

THE EMERGING RUSSIA-ASIA ENERGY NEXUS

By Erica Downs, James Henderson, Mikkal E. Herberg, Shoichi Itoh,
Meghan L. O'Sullivan, Morena Skalamera, and Can Soylu



| NBR Board of Directors | | |
|---|---|--|
| John V. Rindlaub (<i>Chairman</i>) President, Asia Pacific Wells Fargo | Ryo Kubota Chairman, President, and CEO Acucela Inc. | Scott Stoll (<i>Treasurer</i>) Partner Ernst & Young LLP |
| Thomas W. Albrecht Partner Sidley Austin LLP | Quentin W. Kuhrau Chief Executive Officer Unico Properties LLC | David K.Y. Tang Managing Partner, Asia K&L Gates LLP |
| Dennis Blair Chairman Sasakawa Peace Foundation USA U.S. Navy (Ret.) | Regina Mayor Principal, Global Sector Head and U.S. National Sector Leader of Energy and Natural Resources KPMG LLP | Mitchell B. Waldman Executive Vice President, Government and Customer Relations Huntington Ingalls Industries, Inc. |
| Charles W. Brady Chairman Emeritus Invesco LLC | Melody Meyer President Melody Meyer Energy LLC | <i>Honorary Directors</i> |
| Maria Livanos Cattau Secretary General (Ret.) International Chamber of Commerce | Joseph M. Naylor Vice President of Policy, Government and Public Affairs Chevron Corporation | Lawrence W. Clarkson Senior Vice President The Boeing Company (Ret.) |
| George Davidson (<i>Vice Chairman</i>) Vice Chairman, M&A, Asia-Pacific HSBC Holdings plc (Ret.) | Kenneth B. Pyle Professor; Founding President University of Washington; NBR | Thomas E. Fisher Senior Vice President Unocal Corporation (Ret.) |
| Norman D. Dicks Senior Policy Advisor Van Ness Feldman LLP | Jonathan Roberts Founder and Partner Ignition Partners | Joachim Kempin Senior Vice President Microsoft Corporation (Ret.) |
| Richard J. Ellings President NBR | Tom Robertson Vice President and Deputy General Counsel Microsoft Corporation | Clark S. Kinlin President and Chief Executive Officer Corning Cable Systems Corning Incorporated |
| Mark Jones Managing Director, Head of Wells Fargo Securities Asia Pacific Wells Fargo Securities Asia Limited Wells Fargo & Company | Matt Salmon Vice President of Government Affairs Arizona State University | George F. Russell Jr. (<i>Chairman Emeritus</i>) Chairman Emeritus Russell Investments |
| NBR Counselors | | |
| Charles W. Boustany Jr. U.S. House of Representatives (Ret.) | Aaron Friedberg Princeton University | Joseph Lieberman U.S. Senate (Ret.) |
| Norman D. Dicks U.S. House of Representatives (Ret.) | Slade Gorton U.S. Senate (Ret.) | Ashley Tellis Carnegie Endowment for International Peace |
| Thomas B. Fargo U.S. Navy (Ret.) | | |
| NBR Chairman's Council and Board of Advisors | | |
| Michael Armacost Stanford University | Carla A. Hills Hills & Company | Donald P. Nielsen Luminal Lighting LLC |
| Rodney Bindon Bindon and Associates | Robert D. Hormats Kissinger Associates, Inc. | Sam Nunn Nuclear Threat Initiative |
| Richard Cody L-3 Communications, Inc. | David Lampton Johns Hopkins University | Joseph S. Nye Jr. Harvard University |
| Nicholas Eberstadt American Enterprise Institute | Nicholas Lardy Peterson Institute for International Economics | Stanley Palmer Marvin & Palmer Associates, Inc. |
| Karl Eikenberry Stanford University | Richard Lawless New Magellan Ventures | Dwight Perkins Harvard University |
| Donald Emmerson Stanford University | Chae-Jin Lee Claremont McKenna College | Thomas Pickering The Boeing Company (Ret.) |
| Lee Hamilton Indiana University | Kenneth Lieberthal Brookings Institution | William Rademaker Flybuy Technologies |
| Stephen Hanson College of William and Mary | William J. Lynn, III DRS Technologies, Inc. | Clarine Nardi Riddle Kasowitz, Benson, Torres & Friedman LLP |
| Harry Harding University of Virginia | Rajan Menon City College of New York | Stanley Roth The Boeing Company |
| Donald Hellmann University of Washington | Mary Minnick Lion Capital | Sheldon Simon Arizona State University |
| Robert J. Herbold The Herbold Group, LLC | | |

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #74 | DECEMBER 2018

THE EMERGING RUSSIA-ASIA ENERGY NEXUS

*Erica Downs, James Henderson, Mikkal E. Herberg,
Shoichi Itoh, Meghan L. O'Sullivan, Morena Skalamera,
and Can Soylu*

THE NATIONAL BUREAU *of* ASIAN RESEARCH

The NBR *Special Report* provides access to current research on special topics conducted by the world's leading experts in Asian affairs. The views expressed in these reports are those of the authors and do not necessarily reflect the views of other NBR research associates or institutions that support NBR.

The National Bureau of Asian Research is a nonprofit, nonpartisan research institution dedicated to informing and strengthening policy. NBR conducts advanced independent research on strategic, political, economic, globalization, health, and energy issues affecting U.S. relations with Asia. Drawing upon an extensive network of the world's leading specialists and leveraging the latest technology, NBR bridges the academic, business, and policy arenas. The institution disseminates its research through briefings, publications, conferences, Congressional testimony, and email forums, and by collaborating with leading institutions worldwide. NBR also provides exceptional internship opportunities to graduate and undergraduate students for the purpose of attracting and training the next generation of Asia specialists. NBR was started in 1989 with a major grant from the Henry M. Jackson Foundation.

Funding for NBR's research and publications comes from foundations, corporations, individuals, the U.S. government, and from NBR itself. NBR does not conduct proprietary or classified research. The organization undertakes contract work for government and private-sector organizations only when NBR can maintain the right to publish findings from such work.

To download issues of the NBR *Special Report*, please visit the NBR website <http://www.nbr.org>.

This report may be reproduced for personal use. Otherwise, the NBR *Special Report* may not be reproduced in full without the written permission of NBR. When information from NBR publications is cited or quoted, please cite the author and The National Bureau of Asian Research.

This is the seventy-fourth NBR *Special Report*.

NBR is a tax-exempt, nonprofit corporation under I.R.C. Sec. 501(c)(3), qualified to receive tax-exempt contributions.

© 2018 by The National Bureau of Asian Research.

Front cover image: Oil terminal © papa1266 / iStock.

For further information about NBR, contact:

The National Bureau of Asian Research
1414 NE 42nd Street, Suite 300
Seattle, Washington 98105

206-632-7370 Phone
206-632-7487 Fax
nbr@nbr.org E-mail
<http://www.nbr.org>

THE EMERGING RUSSIA-ASIA ENERGY NEXUS

—— TABLE OF CONTENTS ——

- v Introduction
Mikkal E. Herberg
- 1 The Leaders of Russia's Energy Pivot to Asia
James Henderson
- 17 China-Russia Energy Relations: Better Than Ever
Erica Downs
- 33 Japan's Opaque Energy Policy toward Russia: Is Abe Being Trumped by Putin?
Shoichi Itoh
- 43 Russia's Energy Foray into Asia: Implications for U.S. Interests
Meghan L. O'Sullivan, Morena Skalamera, and Can Soylu

Russia possesses enormous reserves of oil, natural gas, and coal, and its size and geographic location put it in close proximity to some of the world's largest energy importers. Japan, China, South Korea, and Asia's other major energy importers have long sought greater access to Russia's immense energy resources. Russian oil and gas supplies could significantly reduce these countries' heavy dependence on energy imports from the Middle East, as well as their reliance on oil and liquefied natural gas (LNG) transported via the Indo-Pacific region's congested and contested sea lanes.

Nevertheless, until recently, the results of Asia's efforts to open up greater access to Russian oil and gas were relatively modest. Russia's original energy "pivot" to Asia was slow and halting. In the wake of Western sanctions imposed on Russia in 2014 following its intervention in Ukraine, President Vladimir Putin announced with great fanfare that Russia would shift its future energy focus toward growing Asian and Chinese energy markets. It signed a major agreement with China to build a new gas pipeline from East Siberia to supply 38 billion cubic meters (bcm) per year beginning in 2018–19. Yet progress on building the pipeline was, until recently, agonizingly slow, and other official initiatives to expand energy ties moved just as slowly, if at all.

However, this has finally begun to change as Russia's energy presence in Northeast Asia and elsewhere in the region has been quietly growing. Of course, Asia's oil and gas importers have welcomed this development as an important opportunity to diversify their sources of both oil and natural gas, aiding in their enduring quest for energy security. But from a broader Western and particularly U.S. strategic perspective, Russia's growing access to Chinese and other Asian capital, energy investments, and energy markets has potentially less welcome strategic implications that are not yet well understood by U.S. policymakers.

Russia's expanding energy footprint in Asia is driven by the convergence of several underlying developments. First, conditions in the Russian energy industry are changing dramatically in ways that are opening up new avenues for energy exports to and investments in Asia, as well as new opportunities for Chinese and other Asian energy investment in Russia. Moscow began turning more urgently toward Asian, and particularly Chinese, energy markets because pressure from much lower oil and natural gas export revenues during the 2014–16 oil price crash, as well as from Western sanctions. Second, the consolidation of Russia's oil industry under Rosneft, combined with the emergence of ambitious private companies such as Novatek, has added new dynamism to this push eastward.

The convergence of Russian and Asian energy interests has also been driven by major energy shifts in China. China's relentlessly rising dependence on Middle East supplies has compelled Beijing to boost efforts to expand oil imports from Russia, which has now become China's largest source of imported oil. China has now doubled the capacity of the Eastern Siberia–Pacific Ocean (ESPO) pipeline to transport Russian oil to northeast China, and its national oil companies have been given new equity energy investment opportunities in Russia that were impossible only a few years ago. At the same time, Beijing's "dash for gas" to reduce coal use and fight air pollution has made the completion of the new Power of Siberia gas pipeline from East Siberia to northeast China a much more important priority. This dash for gas has also driven China's major role in investment, financing, and offtake agreements to support completion of the Yamal LNG project

spearheaded by Novatek. This dovetails with the growing potential for Russian LNG and oil shipments to China and Northeast Asia via the Northern Sea Route.

The picture is much more mixed for Japan, which is looking to encourage further expansion of the export capacity of Sakhalin Island LNG. The Sakhalin-2 project has been a key LNG supplier, and Exxon and Rosneft's Sakhalin-1 project potentially has additional gas supplies that could be available. However, Japan is handicapped by its adherence to Western sanctions on Russia's energy industry and by the historic legacy of their territorial dispute over the Northern Territories (known as the Kuril Islands in Russia). The picture is also mixed for South Korea. Its long quest to develop a natural gas pipeline project from Russia to offset its 100% dependence on seaborne LNG supplies remains blocked by its standoff with North Korea. On the other hand, there is some modest new momentum behind a potential undersea natural gas pipeline from China to South Korea possibly fed by Russian gas.

Russia's growing role in Asia's energy markets is likely to have important cross-cutting implications for both the region and the West. Greater access to Russian energy resources should significantly strengthen Asia's energy security and help diversify the region's import dependence. However, from a U.S. strategic perspective, Russia's growing access to Asian, specifically Chinese, capital, investments, and energy markets has more problematic implications. First, it seems likely to strengthen Sino-Russian strategic alignment and regional collaboration, reinforcing other factors that are leading toward stronger cooperation between China and Russia. Also, access to Asian investment and financing is clearly giving Moscow a "relief valve" from Western sanctions and risks significantly undermining their effectiveness. More broadly, greater Northeast Asian energy alignment and integration with Russia could facilitate Asia's potential shift to reduce its strategic dependence on the United States as doubts grow about the long-term U.S. commitment to the region.

With this in mind, the National Bureau of Asian Research (NBR) convened its 2018 Energy Security Program under the theme "The Emerging Russia-Asia Energy Nexus." Now in its fourteenth year, NBR's Energy Security Program convenes top geopolitical and energy experts from around the globe to produce an in-depth, twelve-month assessment of a major development in Asian energy markets to help policymakers better understand and respond to the implications for energy and national security. With generous support from Chevron and ConocoPhillips, and working in partnership with the Woodrow Wilson International Center for Scholars on a summer workshop, the 2018 program focused on a range of issues, including the evolving conditions in the Russian energy industry, the growing Russia-China energy connection, implications for Japan's energy security and strategic position, and implications for the United States' long-term strategic interests in Asia. An important goal of the program was bringing together policy, industry, and research leaders to better understand how to strengthen common approaches to strategic, economic, and energy concerns involving Russia and its energy ambitions in Asia.

NBR commissioned four essays by leading scholars to address key dimensions of the Russia-Asia energy nexus. The preliminary assessments were discussed at a workshop in Washington, D.C., on July 17, 2018, that included senior representatives from the U.S. and foreign policymaking communities and industry and geopolitical specialists.

In the first essay, James Henderson from the Oxford Institute for Energy Studies examines the new forces that are driving Russia to increase energy exports to Asia, and especially China. While Russia and China are what he calls natural "energy partners," this dynamic is being reinforced by

new geopolitical conditions. Most importantly, the U.S. and EU energy sanctions have accelerated the pace of Moscow's pivot to Asia. The Kremlin has been encouraging its main energy companies, Rosneft and Gazprom, and more recently privately owned Novatek, to turn their attention east. Although strategic suspicions between Russia and China remain, a new balance is emerging between China's strong bargaining position and Russia's increasing ability to deliver oil and gas supplies. Russia also offers China potential long-term access to the Arctic. In the end, Henderson argues that oil and gas exports could become an important foundation for strengthening bilateral strategic ties over the next few decades.

In the second essay, Erica Downs from CNA assesses the growing energy nexus between China and Russia from the Chinese perspective. She argues that the key drivers have been China's ability to provide large-scale capital for the major Russian energy companies at key junctures when they were under debt pressures or when access to Western capital markets was foreclosed by sanctions. In the case of oil, the China Development Bank provided huge loans in 2008–9 to Rosneft, making possible the construction of the ESPO pipeline to China. In the case of natural gas, Russia, and specifically Gazprom, were largely cut off from Western capital markets in the wake of sanctions in 2014. Russia looked to China as a key future gas market and provider of large-scale financing by signing the landmark agreement to build the Power of Siberia pipeline. In the case of LNG, China provided critical financing, equity investment, and offtake agreements for the Yamal LNG project when it faced severe financing constraints due to Western sanctions. In all these cases, China benefited strategically by diversifying its oil, natural gas, and LNG imports. Ironically, the recent U.S. tariffs have cast doubt on the extent to which China will be willing to rely on U.S. crude oil and LNG exports, thus further reinforcing Beijing's incentives to strengthen strategic energy relations with Russia.

Next, Shoichi Itoh from the Institute of Energy Economics, Japan (IEEJ) examines Japan-Russia energy relations in the particular context of the unique and evolving relationship between President Vladimir Putin and Prime Minister Shinzo Abe. As Itoh notes, Abe has struck a markedly different tone in his outreach and prioritization of engagement with Russia from his recent predecessors and sees energy cooperation as a potential foundation for cultivating the necessary trust and common bond required to resolve the long-standing territorial dispute. Yet Itoh argues that this vision may border on "wishful thinking," particularly once practical market realities are taken into account. Moreover, such cooperation may undercut efforts to deepen the already robust U.S.-Japan economic relationship, where cooperation on energy has been a key priority. While Itoh does not argue that Japan's interests in closer cooperation with Russia and forging deeper ties with the United States are in fundamental opposition, he does conclude that these relationships will need to be closely managed.

In the final essay, Meghan O'Sullivan, Morena Skalamera, and Can Soylu from the Geopolitics of Energy Project at Harvard University's Kennedy School of Government assess the implications of Russia's growing energy role in Asia and the extent to which it is contributing to a broader strategic alignment with China. They argue that China and Russia are forging closer ties to build a multipolar world and that these energy ties are the foundation of the economic partnership. Yet China clearly still has the upper hand in the relationship. Moreover, although it has a strong interest in importing Russian oil and gas, its relationship with the United States remains far more important. The authors caution, however, that the aggressive U.S. stance toward trade with China inadvertently plays into Russia's hands by potentially reducing China's interest in importing

U.S. oil and LNG and increasing the attractiveness of Russian oil and gas imports. This approach also undercuts Beijing's strategic logic of keeping a distance from Russia to avoid complicating relations with the United States.

In conclusion, the emerging Russia-Asia energy nexus has significant implications for U.S. policymakers. On the one hand, it is strengthening the region's energy security by providing diversification away from extremely heavy dependence on the Middle East. Clearly China has benefited the most so far, but over time the growing focus of Russia's energy companies on Asian markets is likely to increase the supplies available to Japan, South Korea, and the rest of the region. On the other hand, energy trade and investment could lay the foundation for a closer strategic alignment between China and Russia that would challenge U.S. power and influence in Asia and globally. In this regard, the United States needs to think carefully about how its increasingly confrontational trade policy toward China has the potential to undermine U.S. exports of oil and LNG. Specifically, U.S. policymakers need to re-evaluate the important strategic role of energy exports in shaping the future of U.S. relations with China and Asia more broadly.

Mikkal E. Herberg
Research Director of the Energy Security Program
The National Bureau of Asian Research

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #74 | DECEMBER 2018

The Leaders of Russia's Energy Pivot to Asia

James Henderson

JAMES HENDERSON is Director of the Natural Gas Programme at the Oxford Institute for Energy Studies. He can be reached at <james.henderson@oxfordenergy.org>.

EXECUTIVE SUMMARY

This essay examines Russia's significant hydrocarbon resources in its eastern regions, which provide an obvious source of exports for Asia-Pacific countries, and assesses whether a natural balance can be found between the commercial, political, and strategic issues that these energy links naturally create.

MAIN ARGUMENT

Russia's large oil and gas resources in East Siberia and the Russian Far East have been stranded during most of the post-Soviet era due to the lack of an obvious market. However, economic growth in the Asia-Pacific has provided an obvious outlet for these hydrocarbons, and the Kremlin has been encouraging its main energy companies to turn their attention to the east. This "pivot to Asia" has been further encouraged by Russia's increasingly difficult relations with its historic partners in the West following the annexation of Crimea in 2014 and the subsequent imposition of U.S. and EU sanctions. In the oil sector, Rosneft has led the move to increase exports to Asia. But although this infrastructure was intended to diversify opportunities in the region, in reality Russia's oil exports are dominated by sales to China. In the gas sector, Gazprom is no longer the only major player. Rosneft has been pursuing its own projects, while Novatek has emerged as Russia's liquefied natural gas (LNG) champion. Overall, a natural marriage between Russian resources and Chinese demand is starting to take shape, and oil and gas exports could become an important foundation for the strengthening of ties between the two countries over the next few decades.

POLICY IMPLICATIONS

- Russia and China are obvious energy partners, given the former's huge resources and the latter's rapidly growing demand. These natural forces are now being underpinned by complementary geopolitical considerations.
- U.S. and EU sanctions on Russia, as well as the expanding U.S. trade war with China, are increasing the attractiveness of Russia's oil and gas resources as a source of imports to China.
- Russia's reliance on Western markets is set to decline over the next decade as it increases exports to the east. In particular, talk of constructing a second and third gas pipeline to China and the rapid expansion of LNG developments in the Arctic underlines this trend.
- The Arctic could become a key region for the Russia-China partnership, as it is the one area in which Russia has real bargaining power.

Russia's strategy to shift the balance of its energy exports away from the traditional core markets in Europe and the West toward an eastern vector first took shape in the 1990s, when Gazprom had initial conversations about possible gas exports to China.¹ The first real catalyst for action, though, came from Mikhail Khodorkovsky and his oil company Yukos in the early 2000s, when plans for an oil pipeline to China and the Pacific coast were mooted and oil exports began in earnest via rail.² However, the demise of Yukos also marked the re-establishment of state control over energy relations in the east. Gazprom was given full control of the Eastern Gas Program in 2007, while Rosneft and Transneft have dominated issues surrounding oil exports. Interestingly, though, some private actors have emerged as important players, with Novatek at the forefront thanks to its leadership of Russia's development of liquefied natural gas (LNG). Additionally, the balance of power between the key state actors also appears to be shifting. Rosneft's influence has been enhanced by the leadership of Igor Sechin, while Gazprom's influence appears to be receding. One should not exaggerate this shift, given President Vladimir Putin's propensity to balance the influence of different power groups in the country.³ Nevertheless, it is not unreasonable to suggest that Russia's pivot to Asia could also be a long-term catalyst for domestic reform as well as a key element of the country's foreign policy and geopolitical strategy, particularly in light of the U.S. and European Union sanctions on Russia imposed since 2014.

In order to discuss all these issues, this essay is organized in the following fashion. The first section on the oil sector discusses the history of Russian oil exports to Asia, and in particular to China, focusing on the development of the Eastern Siberia–Pacific Ocean (ESPO) pipeline as a key catalyst. The next section then looks at the gas sector, describing Gazprom's long-running attempts to secure an export contract with China, its failure to develop LNG beyond the Sakhalin-2 project, and its resource base in East Siberia. This section also discusses the emergence of new players in the gas sector and analyzes how Russia's pivot to Asia is allowing them to compete with Gazprom. Finally, the essay concludes with an assessment of the extent of the oil and gas resource base in Russia's eastern regions, the implications of growing hydrocarbon exports to Asia, and the potential for these exports to inspire change in the governance of Russia's energy sector.

The Oil Sector: Rosneft's Dominance, China's Dependence

The overriding context of the Russia-China energy relationship is that Russia is a major owner and producer of oil and gas located in geographic proximity with the fastest-growing energy consumer in the world, China. Russia's eastern resources will be discussed below, but it is important to consider that Chinese demand for oil and gas has been rising at extraordinary rates over the past decade and a half, fueling the country's remarkable economic growth. The "BP Statistical Review of World Energy" reveals that China is now the second-largest consumer of oil in the world (after the United States), accounting for 13% of the global total and with growth averaging 5% per annum over the past decade.⁴ The statistics for gas are even more

¹ James Henderson and Tatiana Mitrova, *Energy Relations between Russia and China: Playing Chess with the Dragon* (Oxford: Oxford Institute for Energy Studies, 2016), 52.

² Martha Brill Olcott and Nikolai Petrov, "Russia's Regions and Energy Policy in East Siberia," James A. Baker III Institute for Public Policy, May 2009, 18.

³ Kathrin Hille, "Russia: How to Exercise Political Control," *Financial Times*, September 7, 2016.

⁴ BP, "BP Statistical Review of World Energy," June 2018, <https://www.bp.com/content/dam/bp/en/corporate/pdf/energy-economics/statistical-review/bp-stats-review-2018-full-report.pdf>.

impressive, as demand grew annually by a 13% average during 2007–17. With total demand of 240 billion cubic meters (bcm) in 2017, China is now the third-largest global market after the United States and Russia. Furthermore, Chinese demand is expected to continue to grow. The International Energy Agency sees oil demand rising by 1.3% per annum to 2040, while gas demand is forecast to increase by 4.6% per annum over the same period.⁵ As a result, there appears to be a natural alignment between Russia and China over energy trade, if the two countries can find a way to balance the commercial, political, and strategic issues that always surround the import and export of oil and gas.

The foundation of Russia's oil exports to Asia is the ESPO pipeline, which connects the main Russian trunk oil pipeline system at Tayshtet with the port of Kozmino on Russia's east coast near Vladivostok (see **Figure 1**).⁶ Importantly, there is also a spur running from Skovorodino to the Chinese border at Mohe, and from there onto Daqing, which provides exclusive exports for China. The ESPO pipeline, which has a current capacity of 58 million tonnes per annum (mtpa), or around 1.2 million barrels per day (bpd), began operations in 2011 and has been expanded to its current size in two phases. The spur to China has a capacity of 30 mtpa (600,000 bpd) but has not yet been used to its full extent due to difficulties on the Chinese side. The overall capacity of the system is expected to reach 80 mtpa (1.6 million bpd), with just over one-third of this going directly to

FIGURE 1 The Eastern Siberia–Pacific Ocean Pipeline



SOURCE: Szymon Kardaś, “The Eastern Partnership of Gas. Gazprom and CNPC Strike a Deal on Gas Supplies to China,” Ośrodek Studiów Wschodnich (OSW), OSW Commentary, June 16, 2014, <https://www.osw.waw.pl/en/publikacje/osw-commentary/2014-06-16/eastern-partnership-gas-gazprom-and-cnpc-strike-a-deal-gas>.

