

Report

China-Russia Gas Deal

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**China's President Xi Jinping and Russia's President Vladimir Putin signed a multi-decade gas supply contract in Shanghai [AFP]
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Abstract

A Sino-Russian gas deal for 30 years and \$400 billion dollars was signed by Xi Jinping and Vladimir Putin on 21 May 2014. The agreement surprised many international economic experts and prompted great speculation about the motive and calculation for both China and Russia. The analysis in this report indicates that the recent crisis in Ukraine and the progress of China's diversification of its energy structure provide great incentive and common interests for making the deal. It is a win-win result for both countries from economic and political standpoints, despite the fact that China apparently gains more than Russia.

Introduction

A Sino-Russian gas deal for 30 years and \$400 billion dollars was signed by PRC President Xi Jinping and Russian President Vladimir Putin on 21 May 2014,⁽¹⁾ an unexpected result after numerous negotiation failures over the past two decades.⁽²⁾ According to the contract (East Line Gas Deal, hereafter), China will begin importing 5 billion cubic meters of natural gas from East Siberia in 2018, and gradually increasing to 38 billion cubic meters in 2023. Eventually, the amount could be possibly raised to 60 billion cubic meters.⁽³⁾ Russia and China are responsible for the cost of field exploitation, pipeline construction, and storage facility in their own respective territories. It is estimated that Russia needs to invest \$55 billion dollars to build 2680km pipelines from the Kovykta field and the Chayanda field through Belogorsk to Chinese border city Heihe and that China has to invest 20 billion dollars to transport natural gas from Heihe

through the Beijing-Tianjin-Hebei Metropolitan Region to Eastern China.(4) The Sino-Russian negotiation will continue on the West Line Gas Deal, by which China can import natural gas from West Siberia through the border city Altay in Northern Xinjiang.(5)

The sudden agreement over the East Line Gas Deal surprised many economic experts worldwide and prompted great speculation about the motive and calculation for both China and Russia. Why did China and Russia reach such a deal all after the two-decade long marathon talk? What changes occurred in both countries bridging the gap that was used to hinder the deal? Which country benefits more from this deal? What are the political, social and economical implications of this deal for China? These are the important questions that require comprehensive answers to fully understand this unexpected event.

A Win-Win Deal for Both of China and Russia

The nuclear issue in the past that prevented the Sino-Russian gas deal is the price problem: Russia expected a higher price more than China could agree. It was reported that the minimal price for Russia was about \$400 dollars/cubic meter, but China was only willing to accept the price between \$350 and \$360 dollars/cubic meter.(6) If we only take the selling or buying price into account, Russia and China could find other business partners in the global market for greater profit and lower cost, respectively.(7) So neither was willing to concede in the price negotiation. However, recent changes in international politics have dramatically altered the nature of the problem, transforming a simple price problem into a complicated strategic game for both Russia and China.(8)

The Ukraine crisis was a critical event and its spill over effect reduces Russia's bargaining power in the European market.(9) Russia is a dominant natural gas supplier in the global oligopoly market. For a long time, 80% of Russia's exported natural gas was sold to Europe and Ukraine, and the revenue was a very important source of financial income.(10) Given its strong bargaining power, Russia often exploited this advantage to exert its political influence over Eastern Europe and Central Asia and meanwhile to balance the European Union in international politics.(11)

However, Russia must now face the following challenges that greatly weaken its dominant role in the global market. Firstly, Ukraine's new political leadership chose to politically lean towards the European Union and the United States regardless of its total dependency on Russia's gas supply.(12) Secondly, the European Union continues to battle with Russia for gaining political allies in Eastern Europe and Central Asia, which could further erode Russia's bargaining power, especially over the possible sanction from the West after Crimea declared independence.(13) Thirdly, the commercial production of shale gas in the United States has gained great competitive advantage for its low cost

