Russian-Chinese Oil Relations: Dominance or Negotiation?

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Russia and China are destined by geography and development to be linked. For its part, China needs to import large quantities of oil (and gas). Oil production in the country grew faster than consumption through 1986 and net production remained positive through 1992. In 1993, however, China became a net importer of oil. In 2009, it passed Japan to become the world's second-largest importer, trailing only the United States. Russia, meanwhile, is endowed with large oil reserves (and enormous gas reserves) and seeks to export much of what it produces to foreign countries, including China. No matter how much officials talk about the need to diversify Russia's economy, and no matter how much progress is actually made in that endeavor, energy will continue to serve as Russia's principal export for a long time. China is the fastest-growing importer in the world, and it would be foolish not to pursue that market.

Given these potentially complementary interests and the countries' proximity to one another, it is unsurprising that Russia and China have had ongoing negotiations over oil shipments, the construction of pipelines, pricing arrangements, and so on. The negotiations, however, have not been easy as each side has sought to obtain the best deal possible. This memo examines the negotiations over petroleum between the two countries and considers their political and economic implications.

Uncertain Negotiations: 2004 and Earlier

Before 2004, China's most significant and consistent oil purchases from Russia were through Mikhail Khodorkovsky's now defunct company, Yukos, and amounted to about 124,000 barrels a day. Yukos had also begun negotiations with China to build a pipeline from Angarsk in Siberia to Daqing in northeastern China. The line was to run south of Lake Baikal, making building an extension to the Pacific Ocean much more expensive than a northern route. In fact, the expanding role of Yukos, a private company, in foreign economic affairs was probably part of what caused Khodorkovsky to run afoul of President Vladimir Putin, leading to his arrest in October 2003. Consequently, 2004 was marked by uncertainty in Chinese-Russian oil relations. As the Khodorkovsky trial wore on and the future of Yukos's assets remained unclear, production and exports declined. Another private company, Lukoil, was pressed into

service to fill the gap in the short run, and the Russian government promised that the relationship would remain beneficial in the long run. Nonetheless, shipments shrank and the Chinese side could not even be sure whom to negotiate with, whether the government or the companies.

In addition, it seemed in 2004 that China might not be connected to any eastward pipeline. When Japan offered to finance most of the construction of the Eastern Siberia-Pacific Ocean (ESPO) line, Russia suggested that it preferred not to limit its sales options and thus would not build a dedicated pipeline to China. Under such a system, China would have to make do with oil shipments by rail or tanker, which were more expensive and more cumbersome transit options.

The First Major Deal: 2005-2009

In late 2004 and early 2005, a new regime began to take shape. As the Yukos affair progressed, it became clear that this was no simple shakedown or transfer of assets to another private company, but a re-nationalization. If the Chinese government wanted to replace, and even expand, the levels of oil once imported from Yukos, then it would have to negotiate directly with the Russian state. It did so and struck a long-term oil supply deal, making a $6 billion down payment in February 2005 on approximately 48 million metric tons of Russian crude to be delivered over the course of several years. Given the timing of the deal, it seems likely that at least part of the money was lent to Rosneft to help pay for its purchase of Yukos's main production asset, Yuganskneftegaz.

The arrangement with Russia was part and parcel of China's strategic expansion of petroleum holdings around the world. This strategy included at least three main approaches. First, through direct purchases, China's major state-owned oil companies acquired shares in such oil majors as Total and BP, as well as 100 percent ownership of smaller companies, including Udmurtneftegaz and PetroKazakhstan. The Chinese National Petroleum Company (CNPC) also acquired a 4 percent stake in Rosneft for $500 million (although it had hoped to buy a $3 billion stake in the company). Second, joint ventures and production-sharing agreements (PSAs) gave China a role in the development and operation of fields in several countries, including Russia via the joint venture Vostok Energy. Finally, loans or down payments (similar to the one arranged with Russia) helped China secure long-term supply contracts for oil from Brazil, Venezuela, and Angola.

Although the deal with Russia was not unique, and although both sides were now clear whom they were negotiating with, the agreement did not always function smoothly. The main recurring issues were Russia's failure to deliver as much oil as was originally promised by a specified date and China's unwillingness to renegotiate the price it paid for the oil. Compiling data from various sources, Russian oil deliveries to China were as follows (all numbers are approximate, with 2005 being the first year of the arrangement):

2005	7.6 million tons	(10 million promised)
2006	10.0 million tons	(15 million promised)
2007	10.0 million tons	
2008	11.5 million tons	
2009	11.5 million tons	

Thus, Russia eventually met the overall target of at least 48 million tons, but it fell short of its annual targets each year.

Regarding oil prices, one source reports that the original contract set the price at $3 per barrel less than Brent blend crude, a price determined in paper trading in London. This is not an uncommon mechanism for pricing in oil contracts; the negotiation is over the level of discount (or premium) from Brent. Russia argued that its oil was worth more than this price and in November 2007 convinced China to agree to a lesser discount of $2.325 per barrel, but it was not able to move the Chinese any further.

Russia and China also continued to negotiate over the possibility of a pipeline spur from the ESPO line to China. During most of this period, China financed or performed the preparatory work. In particular, it paid $37 million for a feasibility study and developed a plan to build the Chinese side of the pipeline, which is projected to be far longer (960 kilometers) than the Russian side (67 kilometers).