⁵ International Energy Agency, *World Energy Outlook 2018* (Paris: OECD Publishing, 2018), 163, 339.

⁶ “Eastern Siberia–Pacific Ocean Pipeline System: Skovorodino–Kozmino Section (ESPO-2),” Transneft, <http://www.en.transneft.ru/about/projects/realized/10709>.

China, while around one-quarter will go into Russian refineries in the east and the remainder will be sold out of Kozmino.⁷

The ESPO pipeline has catalyzed the development of oil assets in East Siberia and has also led to some redirection of flows of crude from other parts of Russia, mainly thanks to the premium that ESPO crude, which is higher quality than the standard Russian Urals export blend, can command.⁸ The leading companies in East Siberia have been Rosneft, TNK-BP, and Surgutneftegas, with the smaller Irkutsk Oil also growing rapidly and the Gazprom subsidiary Gazprom Neft starting to play a more prominent role.⁹ However, since its takeover of TNK-BP in 2013, Rosneft has dominated Russian oil production and exports in the region, especially given that it owns the largest oil field, Vankor, dedicated to the eastern export system.¹⁰ Rosneft also controls large swathes of exploration licenses from Krasnoyarsk to Yakutia, meaning that it is in a strong position to maintain its leadership in the longer term. Igor Sechin's close relationships with politicians and corporate leaders in China, and the partnerships that his company has forged with Chinese and other Asian companies, provide further evidence of Rosneft's long-term goals in the region. It seeks to establish itself not only as the leader of Russia's energy diplomacy but also as a key player in delivering energy to the world's fastest-growing economies.¹¹ **Figure 2** shows the share of exports via the ESPO system in 2017, underlining the powerful position of Rosneft, which already accounts for more than two-thirds of Russia's eastern oil exports.

A number of important issues emerge from Rosneft's dominance of Russia's oil relationship with China. First, it is clear from **Figure 2** that the company is the sole user of two of the routes for Russian crude exports to its southern neighbor, namely the China spur of the ESPO pipeline and the pipeline route via Kazakhstan, where Rosneft is using spare capacity in a 400,000 bpd system that is currently receiving only 50,000 bpd of Kazak crude exports to the east.¹² Rosneft monopolizes these two routes because of financing arrangements with China through which it has received advance payments for crude exports that have allowed it to finance expansion plans and more recently to pay off its significant debts from the TNK-BP acquisition.¹³

The company's reliance on Chinese financing became particularly acute after the imposition of U.S. and EU sanctions in 2014 (in the wake of the Ukraine crisis), which significantly limited its ability to raise funds in international financial markets.¹⁴ Indeed, in 2015, when the price of oil also fell sharply, it appeared that Rosneft could run into severe balance sheet difficulty without the support of the Chinese prepayments. **Figure 3** shows the crude export sales that have been guaranteed by the deals that were struck in 2004, 2009, and 2013. The first was a relatively small \$6 billion purchase of 8.9 mtpa of crude over five and a half years. This was

⁷ "Russian Crude Oil Exports to the Pacific Basin—ESPO Starts Flowing," Platts, Special Report, May 2010.

⁸ Eesha Muneeb, "Analysis: Russian ESPO Blend Crude Premiums Surge to Near 4-Year Highs on Wider EFS," S&P Global Platts, January 23, 2018.

⁹ James Henderson, "The Strategic Implications of Russia's Eastern Oil Resources," Oxford Institute for Energy Studies, Working Paper, January 2011, 23.

¹⁰ "2009 Annual Report: Full-Scale Efficiency," Rosneft Oil Company, 2009, 14–27.

¹¹ Henry Foy, Max Seddon, and Lucy Hornby, "Russia and China Quietly Build Business Bonds," *Financial Times*, September 24, 2017, <https://www.ft.com/content/38f0ce22-9dd7-11e7-8cd4-932067fbf946>.

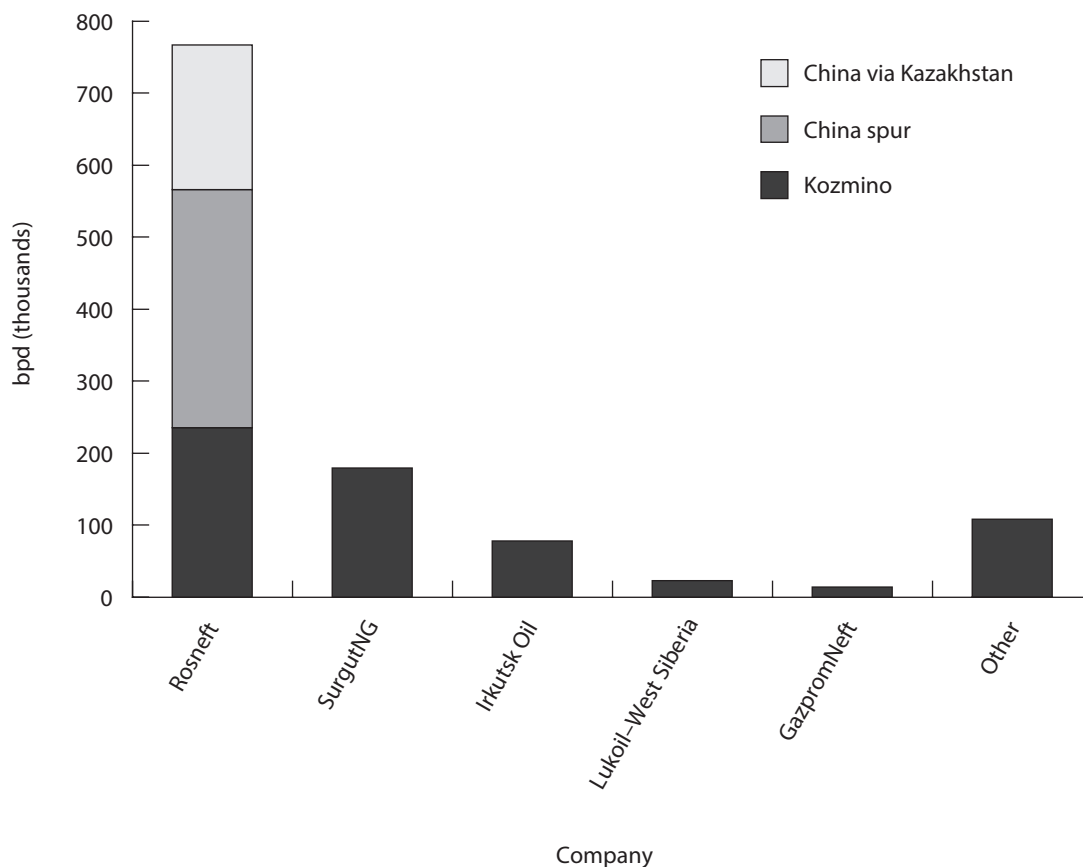
¹² Vladimir Soldatkin and Gleb Gorodnyankin, "Russia's Rosneft Aims for Big Boost in Oil Exports to China Via Kazakhstan," Reuters, October 6, 2017, <https://www.reuters.com/article/us-russia-china-oil-exclusive/exclusive-russias-rosneft-aims-for-big-boost-in-oil-exports-to-china-sources-idUSKBN1CB1KE>.

¹³ Vladimir Soldatkin, "Rosneft Says China Starts Prepayments for Oil Deals," Reuters, January 15, 2014, <https://www.reuters.com/article/rosneft-china/update-1-rosneft-says-china-starts-prepayments-for-oil-deals-idUSL5N0KP2AY20140115>.

¹⁴ Anna Yukhananov and Steve Holland, "U.S. Hits Oil Giant Rosneft, Other Firms with Toughest Russia Sanctions," Reuters, July 16, 2014, <https://www.reuters.com/article/us-ukraine-crisis-usa/u-s-hits-oil-giant-rosneft-other-firms-with-toughest-russia-sanctions-idUSKBN0FL2YN20140716>.

followed by a much more significant \$25 billion deal for the supply of 300 million tonnes (mt) over twenty years (from 2011 to 2030) for the financing of Transneft's construction of the ESPO pipeline and Rosneft's development of fields that would supply the oil.¹⁵ The largest deal was reached in 2013, however, when China National Petroleum Corporation (CNPC) agreed to purchase 360 mt of crude oil over 25 years starting in 2016 (once the spur to China had been expanded), with prepayment of 30% of the total contract value (estimated at \$270 billion at the prevalent oil price).¹⁶ Figure 3 also shows a 10 mtpa deal with Sinopec that was agreed to in 2013, but never finalized, and a current deal with Chinese trading company CEFC China Energy, to which Rosneft has agreed to supply 12 mtpa for five years from 2018.¹⁷ It is clear, then, that Rosneft is committed to exporting a minimum of 600,000–800,000 bpd to China in the 2020s.

FIGURE 2 Russian oil exports to the Asia-Pacific by company and route



SOURCE: "Russia Exports via Transneft Pipelines," Energy Intelligence Group, Nefte Compass Data Service, October 22, 2018.

¹⁵ "Russia and China Strike a Deal," *Forbes*, November 2, 2009, <https://www.forbes.com/2009/10/30/russia-china-banks-business-oxford-analytica.html#22e06ea298f2>.

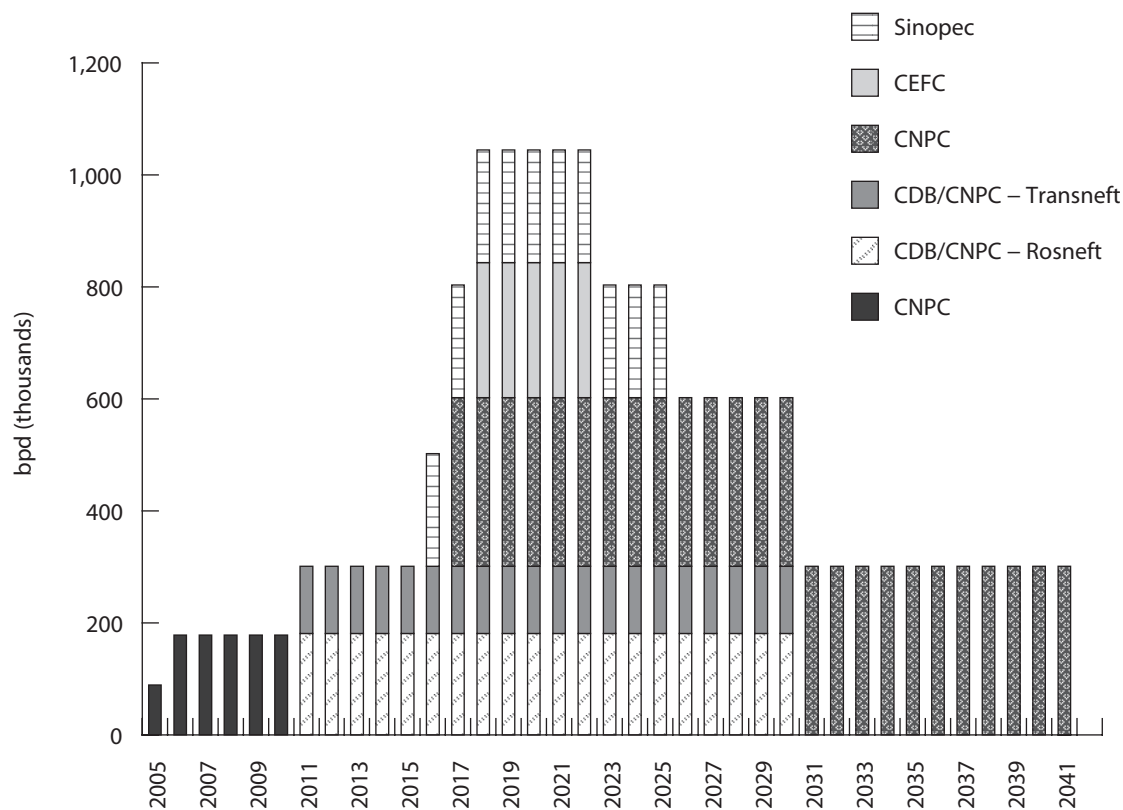
¹⁶ Jake Rudnitsky and Stephen Bierman, "Rosneft's \$270 Billion Oil Deal Set to Make China Biggest Market," *Bloomberg*, June 21, 2013.

¹⁷ Chen Aizhu, Florence Tan, and Olga Yagova, "CEFC to Increase ESPO Crude Cargoes It Gets under Rosneft Supply Contract," *Reuters*, April 30, 2018, <https://af.reuters.com/article/commoditiesNews/idAFL3N1S73ST>.

This is equivalent to as much as 43% of its 2017 crude export sales and underlines the company's, and Russia's, increasing exposure to the Chinese market.

The mention of CEFC, though, highlights the complexity of the relationship between Russia and China, as the two countries balance potential political and commercial partnerships with suspicion and a desire to avoid dependence. In the case of CEFC, the company had committed to buying a 14% stake in Rosneft, but then was forced to renege on the deal when its chairman was investigated on corruption charges. Its ability to fulfill the oil trading deal is also now in some doubt.¹⁸ However, this has only underlined the awkward nature of a relationship that has seen Rosneft accept considerable financing from Chinese institutions even as Russia has been disappointed by their lack of support following the sanctions imposed in 2014. Rosneft also has proposed partnerships in a number of upstream assets in Russia only to find that deals could not be struck with Chinese counterparts (and in particular CNPC), who were more eager than expected to drive a hard bargain.¹⁹ As a result, although CNPC, Sinopec, and ChemChina all have

FIGURE 3 Rosneft export contracts with China



SOURCE: Author's analysis based on company data. CNPC appears more than once to reflect all of its loans to Rosneft.

¹⁸ "China's Planned \$9 Billion Stake in Russian Oil Partner Delayed," Bloomberg, March 12, 2018, <https://www.bloomberg.com/news/articles/2018-03-12/china-s-mystery-russia-oil-partner-seen-delaying-9-billion-deal>.

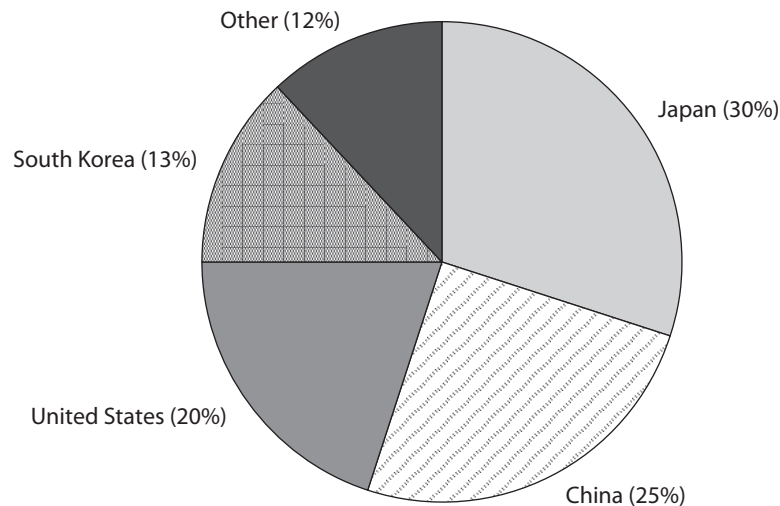
¹⁹ Alexandr Gabuev, "A Pivot to Nowhere: The Realities of Russia's Asia Policy," Carnegie Moscow Center, April 22, 2016, <https://carnegie.ru/commentary/63408>.

joint ventures with Rosneft in eastern Russia, Russia's national oil company has also notably signed deals with Indian and other Asian companies, often for assets originally offered to the Chinese, in order to improve its bargaining position.²⁰

This is not to say, however, that the dependency is entirely one way. Russian crude provides very useful diversification for Chinese oil importers, not only because it is from a different direction and largely comes via pipeline rather than by sea but because of its proximity and relatively high quality. Smaller, independent Chinese refineries (known as “teapot” refineries), in particular, have seen Russian crude as an excellent import now that the global oil market has been opened to them, and they have been enthusiastic buyers of the ESPO blend.²¹ As a result, Russia has dramatically increased its share of the Chinese oil market, displacing Saudi Arabia as China's top source of imported crude in 2016 and 2017.²² This provides an interesting competitive context to Russia-Saudi cooperation on production cuts by the Organization of Petroleum Exporting Countries (OPEC) and non-OPEC countries, and perhaps hints at a future where friendly relations between the world's two largest oil producers may be undermined by market pressures.

China also faces competition for ESPO crude as Russia's strategy of taking the pipeline to the Pacific coast has provided an element of diversity to ensure that other markets are available to it. However, as can be seen from **Figure 4**, Chinese buyers still take a large share of seaborne

FIGURE 4 Purchasers of ESPO crude at Kozmino Bay



SOURCE: Russian and Caspian Crude Export Destinations Database, Argus Media, <https://direct.argusmedia.com/dataanddownloads/allitems?section=FundamentalsAndDownloads&dates=2018-1-1%3A2018-12-31&cats=Crude%20oil®s=FSU>.

²⁰ Jack Farchy, “Rosneft to Sell Major Assets to Indian Companies,” *Financial Times*, March 16, 2016, <https://www.ft.com/content/57621a62-4513-3627-8e3a-9d62ea2cd506>.

²¹ Olga Yagova and Florence Tan, “China Steps Up Russian Oil Imports as Teapots Buy Urals Crude,” Reuters, February 14, 2017, <https://www.reuters.com/article/russia-china-oil-idUSL8N1FY3L8>.

²² Erica Downs, “Russia Not Saudi Arabia Is China's Main Source of Oil,” *Asia Dialogue*, March 28, 2018, <https://cpianalysis.org/2018/03/28/the-new-king-of-chinas-crude-oil-imports-russia-and-the-competition-for-market-share-in-china>.

purchases of ESPO crude. Moreover, when its share at Kozmino is added to its monopoly over the two other routes, China effectively purchased 85% of all the Russian crude oil sold to the Asia-Pacific market in 2017.²³ As a result, Russia's oil diversification to Asia is in reality becoming a dependence on the Chinese market, both for financing and for oil sales. Although Russia has attempted to upgrade this relationship by encouraging investment in value-added refining, the truth of the matter is that it is becoming a commodity supplier to the world's fastest-growing economy, an outcome that the Kremlin has been at pains to avoid.

Two final points can be made about Russia's oil exports to Asia, both of which relate to the sources of crude for the ESPO pipeline. Over the past decade, a number of major fields have been brought online in East Siberia by various Russian companies and become the backbone of oil supply to the Asia-Pacific. Although some of these (Vankor, Talakanskoye, and Verkhnechonskoye) are now at plateau or even in slow decline, there is no reason to expect a decline in production in the short term, as the development and exploration of new fields are providing extra sources of supply.²⁴ As **Figure 5** suggests, it is possible to see oil production from Russia's eastern regions exceeding 2.25 million bpd by the mid-2020s, before going into a gradual decline that could be offset by successful exploration that is difficult to forecast precisely.

Second, although this supply would seem to be more than adequate to fill a pipeline system that will have a maximum capacity of 1.60 million bpd, a significant share of the Russian production will come from Sakhalin Island, which exports its crude via tanker. Indeed, onshore production connected to the ESPO pipeline has not been adequate to meet Asian export demand over the past few years, meaning that Russian oil companies have been diverting crude exports from Western markets to meet Eastern demand.²⁵ They have been happy to do this because of the higher margins on offer. The ESPO blend tends to trade at a premium to the benchmark Brent blend from the Middle East, while Urals oil trades at a discount.²⁶ Nevertheless, European markets have been concerned that supply from Russia is declining, with a clear political dynamic at play. Russia has sought to reduce dependence on regions that have imposed sanctions while demonstrating that it has attractive alternative markets for its hydrocarbons. **Figure 6** underlines the shift in Russian crude exports from west to east at a time when the overall total has remained fairly constant.

The Gas Sector: Challenges to Gazprom's Monopoly

The incentives for Russia to shift also the focus of its gas exports from west to east have been driven by many of the same factors as in the oil sector. But there are also some important differences between its strategies in the two sectors. These differences are being exploited by Asian customers (China in particular) and could provide a catalyst for Russia to reform its gas sector over the long term.²⁷

²³ Based on data from Argus Media and Energy Intelligence Group.

²⁴ Henderson and Mitrova, *Energy Relations between Russia and China*, 20.

²⁵ Vladimir Soldatkin, "Russia's Sea-Borne Urals Crude Exports to Europe Seen Falling Sharply," Reuters, January 12, 2018, <https://www.reuters.com/article/us-russia-oil-urals-export/russias-sea-borne-urals-crude-exports-to-europe-seen-falling-sharply-idUSKBN1F11E9>.

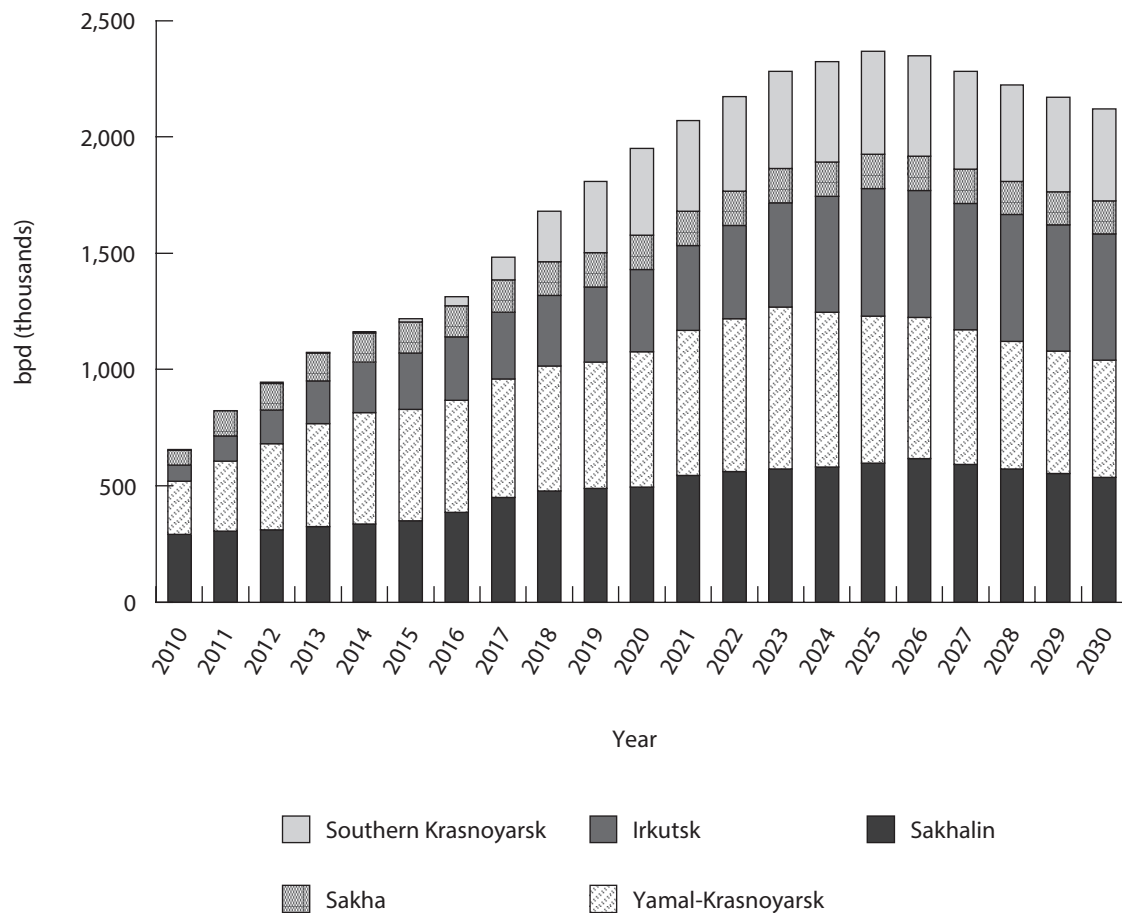
²⁶ "Platts Initiates ESPO Price Assessments for East-Bound Russian Oil," Rigzone, December 17, 2009, https://www.rigzone.com/news/oil_gas/a/84294/platts_initiates_espo_price_assessments_for_eastbound_russian_oil.

