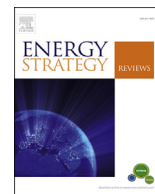




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Sino-Russian energy relations reversed: A new little brother



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ABSTRACT

In the wake of Russia's souring relations with the West over Ukraine, the clinching, on May 21, 2014, of the long-anticipated Sino-Russian gas deal has prompted a flurry of speculation on the deal's implications, not only for global energy markets but also for geopolitical security among the big powers in the rapidly changing world order. In Moscow, officials insist that the deal with China is only part of a more overarching "pivot to Asia." In fact, in 2013, Russia sent more than 30% of its oil exports—more than 1.2 million barrels a day, the most ever—to Asia. But almost half of that energy is heading to one place in Asia: China, the biggest beneficiary of the deal. Russia's heightened tensions with Europe have created very favorable conditions for Chinese energy diplomacy with Russia. As Moscow's relations with the West deteriorate, Putin seeks to show the world and the Russian people that he has alternative friends to the East. Be that as it may, the incentives leading to the mega deal were in place much earlier.

The article is laid out as follows. I review the details of the recent Sino-Russian gas deal and also of the preceding oil agreements, as well as their implications for Sino-Russian energy cooperation. I point out that Sino-Russian gas cooperation followed a different path than the two giants' oil trade for one crucial reason: the intrinsic differences between oil and gas as commodities. Unlike oil, gas is comparatively easy to produce but expensive to transport and difficult to replenish. As a result, gas can be much more readily used as a strategic policy tool. After reviewing the differences between oil and gas trade, the next section discusses the so-called Altai pipeline. I then focus on Vladivostok LNG, a giant project that is likely to be substituted with a third gas pipeline to China. Lastly, I review what I believe to be the most likely future developments in Sino-Russian energy cooperation.

The political economics of the Sino-Russian energy relations involves four crucial issues: ownership of the Russian upstream resources, and Chinese technical participation in the plans to exploit these resources; ownership and financing of the pipelines linking Russian oil and gas to China; the decision on the pipeline routes; and the decision on the price. Evaluating Sino-Russian energy cooperation with these four crucial issues in mind, I conclude that Russia and China will continue to move toward greater energy trade integration. The benefits will, however, be increasingly uneven, to China's advantage.

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^{1,2} On May 21, 2014, during a state visit by President Vladimir Putin in Beijing, China and Russia signed an eleventh-hour agreement for China to import natural gas from Russia's Gazprom. The

agreement consisted of a 30-year, \$400 billion gas deal³ for the delivery of 38 billion cubic meters of natural gas to China starting in 2018.⁴ The long-running discussions over the gas deal had involved the price, the pipeline route, and Chinese stakes in Russian projects. Finally, more than 50 different documents were signed. In Shanghai, President Putin boasted that the deal was "the biggest in the history of Russia's gas industry."⁵ Russian foreign policy and

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¹ Meanwhile, Russian oil exports to Europe via its largest pipeline network have fallen from a peak of 3.72 million barrels a day in May 2012 to less than 3 million barrels a day in July 2014. See: "More Russian Oil Flows East as Relations With West Sour," *The Wall Street Journal*, August 14, 2014.

² In 2013, China imported a total of 25 mt of crude from Russia, or 0.5 million barrels a day. According to Xavier Chen, President of Statoil China AS, in email correspondence with the author, September 2014.

³ According to comments in Russian media by Gazprom chief executive Alexei Miller.

⁴ Reports of the start-up date for deliveries have gradually slipped from 2018 to 2019 to 2021 and beyond. See the last section of this paper. For a recent account see also, Lelyveld, M. *China-Russia Project Stalls as Energy Prices Plunge*, RFA, January 25, 2016.

⁵ China and Russia: Best frenemies, *The Economist*, May 24, 2014.

security expert Andrei Kokoshin concurred: “China and Russia are moving towards a tighter alliance, one that is no longer only declaratory but is acquiring truly strategic depth.”⁶

However, relations have not always been so rosy. The Sino-Soviet split, which came to an end in 1991 with the self-liquidation of the USSR, also prevented the two Communist giants from cooperating for almost thirty years. Beijing expressed interest in Russian oil as early as 1996, when then President Yeltsin visited China for the second time. The atmosphere was cordial, but in practice, no energy deals accompanied the florid rhetoric. It was obvious that rebuilding the long-stalled relationship would take time. Yet, Yeltsin's efforts coincided with another, key, event. In April 1996 Mikhail Khodorkovsky named himself first vice president of Yukos.⁷ At the same time, Yeltsin's efforts to court the Chinese, which were moving in lockstep with Russia's growing distaste for American unilateralism, culminated in his December 1999 trip to Beijing. After taking notice of the new NATO enlargement, a frustrated Yeltsin roared, “No. I repeat, no! A multipolar world, that's the basis of everything. That's what we agreed on with Jiang Zemin ...”⁸

1. Perspectives on the Sino Russian energy relations

Current analyses on Sino-Russian energy relations essentially fall into two camps: those analyses⁹ that place too much emphasis on geopolitics (i.e. pointing to Russia's weakened position on the global stage) and tend to place little attention on domestic developments, such as the important dynamics pertaining to the way the Russian public views its dependency on the European market. Secondly, those interest-based analyses¹⁰ that place too much emphasis on economic incentives, such as pricing disputes and the costs of actual energy infrastructure (such as pipelines and LNG terminals). These tend to ignore the geopolitical incentives that have the potential to transform the Sino-Russian partnership.