(only 1/4 of the market price in East Asia) and rich reservoir, which fundamentally shakes Russia's dominant role in the supply side.⁽¹⁴⁾ Finally, the rapid increase of China's gas demand also transforms the market into the buyer's side for China's persistent and strong domestic consumption.⁽¹⁵⁾ Realising these on-going changes, Russia has to seek a strategic partner with strong and reliable demand to diversify gas export and reduce overdependence of the sale to Ukraine and the European Union.⁽¹⁶⁾ In this regard, China is the perfect strategic ally for Russia to circumvent potential economic loss, even at the cost of price concession.⁽¹⁷⁾

The East Line Gas Deal for China is apparently a political as well as an economical win. It was reported that the negotiated price is slightly higher than 350 dollars/cubic meter, which is about the same price with the imported gas from central Asia.⁽¹⁸⁾ Considering the shorter route and cheaper transportation, the East Line Gas Deal could cut down the gas production cost and earn more revenue in the Chinese domestic market.⁽¹⁹⁾ In the political sphere, the signing of the Sino-Russian deal not only achieve the national interest for energy diversification but also consolidates the strategic partnership with Russia, which is conducive to China's balancing policy against the United States and its allies in East and Southeast Asia. It is no wonder that Putin joked when he met PRC Vice President Li Yuanchao: "The Chinese drank quite a bit of our blood",⁽²⁰⁾ which insinuated that Chinese negotiators knew how to take advantage of Russia when Russia needed a reliable strategic partner like China.

The Diversification of China's Energy Structure

Energy policy is vital for China's national interest and the PRC government has long sought for the secure supply to support its rapid economic development. As Table 1 shows (below), from 2003 to 2012, coal consumption still dominated China's energy structure and maintained 70%; oil consumption was slightly reduced from 22.1% to 17.1%; hydroelectric power was the third largest source of energy and its share increased from 5.3% to 7.1%; natural gas only accounted for less than 5%, despite the significant increase from 2.4% to 4.7%; nuclear power and renewable energy also increased from 0.8% to 2%.⁽²¹⁾ According to the official policy, China is seeking diversification of energy structure, and particularly major adjustment will be directed to reducing coal consumption by natural gas.⁽²²⁾ The gist is to relieve environment pollutions because natural gas is a far cleaner source of energy. It is projected that the percentage of gas consumption will be raised to 15% of total energy, and the imported gas will reach 120 billion cubic meters, which is more than twice of the imported gas in 2013 (53 billion cubic meters).⁽²³⁾

China has already pursued the diversification policy for more than a decade. To achieve this goal, China planned to increase imported gas through four different channels: Sino-

Central Asian gas pipelines from the Northwest, Sino-Myanmar gas pipelines from the Southwest, Sino-Russian pipelines from the Northeast, and shipping imported LNG (liquefied natural gas) from the Middle East, Southeast Asia and Australia.(24) The Sino-Central Asian gas pipelines were inaugurated in December 2009 and began to export natural gas to China.(25) The Sino-Myanmar gas pipelines also began to transport natural gas to China in July 2013,(26) although until April 2014 only about 1 billion cubic meter was imported (designed for imported 10 billion cubic meter per year).(27) After the signing of the East Line Gas Deal last month, China basically has completed the diversification policy and acquired great bargaining power for the gas price due to its predictable stronger demand in the future. As Table 2 indicates, the main source of China's imported gas is from the Sino-Central Asian pipeline (Turkmenistan, 46.48%), followed by imported LNG from Qatar (17.76%), Australia (9.33%), Malaysia (6.77%), and Indonesia (6.59%).(28) If the Sino-Myanmar pipelines and Sino-Russian pipelines can operate normally as planned, the amount of imported gas can be largely increased to 58 billion cubic meters in the near future.

China is expected to continue the diversification policy in raising gas consumption to adjust its energy structure. The governmental research institute has already studied the possibility to import shale gas from the United States.(29) The Chinese government also keeps pursuing the West-Line Gas Deal with Russia. If both sources can work out and add into the portfolio of imported gas, China can expedite its pace to achieve the transformation of energy structure. This result is conducive to the solution of the economic and environmental problems in the midst of becoming the rising global power.