²⁷ James Henderson and Tatiana Mitrova, *The Political and Commercial Dynamics of Russia's Gas Export Strategy* (Oxford: Oxford Institute for Energy Studies, 2015), 22.

The Eastern Gas Program is officially being managed by Gazprom. The company has a monopoly over Russia's gas exports by pipeline and is currently constructing a new line (called Power of Siberia) from its fields in East Siberia to the Russia-China border at Blagoveshchensk, on a route very similar to the ESPO pipeline (see **Figure 7**).²⁸ A key difference, however, is that initial plans to extend the line to the Pacific coast at Vladivostok in order to sell LNG to the entire Asia-Pacific region have stalled due to the high cost of the extra pipeline and new liquefaction facilities.²⁹ As a result, Gazprom is entirely reliant on sales to China.

After a decade of negotiations, the imposition of U.S. and EU sanctions in 2014 catalyzed a final political push to sign a sales contract. In the presence of the Chinese and Russian leaders,

FIGURE 5 Historic and potential oil production from Russia's eastern regions



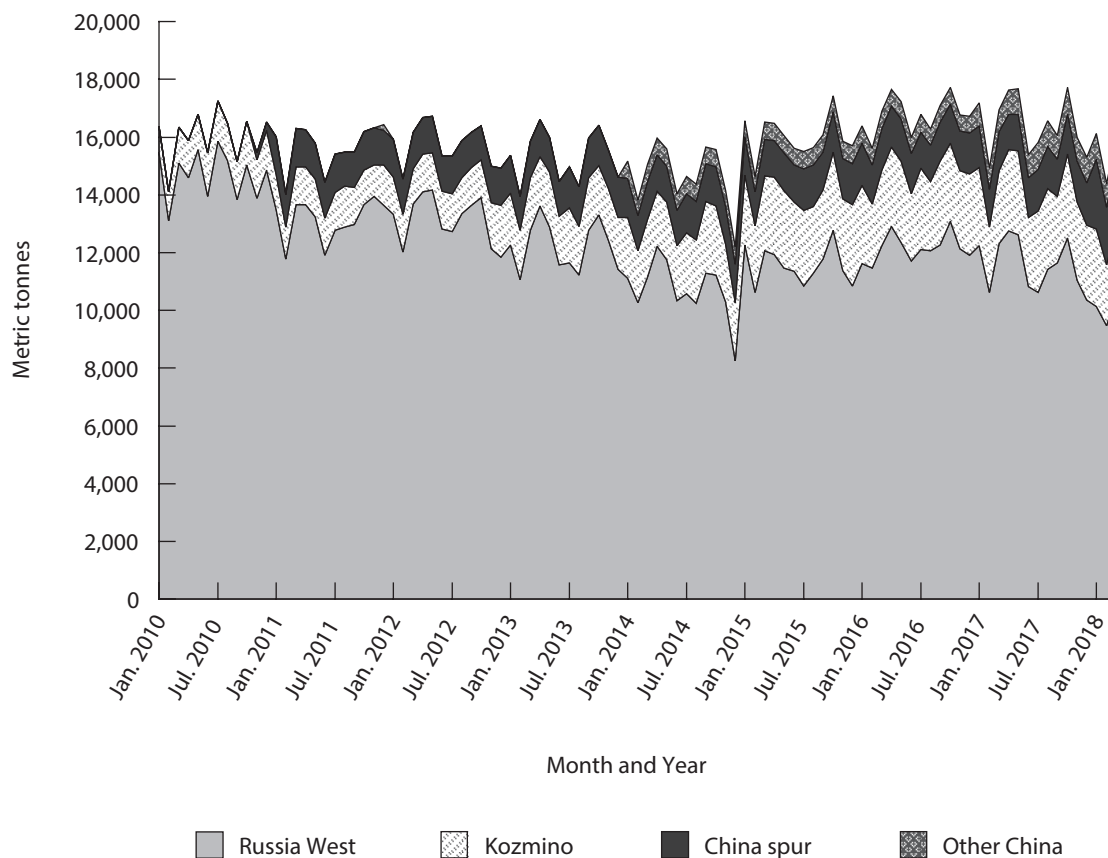
SOURCE: Author's analysis and estimates based on company data.

²⁸ For details, see "Power of Siberia," Gazprom, <http://www.gazprom.com/about/production/projects/pipelines/built/ykv>.

²⁹ Vladimir Soldatkin, "Gazprom's Investment in Vladivostok LNG Plant Seen at \$13.5 Billion," Reuters, November 21, 2013, <https://www.reuters.com/article/gazprom-lng-investment-idUSL5N0J60UD20131121>; and "Vladivostok LNG Launch Officially Delayed," Interfax Global Energy, Natural Gas Daily, February 1, 2016.

Gazprom and CNPC agreed to a 30-year, \$400 billion deal that will see peak deliveries of 38 bcm per annum after a 5-year ramp-up period beginning in 2019.³⁰ The price of the gas was not disclosed, but it appears to have been approximately \$10.5 per million British thermal unit linked to an oil price of \$105 per barrel, with straight-line escalation, implying a “slope” of around 10%. This suggests that China drove a hard bargain using Russia’s political desire for a deal.³¹ Indeed, all indications are that although Russian gas exports again provide useful diversification for China by offering a northern axis to its “gas import compass,” the level and timing of any sales will be entirely dependent on Chinese needs. This has been evidenced in the fact that another option for Russian pipeline exports—from West Siberia via the Altai region into western China (called Power of Siberia-2)—has effectively been ruled out by a

FIGURE 6 Russian crude oil exports by direction

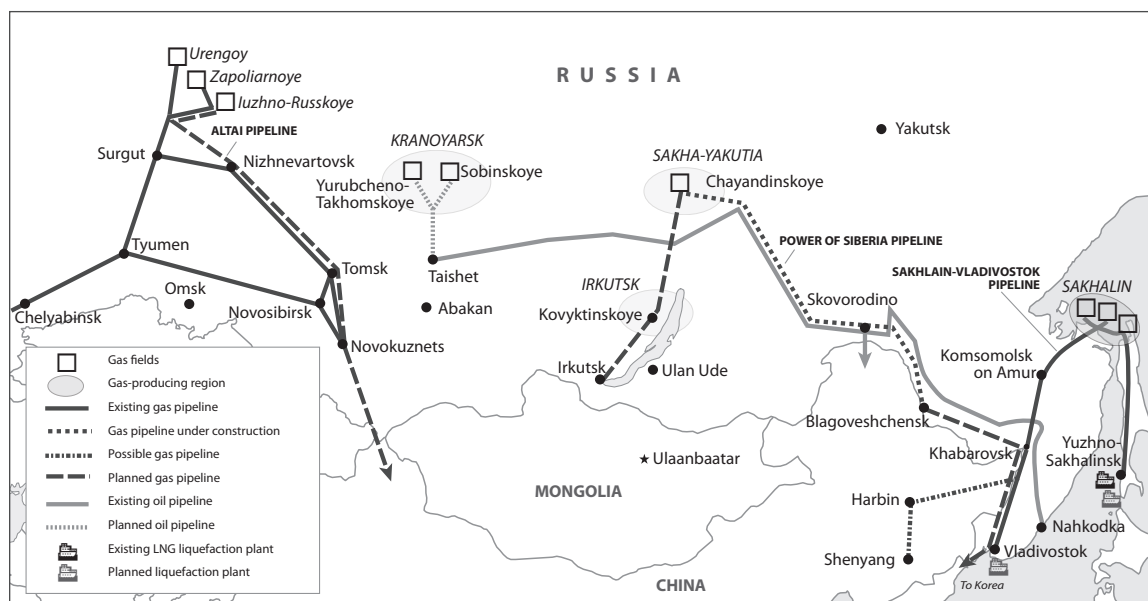


SOURCE: Russian and Caspian Crude Export Destinations Database.

³⁰ Lucy Hornby, Jamil Anderlini, and Guy Chazan, “China and Russia Sign \$400bn Gas Deal,” *Financial Times*, May 21, 2014, <https://www.ft.com/content/d9a8b800-e09a-11e3-9534-00144feabdc0>.

³¹ Henderson and Mitrova, *The Political and Commercial Dynamics of Russia’s Gas Export Strategy*, 19.

FIGURE 7 Russia's eastern expansion plans in the gas sector



SOURCE: Henderson and Mitrova, *Energy Relations between Russia and China*, 56.

lack of Chinese interest.³² At the same time, sales via the Power of Siberia pipeline now being constructed have been accelerated to the earliest possible date in the 2019–21 window that was originally negotiated, owing to faster-than-expected growth in Chinese gas demand.³³ One other Russian option—a connection from an existing pipeline from Sakhalin to Vladivostok—is also now under discussion, although supply issues may delay a final conclusion.³⁴

The topic of supply raises interesting questions about Russia's eastern gas plans overall. Gazprom owns two major fields, Chayanda and Kovykta, which can be linked to the Power of Siberia pipeline and have a capacity of 25 bcm per annum each.³⁵ This is clearly more than enough to supply the 38 bcm per annum under the contract with China. But it raises the question of whether Gazprom really needs to develop both fields, given that alternative third-party gas is available in the region. In particular, Rosneft has offered to supply associated gas from its oil fields, and other producers also have gas that they would like to develop and which could allow Gazprom to delay an expensive development of Kovykta.³⁶ However, Gazprom has been very reluctant to countenance the use of any gas that it does not own because this could provide an

³² Denis Pinchuk, Svetlana Burmistrova, and Katya Golubkova, "Russia Could Postpone Gas Pipe to China Touted by Putin," Reuters, March 18, 2015, <https://www.reuters.com/article/us-russia-gas-china/exclusive-russia-could-postpone-gas-pipe-to-china-touted-by-putin-sources-idUSKBN0ME19120150318>.

³³ "Russia's Gazprom to Supply Gas to China from the End of 2019 in Sign of Tighter Energy Ties," *South China Morning Post*, July 5, 2017, <https://www.scmp.com/news/china/diplomacy-defence/article/2101401/russias-gazprom-supply-gas-china-end-2019-sign-tighter>.

³⁴ "Gazprom, CNPC Proceeding to Commercial Negotiations on Supply of Sakhalin Gas to China," Interfax, February 15, 2017.

³⁵ Andrey Kruglov et al., "Gazprom: Business Growth, Enhancing Supply Security" (slideshow presentation for Gazprom Investor Day, Moscow, February 2018), slide 10, <http://www.gazprom.com/f/posts/41/295497/investor-day-2018-en.pdf>.

³⁶ Henderson and Mitrova, *The Political and Commercial Dynamics of Russia's Gas Export Strategy*, 7.

explicit challenge to its monopoly on gas exports. Rosneft, in particular, has been attempting to use the issue of gas exports to the east to promote its ambitions in this sector, even bringing Beijing Gas into a joint venture in an East Siberian field with hopes of exporting the gas directly. To date, Gazprom has held firm,³⁷ but changes elsewhere in the Russian gas sector suggest that the potential for a serious challenge is real.

This is particularly clear in the case of LNG, which is gas exported by ship in liquefied form rather than by pipeline. Russia has long had ambitions to become a major player in this sector, but Gazprom's failure to make any real progress in the first two decades of the post-Soviet period has led to two other companies, Novatek and Rosneft, being given the opportunity to develop their own export schemes.³⁸ In reality, it would seem that Rosneft's plans, which involve constructing an LNG plant to take gas from its Sakhalin-1 project, are more a bargaining chip to use against Gazprom in other negotiations than a solid plan. Indeed, the Sakhalin-1 gas may ultimately be sold to Gazprom to allow for the expansion of the existing Sakhalin-2 LNG scheme, which would add a third 5 mt train to the existing 10 mt capacity, freeing up other Sakhalin gas (at Gazprom's Sakhalin-3 project) for potential pipeline export to China or even Japan.

In contrast, Novatek, a private company in which Total owns almost 20% and Gazprom just below 10%, is rapidly becoming the leader of Russia's LNG business, with a particular focus on the Asian market. In 2013 the Russian government decided that offshore projects controlled by state companies or gas fields with LNG plans written into the license could export gas even if not owned by Gazprom. This decision gave Novatek the chance to develop its Yamal LNG scheme and to propose a second project, Arctic LNG-2, both located in the north of West Siberia (on the Yamal and Gydan Peninsulas, respectively).³⁹ Both projects rely on their ability to supply the European and Asian markets through the Northern Sea Route, which is currently open to ice-breaking tankers for twelve months to Europe and five to six months to Asia per year.⁴⁰ This provides an opportunity for Novatek, and by default Russia, to become a global LNG player, but these ambitions appeared to be limited by the inclusion of the company on the U.S. sanctions list in 2014.⁴¹ This severely restricted its ability to raise financing in U.S. dollars and forced it to look elsewhere for support. With Asia already being a target market, because of the premium prices usually paid there for LNG, Novatek naturally looked toward the traditional markets of Japan, South Korea, and Taiwan, as well as the growth market of China.

China was less encumbered by a close U.S. relationship and therefore seemed more prepared to support Novatek in the face of sanctions. The situation gave it the opportunity to create competitive tension within the Russian gas sector by negotiating with Gazprom at the same time, while maintaining an ongoing relationship with Rosneft. Furthermore, China has a strategic interest in expanding its position in the Arctic as part of its strategy to develop a "polar Silk Road" trading route to Europe and the West via the Northern Sea Route. Indeed, in January 2018 the

³⁷ Henderson and Mitrova, *Energy Relations between Russia and China*, 45.

³⁸ James Henderson, "Russian LNG: Progress and Delay in 2017," Oxford Institute for Energy Studies, March 2017, 3.

³⁹ Tatiana Mitrova, *Russian LNG: The Long Road to Export* (Paris: Institut français des relations internationales, 2013), 28.

⁴⁰ "Transforming into a Global Gas Company," Novatek, December 12, 2017, slide 56.

⁴¹ Jonathan H. Hines and Bruce Johnston, "U.S. and EU Russia Sanctions Update: Overview and Focus on the Energy Sector (and the New Russian Countersanctions)" (slideshow presentation, July 30, 2018).

Chinese authorities published a white paper entitled *China's Arctic Policy* that clearly emphasizes the potential for trade and the development of natural resources in the region.⁴²

As a result, when CNPC purchased a 20% stake in the Yamal LNG project, and contracted to purchase 3 mtpa from 2019, it created another strong link with the Russian energy sector.⁴³ This was then reinforced when the Silk Road Investment Fund purchased another 9.9%, bringing with it additional financing from Chinese institutions.⁴⁴ With this backing, and with key technical support from Total, which owns a further 20% of the project, the first train of the three-train 16.5 mt scheme went online on time in December 2017 and will reach peak output by the end of 2019.⁴⁵ Indeed, a smaller 0.9 mt fourth train using Russian liquefaction technology is now also planned to be online by 2020, providing a potential template for Russia to build an independent Arctic liquefaction business.⁴⁶ Novatek's plans through 2030 include the development of the 19.8 mt Arctic LNG-2 project, using new Russian-built gravity-based platforms, and the potential expansion of the region's LNG capability to 70 mt, the size of Qatar's output today.⁴⁷ The link with Asia will be strengthened further by the construction of a transshipment facility in Kamchatka, which will reduce transportation costs and provide a potential trading hub in the Asia-Pacific.⁴⁸ This underlines the company's commitment to drive Russia's LNG strategy forward, with a specific goal of targeting the Asian market as a priority while keeping the European market as a fallback option.

Of course, Russia would prefer that China were not the only market for its pipeline gas and LNG in the east. Gazprom does sell some LNG to Japan and other markets from Sakhalin-2, and Japanese companies appear keen to invest in Russian LNG projects if the political situation allows. Specifically, they have talked of investing in a transshipment hub in the Far East, participating in the Arctic LNG-2 project, and even possibly acquiring a stake in the Baltic LNG project.⁴⁹ Meanwhile, Gazprom also has a contract to sell 2.9 mtpa to GAIL of India from 2019 (using gas purchased from Yamal LNG).⁵⁰ In addition, Novatek has contracted other Yamal LNG gas to a variety of portfolio buyers such as Total, Enagás, and its own trading company.

Nonetheless, it seems inevitable that Chinese backing will be a core foundation for any new projects in Russia, given the growth of the market in China and the continuing impact of U.S. and EU sanctions. Novatek has announced that it is in discussion with Japanese state company Japan Oil, Gas and Metals National Corporation (JOGMEC) and even Saudi Aramco as potential

⁴² Information Office of the State Council of the People's Republic of China, *China's Arctic Policy* (Beijing, January 2018), http://www.xinhuanet.com/english/2018-01/26/c_136926498.htm; and Charlotte Gao, "China Issues Its Arctic Policy," *Diplomat*, January 26, 2018, <https://thediplomat.com/2018/01/china-issues-its-arctic-policy>.

⁴³ "Management Discussion and Analysis of Financial Condition, Full Year 2016," Novatek, 2016, 4.

⁴⁴ *Ibid.*, 5.

⁴⁵ "Transforming into a Global Gas Company," Novatek, Annual Report, December 31, 2017, 41.

⁴⁶ *Ibid.*, 39.

⁴⁷ *Ibid.*, 47.

⁴⁸ *Ibid.*, 58.

⁴⁹ Takashi Tsuji, "Japan and Russia Plan LNG Hub in Far East," *Nikkei Asian Review*, July 31, 2018, <https://asia.nikkei.com/Economy/Japan-and-Russia-plan-LNG-hub-in-Far-East>; and Nastassia Astrasheuskaya, "Russia's Gazprom, Japan's Mitsui Sign MOU on Baltic LNG Project," S&P Global Platts, September 12, 2018, <https://www.spglobal.com/platts/en/market-insights/latest-news/natural-gas/091218-russias-gazprom-japans-mitsui-sign-mou-on-baltic-lng-project>.

⁵⁰ Daniel Fineren, "Gazprom, India's GAIL Agree 20-yr LNG Sales Deal," Reuters, October 1, 2012, <https://www.reuters.com/article/russia-india-lng/gazprom-indias-gail-agree-20-yr-lng-sales-deal-idUSL6E8L1DXG20121001>.

partners in Arctic LNG–2 (with Total having already signed up for a 10% stake).⁵¹ The Korea Gas Corporation (KOGAS) has also signed a memorandum of understanding expressing its interest in becoming a shareholder. Yet it will be a big surprise if at least one Chinese company is not also involved. CNPC reportedly is already engaged in discussions about purchasing a stake in the project, according to Russian energy minister Alexander Novak.⁵² Given all this interest, Novatek CEO Leonid Mikhelson has expressed his confidence that the project will make a final investment decision in 2019.⁵³

Conclusion

Overall, there are some significant similarities between Russia's oil and gas strategies toward Asian markets, but also some interesting differences. In both sectors, state companies dominate but face competition from significant rivals. In the oil sector this is not so surprising. Although the influence of Rosneft continues to increase, there has always been a multiplicity of companies who can export crude oil and products. This story continues to play out in the east. Rosneft is by far the largest player and monopolizes two export routes, but others such as Surgutneftegas, Lukoil, Gazprom Neft, and Irkutsk Oil also use the key export infrastructure based around the ESPO pipeline. The significant feature of the oil market, though, is the surprising reliance on the Chinese market. The ESPO system was specifically designed to provide diversity, but in reality this has not occurred. The problem is magnified by the reliance of Rosneft on Chinese financial backing, secured through prepayments for oil exports. Although the company would never admit it, Rosneft, and therefore Russia, is dependent on the Chinese market and Chinese money.

In contrast, Gazprom is unaccustomed to competition in its export markets. However, Russia's drive to open up Asian markets for its gas, via pipeline and LNG, has encouraged the Kremlin to disturb the status quo by introducing new actors. Gazprom continues to dominate the pipeline business, at least for the time being, but is wholly reliant on the Chinese gas market. The price, timing, and direction of its export sales are essentially being driven by Beijing's policy for developing the gas sector. That said, the rapid acceleration of gas demand in China and the country's ongoing trade war with the United States have increased the attractiveness of Russian gas as a source of imports. In addition, while Russian gas does provide an increasingly important diversification option, it is also now clear that Gazprom is not the only potential partner for China and its state companies. Novatek, with its existing LNG project and extensive plans, has essentially become the leader of Russia's LNG sector and is providing stiff competition. Thus, Chinese companies can create competitive pressure between the two Russian companies, with Rosneft's ambitions in the gas sector providing another point of bargaining leverage for CNPC and others. There is no doubt that Russia has an abundance of gas resources for sale; the key question is who will strike the best deal with Asian buyers, especially those from China.

Finally, from a political perspective Russia's Asian energy strategy creates a number of opportunities and dilemmas. Obviously, Asia provides an opportunity to diversify away from

⁵¹ "Novatek Signs Framework Agreement with Japan's JOGMEC," Interfax, September 10, 2018; and Francois De Beaupuy, "Total Takes 10% Stake in Russia's Arctic LNG 2 from Novatek," Bloomberg, May 24, 2018, <https://www.bloomberg.com/news/articles/2018-05-24/total-takes-10-stake-in-russia-s-arctic-lng-2-from-novatek>.

⁵² "CNPC Discussing Entry into Arctic LNG-2 on Same Terms as Total—Mikhelson," Interfax, September 11, 2018.

⁵³ "Total Joins Novatek in \$25.5B Arctic LNG 2 Project," *Offshore Energy Today*, May 25, 2018.

regions currently imposing sanctions on Russia and show that there are alternative fast-growing markets for Russian energy. Indeed, this trend has been further catalyzed by China's trade war with the United States and its imposition of tariffs on U.S. LNG. However, the geopolitical risk is that Russia becomes what it has always been desperate to avoid—the commodity provider fueling the expanding Chinese economy. At the same time, Russia also faces the likelihood of increasing tension with other commodity providers, especially in the oil sector, where its position as the leading exporter to China puts Russia in direct competition with its new ally in the Middle East, Saudi Arabia. As a result, although the pivot to Asia has clear political and commercial logic for Russia, the unintended consequences of this strategy could create significant long-term risk for the Kremlin.

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #74 | DECEMBER 2018

China-Russia Energy Relations: Better Than Ever

Erica Downs

ERICA DOWNS is a Senior Research Scientist in the China Studies Program of CNA. She is also a Nonresident Fellow at the Center on Global Energy Policy at the Columbia University School of International and Public Affairs. She can be reached at <ed347@columbia.edu>.

NOTE: This essay reflects the author's own views and not those of the institutions with which she is affiliated.

EXECUTIVE SUMMARY

This essay examines the factors that have contributed to the deepening of the China-Russia energy relationship since 2008 and draws implications for the U.S.

MAIN ARGUMENT

The China-Russia energy relationship is more robust than it has been at any other time over the past decade. Russia's crude oil exports to China more than quintupled between 2008 and 2017, with the country displacing Saudi Arabia as China's top crude supplier in 2016. Meanwhile, Russia is poised to become a major supplier of natural gas to China within the next decade as new export projects commence operations and ramp up to full capacity. The primary driver of the deepening bilateral energy relationship has been the strategic provision of capital by Chinese financial institutions to Russian energy companies both to secure large-volume, long-term contracts for oil and natural gas supplies and to develop the infrastructure to deliver them to China. These institutions provided this support not only to enhance China's energy security by diversifying its oil and natural gas suppliers and import routes but also to advance other national objectives, such as transforming the country into an advanced manufacturing superpower and gaining access to Arctic shipping routes. A secondary driver of the deepening energy relationship is the emergence of new Chinese crude importers.