This study complements existing analyses in two ways. First, through a political economy approach, it sheds light on the interaction between political and economic factors in Eurasian energy relations. Second, this paper contributes to the often-partisan literature on the Sino-Russian gas trade by building on primary data. Unlike most existing studies relying on secondary sources, it offers important insights by focusing on the analysis and perceptions of key figures in Eurasian energy affairs.

To explain why 2014 has been such a turning point in Sino-Russian natural gas relations, by necessity, much of the data comes from an eclectic mix of sources. Some are open source analyses appearing in specialists' articles, some are documents and statistics in the public domain. I am obviously constrained in accessing all the details of actual energy trade contracts, due to the secrecy that usually surrounds these clauses and the two governments' lack of openness on strategic questions involving energy

security. Just as importantly, however, I have relied on extensive interviews with energy specialists, most of whom have been involved in the discussions revolving around Sino-Russian cooperation in gas and oil.¹¹ Based on a review of the literature,^{12,10,13} analysis of the macroeconomic and industry data available and primary research interviewing Chinese and Russian business leaders, industry analysts, government officials, academics and activists, I draw a number of conclusions on the nature of Sino-Russian energy ties, which then leads into an assessment of the likely implications and future trajectory of the relationship.

2. From Sino-Soviet split to the largest commercial deal of all time: ESPO

Between 2000 and 2010, Sino-Russian trade increased nearly tenfold.¹⁴ The most significant export increases from Russia's side were, not surprisingly, hydrocarbons. In oil, developments accelerated in early 2000s when Mikhail Khodorkovsky's Yukos pursued a strong international expansion toward China. As documented by Gustafson,¹⁵ in Khodorkovsky's mind the Chinese were an integral part of his grand strategy for the development of East Siberia. In 2002, Yukos held talks about engaging the Chinese in the development of Eastern Siberian upstream, and building an oil pipeline that would service the Chinese market from those fields. Such a proposition, however, ran against Putin's plans to build a pipeline all the way to the Pacific port of Nakhodka, thereby adding an extra 3000 km to the original Khodorkovsky plan. Putin by no means wanted to put all his Far Eastern eggs in the Chinese basket. In fact, concerns about the socio-economic development of the Russian Far East, efforts to promote closer ties with Japan and South Korea, and, most crucially, qualms about complete dependence on China, prompted the Kremlin to look for other oil routes. Meanwhile, Khodorkovsky's public denunciations of Putin's foreign policy priorities, his independent overtures to the Chinese, and potential plans to sell out the national riches, in Putin's eyes simply became too much to bear.

Somewhat unsurprisingly,⁷ in 2004, Mikhail Khodorkovsky was arrested and accused by the Russian government of, among other things, large tax evasion. The Yukos Affair marked the beginning of a large renationalization of Russia's oil and gas industry. Rosneft, Russia's national oil company, which in the 1990s struggled to survive, swallowed Yukos's assets, and emerged as an increasingly powerful national oil champion. Along with Yukos's assets, Rosneft inherited the company's fascination with China. However, while the relationship between Khodorkovsky and Putin was, at the very least, scratchy, the liquidation of Yukos and the subsequent rise of Rosneft are by contrast tied to Igor Sechin, one of the most influential persons in Putin's entourage, or as energy expert Gustafson puts it, the ultimate Kremlin insider.¹⁶ Under Sechin's watch, Rosneft was quickly promoted to the status of leader of the domestic oil industry. He strongly backed the deal that was signed with China in October 2008, when, due to Russia's invasion of Georgia, Russian-Western relations were at their post-Cold War low. The deal was only sealed, however, in February 2009, after China

⁶ Andrei Kokoshin, in discussion with the author, May 2014, Moscow.

⁷ Gustafson T., *Wheel of Fortune – the battle for oil and power in Russia*, Harvard University Press, 2013, Chapter 7.

⁸ Boris Yeltsin's Chinese Warning,” *Kommersant*, December 10, 1999, in *CDPSP*, 51, no. 50 (1999), p. 1. Quoted in Robert. H. Donaldson, “Boris Yeltsin's Foreign Policy Legacy”; see at: <http://www.personal.utulsa.edu/~robert-donaldson/yeltsin.html>.

⁹ Rozman, G., *The Sino-Russian Challenge to the World Order*, Stanford University Press, 2014.

¹⁰ Henderson, J., Competition for customers in the evolving Russian gas market, *Europe-Asia Studies* 67 (3), 2015, 345–369.

¹¹ While experts were primarily chosen according to their specific position, I also used “snowball” sampling, i.e., personal references from interviewees to identify additional respondents. Public figures—including appointed and elected officials and well-known political observers—are identified by name, except in cases where they asked to remain anonymous. All other respondents, including energy industry insiders, remain anonymous and are identified only by the nature of their expertise.

¹² Keun Paik, *Sino-Russian Oil and Gas Cooperation – The reality and Implications* (Oxford, UK: The Oxford Institute for Energy Studies, 2012) p. 362–368.

¹³ Chow, E. and Lelyveld, M., *Russia-China Gas Deal and Rethink*, CSIS Commentary, 2015, May 11.

¹⁴ Source: International Monetary Fund, *Directions of Trade Statistics*, <http://elibrary-data.imf.org/DataReport.aspx?c=1449303&d=33061&e=170921>, Accessed in January 2015.

¹⁵ Gustafson T., *Wheel of Fortune – the battle for oil and power in Russia*, Harvard University Press, 2013, p. 290.

¹⁶ *Wheel of Fortune*, p.248.

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