asian markets, but if the Siberian pipeline to China were the only source of gas for the LNG plant, this plant would not be financially viable.

In the interim, as negotiations between Gazprom and CNPC dragged on, in December 2013 Novatek and Rosneft successfully convinced Putin to allow them to export LNG. This has ended Gazprom's monopoly on these exports but also potentially brought in new sources of gas for the proposed Vladivostok LNG plant (from Novatek's Yamal fields in the Arctic, in which CNPC has 20 percent stake, and possibly from Rosneft's Sakhalin 1 project). It has also made the prospect of significantly increasing Russia's share of Asian gas market a reality. While holding 19 percent of the world's gas reserves, Russia currently accounts for less than 4 percent of global LNG sales, but Russian Deputy Energy Minister Kirill Molodstov told the Sakhalin Oil and Gas conference last year that Russia aims for a 20 percent share by 2030.

And the Winner Is....

Energy analysts have sought to identify a winner and loser in the sudden conclusion to the Sino-Russian gas negotiation. This is all the more complicated as many details have not been made public, including the exact price formula for the gas, which has fed speculation about the costs and benefits of the deal.

Some argue that China "won" because it bargained down the price and could show off its economic strength by prepaying. Others note that despite the prepayment, Russia has so far held firm and refused to allow any Chinese upstream investment. Chinese observers comment that the price is higher than they expected, though some note that the price will adjust as the yuan appreciates. Russian critics of the deal accuse Putin of

giving away Russian resources in exchange for the Chinese prepayment and fear that the reliance on Chinese financing will turn Russia into a Chinese colony. Some Russian criticism of the gas agreement was even more extreme. Russian political analyst Andrei Piontkovsky warned, for example, that the deal would accelerate “the process of amalgamation of the territories of the Far East and Siberia into a ‘living space’ for China.”

The reality is that both sides gained and had to compromise to achieve a deal. China got a reasonable price, which will give it leverage on its growing LNG purchases in Asia, but no upstream investment so far. This could change if Gazprom faces additional difficulties down the road in obtaining financing for the project. After the deal was signed, Merrill Lynch downgraded its investment outlook for Gazprom, a reflection on the company’s increasingly stretched finances.

Russia got a deal at a politically crucial moment, which will make it more of a player in Asian energy markets at a time when Europe is actively seeking to reduce its reliance on Russian gas due to the Ukrainian crisis and the changes in the gas market produced by the shale revolution. Gazprom had been slow to adjust to changes in global demand for gas and now faces additional political barriers to its longstanding relationships with European energy companies. Russia has supplied 30 percent of Europe’s gas, with half of it flowing through Ukraine. As Morena Skalamera of Harvard’s Belfer Center pointed out, now that Europe is looking to alternatives to long-term contracts with Gazprom, the company needs a new long-term partner and views China as a potential cash cow.

China energy analyst Erica Downs notes that this is the third time China came in and rescued a Russian energy company at a time of need. Rosneft was the previous beneficiary – first receiving a \$6 billion loan in 2005 to buy Yukos and then another \$25 billion in 2009 to build the East Siberian Pacific Ocean (ESPO) oil pipeline. In the current deal with Gazprom, CNPC agreed to a \$25 billion “prepayment” on future gas deliveries, which will provide a portion of the \$70 billion the Russian company needs to develop the gas fields in eastern Siberia and build the pipeline. According to Downs, this shows China’s clout but also highlights the fact that Russia has a powerful friend in China. Geopolitically, the prospect of Chinese financing lessens the impact of Western sanctions.

Policy Implications

In this landmark deal, Russia and China have opted for greater interdependence at a time of closer Sino-Russian partnership. Despite its determination to maintain diversity of supply, with the signing of this agreement China has become more dependent on Russia for its energy than ever before. China already receives 9 percent of its oil from Russia thanks to the Eastern Siberia-Pacific Ocean (ESPO) oil pipeline. Once the gas pipeline goes online, Russia will be China’s number one or number two supplier of gas,

depending on the level of expected increases in gas from Turkmenistan. According to Cui Shoujin of China's National Academy of Development and Strategy and Renmin University, "That the long-awaited deal could be reached at this moment is related to the tension between Russia and the West over the Ukrainian crisis. But the fundamental cause is the energy interdependence between China and Russia."

In the aftermath of a third round of economic sanctions, Russia is even more reliant on Chinese financing and may yet offer China upstream investment opportunities in exchange. Although dollars will be used in the gas deal, sanctions may encourage the further use of yuan-to-ruble exchanges in Sino-Russian economic cooperation. Just before the gas deal was signed, the Bank of China and Russia's VTB bank agreed to use their own currencies to pay each other instead of the dollar.

The Sino-Russian gas deal has the potential to make Russia more of a player in Asian gas markets more broadly. One month after the Sino-Russian deal was reached, Japanese companies signed LNG deals with Rosneft and Gazprom. Some politicians from Japan's ruling Liberal Democratic Party (LDP) have revived the idea of a \$6 billion gas pipeline from Sakhalin to Japan, which could provide 17 percent of Japanese gas imports. India and South Korea also are discussing gas cooperation with Russia. All will benefit from the downward pressure on LNG prices in Asia that the Sino-Russian gas deal will exert.

Thus, at a time when the United States seeks to isolate Russia in response to the Ukrainian crisis, U.S. partners in Asia are contemplating greater energy cooperation with it. Some members of Congress are proposing that the United States respond by increasing LNG sales to Europe and Asia, thereby reducing Russia's market share, and U.S. legislation is currently being proposed to facilitate the process for approving such LNG contracts.

Conclusion

The crisis in Ukraine has added urgency to President Putin's quest for a gas pipeline with China, but it may now further delay its fruition (now projected for 2018) due to uncertainties about Gazprom's access to financing and necessary technology. Some of the sanctions imposed by the United States and the European Union on exports of energy production technology to Russia may affect Gazprom's ability to obtain the equipment needed for horizontal drilling, a technique which the company announced it would use to minimize environmental damage in the Amur River border area. Despite the uncertain impact of the sectoral sanctions, Gazprom has begun work on the pipeline. At the start of August, Gazprom delivered the first pipes to Lensk in Sakha which will be used in building the Russian part of the trunkline connecting the Chayanda field in Sakha to Khabarovsk and Vladivostok, set to be completed in 2017. For the time being, the pipeline project appears to be on track.

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