POLICY IMPLICATIONS

- Despite the substantial growth in Russian crude oil exports to China over the past decade, seaborne oil imports will remain a vulnerability likely requiring substantial Chinese resources to address.
- The growth in Russian energy exports to China over the past decade has not prevented the U.S. from selling crude oil and liquefied natural gas (LNG) to the country. However, the extent to which U.S. exporters will be able to compete for larger shares of China's crude oil and LNG imports may depend in part on how the ongoing bilateral trade dispute plays out.
- Uncertainty over whether Chinese tariffs on U.S. LNG imports will increase may prompt Chinese leaders and national oil companies to view Russia as a more reliable natural gas supplier and increase Chinese interest in the development of a second cross-border natural gas pipeline and Russia's Arctic LNG-2 project.

What a difference a little more than a decade makes. In the mid-2000s, the China-Russia energy relationship was one of unfulfilled potential. To be sure, Russia had already emerged as one of China's top oil suppliers, but the two countries lacked the infrastructure needed to substantially increase deliveries of Russian crude oil and to start shipments of natural gas. Moreover, China's national oil companies felt unwelcome in the Russian upstream after political opposition prompted China National Petroleum Corporation (CNPC) to abandon its bid for the Russian oil company Slavneft in 2002.¹

Zhang Guobao, a former head of China's National Energy Administration and a veteran of energy negotiations with Russia, expressed his frustration with the state of the bilateral energy relationship in a lengthy interview with Russian media in 2006. He said that "the Sino-Russia [oil] pipeline is one step forward, two steps back." He also lamented the lack of headway in discussions about a cross-border natural gas pipeline, noting that "even though there have been a lot of promises expressing Russia's interest in exporting natural gas to China, in truth no real progress has been made." Zhang was just as blunt in responding to a question about whether China had any plans to invest in the development of Russian oil reserves, stating that "Russia wouldn't let China purchase a small, little-known oil company....We've shown our willingness to cooperate with and invest in other countries, but Russia isn't willing to let us invest."²

Today, Zhang may have a different view of the energy relationship. In 2016, Russia surpassed Saudi Arabia to become China's largest supplier of crude oil on an annual basis, a position it retained in 2017.³ Russia is also poised to become a major supplier of natural gas to China within the next decade as new export projects commence operations and ramp up to full capacity. Moreover, Moscow has opened the door wider to Chinese investment in the Russian upstream.

Consequently, the bilateral energy relationship is now more robust than at any other time over the past decade. China has taken advantage of the needs of Russian energy firms for cash—both to pay down debts and to replace capital lost from the West due to U.S. and European Union sanctions—not only to secure large-volume, long-term contracts for oil and natural gas but also to pursue other national interests. These include creating business opportunities for Chinese firms in line with China's ambition to become an advanced manufacturing superpower and expand its access to Arctic shipping routes.

The first section of this essay details the increase in Russian oil exports to China over the past decade and the large volumes of natural gas that are set to be shipped from Russia to China over the next decade. The second section examines the main drivers of the burgeoning bilateral energy relationship. The essay then concludes by discussing implications for the United States and other exporters of oil and natural gas.

¹ The best account of this is Bo Kong, *China's International Petroleum Policy* (Santa Barbara: Praeger, 2010), 104–7.

² "Interview with China's NDRC Vice Director Zhang Guobao," reprinted by *Hard Assets*, March 8, 2006, <http://www.resourceinvestor.com/2006/03/07/interview-chinas-ndrc-vice-director-zhang-guobao>.

³ Oceana Zhou and Sambit Mohanty, "In Race for China's Crude Market, Russia Wins Gold, Yet Again," *S&P Global Platts*, February 4, 2018, <https://www.spglobal.com/platts/en/market-insights/latest-news/oil/020418-analysis-in-race-for-chinas-crude-market-russia-wins-gold-yet-again>.

The Burgeoning Energy Relationship

China's imports of Russian crude oil have more than quintupled over the past decade, increasing from 234,000 barrels per day (bpd) in 2008 to 1.2 million bpd in 2017.⁴ Russian crude exports to China topped 1 million bpd for the first time in 2016, the year Russia surpassed Saudi Arabia to become China's largest supplier of crude oil on an annual basis.⁵ Saudi Arabia had previously held this position every year from 2001 to 2015, except for 2007, when Angola occupied the number one slot. Russia retained its status as China's largest oil supplier in 2017, increasing its share of China's crude oil imports to 14% (see **Figure 1**).⁶

Russia's emergence as China's largest crude oil supplier is underpinned by the development of the Eastern Siberia–Pacific Ocean (ESPO) pipeline and its spur to China, which allow Russia to export large volumes of oil to China by land and by sea.⁷ The ESPO pipeline, which was built in two phases, runs from Taishet in East Siberia to Kozmino Bay on Russia's Pacific coast. The first phase (Taishet to Skovorodino) went into operation in 2009 and has a capacity of 1.2 million bpd. The second phase (Skovorodino to Kozmino) commenced operation in 2012 and has a capacity of 1 million bpd, of which around 630,000 bpd go to Kozmino. The so-called ESPO spur comprises two parallel pipelines running from Skovorodino to Mohe on the Chinese border for onward delivery to Daqing. The first line went into operation on January 1, 2011, and the second line started deliveries on January 1, 2018. The two lines of the ESPO spur have the capacity to transport 600,000 bpd.⁸

In 2017, Russia exported 464,000 bpd to China from Kozmino Bay.⁹ It also delivered 335,000 bpd via the ESPO pipeline spur and 200,000 bpd via the Kazakhstan–China oil pipeline.¹⁰ The remaining 200,000 bpd probably traveled to China by rail or sea.

Russia is also poised to become a major supplier of natural gas to China. The Power of Siberia pipeline will deliver natural gas three thousand kilometers from fields in East Siberia to the Chinese border. Deliveries are scheduled to start in December 2019 and will gradually ramp up to 38 billion cubic meters (bcm) per year.¹¹ Meanwhile, the first phase of Yamal LNG (liquefied natural gas) began operations in December 2017. The project is slated to reach full capacity in 2019 and will ship 5 bcm per year to China.¹² Russia and China are also interested in continuing negotiations on the Power of Siberia–2 pipeline, and firms from both countries have discussed

⁴ "Table of China December Data on Oil, Oil Product, LNG Imports," Dow Jones Institutional News, January 25, 2018; and Tian Chunrong, "2008 nian Zhongguo shiyou jinchukou zhuangkuang fenxi" [Analysis of China's 2008 Oil Imports and Exports], *Guoji shiyou jingji*, no. 3 (2009): 34.

⁵ Chen Aizhu and Meng Meng, "Russia Beats Saudi Arabia as China's Top Crude Oil Supplier in 2016," Reuters, January 23, 2017, <https://www.reuters.com/article/us-china-economy-trade-crude/russia-beats-saudi-arabia-as-chinas-top-crude-oil-supplier-in-2016-idUSKBN1570VJ>.

⁶ "Table of China December Data on Oil."

⁷ This paragraph is based on James Henderson and Tatiana Mitrova, *Energy Relations Between Russia and China: Playing Chess with the Dragon*, Oxford Institute for Energy Studies (OIES) Paper (Oxford: OIES, 2016), 28–31, <https://www.oxfordenergy.org/publications/energy-relations-russia-china-playing-chess-dragon>; and "Transneft Says Kozmino Capacity Allows for 31.3 Mln T of Oil Exports in 2017," Reuters, January 17, 2017, <https://af.reuters.com/article/africaTech/idAFR4N1F200V>.

⁸ "New Line of China–Russian Oil Pipeline Begins Operation," Xinhua, January 1, 2018, http://www.xinhuanet.com/english/2018-01/01/c_136864998.htm.

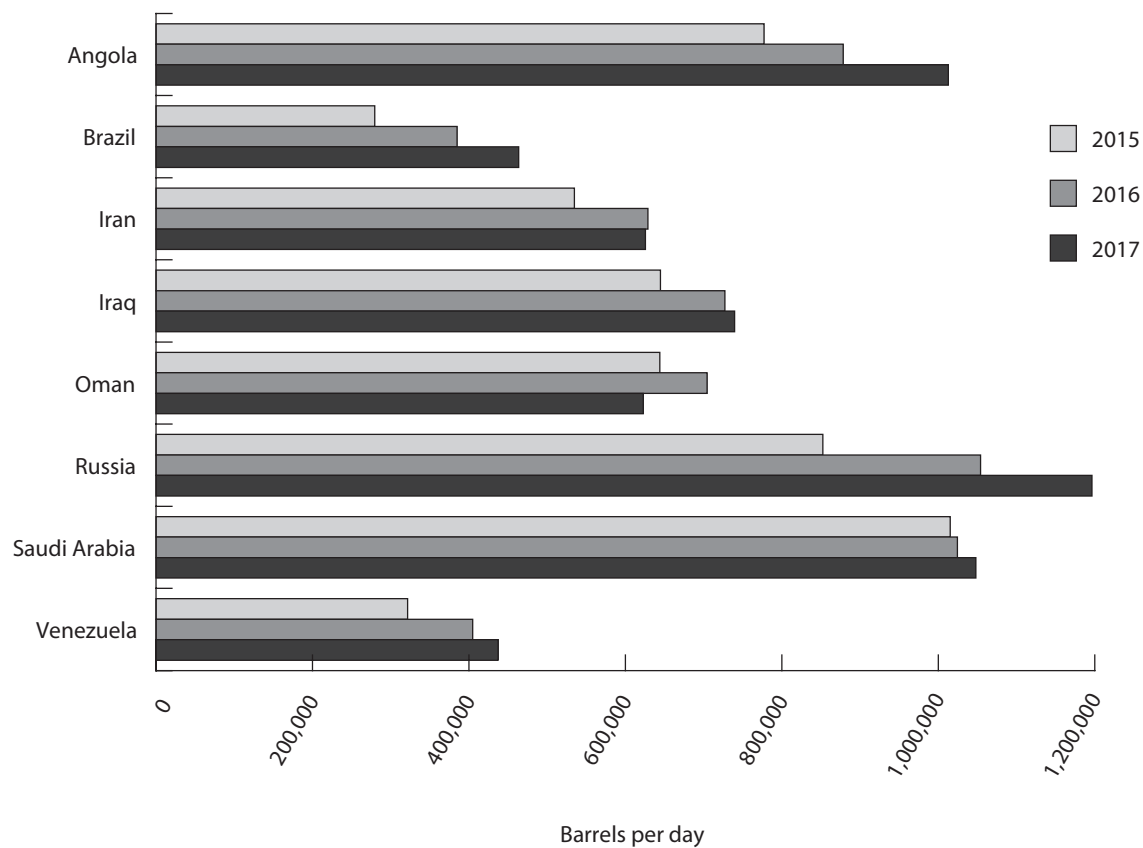
⁹ "Russia's Transneft to Deliver 568,362 b/d to China via Skovorodino Mohe in 2018," Platts Commodity News, January 12, 2018.

¹⁰ Vladimir Soldatkin, "Russia's Sea-Borne Urals Crude Exports to Europe Seen Falling Sharply," Reuters, January 12, 2018, <https://www.reuters.com/article/us-russia-oil-urals-export/russias-sea-borne-urals-crude-exports-to-europe-seen-falling-sharply-idUSKBN1F11E9>; and "2017 Annual Report," KazTransOil JSC, 2017, 4, <http://www.kaztransoil.kz/doc/en/1275.pdf>.

¹¹ Stuart Elliott, "Gazprom Says On Track to Begin Chinese Gas Exports in December 2019," Platts European Gas Daily, March 22, 2018.

¹² Chen Aizhu, "Russia's Yamal LNG Loads Its First Export Cargo—CNPC," Reuters, December 11, 2017, <http://af.reuters.com/article/energyOilNews/idAFL3N1OB1MR>.

FIGURE 1 China's top oil suppliers, 2015–17



SOURCE: China's General Administration of Customs, reported by Dow Jones.

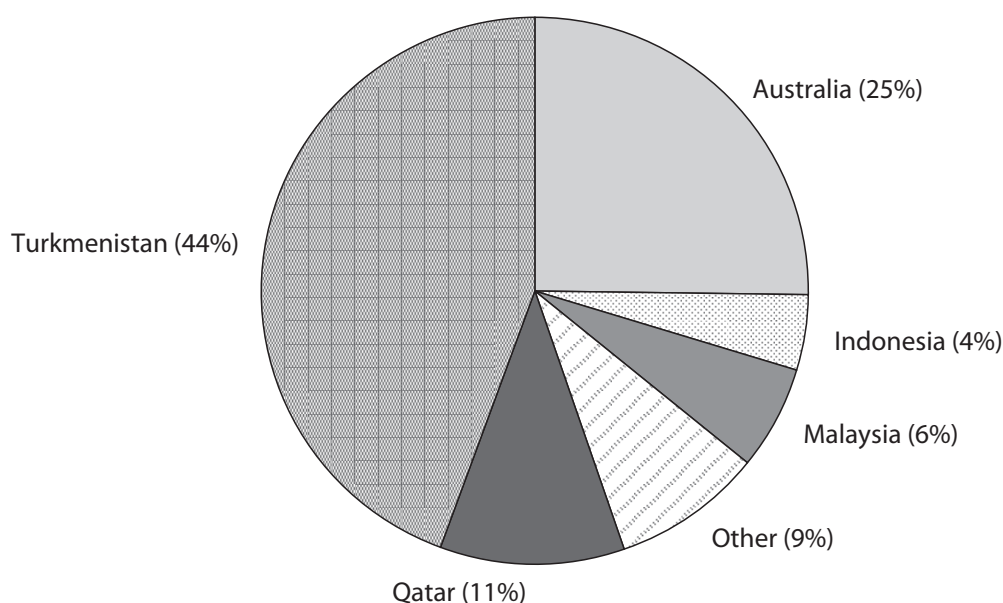
the Arctic LNG-2 project as well.¹³ The 43 bcm of Russian gas already contracted by China is greater than the amount that it imported from Turkmenistan (33 bcm), China's largest natural gas supplier, in 2017 (see **Figure 2**).¹⁴ If China were to import 43 bcm from Russia in 2023, this would constitute 25% of the natural gas that the International Energy Agency (IEA) projects China will import in that year.¹⁵

¹³ "Moscow, Beijing to Agree Gas Supplies via Power of Siberia's 'Western Route' Shortly," TASS, September 12, 2018, <http://tass.com/economy/1021135>; and Denis Pinchuk and Tom Balmforth, "Russia's Novatek in Talks with China's CNPC on Arctic LNG-2," Reuters, July 19, 2018, <https://af.reuters.com/article/commoditiesNews/idAFL8N1UF0Z4>.

¹⁴ "Table of China December Data on Oil."

¹⁵ International Energy Agency, *Gas 2018* (Paris: OECD Publishing, 2018), 16, 68.

FIGURE 2 China's natural gas suppliers, 2017



SOURCE: "Table of China December Data on Oil, Oil Product, LNG Imports," Dow Jones Institutional News, January 25, 2018.

Drivers of the Deepening Sino-Russian Energy Relationship

The primary driver of the growth in bilateral energy relations over the past decade has been China's ability to use capital to pursue strategic opportunities vis-à-vis Russia, especially after the global financial crisis in 2008 and the imposition of Western sanctions on Russia in 2014 for its annexation of Crimea. As a result, Moscow has increasingly looked to China to replace some of the capital and technology it would have otherwise received from the West. While Chinese entities have not provided Russia with everything it wants, they have offered enough to substantially deepen the bilateral energy relationship in ways that further a mix of corporate and national objectives.

Loans and Prepayment for Oil: Turning Crisis into Opportunity

In the words of former chairman of the China Development Bank (CDB), Chen Yuan, the global financial crisis that erupted in 2008 allowed China to turn "a very real crisis into a truly great opportunity."¹⁶ The collapse in oil prices and credit crunch resulting from the global financial crisis left Russian energy companies short of capital. CDB, a policy bank that lends in support of national interests, took advantage of their need for financing to broker the largest single cross-border loan in history. The agreement secured the construction of an oil pipeline from Russia to China and a twenty-year supply contract to fill it. With this transaction, CDB enhanced China's

¹⁶ Chen Yuan, *Aligning State and Market: China's Approach to Development Finance* (Beijing: Foreign Language Press, 2013), 360.

oil security in two ways. First, the deal paved the way for the further diversification of China's crude oil supplies and import routes away from major maritime chokepoints, including the Strait of Hormuz and the Strait of Malacca. Second, the transaction provided China with a stable, predictable crude supply over two decades at a time (before the U.S. shale revolution took off) when Chinese officials were much more concerned about oil scarcity than they are today.

On the eve of the global financial crisis, negotiations between China and Russia for a cross-border oil pipeline had dragged on for more than a decade. According to Zhang Guobao, one of the stumbling blocks was that in the mid-2000s Russian negotiators repeatedly tried to maximize their country's national interests by seeking to link the oil pipeline to other activities. These included requests for China to purchase Russian equipment and technology for the construction of additional reactors at the Tianwan nuclear power plant, permit Rosneft to invest in a refinery and gas stations in China, import Russian coal, and buy more electricity from Russia.¹⁷ By September 2008, the main point of contention had shifted to price.¹⁸ However, the global financial crisis set the stage for a breakthrough. The plunge in crude oil prices (from \$147 per barrel in July 2008 to less than \$40 per barrel in December 2008) and the tightening credit markets created a difficult operating environment for Rosneft, the Russian national oil company, and Transneft, the Russian pipeline monopoly. Rosneft, which had outstanding net debt of \$21.28 billion at the end of 2008, was due to repay \$8.46 billion in 2009.¹⁹ Meanwhile, Transneft expected its capital expenditure to increase with the construction of major pipelines to Asia and Europe.²⁰

The financial challenges faced by Rosneft and Transneft prompted Russia's deputy prime minister, Igor Sechin, to propose a new way to jump-start the stalled oil pipeline talks between China and Russia.²¹ When the Chinese visited Moscow for another round of negotiations in late October 2008, Sechin told Zhang that Russia did not have the funds to build an oil pipeline to China or to develop the oil fields needed to ensure the delivery of 300,000 bpd for twenty years, but that Russia would be able to do both if China provided a \$15 billion loan. When Vice Premier Wang Qishan arrived in Moscow on October 26, 2008, for further discussions, the Russians increased the size of the loan they wanted to \$25 billion.

China moved quickly to capitalize on the Russian energy companies' financial difficulties to advance its energy security agenda. As Chen Yuan later recalled, "I knew that if we backed away, this opportunity might fade out of reach as quickly as it had come, so I encouraged my team to take the initiative, telling them that the project must move forward, that we must not fail to grasp the opportunity this crisis was giving us."²² After four more rounds of tough negotiations that ended in February 2009, the Chinese and Russians reached an agreement that was larger, longer, and more complex than standard lending practices.²³ CDB agreed to extend loans of \$15 billion

¹⁷ Zhang Guobao, "ZhongE yuanyou guandao shiwu nian tanpan jishi" [Report on 15 Years of Negotiations on the China-Russia Crude Oil Pipeline], *Zhongguo jingji zhoubao*, January 9, 2018, <http://world.people.com.cn/n1/2018/0109/c1002-29754237.html>.

¹⁸ Ibid.

¹⁹ "Q4 and 12M 2009 US GAAP Results," Rosneft, February 1, 2010, 23, https://www.rosneft.com/upload/site2/document_file/d1pW569Hvr.pdf; and "Rosneft Due to Pay Off \$8.5 Bln Debt in 2009," Interfax, February 27, 2009.

²⁰ "Reuters Summit—Transneft to Seek More Funds as Costs Rise," Reuters, September 10, 2008.

²¹ This paragraph is based on Guobao, "ZhongE yuanyou guandao shiwu nian tanpan jishi."

²² Yuan, *Aligning State and Market*, 361.

²³ Ibid., 360.

to Rosneft and \$10 billion to Transneft, both with twenty-year terms. In return, Transneft would build the ESPO spur and Rosneft and Transneft would supply 300,000 bpd for twenty years.²⁴

China came to Rosneft's rescue again in 2013. The Russian firm had borrowed \$31 billion from international banks to finance its \$55 billion acquisition of TNK-BP in 2013 and had to pay back \$15.9 billion in 2014 and \$16.2 billion in 2015.²⁵ Rosneft had arranged for nearly \$10 billion in prepayments for crude supplies with oil traders Glencore, Trafigura, and Vitol but was still short of funds to service its debt.²⁶ CNPC filled the funding gap in return for more long-term crude supplies and the expansion of the ESPO spur to transport them. In June 2013 the two sides finalized a prepayment deal. CNPC agreed to provide \$70 billion as prepayment for future crude supplies. In return, Rosneft agreed to deliver an additional 2.64 billion barrels over the next 25 years and to increase the capacity of the ESPO spur to 400,000 bpd by 2015 and 600,000 bpd in 2018.²⁷ Both companies used superlatives to describe the transaction. CNPC said it was the biggest-ever single crude oil purchase from a foreign entity, while Rosneft said the deal was worth \$270 billion (based on oil prices at that time), making it one of the largest in the history of the oil industry.²⁸

Sanctions Relief

The implementation of U.S. and EU sanctions after Russia's annexation of Crimea further deepened the Sino-Russian energy relationship. Russia's turn to China to replace capital lost from the West created another opportunity for Chinese entities to throw an economic lifeline to a Russian energy company to advance multiple national interests. This time the beneficiary was Novatek, the private Russian gas company operating Yamal LNG. Moreover, Russia's desire to demonstrate that it was not internationally isolated provided a strong incentive for the country to quickly conclude an agreement on the Power of Siberia pipeline. This quest for Chinese capital also prompted Rosneft to open the door wider to Chinese upstream investment, although only one of three major deals was completed.

Yamal LNG. The Yamal LNG project is an example of how Western sanctions have spurred closer energy relations. Chinese financing enabled Novatek to complete the project on time and on budget, despite the fact that both Novatek and a leading shareholder, Gennady Timchenko, are under U.S. and European sanctions. Securing LNG supplies was not the only reason that Chinese financiers threw an economic lifeline to Yamal LNG. They also supported the project because it advanced other goals of the Chinese government, including creating business opportunities for Chinese firms along the LNG supply chain, showcasing China's LNG technologies, and furthering the country's ambition to be a stakeholder in the Arctic.

When CNPC purchased a 20% stake in Yamal LNG from Novatek in September 2013, it agreed to help secure financing for the project.²⁹ That same month, CNPC and Novatek also signed a memorandum of understanding (MOU) with four state-owned Chinese banks.³⁰ However, by early

²⁴ Erica S. Downs, "Inside China, Inc: China Development Bank's Cross-Border Energy Deals," Brookings Institution, John L. Thornton China Center, Monograph, no. 3, March 2011, 40–41.

²⁵ Vladimir Soldatkin, "Update 1—Rosneft Says China Starts Prepayments for Oil Deals," Reuters, January 15, 2014, <https://www.reuters.com/article/rosneft-china-idUSL5N0KP2AY20140115>.

²⁶ Nadezhda Sladkova, "Rosneft Seeks Chinese Oil-for-Loan Deal to Fund TNK-BP Purchase," NEFTE Compass, January 10, 2013.

²⁷ Nadezhda Sladkova, "Rosneft Reveals Prepayment Deals but Questions Remain," NEFTE Compass, August 1, 2013; and Jacob Gronholt-Pedersen, "Refile-Factbox-Russia-China Crude Oil Deals," Reuters, February 19, 2014.

²⁸ "Rosneft, CNPC Ink Blockbuster Prepayment," NEFTE Compass, June 27, 2013.

²⁹ Rosemary Griffin, "Russia's Novatek, CNPC Finalize Yamal LNG Deal," Platts Oilgram News, September 6, 2013.

³⁰ "Yamal LNG Financing Comes Through," LNG Intelligence, September 11, 2013.