New Pipeline, New Contract: 2009-Present

The past year and a half witnessed some important new milestones in the Russian-Chinese relationship. In February 2009, China issued a new set of loans to Russia: $10 billion to Transneft to help finance pipeline construction and $15 billion to Rosneft as a down payment on 300 million tons of oil to be delivered over the course of 20 years, beginning in 2011. After a long negotiation period in which China asked for an interest rate of 7 percent or higher, the deal was finally concluded at 6 percent. Again, price and delivery schedules were sticking points, but for the moment it seemed as if these issues had been overcome. China will pay whatever price Russian oil is fetching at Kozmino Bay in the Russian Far East, and Russia will deliver 15 million tons a year via a pipeline spur to Daqing, a refining center in northeastern China.

In December 2009, the first phase of the ESPO pipeline opened. It carries oil from Siberian oil fields to the town of Skovorodino, located in the Amur region, still 2,100 kilometers from the Pacific Ocean, but 2,750 kilometers closer than was possible before. From there it is shipped by rail to Kozmino Bay. This was a major achievement for Russia, giving the country a significant opening to the Far East. It was also important to China for a number of reasons. First, it gave China's energy companies a chance to buy Russian crude shipped by tanker to any destination they desired, rather than by rail to a fixed location. Second, it created the spot market for Russian crude that would be used to determine the price China would pay for oil delivered through the ESPO pipeline spur. Finally, it made the spur itself feasible, as it brought oil out as far as Skovorodino.

The construction of the spur has proceeded relatively smoothly thus far. Both sides of the line were completed on time, and the link was dedicated at the end of September 2010. The system is still on schedule to begin full deliveries in January 2011.

Disagreements and technical problems will continue to arise, of course, but the project has already proceeded further than many would have thought possible just a few years ago.

Successfully opening the spur will clear the way for another set of issues to take center stage: those of supply. The long-range plan for the ESPO line has always been that the line will be filled from newly developed fields in Eastern Siberia, rather than oil diverted from Western Siberia or the Urals. In principle, Russia could simply decrease shipments to Europe and send that oil to China or the Pacific, but that would raise technical and political problems that would be better avoided, including the fact that West Siberian and Urals crudes are of lower quality than East Siberian oil, so China would be unhappy with the delivered goods.

Even on this question, the forecast is better now than it was just a couple of years ago. Most notably, Rosneft's Vankor field has come on-line. This large field began producing oil in late 2009, and by mid-2010 it was producing over 260,000 bbl/day (13 million tons a year). It can thus nearly fill Russia's obligations to China on its own, even before production at the field reaches its peak. In addition, there are three other new East Siberian fields in operation—Verkhnechonsk, owned by Rosneft and TNK-BP, Urals Energy's Dulismin, and the Talakan field of Surgutneftegaz—and almost twenty more under development.

Implications

How are we to evaluate these developments? What do they mean for Russia, China, and the rest of the world? It is sometimes tempting to imagine an extreme interpretation—China is taking over Russia's (and the world's) hydrocarbon sector; Russia is marching eastward; or the two countries are forming an energy partnership that will become the basis for a deeper alliance against the West—and look for examples that seem to support it. The analysis presented in this paper, however, suggests a more nuanced interpretation than any of these.

China certainly plays an enormous role in Russian oil (and gas) policy in the Far East. It is expanding its ownership shares in Russia and it has achieved greater flexibility in the global energy arena by developing Russia as a supplier. (Likewise, the opening last year of the Kazakhstan-China pipeline, which runs from the Caspian Sea to northwestern China and has a capacity of 10 million tons per year, enhances China's power as a buyer.) Nonetheless, China did not get the pipeline it originally wanted, it had to pay for a large part of the new pipeline exporting oil from Russia, and China appears to be paying top dollar (or even overpaying) for the oil it will receive through that line. It is also hard to know how the decision to commit to a 20-year supply deal will work out. China's reach continues to expand, but it does not get everything that it wants.

For Russia's part, it has allowed China greater involvement in the energy sector than it originally intended but it has also built a pipeline system that gives it multiple options in the Far East, received considerable outside support for financing the project, and locked in a long-term customer at a more than reasonable price. In its relationship

with China, Russia retains the ability to cut supplies in a price dispute or related disagreement (while China retains the ability to turn to other suppliers).

Overall, this appears to be a fairly normal negotiation and each side has generally made the best of its situation. China has a great deal of money and a growing number of supply options. Russia has significant oil reserves and a multi-option pipeline. True, the situation could worsen for either side. For Russia, petroleum reserves could disappoint, Rosneft's or Transneft's borrowing could come back to haunt it, or oil revenues could be spent unwisely. For China, its spending spree could leave it vulnerable in an economic downturn, its economic growth could finally exhaust itself, or its political situation could worsen. But neither country seems to have been forced into making an egregious negotiating error over oil.

As a final note, it is worth pointing out that a similar process to the one discussed here is underway in the area of natural gas. Russia and China have been discussing a natural-gas pipeline (actually two of them) for several years, but discussions have foundered on disagreements over pricing. As difficult as it has been to agree on a pricing formula for crude oil, the issue is even more troublesome with gas because there is no internationally recognized marker—such as the Brent contract in London or the Dubai contract in the Middle East—to which the price of gas might be tied. Nevertheless, Russia is losing leverage as China continues to explore other options. Most significantly, the newly opened Turkmenistan-China pipeline undercuts Russia's position and appears to have reignited discussions.

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