Ramification of the Gas Deal

China has reached a developmental level that needs to balance economic growth and environmental protection. For all kinds of environmental problems, air pollution is one of the most serious issues that require immediate action to resolve. Chinese media reported that only less than 1% of the top 500 cities in China of which PM 2.5 meet the WHO standard.(30) Nearly all of the major cities suffered serious air pollution problems. The problem does not confine to PM 2.5, but also includes sand storms, sulfur dioxide, nitrogen dioxide, acid rain, exhaust emission, etc.(31) According to the report by Asian Development Bank and Tsinghua University, the economic loss caused by air pollution amounts to 1.2% and 3.8% GDP when referring to health cost and customer's willingness-to-pay (WTP).(32) China is now at the crossroads to make a determined structural adjustment of energy consumption, and the increase of imported natural gas is a critical step to reduce the polluted coal consumption.

Economically speaking, the negotiated price for China is fairly low comparing to the market price (about \$400 dollars/cubic meter) for imported gas from Uzbekistan and

Russia.⁽³³⁾ As China raises the demand and diversifies its suppliers, its bargaining power will become even stronger. The signing of the long-term gas deal can stabilize the energy cost and prevent suffering from the surging and volatile oil price. Furthermore, as the domestic construction of the gas pipeline networks become more and more extensive, Chinese consumers will benefit from economies of scale for cheaper and cleaner energy.

Politically, China achieves multiple goals by signing the deal with Russia. Firstly, China does need Russia to be its powerful ally in dealing with the escalation of territorial disputes with Japan, Philippines, and Vietnam, all of which are supported by the United States. Secondly, the diversification policy not only drives Russia to concede in the price negotiation, but successfully bundles economic and political interests with individual ASEAN members. This would divide the political stance regarding China within the ASEAN countries and prevent from shaping an antagonistic political union promoted by Philippines and Vietnam. Thirdly, China has demonstrated to the world that its economic power can be diffused to the political arena and cause important changes in the global strategic game. China's political influence is not only present in the Middle East and Africa; now it is capable to make Russia concede in the price negotiation. In view of these facts, despite a win-win result for both countries, China apparently gains more interest than Russia does, and this perfectly exhibits China's rising status in the future of great power politics.

Conclusion

The recent crisis in Ukraine and the rising gas demand in China driven by the diversification policy fundamentally change the nature of the Sino-Russian gas deal from a price problem into a strategic game. Both China and Russia have great incentive and share common interests to build a strategic alliance, but the price concession in the negotiation process clearly shows that Russia is under more pressure to make this deal given its diminishing bargaining power related to the potential market changes in Ukraine and European Union. For China, the progress in diversifying energy sources, particularly building multiple channels for imported gas, has raised its bargaining leverage in the global energy market, which signifies China's ascending political influence brought by its strong economic power.

Table 1. China's Energy Structure, 2003-2012

	Oil	Natural Gas	Coal	Nuclear Power	Hydroelectric power	Renewable energy
2003	22.1	2.4	69.3	0.8	5.3	—
2004	22.4	2.5	68.7	0.8	5.6	—

2005	20.9	2.6	69.9	0.8	5.7	—
2006	20.4	2.9	70.2	0.7	5.7	—
2007	19.5	3.4	70.5	0.8	5.9	—
2008	18.8	3.6	70.2	0.8	6.6	—
2009	17.7	3.7	71.2	0.7	6.4	0.3
2010	17.6	4.0	70.5	0.7	6.7	0.5
2011	17.7	4.5	70.4	0.7	6.0	0.7
2012	17.7	4.7	68.5	0.8	7.1	1.2

Source: Pang (2013), see endnote 21.

Table 2. Top-Ten Countries for China's Imported Gas

Country	Imported Amount	Percentage
Turkmenistan	24.7	46.48
Qatar	0.95	17.76
Australia	0.5	9.33
Malaysia	0.36	6.77
Indonesia	0.35	6.59
Uzbekistan	0.29	5.50
Yemen	0.12	2.94
Egypt	0.06	1.14
Equatorial Guinea	0.056	1.05
Nigeria	0.051	0.96

Source: Sun Wu (2014), see endnote 28.

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***Endnotes:**

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