2015 the MOU had not been converted into a final agreement, reportedly because the Chinese banks were reluctant to lend.³¹ The lack of Chinese cash appears to have triggered a high-level political intervention. Project financing for Yamal LNG was on the agenda for the meeting between Deputy Prime Minister Arkady Dvorkovich and Vice Premier Zhang Gaoli in Beijing in April 2015. According to the Russian government website, the two sides agreed to solve the Yamal LNG financing issue.³²

The solution began to appear in December 2015 when China's state-owned Silk Road Fund (SRF) agreed to purchase a 9.9% stake in Yamal LNG and provide a loan of \$790 million.³³ The fact that the financing came from the SRF was significant. First, the fund, whose board of directors includes representatives of several government agencies, lends in support of national interests. Second, it views itself as an anchor investor; it expects its involvement in a project to attract other financiers. After the SRF bought into Yamal LNG, its president, Wang Yanzhi, expressed hope that its "entrance into the project will facilitate an expedited closing of the project's general external financing."³⁴ Five months later, CDB and the Export-Import Bank of China agreed to lend \$12.1 billion to the project. The two banks extended two loans with fifteen-year terms, one for \$10.7 billion and another for \$1.5 billion. The Chinese loans, combined with financing from within Russia, covered the required amount of external funding.³⁵

The decision of the SRF, CDB, and the Export-Import Bank of China to help finance Yamal LNG reflects the fact that the project advances Chinese objectives beyond securing natural gas supplies. First, it provided Chinese companies an opportunity to expand their manufacturing capabilities to another part of the LNG supply chain. China Offshore Oil Engineering Company (COOEC), a subsidiary of China National Offshore Oil Corporation, built 36 core modules for Yamal LNG, mastering this technology through participation in the project.³⁶ The modules were the first to be independently designed and manufactured by a Chinese firm.³⁷ This breakthrough is in line with Beijing's plan for China to move up the value chain in manufacturing ocean engineering equipment, which is part of a broader effort to transform China into a global leader in advanced manufacturing.³⁸

³¹ "Yamal Turns Screw on CNPC," World Gas Intelligence, February 25, 2015. See also "China Plays Yamal Financing Game," World Gas Intelligence, August 5, 2015.

³² "Russia and China to Address Financing of Yamal LNG Project," AK&M, April 24, 2015.

³³ "Novatek Sells Stake in Yamal LNG to Chinese Firm," International Oil Daily, December 18, 2015.

³⁴ "Novatek and the Silk Road Fund Conclude Framework Agreement on Acquisition of Stake in Yamal LNG," Novatek, Press Release, September 3, 2015, http://www.novatek.ru/en/press/releases/archive/index.php?id_4=984&from_4=01.01.2015&to_4=31.12.2015&from_4=2.

³⁵ "Yamal LNG Signed Loan Agreements with the Export-Import Bank of China and the China Development Bank," Yamal LNG, Press Release, April 29, 2016.

³⁶ "COOEC Delivers 36 Core Modules of Yamal LNG Project On Time," China National Offshore Oil Corporation (CNOOC), Press Release, August 18, 2017, http://www.cnooc.com.cn/art/2017/8/18/art_6261_2708441.html.

³⁷ Zheng Xin and Zhang Min, "Top-End Oil-Gas Equipment Next," *China Daily*, April 17, 2017, http://www.chinadaily.com.cn/business/2017-04/17/content_28953838.htm.

³⁸ Jost Wübbeke et al., "Made in China 2025: The Making of a High-Tech Superpower and the Consequences for Industrial Countries," *MERICCS Papers on China*, December 2016, https://www.merics.org/sites/default/files/2017-09/MPOC_No.2_MadeinChina2025.pdf; "Made in China 2025 Sectors," China-Britain Business Council, May 2016, 37–38, <http://cbcc.org/mic2025>; and "Yunwang Beiji quan de 'Zhongguo zhizao'" ["Made in China" Shipped to the Arctic Circle], *People's Daily*, August 17, 2017, <http://energy.people.com.cn/n1/2017/0817/c71661-29476054.html>. See also Wu Cuiping, Tong Minglei, and Li Chao, "Zhongguo haiyou gaochuan zhizao shan liang Beiji quan," [CNOOC's High-end Manufacturing Shines in the Arctic Circle], CNOOC, August 17, 2017, http://www.cnooc.com.cn/art/2017/8/17/art_191_2705501.html.

Second, Yamal LNG generated business for many companies in China. Forty-five Chinese firms supplied more than one hundred different kinds of products to the project. They signed manufacturing contracts worth \$8.5 billion and shipbuilding contracts worth \$7.8 billion.³⁹

Third, the project furthers Beijing's objective of developing Arctic shipping routes, which is articulated in a white paper released by the Chinese government in January 2018.⁴⁰ Specifically, Yamal LNG is opening a new shipping route between China and Europe that will save time and money. During the construction, China shipped modules and other components through the Arctic's Northeast Passage, which took an average of sixteen days, nearly twenty days less than a voyage through the Suez Canal.⁴¹ According to China Central Television, once the Northeast Passage is officially opened, the voyage from Shanghai and China's northern ports to ports in Western Europe, the North Sea, and the Baltic Sea will be shortened by 25%–55% compared with the existing routes, resulting in savings of \$53–\$127 billion per year in shipping costs.⁴² Moreover, further diversifying shipping routes undoubtedly has strategic value for China, which maintains that its oil imports are still “too dependent” on the Strait of Malacca.⁴³

Power of Siberia. Western sanctions also facilitated the conclusion of twenty years of negotiations over the construction of the Power of Siberia pipeline. On May 21, 2014, China and Russia inked a purchase and sales agreement for the delivery of 38 bcm of Russian natural gas to China for twenty years, which was valued at \$400 billion.⁴⁴ There had long been a clear logic for both countries to proceed with the project. For Russia, the country's dominant natural gas producer, Gazprom, has an imperative to diversify its exports away from Europe, where demand growth is sluggish and countries continue to look for alternative suppliers. For China, Russian natural gas not only would help fill the widening gap between domestic supply and demand and support the goal of increasing the role of natural gas in the national energy mix to combat air pollution; it also would diversify the country's portfolio of natural gas imports. Despite these compelling reasons, countless summit meetings between Chinese and Russian leaders had come and gone without a deal on the pipeline, with disagreements over the starting price for gas deliveries remaining a major stumbling block.

The negotiations in May 2014, however, turned out to be different. When President Vladimir Putin arrived in Shanghai for his meeting with President Xi Jinping, Russia's relationships with the United States and Europe had deteriorated, and the country faced the prospect of additional sanctions for its annexation of Crimea.⁴⁵ These developments added a political imperative for Moscow to conclude a bilateral natural gas pipeline deal. Such an agreement would send a powerful signal to the world that Russia was not completely isolated internationally and that Western sanctions would not deter the development of its energy sector.

China was able to capitalize on Russia's ambition to show the United States and Europe that it was not without friends and other natural gas markets to finalize a deal on the pipeline

³⁹ “Zhongguo zhizao dazao Beijin quan xin mingpian kaipi Beiji hangdao zhutui bing shang sichou lu” [Made in China Becomes a New Feature of the Arctic and Opens the Arctic Channel to Boost the Polar Silk Road], China Central Television, December 9, 2017.

⁴⁰ Information Office of the State Council of the People's Republic of China (PRC), *China's Arctic Policy* (Beijing, January 2018), http://english.gov.cn/archive/white_paper/2018/01/26/content_281476026660336.htm.

⁴¹ “Zhongguo zhizao dazao Beijin quan xin mingpian kaipi Beiji hangdao zhutui bing shang sichou lu.”

⁴² Ibid.

⁴³ National Development and Reform Commission (PRC), “Shiyou fazhan ‘shi san wu’ guihua” [13th Five-Year Plan for Oil Development], January 2017, 5, http://www.sohu.com/a/124822613_465501.

⁴⁴ Alexei Anishchuk, “As Putin Looks East, China and Russia Sign \$400 Billion Gas Deal,” Reuters, May 21, 2014, <https://www.reuters.com/article/us-china-russia-gas/as-putin-looks-east-china-and-russia-sign-400-billion-gas-deal-idUSBREA4K07K20140521>.

⁴⁵ Thane Gustafson, Zhouwei Diao, and Jenny Yang, “Russia-China Gas Deal: The Winding Road to an Agreement,” IHS Energy, Energy Insight, May 23, 2014, 8.

without offering the large loans or prepayments for supplies that Beijing had used to secure the construction of the ESPO spur and supply contracts to fill it. To be sure, China had agreed in 2013 to consider making an advance payment for natural gas to help overcome the impasses over price before entertaining in 2014 the provision of long-term credit to Gazprom.⁴⁶ However, such a loan never materialized, reportedly because Chinese negotiators insisted on an interest rate that was higher than what Gazprom was willing to accept.⁴⁷ That said, China has been willing to provide some sanctions relief to Gazprom in the form of capital. In 2016, for example, the Bank of China agreed to lend Gazprom \$2.7 billion, which was the largest credit from a single bank ever received by the Russian company.⁴⁸

The door to upstream investment opens wider. Western sanctions also compelled Russia to open the door wider to Chinese participation in the exploration and development of Russian hydrocarbons. However, as mentioned above, the results have been mixed, with only one of three major deals completed.

In September 2014, Putin extended an invitation from Rosneft to CNPC to acquire a 10% stake in the company's giant Vankor oil field in East Siberia, stating that "we take a cautious approach to letting in our foreign partners but of course we set no restrictions for our Chinese friends."⁴⁹ CNPC, however, did not take up Rosneft's offer. This was probably due to disagreements over terms, notably the price (given the higher risk of doing business in Russia owing to the sanctions).⁵⁰ In addition, CNPC may have wanted a larger stake on par with the terms Russia had previously offered Western companies under the joint-venture arrangements.⁵¹

In September 2017 a private Chinese company, CEFC China Energy, agreed to purchase a 14.16% stake in Rosneft from Glencore and the Qatar Investment Authority (QIA).⁵² The transaction would have made CEFC the second-largest minority shareholder after BP.⁵³ However, Glencore and QIA terminated the sale in May 2018 as CEFC faced mounting legal and financial problems as a result of an investigation into economic crimes by its chairman and mounting debt from rapid expansion abroad.⁵⁴

However, Rosneft did secure investment from another Chinese company. In June 2017, Beijing Gas purchased 20% of a Rosneft production subsidiary, Verkhnechonskneftegaz, for \$1.1 billion.⁵⁵ Verkhnechonskneftegaz is exploring and developing one of the largest oil and gas condensate fields in East Siberia.⁵⁶ The deal was part of a broader effort by Rosneft to raise

⁴⁶ Gustafson, Diao, and Yang, "Russia-China Gas Deal," 4.

⁴⁷ Jack Farchy, "Gazprom Secures €2bn Loan from Bank of China," *Financial Times*, March 3, 2016, <https://www.ft.com/content/ac5b1ee4-e159-11e5-9217-6ae3733a2cd1>.

⁴⁸ *Ibid.*

⁴⁹ Jack Farchy and Kathrin Hille, "Russia Eyes Energy Boost; Investment: Yamal Gas Project," *Financial Times*, May 6, 2015.

⁵⁰ *Ibid.*

⁵¹ I thank an expert on Russia's energy sector for this point.

⁵² Henry Foy and Neil Hume, "CEFC China Energy Buys \$9Bn Stake in Rosneft," *Financial Times*, September 8, 2017, <https://www.ft.com/content/25b18d2e-94a4-11e7-a9e6-11d2f0ebb7f0>.

⁵³ Rosemary Griffin, "Glencore, QIA Drop Deal to Sell Rosneft Stake to CEFC," *Platts Oilgram News*, May 7, 2018.

⁵⁴ Neil Hume and David Sheppard, "Qatar and Glencore Scrap Plan to Sell \$9Bn Rosneft Stake to CEFC," *Financial Times*, May 4, 2018, <https://www.ft.com/content/402ab57c-4fb6-11e8-9471-a083af05aea7>; and Alexandra Stevenson, "Hard-Charging Chinese Energy Tycoon Falls from Xi Government's Graces," *New York Times*, March 14, 2018, <https://www.nytimes.com/2018/03/14/business/china-cefc-investigation.html>.

⁵⁵ "Rosneft and Beijing Gas Close the Deal for Sale and Purchase of 20% Shares in Verkhnechonskneftegaz," Rosneft, Press Release, June 29, 2017, <https://www.rosneft.com/press/releases/item/187075>.

⁵⁶ "Herbert Smith Freehills Advises Beijing Gas on Completion of Energy Investment with Rosneft and US\$500 Million Bond Issue," Herbert Smith Freehills, July 18, 2017, <https://www.herbertsmithfreehills.com/news/herbert-smith-freehills-advises-beijing-gas-on-completion-of-energy-investment-with-rosneft-and>.

capital by selling off East Siberian assets.⁵⁷ For Beijing Gas, already one of the largest natural gas distributors in China, the acquisition presented an opportunity to expand its business along the natural gas value chain.⁵⁸

Rise of New Chinese Crude Purchasers

In addition to the provision of Chinese capital following the global financial crisis and Western sanctions, another factor that contributed to the growth in Russian crude oil exports to China is the emergence of China's independent refineries as buyers of imported crude oil.⁵⁹ In 2015, Beijing granted these independent refineries—often called “teapots”—direct access to imported crude oil, a privilege that had previously been enjoyed by only a handful of state-owned companies.⁶⁰ This move to open up the oil trading business to a much larger number of participants essentially created a new country's worth of demand for crude oil imports. Beijing awarded the independent refineries, most of which are located in Shandong Province in northeast China, import quotas totaling 1.5 million bpd in 2016 and 1.9 million bpd in 2017.⁶¹ Russia quickly became a preferred supplier because the short distance from the port of Kozmino to Shandong (compared with Persian Gulf ports) makes the smaller cargoes these refineries prefer more economical.⁶² Purchases of Russian crude accounted for more than 90% of the growth in Russian exports to China in 2016 and all of the growth in 2017.⁶³

In contrast, other major oil exporters, notably Saudi Arabia were slower to take advantage of the emergence of independent refineries as a new source of Chinese crude demand. First, there is a mismatch between Saudi Aramco's practice of selling most of its crude via long-term contracts and these refineries' preference for purchasing smaller volumes on the spot market due to credit constraints and inadequate access to ports.⁶⁴ Second, the company was not as flexible on pricing as some of the other oil exporters selling crude to the independents.⁶⁵ Third, Saudi Aramco, which has a low tolerance for risk, was initially cautious about doing business with the independent refineries due to concerns about their creditworthiness.⁶⁶

⁵⁷ Nastassia Astrasheuskaya, “Rosneft \$1 Billion Siberian Oil Field Sale to Beijing Gas,” *Platts Oilgram News*, November 8, 2016.

⁵⁸ Beijing Enterprises Holdings Limited, “Overseas Regulatory Announcement,” April 21, 2017, 59, <http://www.hkexnews.hk/listedco/listconews/sehk/2017/0421/LTN20170421695.pdf>.

⁵⁹ This section partly draws from Erica Downs, “Russia Not Saudi Arabia Is China's Main Source of Oil,” *Asia Dialogue*, March 28, 2018, <http://theasiadialogue.com/2018/03/28/the-new-king-of-chinas-crude-oil-imports-russia-and-the-competition-for-market-share-in-china>.

⁶⁰ National Development and Reform Commission (PRC), “Guojia fazhan gaige wei guanyu jinkou yuanyou shiyong guanli youguan wenti de tongzhi” [Notice of the National Development and Reform Commission on Issues Related to the Use of Imported Crude], Document, no. 253, 2015, http://www.sdpc.gov.cn/gzdt/201502/t20150216_664965.html.

⁶¹ Julien Mathonniere, “Insight: China Takes a Driving Seat in Global Oil Markets,” ICIS, December 13, 2017, <https://www.icis.com/resources/news/2017/12/13/10173856/insight-china-takes-a-driving-seat-in-global-oil-markets/?redirect=english>; and Chen Aizhu and Meng Meng, “Update 1—China March Refinery Runs Hit Record; Crude Output Near Multi-Year Low,” *Reuters*, April 16, 2018.

⁶² Gawoon Philip Vahn, Deborah Lee, and Dexter Wang, “Far East Russian Crudes Rally as China Shifts Focus to Low Sulfur Crudes,” *S&P Global Platts*, October 25, 2016, <http://www.platts.com/latest-news/oil/singapore/far-east-russian-crudes-rally-as-china-shifts-27695519>; and Meng Meng and Chen Aizhu, “Russia Beats Saudi for Third Straight Month as China's Top Crude Supplier,” *Reuters*, June 21, 2016, <http://www.reuters.com/article/us-china-crude-imports-idUSKCN0Z72DX>.

⁶³ “Table of China December Data on Oil”; and “Zhongguo defang lianchang yue bao” [Monthly Report on Independent Refineries], ICIS, December 2016, 3. Crude oil imports for independent refineries in 2017 were calculated from multiple Platts reports.

⁶⁴ Aizhu Chen, Gavin Maguire, and Mark Tay, “RPT- Saudis, Mideast Producers Vie for China's Teapot Crude Imports,” *Reuters*, October 30, 2016, <https://www.reuters.com/article/mideast-china-oil/rpt-saudis-mideast-producers-vie-for-chinas-teapot-crude-imports-idUSL4N1CY3GK>.

⁶⁵ Brian Spegele, Jenny W. Hsu, and Dan Strumpf, “Oil Producers Tap Brewing Demand from China's ‘Teapots,’” *Wall Street Journal*, September 26, 2016, <http://www.wsj.com/articles/oil-producers-tap-brewing-demand-from-chinas-teapots-1474789780>.

⁶⁶ Chen Aizhu and Florence Tan, “Exclusive: China's Opening Up of Oil Market under Scrutiny after Deals Sour,” *Reuters*, January 21, 2016, <http://www.reuters.com/article/us-china-refinery-financing-exclusive-idUSKCN0V00KP>.

Yet another new buyer of Russian crude emerged in September 2017, when CEFC signed a supply contract with Rosneft for 244,000 bpd over five years.⁶⁷ Rosneft began delivering the crude in January 2018 and has stated that it will honor the supply contract despite the collapse of CEFC's plans to purchase a 14.16% stake in the company.⁶⁸

Conclusion: Implications for the U.S. Government and Companies

Seaborne Oil Imports Remain a Significant Vulnerability for China

Despite the impressive growth in Russian crude oil exports to China over the past decade, the vast majority of the country's crude oil imports will continue to travel through major maritime chokepoints such as the Strait of Hormuz and the Strait of Malacca.⁶⁹ To be sure, Russia has contributed more than any other country to the diversification of China's oil import routes. The 1.2 million bpd that it delivered to China in 2017 traveled either overland or only a short distance by sea. In contrast, Kazakhstan, China's other overland supplier, only exported 50,000 bpd to the country in 2017 because of production declines in the region where crude for the Kazakhstan-China oil pipeline is sourced.⁷⁰ Together, Russia and Kazakhstan provided 14% of China's crude oil imports in 2017.⁷¹

However, the projected growth in China's oil imports over the next five years will likely be greater than any increases in crude deliveries from Russia and Kazakhstan. For example, the IEA expects China's crude oil imports to grow from 8.8 million bpd in 2017 to 10.8 million bpd in 2023.⁷² For comparison, the combined capacity of the ESPO spur, the port of Kozmino, and the Kazakhstan-China oil pipeline is only 1.63 million bpd (see **Table 1**). Even if all this capacity were used to deliver crude oil to China, the share of its total imports supplied by Russia and Kazakhstan would remain around 15% in 2023. The remaining 85% would continue to travel long distances by sea and pass through major maritime chokepoints.

Russian Energy Exports Have Not Crowded Out U.S. Crude and LNG Sales to China

The growth in Russian crude deliveries has not prevented the United States from winning a share of China's crude oil imports. In 2017, China emerged as the second-largest buyer of U.S. crude after Canada, importing 224,000 bpd.⁷³ Its purchases of U.S. crude increased to 300,000 bpd in the first quarter of 2018, making the United States the tenth-largest crude oil supplier to China

⁶⁷ Elena Mazneva, Stephen Bierman, and Javier Blas, "China Deepens Oil Ties with Russia in \$9 Billion Rosneft Deal," Bloomberg, September 8, 2017, <https://www.bloomberg.com/news/articles/2017-09-08/china-s-cefc-buys-stake-in-rosneft-from-glencore-and-qatar>; and Maria Kiselyova, Vladimir Soldatkin, and Florence Tan, "Russia's Rosneft Confirms Oil Supply Deal with China's CEFC," Reuters, November 19, 2017, <https://www.reuters.com/article/us-russia-china-oil/russias-rosneft-confirms-oil-supply-deal-with-chinas-cefc-idUSKBN1DK0JZ>.

⁶⁸ Kiselyova et al., "Russia's Rosneft Confirms Oil Supply Deal with China's CEFC"; and "Rosneft Tackles CEFC Supplies Dilemma," NEFTE Compass, May 31, 2018.

⁶⁹ IEA, *World Energy Outlook 2017* (Paris: OECD Publishing, 2017), 630–31.

⁷⁰ "Table of China December Data on Oil"; and Matthew J. Sagers, "Step by Step, the Kazakhstan-China Oil Pipeline Becomes a Major Oil Export Conduit," IHS CERA, July 2016, 12.

⁷¹ "Table of China December Data on Oil."

⁷² IEA, *Oil 2018: Analysis and Forecasts to 2023* (Paris: OECD Publishing, 2018), 34, 52.

⁷³ U.S. Energy Information Administration (EIA), "Petroleum and Other Liquids: Exports by Destination," June 29, 2018, https://www.eia.gov/dnav/pet/pet_move_expc_a_EPC0_EEX_mbbldpd_a.htm; and EIA, "U.S. Crude Oil Exports Increased and Reached More Destinations in 2017," March 15, 2018, <https://www.eia.gov/todayinenergy/detail.php?id=35352>.

TABLE 1 Capacity of major oil export routes from Kazakhstan and Russia to China (bpd)

| Route | Capacity |
|-------------------------------|-----------|
| Kazakhstan-China Oil pipeline | 400,000 |
| ESPO spur | 600,000 |
| Port of Kozmino | 630,000 |
| Total | 1,630,000 |

SOURCE: Kazakhstan-China Pipeline LLP, "About the Company," <http://www.kcp.kz/company/about?language=en>; "New Line of China-Russian Oil Pipeline Begins Operation," Xinhua, January 1, 2018, http://http://www.xinhuanet.com/english/2018-01/01/c_136864998.htm; and "Transneft Says Kozmino Export Capacity Allows for 31.3 Mln T of Oil Exports in 2017," Reuters, January 17, 2017, <https://af.reuters.com/article/africaTech/idAFR4N1F200V>.

in this period.⁷⁴ Similarly, China, which began buying U.S. LNG in 2016, was the third-largest buyer in 2017 after Mexico and South Korea, purchasing 1.5 million tons on the spot market.⁷⁵ China maintained this position in the first quarter of 2018.⁷⁶ Meanwhile, CNPC and Cheniere signed the first long-term contract for U.S. LNG deliveries to China in February 2018. Cheniere will ship 1.2 million tons of LNG a year to CNPC through 2043.⁷⁷

There is certainly room for more U.S. crude and LNG in China. The IEA, for example, projects that Chinese oil imports will increase by 2.2 million bpd between 2017 and 2023.⁷⁸ Similarly, China will need to contract another 70 million tons per year of LNG through 2025 to meet its growing natural gas demand, according to industry analysts at Bernstein.⁷⁹ How much of the country's crude and LNG import requirements are met by U.S. supplies may partly depend on how the ongoing bilateral trade dispute unfolds.

U.S.-China Trade Dispute May Spur More Russian Gas Exports to China

The ongoing U.S.-China trade dispute may help facilitate the development of infrastructure to deliver more Russian natural gas to China.⁸⁰ Beijing implemented a 10% tariff on U.S. goods, including LNG, on September 24, 2018, in response to tariffs imposed by the United States on Chinese goods.⁸¹

Although some analysis shows that U.S. LNG would still be cheaper in China than LNG from other sources, the tariff is nonetheless likely to prompt Chinese buyers to reduce their

⁷⁴ "Table of China March Data on Oil."

⁷⁵ EIA, "U.S. Natural Gas Exports and Re-exports by Country," June 29, 2018, https://www.eia.gov/dnav/ng/ng_move_expc_s1_a.htm; and *ibid.*

⁷⁶ *Ibid.*

⁷⁷ Ed Crooks and Emiko Terazono, "Cheniere Signs Long-Term LNG Export Deal with China," *Financial Times*, February 9, 2018, <https://www.ft.com/content/cf27354a-0dbf-11e8-8eb7-42f857ea9f09>.

⁷⁸ IEA, *Oil 2018*, 34, 52.

⁷⁹ Neil Beveridge et al., "Bernstein Global Gas: China Steps on the Gas. Will This Trigger the Next LNG Super-Cycle?" Bernstein Research, October 18, 2017, 1.

⁸⁰ I thank James Henderson for this point.

⁸¹ Scott DiSavino and Sabina Zawadzki, "China LNG Tariff Casts Shadow over New U.S. Export Terminals," Reuters, September 18, 2018, <https://www.reuters.com/article/us-usa-trade-china-lng/china-lng-tariff-casts-shadow-over-new-u-s-export-terminals-idUSKCN1LY27T>.

purchases from the United States because of uncertainty over whether the tariff will increase.⁸² This uncertainty about U.S. LNG exports may lead the Chinese government and national oil companies to view Russia as a more reliable supplier of natural gas and pursue additional projects to deliver Russian gas to China. Indeed, during a meeting with Putin in September 2018, Xi expressed renewed interest in developing a second cross-border natural gas pipeline from West Siberia to western China. Specifically, he “set the task of getting approval for gas supplies via the western route in the shortest possible time,” according to Russia’s energy minister.⁸³ Another Russian export project that may benefit from the U.S.-China trade dispute is Novatek’s Arctic LNG 2. The company has held talks with CNPC and the SRF about participation.⁸⁴

⁸² Jessica Jaganathan, “U.S. LNG to China Cheaper Than Other Origins Despite Tariff—Sources,” Reuters, September 19, 2018, <https://www.reuters.com/article/us-usa-trade-china-lng/u-s-lng-to-china-cheaper-than-other-origins-despite-tariff-sources-idUSKCN1LZ2EZ>; and Stephen Stapczynski and Dan Murtaugh, “U.S. Gas Shunned by China as Goldman Sees Swift End to Trade,” Bloomberg, September 19, 2018, <https://www.bloomberg.com/news/articles/2018-09-19/u-s-gas-still-a-no-go-for-chinese-buyers-despite-weaker-tariff>.

⁸³ “Moscow, Beijing to Agree Gas Supplies Via Power of Siberia’s ‘Western Route’ Shortly,” TASS, September 12, 2018, <http://tass.com/economy/1021135>.

⁸⁴ “Russia’s Novatek in Talks with China’s CNPC on Arctic LNG-2—TASS,” Reuters, July 19, 2018, <https://af.reuters.com/article/commoditiesNews/idAFL8N1UF0Z4>.

Japan's Opaque Energy Policy toward Russia: Is Abe Being Trumped by Putin?

Shoichi Itoh

SHOICHI ITOH is a Senior Analyst at the Institute of Energy Economics, Japan (IEEJ). He is also the Reconnecting Asia Virtual Fellow at the Center for Strategic and International Studies and a Visiting Professor in the Slavic-Eurasian Research Center at Hokkaido University. He is the author of multiple publications on energy ties between Russia and Asia, including *Russia Looks East: Energy Markets and Geopolitics in Northeast Asia* (2011). He can be reached at <shoichi.itoh@tky.ieej.or.jp>.

NOTE: The views expressed in this essay are solely the author's own and do not represent any of the organizations with which he is affiliated.

EXECUTIVE SUMMARY

This essay examines Tokyo's proactive energy outreach to Moscow amid Western sanctions and assesses its consequences for U.S.-Japan energy cooperation, as well as for overall Japan-Russia relations.

MAIN ARGUMENT

Prime Minister Shinzo Abe, with his self-proclaimed deep trust in President Vladimir Putin, has made striking a historic deal on improving Japan-Russia relations a priority. The Abe administration's economic cooperation proposals prioritize the energy sector as an area to capture Moscow's interest, despite difficulties identifying economically viable gas and oil projects. Russia aims to consolidate and strengthen its LNG export capacity against emerging competition with the U.S., and Tokyo has pursued policies that essentially underpin this ambition, despite the importance of U.S.-Japan cooperation on LNG to Japan's long-term interests and energy security.

POLICY IMPLICATIONS

- The Abe administration needs to realize that only power politics will draw Moscow's serious attention to improving Japan-Russia relations. Tokyo's appeasement policy reflects wishful thinking on the outcomes of economic cooperation and will likely be exploited by Putin to further destabilize the West without offering tangible benefits in return to Japan.
- Japan should stop politically covering up the difficulty of identifying economically viable gas and oil projects in Russia, given that they would not bolster Japan's energy security or weaken the Sino-Russian partnership.
- The U.S. and Japan should accelerate efforts to jointly shape the expansion of the global LNG market and increase further market opportunities for U.S. LNG exports. A thorough review of Japan's energy policy toward Russia should be undertaken to ensure that it does not damage this strategic objective.

Amid the escalating tension in Russia's relations with the United States and the European Union, Japan has maintained a semi-independent policy toward Russia. Prime Minister Shinzo Abe has taken a more conciliatory approach toward Moscow than any other prime minister since the Soviet-Japanese Joint Declaration was signed by Prime Minister Ichiro Hatoyama in 1956. Western policymakers have been widely appalled by Prime Minister Abe's emphasis on personal trust with President Vladimir Putin.¹ The Japanese leader has attempted to strike a historic deal in resolving the dispute over the Northern Territories (known as the Kuril Islands in Russia), with a view toward making this a defining legacy of his administration.

The Abe administration has identified energy as one of its priority areas for cooperation, given that this strategic sector will likely capture President Putin's attention more than any other. From an economic standpoint, however, Japan has struggled to find a gas or oil project that satisfies an essential need. Notable obstacles are that Japanese demand for hydrocarbons has peaked at the same time that non-Russian supply sources, including U.S.-based projects, are increasingly available. Tokyo, nonetheless, is in pursuit of viable energy projects, including those that could spur Russia to strengthen its presence in the globally expanding liquefied natural gas (LNG) market, where it would compete with U.S. interests. Yet the Abe administration's efforts to politically encourage private Japanese companies to develop more business opportunities in the Russian energy sector have brought about only limited success, partly due to concern regarding a potential conflict with U.S. and Western sanctions.

With this in mind, this essay examines Tokyo's proactive energy outreach to Moscow amid Western sanctions and its implications for U.S.-Japan energy cooperation and overall Japan-Russia relations. The first section begins by outlining Prime Minister Abe's pursuit of improved relations with President Putin while virtually ignoring the importance of solidarity with the West. This section then surveys Northeast Asia's energy environment, focusing on Russia's successful expansion into the region and the potential for Japan to use the energy sector to boost cooperation with Russia. The second section discusses Tokyo's strategic ambivalence about LNG cooperation with the United States, including its attempts to support Russia's LNG strategy. The essay concludes that, despite Prime Minister Abe's political will to use energy to improve relations between Japan and Russia, energy can no longer be an effective area of Japanese diplomacy toward Russia without imprudently undermining the vital interests of the U.S.-Japan energy relationship.

Russia's Energy Pivot to Northeast Asia

Russia has made a striking debut in Northeast Asian energy markets in the first two decades of the 21st century. The construction of the Eastern Siberia–Pacific Ocean (ESPO) crude oil pipeline, in particular, rapidly increased crude oil exports from Russia's eastern flank. Russia's crude oil supplies to Northeast Asia increased approximately threefold in the past decade to 73.2 million tons (mt) in 2017, accounting for 29% of Russia's total exports.²

Moscow regards expanding the Russian share of Northeast Asian energy markets as of vital importance in view of globally intensifying competition among energy suppliers as well as

¹ This assessment is based on the author's interactions with policymakers of the other G-7 member countries.

² Calculated from Federal Customs Service (Russia), "Customs Statistic of Foreign Trade."

geopolitical competition.³ Since the 2000s, its increasing oil and gas exports have been Russia's single most important point of leverage to regain its regional influence after the country's presence on the international stage was drastically reduced by the collapse of the Soviet Union.

Similarly, a vital goal of Japan's energy strategy is to diversify its portfolio of crude oil imports. Russia is one of the alternative suppliers for Japan to reduce its dependence on oil imports from the Middle East, especially in light of the increase in Russia's crude oil exports from its eastern regions following the completion of the ESPO pipeline. Russia's share in Japan's crude oil market fluctuated around 4%–10% during the past decade, depending on the spot market conditions.⁴ It is also true, however, that Japanese buyers can easily find more price-competitive crude oil in the global market. The short distance from Russia to Japan thus does not necessarily give Russia a sufficient advantage over other suppliers.

The Abe Administration's Wishful Thinking

A key question about Japan's role in this pivot is the politics of bilateral ties. Prime Minister Abe has repeatedly emphasized in public the personal trust that he has successfully developed with President Putin. Although his administration has officially stated that Japan's basic diplomatic principle—finding a solution to the Northern Territories issue by way of resolving the attribution of the four islands—would remain a precondition for signing a peace treaty, Prime Minister Abe maintains that Japan, having failed to move forward on the territorial issue “even by one millimeter,” should review its traditional Russia policy and take a new approach, one unconstrained by historical disputes.⁵ The Japanese leader has underlined his personal special interest in improving relations with Russia due to his own family's decades-long commitment that dates back to the Soviet period.⁶ Reflecting this prioritization of improving the bilateral relationship over resolving the territorial issue, and despite Abe and Putin meeting a total of 22 times as of September 2018, virtually no progress has been made with regard to the status of the Northern Territories.⁷

Japan has in principle joined the other G-7 nations in denouncing Russia for its illegal annexation of Crimea in March 2014. Tokyo, however, deliberately refrained from provoking Moscow by imposing no more than symbolic sanctions on the grounds that Japan is engaged in peace treaty negotiations with Russia.⁸ Likewise, in the case of the Salisbury nerve agent attack in spring 2018, Japan did not fall in line with the United Kingdom, France, Germany, and the United States, which released a joint statement blaming Russia. In fact, in contrast with the West's overall approach, the Abe administration's quasi-appeasement policy toward Russia has helped

³ Shoichi Itoh and Andrew Kuchins, “The Energy Factor in Russia's ‘Asia Pivot,’” in *Energy Security in Asia and Eurasia*, ed. Mike M. Mochizuki and Deepa M. Ollapally (New York, Routledge: 2017), 140–62.

⁴ Calculated from Ministry of Finance (Japan), “Trade Statistics of Japan.”

⁵ Prime Minister of Japan and His Cabinet, “Hoppouryoudo henkan youkyu zenkokutakai” [National Convention on Reclaiming the Northern Territories], February 7, 2018, https://www.kantei.go.jp/jp/97_abe/actions/201702/07hoppou.html.

⁶ Prime Minister Abe has stressed that signing a peace treaty with Moscow was a lifetime goal of his father, former foreign minister Shintaro Abe. In 1990, Abe's father visited Moscow despite a serious illness, and the meeting led to the realization of Mikhail Gorbachev's visit to Japan. “Tasu tushin (Rosiya) niyoru Abe souridaijin intabyu, Abe Shinzo (Souri): Putin daitouryou tonokaidan ha heiwajouyaku ni muketa ookina ippo” [Interview with Prime Minister Abe by Russian News Agency, Tass: The Meeting with President Putin Is Big Progress toward a Peace Treaty], Ministry of Foreign Affairs (Japan), December 18, 2016, https://www.mofa.go.jp/mofaj/p_pd/ip/page4_002607.html.

⁷ So far Japan and Russia merely have agreed on launching joint economic activities in the disputed Northern Territories; they have yet to reach a consensus in regard to the application of the Russian and Japanese laws.

⁸ Maria Shagina, “Japan's Sanctions Policy vis-à-vis Russia: Implications for Western Sanctions Unity,” Sasakawa Peace Foundation USA, Forum Issue, no. 15, September 25, 2018.

President Putin make the argument to the Russian public that the G-7 members have failed to isolate Russia internationally.

At the summit in Sochi in May 2016, Prime Minister Abe proposed the eight-point cooperation plan for galvanizing bilateral relations, and in September of the same year he created a new cabinet post, minister for economic cooperation with Russia.⁹ Given President Putin's emphasis on development of the oil and gas sector to Asia, energy was identified as a priority area for cooperation in the plan.¹⁰

Well in advance of his visit to Japan in December 2016, Putin publicly cautioned against excessive optimism about Moscow's willingness to make concessions on the territories. He reminded Tokyo that Russia could not disengage the territorial question from its security concerns, given that Japan is a close ally of the United States.¹¹ Ironically, this uncompromising position on the territorial talks is exactly the same as the Kremlin's traditional approach during the Soviet period. In a nutshell, the Abe administration has turned back the clock on Japanese-Russian relations by letting Moscow emphasize its desire to ink a peace treaty with Tokyo by way of "shelving" the territorial issue.

During Putin's visit to Japan in December 2016, Japan and Russia signed a total of more than 80 agreements, including twelve documents at the intergovernmental level, though these agreements mostly remained at the level of memoranda of understanding (MOUs). Energy-related projects accounted for 23 agreements, including some aiming to enhance LNG partnerships with Gazprom and Novatek.¹² Energy ties are thus central to the Abe administration's strategy to induce Russia into negotiating a resolution to the historical tensions over the Northern Territories.

Economic Obstacles to Japan-Russia Energy Ties

Today, Japan cannot easily find an economically justifiable big oil development project in Russia, despite Tokyo's political will to do so. Japan's mature oil market is forecast to decrease by 2.5% per annum from 2017 to 2040.¹³ Besides, in Russia's continental eastern flank, there remain only leftovers of small-sized oil fields with little economic attractiveness internationally due to the unfavorable investment environment in the region, including the limited amount of proven reserves, severe climate conditions, and enormous cost of overcoming underdeveloped infrastructure.

Japan Oil, Gas and Metals National Company (JOGMEC) and Irkutsk Oil Company (INK) have conducted a joint seismic study in the Irkutsk region since 2007 and found four small-sized hydrocarbon fields to date. At the time of the 2016 Sochi summit, JOGMEC and INK signed an MOU to negotiate future joint-exploration projects and signed a "heads of" agreement with the

⁹ Hiroshige Seko, minister for economy, trade and industry, was appointed to concurrently serve as minister for economic cooperation with Russia.

¹⁰ See "Japan-Russia Summit Meeting," Ministry of Foreign Affairs (Japan), May 7, 2016, https://www.mofa.go.jp/erp/rss/northern/page4e_000427.html.

¹¹ Denis Pinchuk, "Putin Links Japan Peace Treaty to Tokyo's Alliances," Reuters, November 11, 2017, <https://www.reuters.com/article/us-apec-summit-russia-japan/putin-links-japan-peace-treaty-to-tokyos-alliances-idUSKBN1DB0BZ>.

¹² Nastassia Astrasheuskaya, "Russia, Japan Deepen Ties with Agreements on Upstream LNG Cooperation," S&P Global Platts, December 18, 2016, <https://www.spglobal.com/platts/en/market-insights/latest-news/natural-gas/121816-russia-japan-deepen-ties-with-agreements-on-upstream-lng-cooperation>.

¹³ International Energy Agency (IEA), *World Energy Outlook 2018* (Paris: OECD Publishing, 2018), 586.

aim to start new joint exploration in East Siberia for at least five new blocks.¹⁴ As of 2016, the INK-related group of companies in East Siberia had produced 7.8 mt of oil and gas condensate.¹⁵ However, these projects do not make a significant contribution to Japan's energy security and thus primarily have symbolic value for Japan-Russia cooperation.

Although Japan is the biggest importer of LNG from Russia's export facility, the Sakhalin-2 project, which went online in 2009, Russia has dim prospects to export more LNG to the Japanese market. Japan has imported around 9%–10% of its total LNG supply from Russia since 2010, and its portfolio of LNG imports is already considerably diversified.¹⁶

Even with the slow and limited restart of nuclear reactors in the aftermath of the Great East Japan Earthquake in 2011, Japan's gas demand peaked in the mid-2010s and is already gradually declining.¹⁷ The sudden increase in LNG consumption, as thermal plants replaced nuclear power generation following the earthquake, once raised a serious anxiety about securing access to LNG at internationally competitive prices. However, drastic changes in international gas markets, mainly thanks to the growing impact of the U.S. shale gas revolution, significantly reduced this concern.

Japanese gas buyers are growing more cautious about increasing the number of long-term contracts to purchase LNG because Japan's natural gas demand is projected to contract by 0.7% per annum from 2017 to 2040.¹⁸ Russia has still yet to have a sizable amount of spare LNG capacity for the spot market at internationally competitive prices. Although Japan has made financial and technological commitments in the construction of the Yamal LNG project, finding a Japanese buyer to purchase cargos from this project has proved difficult.

China's growing dominance of Asia's energy markets has further reduced Japan's weight in Russia's Asian energy policy. In other words, Russia's presence in Northeast Asian energy markets is increasingly dependent on the Chinese market. Chinese demand for oil and gas is estimated to rise by 1.0% and 4.5% per annum, respectively, from 2017 to 2040.¹⁹ China already became the world's second-largest LNG-importing nation in 2017 and is expected to overtake Japan in 2019.²⁰ Moreover, China may well have a heightened strategic incentive to tilt more toward gas supplies from Russia because its procurement of LNG from the contiguous United States might be discouraged as a result of the escalation of the current "trade war" with the Trump administration.

The first gas pipeline between Russia and China (Gazprom's Power of Siberia-1) is planned for completion in December 2019.²¹ China is also one of the main markets for the Yamal LNG project, with Novatek and China National Petroleum Company (CNPC) signing a heads of agreement in

¹⁴ "Memorandum of Understanding Signed between JOGMEC and INK," Japan Oil, Gas and Metals National Corporation (JOGMEC), News Release, December 16, 2016, http://www.jogmec.go.jp/english/news/release/news_06_000035.html; and "Heads of Agreement Signed between JOGMEC and INK on New Joint Exploration Project," JOGMEC, April 27, 2017, http://www.jogmec.go.jp/english/news/release/news_10_000059.html.

¹⁵ "Heads of Agreement Signed between JOGMEC and INK on New Joint Exploration Project."

¹⁶ As of 2017, Australia, Malaysia, Qatar, and Indonesia accounted for 31%, 18%, 12%, and 8%, respectively, of Japan's LNG import portfolio. Calculated from Ministry of Finance (Japan), "Trade Statistics of Japan."

¹⁷ Japan's LNG imports, having peaked at 88.5 mt in 2014, decreased by 6% to 83.6 mt in 2017. Calculated from Ministry of Finance (Japan), "Trade Statistics of Japan."

¹⁸ IEA, *World Energy Outlook 2018*, 586.

¹⁹ *Ibid.*, 578.

²⁰ IEA, *Gas 2018* (Paris: OECD Publishing, 2018), 124.

²¹ "Power of Siberia Gas Pipeline 83 Percent Complete, Over 1,790 Kilometers Built," Gazprom, Press Release, May 17, 2018, <http://www.gazprom.com/press/news/2018/may/article429502>. The designed annual capacity of natural gas deliveries by this pipeline is 38 billion cubic meters, which was nearly equivalent to the total amount of China's natural gas imports as of late 2017.

October 2013 for the supply of 3 mt per annum for twenty years.²² Having a maximum production capacity of 5.5 mt per year, the project went online in December 2017 and loaded its first cargo in March 2018. CNPC and China's Silk Road Fund have 20.0% and 9.9% stakes, respectively. The project is planned to triple its capacity to 16.5 mt per annum by 2019 with the addition of second and third trains now under construction.²³

In sum, energy can no longer play more than a limited role in Japanese diplomacy toward Russia. From an energy security perspective, it is neither economically rational nor viable for Japan to aggressively search for an oil or gas project in Russia today, given that domestic demand has peaked and non-Russian sources are increasingly available. By stark contrast, the oil and gas sector has steadily reinforced the Sino-Russian strategic energy partnership.

Tokyo's Janus-Faced Approach to U.S.-Japan LNG Cooperation

The Abe administration's politically motivated, if not necessarily economically grounded, attempts at energy outreach to Russia have taken place amid a strengthening of U.S.-Japan energy ties. Tokyo's efforts to advance Putin's LNG ambitions have disregarded the negative impact on both G-7 solidarity and energy cooperation with the United States.

The U.S.-Japan LNG Partnership

In May 2016 the Japanese government published the "Strategy for LNG Market Development." This strategy emphasizes three aims: (1) to minimize the number of long-term contracts by Japanese LNG buyers by making the best of short-term and spot markets, (2) to abolish or relax destination clauses in view of increasing arbitrage in LNG trading, and (3) to make gas pricing more effectively reflect the supply-demand balance of the global LNG market by means of fostering stable and transparent prices.²⁴

Japan, as a leading LNG importer, benefits from increases in the world's LNG trade flows, which will hopefully promote further convergence of the hitherto globally compartmentalized regional gas markets in Asia, Europe, and North America. In this regard, the maximization of U.S. LNG exports is in Japan's own interest.²⁵ The increase of supplies from the contiguous United States contributes to further diversification of Japan's gas import portfolio as well as pricing mechanisms.²⁶ The country's purchasing of LNG is traditionally indexed to crude oil prices, known as JCC (Japan Crude Cocktail), whereas its imports of U.S. LNG are indexed to the Henry Hub price and have gradually introduced pricing contracts based on gas-to-gas competition.

Japanese gas companies, utilities, and trading houses have already inked agreements for more than 20 mt per year of LNG from the contiguous United States, including purchase-and-sale and

²² "Yamal Trade and Gazprom Marketing and Trading Singapore Sign LNG Agreement," Novatek, Press Release, May 23, 2014, http://www.novatek.ru/en/press/releases/index.php?id_4=883.

²³ Novatek and Total have 50.1% and 20.0% stakes, respectively.

²⁴ Ministry of Economy, Trade and Industry (METI) of Japan, "Strategy for LNG Market Development," May 2016.

²⁵ In October 2017 the Japanese government announced that it would offer \$10 billion for public-private initiatives to support the growth of the LNG market in Asia. "The LNG Producer-Consumer Conference 2017 Was Held," METI (Japan), Press Release, October 18, 2017, http://www.meti.go.jp/english/press/2017/1019_001.html.

²⁶ Shoichi Itoh, "Japan's Energy Security in the Age of Low Oil Prices," National Bureau of Asian Research, Pacific Energy Summit, Policy Brief, May 26, 2016, <http://www.nbr.org/research/activity.aspx?id=693>.

tolling agreements. This is equivalent to around a quarter of Japan's total LNG imports in 2017.²⁷ Japanese buyers are gradually becoming portfolio players in the global LNG market; the contracted off-take volumes of LNG are not necessarily slated to be delivered to Japan, given that U.S. LNG contacts basically have no destination clause.

The maximization of LNG supplies from the United States thus has a special significance for Japan, going far beyond market forces. On top of the fact that the United States is Japan's ally, the transportation of energy products across the Pacific Ocean is virtually free from the security concerns that affect the other seaborne routes through the Arctic and the South China Seas. Furthermore, the increase of exports from the United States would not only enhance the liquidity of the global LNG market but also reduce the capability of major nonliberal energy producers, such as Russia, to use gas as a diplomatic weapon in the future. Given the strategic importance of facilitating the rapid and sustainable growth of U.S. LNG exports, Japan shares a common interest with the United States in creating and increasing new demand and building receiving infrastructure worldwide.

In November 2017, Tokyo and Washington launched the Japan-U.S. Strategic Energy Partnership (JUSEP) within the framework of the Japan-U.S. Economic Dialogue.²⁸ One of JUSEP's priority areas includes "development of a global market for natural gas." At the same time, Japan's Ministry of Economy, Trade and Industry and the U.S. Trade and Development Agency signed a memorandum of cooperation to "support Japan-U.S. cooperation on energy infrastructure in third countries."²⁹ In addition, the Japan Bank for International Cooperation (JBIC) and Nippon Export and Investment Insurance (NEXI) separately signed an MOU with the U.S. Overseas Private Investment Corporation (OPIC) for the purpose of promoting joint financing of economic infrastructure, including for energy, in third countries in Asia, the Indo-Pacific, the Middle East, and Africa.³⁰ Joint enhancement of expanding LNG infrastructure in view of increasing destinations for LNG exports is one of the prioritized areas for cooperation.³¹ These recent developments bolster Japan's geopolitical and energy interests far more than the insignificant deals it has orchestrated with Russia.

Japan's Support for Russia's Challenge to U.S. LNG

According to the International Energy Agency, the share of LNG in the world's gas trade will increase from 42% in 2017 to around 60% in 2040.³² The United States is projected to account for 40% of the growth in global LNG output by the mid-2020s and to become the largest exporting country, with liquefaction capacity of 104 mt (140 billion cubic meters), or 25% of global

²⁷ These LNG cargoes come from the Cameron LNG project in Louisiana, the Cove Point LNG project in Maryland, and the Freeport LNG project in Texas. In May 2018 the first LNG cargo supplies from U.S. shale formations arrived in Japan from the Cove Point project. See Aaron Sheldrick and Osamu Tsukimori, "Japan's Tokyo Gas Takes First LNG Cargo from Cove Point," Reuters, May 21, 2018, <https://www.reuters.com/article/usa-trade-tokyo-gas/japans-tokyo-gas-takes-first-lng-cargo-from-cove-point-idUSL3N1SS240>.

²⁸ METI (Japan), "Japan-United States Strategic Energy Partnership (JUSEP)," November 7, 2018, http://www.meti.go.jp/english/press/2017/pdf/1107_001a.pdf.

²⁹ "Memorandum of Cooperation between the Ministry of Economy, Trade and Industry Government of Japan and the United States Trade and Development Agency to Support Japan-U.S. Cooperation on Energy Infrastructure in Third Countries," METI, 2017, <http://www.meti.go.jp/press/2017/11/20171107002/20171107002-2.pdf>.

³⁰ "JBIC Signs MOU with OPIC of the U.S.," JBIC, Press Release, November 8, 2017, <https://www.jbic.go.jp/en/information/press/press-2017/1108-58390.html>; and "United States of America / Memorandum of Understanding on Cooperation between NEXI and Overseas Private Investment Corporation (OPIC)," NEXI, Press Release, November 8, 2017, <https://www.nexi.go.jp/en/topics/newsrelease/2017110701.html>.

³¹ "Joint Statement of the Second Public-Private Sector Roundtable Discussion on U.S.-Japan Cooperation on Third Country Infrastructure," U.S. Department of State, Press Release, April 23, 2018, <https://www.state.gov/r/pa/prs/ps/2018/04/281141.htm>.

³² IEA, *World Energy Outlook 2018*, 182.

LNG trade.³³ Given that import growth of LNG is forecast to absorb overcapacity of supplies by the mid-2020s, however, competition among exporters will likely intensify thereafter.³⁴ It is estimated that Russia will double its production by 2023 through the expansion of the Yamal LNG project.³⁵ In June 2018 the Russian deputy energy minister suggested that the country might increase its production capacity to 100–120 mt by 2035.³⁶

Ahead of President Putin's visit to Japan in December 2016, Tokyo decided to make a commitment to financing the Yamal LNG project, despite having difficulty finding domestic buyers to symbolically underpin Prime Minister Abe's self-proclaimed good terms with President Putin.³⁷ Moreover, at the Japan-Russia summit meeting during the 4th Eastern Economic Forum in September 2018, the Japanese government signed an MOU with Novatek to promote cooperation on the planned Arctic LNG-2 project, in addition to the Yamal LNG project.³⁸

Conclusion

The Abe administration has increased its commitment to Russia's LNG strategy, especially on the Arctic front, without clarifying either the economic rationale or the benefits for Japan's energy security. This essay has argued that Tokyo's imprudent commitment to Russia's projects, especially in the Arctic, will have negative effects on Japan's long-term energy security at a time when the country is beginning to reap benefits from the U.S. shale gas revolution.

First, the idea that economic cooperation, including in the energy realm, would ever induce Moscow to make concessions on the territorial dispute is no more than a pipe dream. In its attempts to court President Putin by means of proposals for unilateral economic cooperation without assurances of specific reciprocal benefits in return, the Abe administration may well be accused of implementing a "semi-tributary" approach to Russia's advantage.

Second, the geopolitical assumption that Japan could increase its relative importance compared with that of China in Russia's Asia policy is similarly naive. Moscow's traditional anxiety about the drastic expansion of Chinese presence in Russian territory has no doubt increased with the acceleration of China's activities in the Arctic and eastern regions.³⁹ The deepening bilateral energy interdependence between the two countries has further complicated Sino-Russian relations. This does not mean, however, that Japan could drive a wedge between China and Russia, which

³³ IEA, *World Energy Outlook 2017*, 335, 378–79.

³⁴ *Ibid.*, 333.

³⁵ IEA, *Gas 2018*, 114.

³⁶ Oksana Kobzeva and Olesya Astakhova, "Russia to Boost Presence on Global LNG Market, Helped by Lower Costs," Reuters, June 1, 2018, <https://www.reuters.com/article/us-russia-lng/russia-to-boost-presence-on-global-lng-market-helped-by-lower-costs-idUSKCN1IX4FI>.

³⁷ Japan's apparent involvement was deliberately reduced by way of forming an international syndicate partially to reduce Japan's visibility. See "Yamal LNG Secures €200 Mln JBIC Loan," LNG World News, December 16, 2016, <https://www.lngworldnews.com/yamal-lng-secures-e200-mln-jbic-loan>. A small minority of experts have even proposed that Japan could increase its bargaining power vis-à-vis U.S. LNG sellers by way of multiplying access to Russian gas, including by building a gas pipeline from the Sakhalin Island to Japan. But neither the government nor domestic gas buyers have endorsed this plan to date. First, it basically undercuts their overall business strategy of reducing the number of long-term contracts in view of the growing spot and short-term gas markets globally. Second, beneficiaries would be reduced to very limited direct off-takers with access to the transnational pipeline due to the absence of a nationwide gas pipeline network. The concept of a Sakhalin-Japan pipeline is also supported by those who have neither essential interest nor expertise in energy. This includes some Diet members whose business interests are related to the construction of the pipelines, regardless of the economic and political implications and the impact on the energy market.

³⁸ "JOGMEC and NOVATEK Signed a Memorandum of Understanding," JOGMEC, Press Release, September 10, 2018, http://www.jogmec.go.jp/english/news/release/news_03_000002.html.

³⁹ The combined area of the Russian Far East and East Siberia accounts for about 60% of Russia's territory.

was the Abe administration's initial expectation.⁴⁰ If Japan were to make an excessive economic commitment, it would simply help reduce Russia's concern about overdependence on China and thus give it some leeway to accept larger-scale Chinese investment. In other words, contrary to the administration's unsophisticated geopolitical calculation, such a commitment would only further reinforce the Sino-Russian energy relationship.

Third, realizing Russia's Arctic LNG potential might decrease even bigger marketing opportunities for U.S. LNG producers. Unlike in the United States, where the private sector makes final investment decisions, Russia has pursued a national strategy to increase its capability to export LNG, regardless of commercial feasibility. Since investment decisions on greenfield U.S. LNG export projects may slow down without securing new gas markets to absorb corresponding amounts of exports, Washington and Tokyo are aiming to create and expand new markets in third countries. The impact of these efforts, however, might be offset by the Abe administration's support of Moscow's LNG strategy.

Prime Minister Abe, firmly believing in the personal trust he has built with his Russian counterpart, continues to ardently seek ways of supporting President Putin's enterprise to "make Russia great again" in the global energy market. With Japanese energy demand having peaked and the drastic changes in the global gas market due to the U.S. shale gas revolution, neither economic interests nor energy security necessitate politically driven Japanese investment in oil or gas projects in Russia today. To the contrary, given the rising strategic importance of the U.S.-Japan relationship for Japan's long-term energy security, Tokyo needs to change course and correct its naive disregard for Russia's ambition to compete with the United States. Otherwise, President Putin may well take advantage of Prime Minister Abe's personal commitment to improving bilateral relations.

⁴⁰ This assessment is based on the author's numerous conversations with high-ranking Japanese officials.

Russia's Energy Foray into Asia: Implications for U.S. Interests

Meghan L. O'Sullivan, Morena Skalamera, and Can Soylu

MEGHAN L. O'SULLIVAN is the Jeane Kirkpatrick Professor of the Practice of International Affairs and the Director of the Geopolitics of Energy Project at Harvard University's Kennedy School of Government. She can be reached at <meghan_osullivan@hks.harvard.edu>.

MORENA SKALAMERA is an Associate in the Geopolitics of Energy Project at Harvard University's Kennedy School of Government and an Assistant Professor at Leiden University. She can be reached at <morena_skalamera@hks.harvard.edu>.

CAN SOYLU is a Fellow in the Geopolitics of Energy Project at Harvard University's Kennedy School of Government. He can be reached at <can_soylu@hks.harvard.edu>.

EXECUTIVE SUMMARY

This essay examines Russia's growing role in Asia's energy markets, assesses the implications for the U.S., and examines the claim that closer Sino-Russian energy ties are adding new incentives for a broader strategic alignment.

MAIN ARGUMENT

China and Russia are forging closer ties to build a “multipolar world” and challenge what they lament as U.S. unilateralism. Energy ties are the backbone of this evolving economic partnership: China has become Russia's main source of funds and its single biggest energy customer. Yet this essay argues that recent developments do not indicate the formation of a true strategic partnership that is based on a common set of values or a developed worldview that encompasses both powers. China is interested in purchasing Russian oil and gas, but still privileges economic relations with the U.S. Russia, meanwhile, feels uncomfortable about the growing power asymmetry with China, which highlights a shortcoming in the Kremlin's claim of resurgent Russian greatness. Russia also displays a state-led mercantilist economic policy that seeks to augment its prowess at the expense of China. While a status-concerned Russia might in principle welcome a firm alliance meant to discomfit the U.S., there is limited value in advancing a strategic alignment (let alone an alliance) for China. Beijing has the upper hand, and keeping its options open will continue to deliver maximum benefits.

POLICY IMPLICATIONS

- While energy has not provided the springboard to a more robust strategic partnership, increasing tensions between China and the U.S. may provide Moscow with new openings to draw closer to Beijing. U.S. policymakers must track developments between Russia and China carefully, as a closer relationship between the two could pose new strategic challenges to the U.S.
- The U.S. should be aware that its more aggressive stance toward China—vis-à-vis trade and other factors—inadvertently plays into Russia's hands by diminishing the U.S. role as an energy competitor for Chinese markets. This approach also removes a Chinese rationale for keeping a distance from Russia: the desire not to complicate relations with the U.S.
- U.S. policymakers should remove barriers to U.S. liquefied natural gas development to ensure that China has alternative sources of natural gas apart from Russia.

Russia has made bold and significant inroads into the Asian energy sector over the past several years. These developments have made headlines and led some to tout Russia's growing power in Asia. Russia's move into the region clearly affects U.S. interests in a variety of ways. The U.S. ability both to curb nefarious Russian behavior and to defend traditional U.S. interests in Asia—including protecting allies, maintaining the free flow of commerce, safeguarding the global commons, meeting the challenges of a rising China, and achieving a denuclearized Korean Peninsula—could be influenced by a changing Russian stance in Asia. Additionally, by leaning more on Asia, Russia has to some extent been able to be more resilient in the face of pressure from Western sanctions.

Nevertheless, this engagement with Asia has still fallen short of what Moscow envisions and has not yet resulted in the sort of relationships that it seeks to establish. While there is still scant evidence that U.S. concerns over the Sino-Russian strategic relationship have been realized, the balance of power between China and Russia has been affected in other ways that could run counter to U.S. interests.

When evaluating the impact of Russia's expansion of ties with Asia for U.S. interests, a few questions are important. First, to what extent have growing links with Asian countries provided Russia relief from the strictures of the largely Western sanctions imposed after the annexation of Crimea? Second, what are the implications of Russia's new posture in Asia for U.S. allies there, in terms of both energy security and their relations with the United States? Finally, and most significantly, has Russia's foray into Asia led to a new strategic relationship with China that challenges the United States in a fundamental way?

This essay looks at each of these areas in turn. It concludes that while Russia's inroads into Asia are real and significant, and in some cases problematic for the United States, concern over Russia's enhanced influence in the region is most likely overblown. At the same time, the essay cautions that recent shifts in U.S. policy that diminish the costs to China of a closer relationship with Russia could have the unintended consequence of facilitating a closer Sino-Russian partnership.

Alleviating the Pressure of Sanctions on Russia

Russia has withstood the pressures of the simultaneous drop in oil prices and Western sanctions far better than most analysts expected. The Russian oil sector has managed to continue expanding its production capacity and only ratcheted down production on account of a deal agreed on with members of the Organization of the Petroleum Exporting Countries (OPEC) in late 2016. As a result of loosening that agreement in 2018, Russia's crude oil production reached record levels of 11.36 million barrels per day.¹ Its natural gas sector had a major win last year as well, with the launch of the giant liquefied natural gas (LNG) project in Yamal, and Russia's gas exports to Europe, Turkey, and the former Soviet republics remain robust.²

Yet sanctions were never intended to crimp current Russian production significantly and have focused more on future production by restricting access to Western finance and technologies critical to complex projects, including the development of Russia's unconventional resources.

¹ Brian Wingfield, Samuel Dodge, and Cedric Sam, "Saudi's, Russia Step Up Oil Pumping to Fill Voids Elsewhere," Bloomberg, October 17, 2018, <https://www.bloomberg.com/graphics/opec-production-targets>.

² See "Delivery Statistics," Gazprom Export, 2017, <http://www.gazpromexport.ru/en/statistics>; and "Former Soviet Union," Gazprom, 2017, <http://www.gazprom.com/about/marketing/cis-baltia>.

These projects have in fact slowed; notably, two large LNG projects intended to serve the Asian market, Sakhalin-1 and Vladivostok LNG, are frozen. Russian development of tight oil is likewise moving along, but at a sluggish pace.

At least part of Russia's resilience to sanctions lies in its strengthened relationship with Asia. Though Asian countries have been unable or unwilling to provide the technology needed for complex projects, China in particular has alleviated the most acute pressure on financing. For instance, during Xi Jinping's state visit to Moscow in July 2017 (just around the time the U.S. House of Representatives was considering a bill that would tighten existing sanctions), it was announced that the China Development Bank had agreed to provide \$11 billion to two Russian state entities that were under Western sanctions.³ Without this critical financing, Russian oil companies most likely would not have had the ability to quickly find ways to work around the tighter restrictions imposed in August 2017.

Notably, Novatek, an independent Russian gas company, would have been unable to complete the landmark Yamal LNG project without vital support from China. China's interest in this project dates back to 2013, when China National Petroleum Corporation (CNPC) agreed to take a 20% stake in it. Two years later, in the wake of sanctions, Novatek once again turned to China when faced with difficulty in raising needed funds from Western banks. This time the Silk Road Fund, a special purpose vehicle established to advance Xi's Belt and Road Initiative (BRI), took a 9.9% stake in the project in exchange for a fifteen-year loan of \$790 million.

This Chinese support saved the Yamal project from potential cancellation. Instead, it went online in December 2017 amid much fanfare, including Vladimir Putin's personal participation in the launch of the first cargo. The strategic value of this project extends beyond the 16.5 million tonnes (mt) per year of exports it is intended to provide to Asian markets between now and 2020, when the project will ostensibly reach full capacity. Yamal is viewed as a critical step in the Kremlin's strategy of developing the Arctic and is intended to jump-start the development of the Northern Sea Route, which Putin has highlighted as a priority.⁴

Asia has also provided Russia with a growing market for its oil exports. In June 2013, Rosneft signed a deal to supply China with \$270 billion worth of oil over the next 25 years.⁵ As a result of this deal, a second branch of the Eastern Siberia–Pacific Ocean pipeline began operations on January 1, 2018, thus doubling China's capacity to import crude from Russia. China can now import 30 mt annually, about 600,000 barrels per day (bpd).⁶

Russia's growing relations with Asia have also born less tangible, but equally important, fruits in undermining other, less energy-specific goals of the sanctions. Putin's close relationship with Xi, his frequent meetings with Japanese prime minister Shinzo Abe, and his warming ties with South Korean president Moon Jae-in have enabled Putin to counter the image of Russian isolation that U.S. and European sanctions were intended to project. Budding relations with Vietnam have further deepened Russia's foray into Asia, while occasional deals with India hold out the prospect

³ Henry Foy, Max Seddon, and Lucy Hornby, "Russia and China Quietly Build Business Bonds," *Financial Times*, September 24, 2017; and Max Seddon and Kathrin Hille, "China and Russia Strike \$11Bn Funding Deal," *Financial Times*, July 4, 2017.

⁴ "Our goal is to make the Northern Sea Route a truly global and competitive transport route," Putin told the Russian Federal Assembly in March 2018. See Keith Johnson and Reid Standish, "Putin and Xi Are Dreaming of a Polar Silk Road," *Foreign Policy*, March 8, 2018, <https://foreignpolicy.com/2018/03/08/putin-and-xi-are-dreaming-of-a-polar-silk-road-arctic-northern-sea-route-yamal>.

⁵ "Russia and China Agree \$270Bn Oil Deal," *Financial Times*, June 21, 2013; and Denis Pinchuk, "Rosneft to Double Oil Flows to China in \$270 Billion Deal," Reuters, June 21, 2013.

⁶ "Russia Tightens Oil Grip with China's Second Pipeline," Bloomberg, January 1, 2018, <https://www.bloomberg.com/news/articles/2018-01-01/second-chinese-crude-oil-pipeline-linked-to-russia-s-espo-opens>.

of a more systematic relationship with the region as a whole. While such relationships are not based solely on energy matters, Russian supplies do figure prominently in each.

In addition, Russia's reorientation toward Asia has strengthened national champions such as Rosneft and Gazprom at the expense of smaller players. Igor Sechin, the CEO of Rosneft and a member of Putin's innermost circle, has been personally successful in courting Asian interests and in doing so has won considerable financial support for his firm. This support, plus his standing as an early proponent of a turn to the east, has helped Rosneft become more than just a big business; it is a defender of Russia's *raison d'état*. In contrast, Gazprom, basking in the formerly easy money from its European business, was surprisingly slow to take advantage of the shift to Asia. However, its Power of Siberia pipeline is now the centerpiece of Moscow's strategy to develop the Russian Far East and the means by which the world's largest gas exporter connects for the first time with its largest gas importer. The project is a huge financial undertaking and a difficult engineering challenge in the most remote areas of Russia. Yet it will undoubtedly reinforce Gazprom's status as the linchpin of new developments in the Russian Far East. The rise in dominance of these two players makes reform of the Russian economy, which could jeopardize Putin's power base, more unlikely than ever.

Implications for U.S. Allies in Asia

Russia's pivot to Asia has created challenges for U.S. allies in the region, which are eager to diversify their energy supplies but also wary of doing so at the expense of their political and security relationship with the United States. Although this turn to Asia has mostly been realized through closer relations with China, Russia is acutely aware of the need not to be overly dependent on one country and to expand its ties beyond China to encompass other Asian powers.

In some respects, this serves U.S. interests, although the extent to which this is the case is debated among experts. At a minimum, Russian supplies add to the overall liquidity of oil and natural gas markets, which enhances the smooth functioning of energy markets and the energy security of those who rely on them. Even if Japan and South Korea are not direct consumers of Russian energy, more efficient oil and especially natural gas markets are in their interests. Recent increases in non-Russian LNG supplies have already had salubrious effects on Asian energy security. The entrance of many more suppliers to global natural gas markets has weakened the link between the price of oil and natural gas, encouraged more flexible contracts, and led to an increase in the sale of spot cargoes. Additional supplies of Russian natural gas contribute to this new, more flexible market, creating a positive feedback. In addition, when Russia begins to supply China with natural gas through the Power of Siberia pipeline, other Asian countries will benefit to the extent that Chinese demand for global LNG supplies will be correspondingly less.

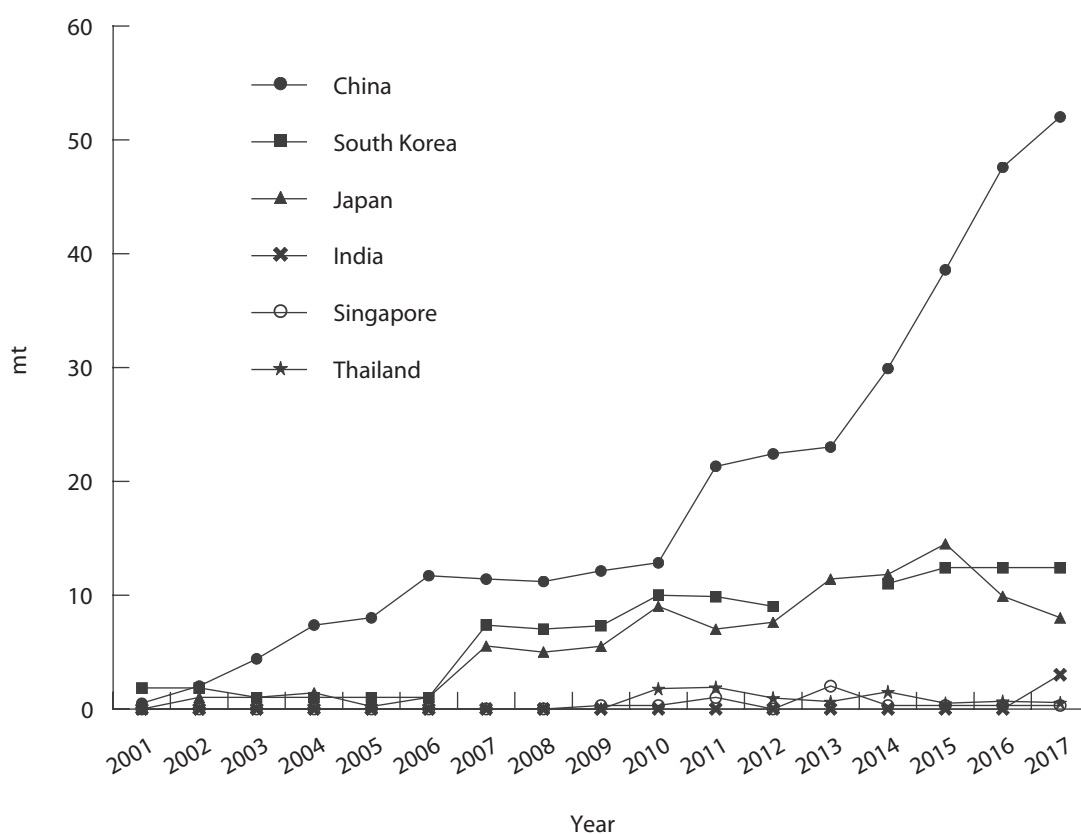
One can also argue that Russia's direct provision of oil and natural gas supplies to Asian countries enhances their energy security, given that diversity of supply is a key element of energy security and that Asia's reliance on Middle Eastern oil is alarmingly high. This is particularly true for Japan and South Korea, as the absence of pipelines between these countries and Russia means that neither is in a situation where a cutoff of energy supplies would create critical or potentially politically significant shortages. Tokyo and Seoul could find other sources of oil and LNG in this scenario, although likely at higher costs.

U.S. allies already benefit from Russian oil exports, both directly and through the effects on global markets. Asia's share of Russia's crude oil export revenues has increased from 6% in 2001

to 31% in 2017.⁷ However, as can be seen in **Figure 1**, this increase has been almost entirely on account of increased imports of Russian crude oil by China. In contrast, Japanese and South Korean imports of Russian crude oil have remained relatively constant in recent years.

Natural gas is a slightly different matter. Russian exports to Asia remain modest but are expected to expand in the next several years. Since 2013, Russia's share of Asia's natural gas imports has remained relatively constant at around 5%.⁸ Japan is the country most dependent on Russian LNG, which has accounted for nearly 9% of its LNG imports over the last eight years.⁹ These percentages,

FIGURE 1 Russia's major Asian partners for crude oil exports



SOURCE: International Trade Centre, "List of Importing Markets for a Product Exported by Russian Federation, Product: 2709 Petroleum Oils and Oils Obtained from Bituminous Minerals, Crude," International Trade Statistics database, https://www.trademap.org/tradestat/Country_SelProductCountry_TS.aspx?nvpm=1|643|||20|2709|||4|1|1|2|2|1|2|2|1.

⁷ International Trade Centre, "List of Products Exported by Russian Federation Metadata at the Same Aggregating Level as the Product: 2709 Petroleum Oils and Oils Obtained from Bituminous Minerals, Crude," International Trade Statistics database, https://www.trademap.org/tradestat/Product_SelCountry_TS.aspx?nvpm=1|643|||2709|||4|1|1|2|2|1|1|2|1.

⁸ "The Natural Gas Statistical Data Base," Cedigaz, September 2017, <http://www.cedigaz.org/products/natural-gas-database.aspx>; and BP, "Statistical Review of World Energy 2018," June 13, 2018, <https://www.bp.com/content/dam/bp/en/corporate/pdf/energy-economics/statistical-review/bp-stats-review-2018-full-report.pdf>.

⁹ Ibid.

however, are due to change in the months and years ahead as two developments unfold. First, even if Russia remains unable to develop Sakhalin-1 and Vladivostok LNG, the Yamal project has increased global LNG liquefaction capacity by 5.5 mt, and the project's capacity is expected to triple, reaching 16.5 mt when it becomes fully operational. Much of this gas will go to Asian markets, at least during the May to November period when the Northern Sea Route through the Arctic is navigable. In addition, the eventual completion of the Power of Siberia pipeline will help meet Asia's expected burgeoning gas demand.

A fuller assessment of Russia's foray into Asia, however, needs to look beyond direct energy matters to gauge whether this trend complicates relations between the United States and its allies Japan and South Korea. Given that both East Asian countries are almost fully import-dependent in oil and natural gas, Russia understandably holds real interest for them.¹⁰ On the flip side, given the need to diversify its political and economic dependence on China, Moscow has a persistent interest in improving relations with Tokyo and Seoul.

This dynamic has been an irritant to the United States more in relation to Japan than South Korea, although the potential for Russia to play a complicating role in the North Korean denuclearization efforts is real. Japan only reluctantly agreed to follow suit on international sanctions after Russia's annexation of Crimea. Since then, it has continued to seek improvements to its relationship with Russia, with energy projects often the subject of discussion. Putin reportedly has met Abe more than any other leader, as many as twenty times since Abe's first term as prime minister.¹¹ The appeal for Abe is the prospect of not only solidifying stronger ties and diversifying Japan's energy imports but resolving the territorial dispute over the Kuril Islands (known as the Northern Territories in Japan).

The United States has on occasion intervened to express displeasure and ultimately reverse steps forward in this relationship. Most notably, on the sidelines of a December 2016 state visit by Putin to Japan, Rosneft and a consortium of Japanese companies signed agreements in the presence of Putin and Abe for joint hydrocarbon exploration, development, and production in one of Russia's offshore zones.¹² Washington objected to this prospect, which it felt would undermine the consensus of countries standing against Russia's actions in Crimea. As a result, the project was shelved for the time being.¹³

Although Washington is openly wary of closer relations between Tokyo and Moscow, this is not the only or even most important impediment to Japan and Russia forging a closer partnership. Russia appears unwilling to yield sovereignty over the Kuril Islands and conducted military exercises there in early 2018 to the dismay of leaders in Tokyo. Both Japanese and Russian officials have recently made public statements dampening any optimism about breakthroughs in the bilateral relationship. In August 2017, Japan's minister for economy, trade and industry, Hiroshige Seko, said that trust needed to be built between the two countries before a proposed \$6 billion, 1,500 kilometer gas pipeline from Sakhalin to Tokyo would be possible. A few months later,

¹⁰ BP, "World Energy 2018"; and U.S. Energy Information Administration (EIA), "Imports of Crude Oil including Lease Condensate," International Energy Statistics, 2018.

¹¹ Koya Jibiki, "Abe, Putin Keep Ball Rolling on Economic Deal for Disputed Islands," *Nikkei Asian Review*, November 11, 2017, <https://asia.nikkei.com/Politics/Abe-Putin-keep-ball-rolling-on-economic-deal-for-disputed-islands>.

¹² Nastassia Astrasheuskaya, "Russia, Japan Deepen Ties with Agreements on Upstream, LNG Cooperation," S&P Global Platts, December 18, 2016, <https://www.platts.ru/latest-news/natural-gas/moscow/russia-japan-deepen-ties-with-agreements-on-upstream-27733406>.

¹³ "Japan-Russian Oil Exploration Project Meets with U.S. Resistance," *Japan Times*, July 14, 2017, https://www.japantimes.co.jp/news/2017/07/14/business/japan-russian-oil-exploration-project-meets-u-s-resistance/#.W9oIQ3_QaUk.

Russian foreign minister Sergei Lavrov was equally downbeat, underscoring the need for broader improvements in the relationship before any territorial agreement could be made.¹⁴

Thus far, Russian outreach to traditional U.S. allies in Asia has remained primarily an irritant rather than a strategic threat. The risk, however, is that as these states become more wary and uncertain about the U.S. commitment to their defense and to the global international order that such alliances have underpinned, they may be less susceptible to U.S. pressure to resist Russian entreaties and more likely to hedge their bets by strengthening relations with Moscow in a way that lessens U.S. influence in the region.

The Sino-Russian Partnership

In June 2018, just as U.S. president Donald Trump was leaving the G-7 in turmoil, Xi handed Putin a large, golden medal of friendship at a meeting in Beijing. Xi declared the Russian leader his “best, most intimate friend.”¹⁵ After the meeting, he told reporters that his relationship with Russia “is the highest-level, most profound and strategically most significant relationship between major countries in the world.”¹⁶ Such rhetoric has been accompanied by a burgeoning energy relationship. As discussed earlier, in the years since the annexation of Crimea and the energy price collapse in 2014, China’s state-owned investment funds, such as the Silk Road Fund, and banks with little exposure to the global system, like the China Development Bank and the Export-Import Bank of China, have provided Russia with much-needed financing for energy projects. In doing so, they have helped Russia’s state-owned energy giants sweep up lucrative stakes in energy projects and secure future oil and gas imports under favorable terms.¹⁷

The major shift in landscape from before 2014—when Russia fervently resisted any Chinese equity investments in its energy sector—to today is enough to raise eyebrows and fuel speculation that the bilateral relationship between Moscow and Beijing has fundamentally changed and even moved toward a strategic alliance or at least a more robust strategic partnership. As noted above, both Xi and Putin have sought to actively fuel this speculation through their use of rhetoric about one another. However, such speculation is based on more than just a straightforward reading of these statements, and indeed appears to closely track with merging political narratives in both countries that view the United States as a threat to their respective civilizations. Putin and Xi have a personal connection forged by their common defense of the traditional postulates of state sovereignty and nonintervention and their distaste for “color revolutions” (or any form of popular uprising), which they see as a sign of the United States’ meddling in their respective spheres of interests.

A true strategic partnership between Russia and China would weaken the U.S. alliance structure in Asia and undermine U.S. partnerships with key nonaligned powers (e.g., India, Egypt,

¹⁴ Yoshifumi Takemoto and Osamu Tsukimori, “Japan, Russia Need to Enhance Trust before Gas Pipeline Plans: Minister,” Reuters, August 7, 2017, <https://www.reuters.com/article/us-japan-russia-gas-idUSKBN1AN000>; and Henry Meyer and Isabel Reynolds, “Putin Holds Military Exercises on Islands Claimed by Japan,” Bloomberg, February 13, 2018, <https://www.bloomberg.com/news/articles/2018-02-14/putin-s-arms-buildup-puts-abe-on-defensive-in-islands-dispute>.

¹⁵ Ben Blanchard and Denis Pinchuk, “China’s Xi Awards ‘Best Friend’ Putin Friendship Medal, Promises Support,” Reuters, June 8, 2018, <https://www.reuters.com/article/us-china-russia/chinas-xi-awards-best-friend-putin-friendship-medal-promises-support-idUSKCN1J41RO>.

¹⁶ “Putin, Xi Hail Partnership as Trump’s North Korea Summit Looms,” Bloomberg, June 7, 2018, <https://www.bloomberg.com/news/articles/2018-06-08/putin-xi-to-meet-in-china-as-trump-s-north-korea-summit-looms>.

¹⁷ For instance, in November 2016, China’s Beijing Gas Group bought 20% of Rosneft’s oil and gas fields for \$1.1 bn; in exchange, the Russian oil company was given access to the Chinese domestic gas market. In September 2017, CEFC China Energy bought a 14% stake in Rosneft for about \$9 billion, although this mega-deal has since collapsed.

and Vietnam). It could also impinge on the interests of NATO and the European Union, especially in Eurasia, where Russia claims “privileged interests.” Those who see such a partnership as already established argue that the evolving, multidimensional nature of national identity under Xi and Putin is bringing the two countries together in ways that will challenge the West’s preferred world order.¹⁸ However, a closer look suggests that while Chinese influence in the Russian energy sector has increased dramatically, it would be an overstatement to say that the two powers have consolidated their strategic partnership on the back of these energy deals. In fact, contrary to popular wisdom, energy is not the most likely vehicle for such a relationship. The new global energy abundance has presented China with many possible energy partners, diminishing Russia’s unique value. Moreover, China has thus far not wanted to cultivate closer relations with Russia at the expense of its much more important relationship with the United States.

What we have defined as a true strategic partnership would require several elements that do not, at least yet, seem to exist in the bilateral relationship between Moscow and Beijing. Leaders in the two capitals do share an antipathy for what they perceive to be Western arrogance and sometimes chafe under global institutions they see as either impervious or counter to their interests. But they do not appear to share a common set of values nor a developed worldview that encompasses both powers. Moscow would prefer a global order marked by spheres of influence, including a generous one for Russia. Beijing, by contrast, is promoting a China-centric model, where economic and other ties bind countries far and wide to China. Not only do the two countries’ visions for the world order differ, but Russia is keenly aware of the risk of becoming a junior partner to a country with an economy and population at least an order of magnitude larger than its own.

Moreover, a deeper look at economic ties between Russia and China reveals that their enhanced energy cooperation has not extended to other parts of the economic portfolio. According to the Russian Central Bank, Chinese FDI in Russia actually declined from 2016 to 2017, reinforcing, rather than compensating for, diminished investment from the United States and Europe.¹⁹ Trade in energy has increased continuously by volume, rather than value, given the major fluctuations in energy prices over recent years (see **Figure 2**). But overall trade beyond energy between Russia and China remains minuscule. **Figure 3** demonstrates how Russia’s non-energy exports to China are virtually nonexistent at less than 1% of its total non-energy imports. Russia is only one among many countries participating in BRI, despite its desire to be recognized as a more strategic partner as China implements this vast infrastructure-building initiative in its backyard.

Politically and diplomatically, there is also limited evidence of shared objectives or coordinated strategies. The two powers have found common cause in countering separatism, organized crime, and radical Islam, given that they both have significant Islamic minority groups. But in many areas, the two countries’ interests diverge. Russia is eager to secure a role in the unfolding drama around North Korea, although it is more interested in carving out its own slice of influence than in advancing China’s preferred outcome. In 2016, Russia joined Chinese military exercises in the South China Sea. In September 2018, the two countries jointly held exercises in Siberia that Russia advertised as its largest since the height of the Cold War.²⁰ To some, these massive war games

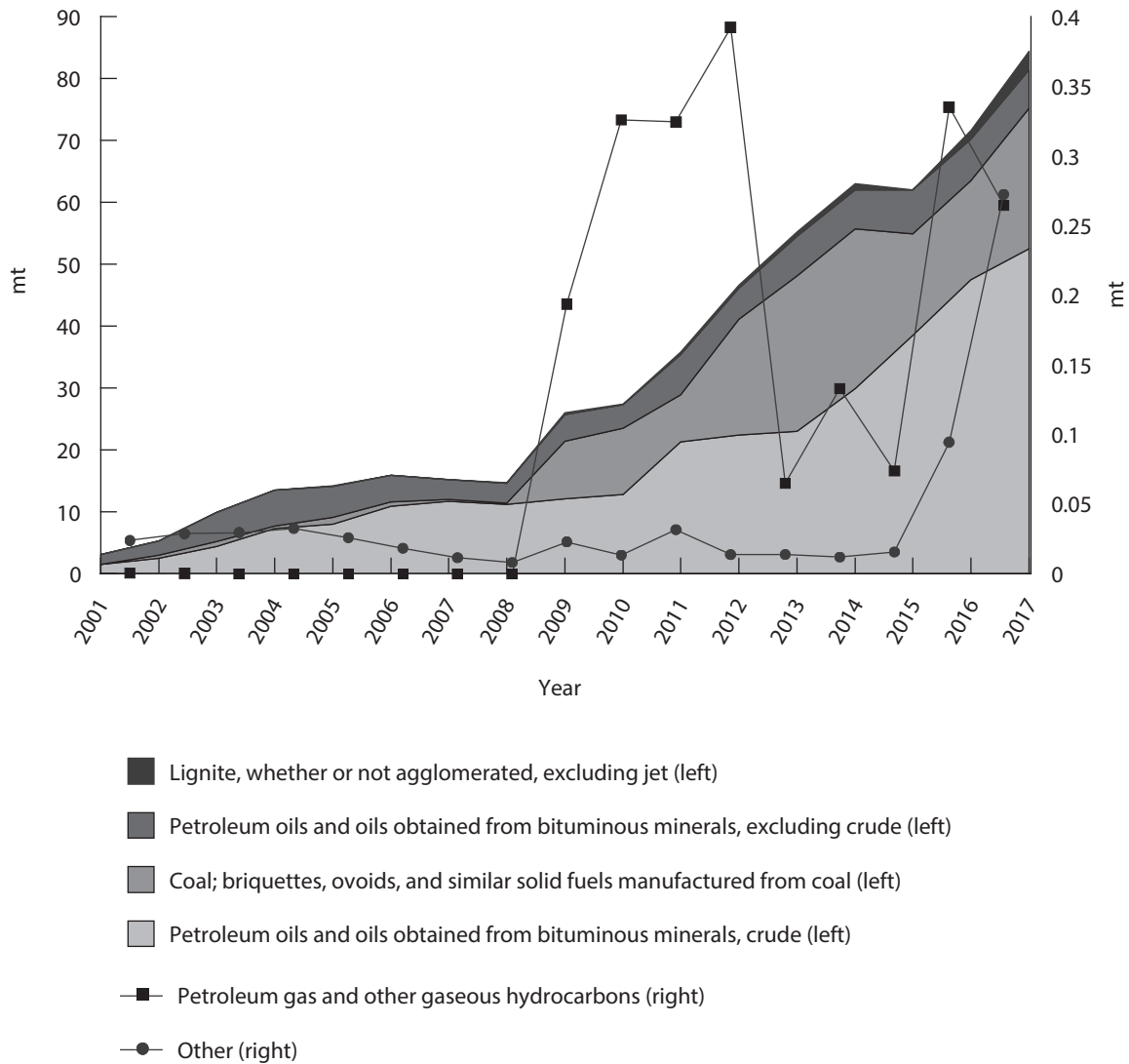
¹⁸ Gilbert Rozman, *The Sino-Russian Challenge to the World Order: National Identities, Bilateral Relations, and East versus West in the 2010s* (Stanford: Stanford University Press, 2014).

¹⁹ “Russian Federation: Inward Foreign Direct Investment,” Central Bank of Russia, http://www.cbr.ru/Eng/statistics/credit_statistics/inv_in-country_e.xlsx.

²⁰ Andrew Higgins, “300,000 Troops and 900 Tanks: Russia’s Biggest Military Drills since Cold War,” *New York Times*, August 28, 2018, <https://www.nytimes.com/2018/08/28/world/europe/russia-military-drills.html>.

reflect the United States' weakened alliances in the region.²¹ Yet the two governments have avoided entering into a formal alliance or taking substantial risks in support of one another in areas where their interests do not overlap.

FIGURE 2 Russian energy exports to China excluding electricity

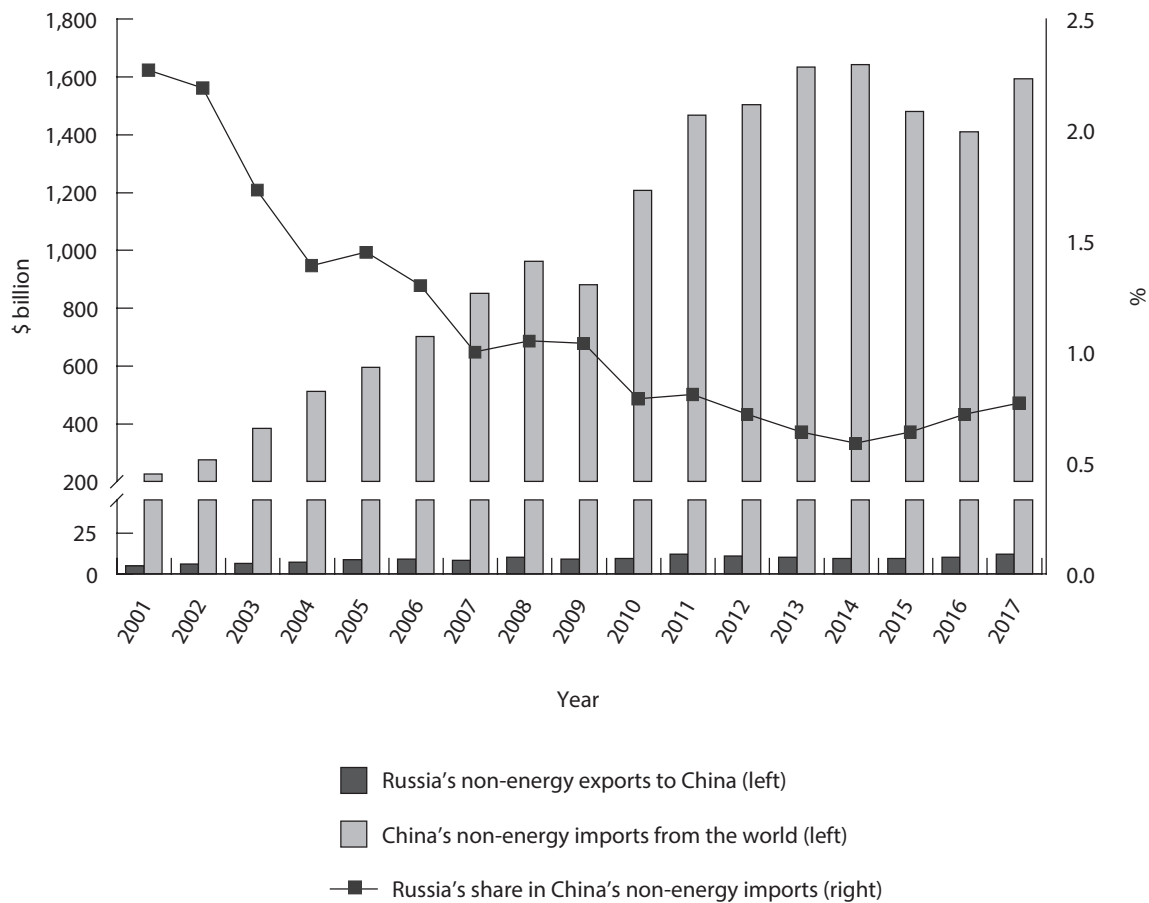


SOURCE: International Trade Centre, "Bilateral Trade between Russian Federation and China Product: 27 Mineral Fuels, Mineral Oils and Products of Their Distillation; Bituminous Substances; Mineral," International Trade Statistics database, https://www.trademap.org/tradestat/Bilateral_TS.aspx?nvpm=1|643||156||27||4|1|1|2|2|1|1|2|1.

²¹ "Why Russia and China's Joint Military Exercises Should Worry the West," *Economist*, September 6, 2018, <https://www.economist.com/leaders/2018/09/06/why-russia-and-chinas-joint-military-exercises-should-worry-the-west>.

Moreover, in Asia more broadly the two countries are taking positions that are in some cases directly opposed to each other's interests.²² For instance, Russia sells arms to China's rivals, India and Vietnam, and Gazprom and Rosneft have helped Vietnam develop offshore gas deposits in an area of the South China Sea that falls inside China's nine-dash line.²³ While Moscow and Beijing might find common cause on Iran, their interests could as easily come into tension. China wants

FIGURE 3 Russian non-energy exports to China



SOURCE: International Trade Centre, "Bilateral Trade between Russian Federation and China Product: Total All Products," International Trade Statistics database, https://www.trademap.org/tradestat/Bilateral_TS.aspx?nvpm=1|643|156|TOTAL||2|1|1|2|2|1|1|1|1.

²² For a compelling analysis of the logic of energy mercantilism, see Jennifer Lind and Daryl G. Press, "Markets or Mercantilism? How China Secures Its Energy Supplies," *International Security* 42, no. 4 (2018): 170–204; and Dani Rodrik, "The New Mercantilist Challenge," Project Syndicate, January 9, 2013, <http://www.project-syndicate.org/commentary/the-return-of-mercantilism-by-dani-rodrik>.

²³ See "Vietnam Deemed One of Gazprom's Key Partners in Southeast Asia," Gazprom, Press Release, November 10, 2017, <http://www.gazprom.com/press/news/2017/november/article379688>; and James Pearson, "As Rosneft's Vietnam Unit Drills in Disputed Area of South China Sea, Beijing Issues Warning," Reuters, May 17, 2018, <https://www.reuters.com/article/us-rosneft-vietnam-southchinasea-exclusv/exclusive-as-rosnefts-vietnam-unit-drills-in-disputed-area-of-south-china-sea-beijing-issues-warning-idUSKCN1I109H>.

more Iranian oil on global markets immediately, while Russia stands to gain from a continued stalemate that keeps Iranian natural oil and gas out of global markets.

China's vast infrastructure investments in Central Asia as part of BRI are displacing Russia in its own neighborhood. Although Russia is still the dominant security influence in Central Asia, and China publicly still defers to it in the security realm, China increasingly holds its own military and counterterrorism exercises with Central Asian partners. Such drills are likely to increase, as Beijing looks to protect its regional investments and supply networks, especially as part of BRI. In the economic realm, China makes no pretense of deferring to Russia, as it is the most important trading partner of four of the region's five countries. Moreover, it does not make sense for Russia to confront China over Central Asia when it has a much larger interest in acquiring Chinese resources to develop its upstream sector in Siberia and the Arctic and to secure the Chinese market for its own energy resources. This means turning a blind eye to Beijing's active reach into Central Asia's natural resources.

In the Arctic, Russia is focused on the Northern Sea Route and would like to see some sort of guaranteed strategic partnership with China so that it can sell its newly developed LNG from the Yamal Peninsula and thereby undercut U.S. expansion into the Asian LNG market. China, however, has its own vision for the Arctic. Dubbed the "polar Silk Road," this strategy has been lumped into the sprawling, trillion-dollar BRI. At the moment, Chinese state media outlets seem to be ignoring Russia's nationalist dreams for the Northern Sea Route and are trying to bring the Russian Arctic into China's sphere of maritime influence. Rather than referring to the Northern Sea Route as such, a term that emerged under Soviet rule, Xinhua defines it as the "Silk Road on ice."²⁴

Finally, the relationship between Russia and China is primarily undergirded by important personal relationships—not only between Presidents Putin and Xi, but also between Rosneft's Sechin and senior Chinese businessmen such as Zhou Jiping, the CEO of PetroChina, and more recently Ye Jianming, the head of CEFC China Energy. Institutions do not yet play the role that one would expect in a well-developed strategic partnership. While Russia and China sit alongside one another in the Shanghai Cooperation Organisation, Russia is increasingly uncomfortable with Chinese efforts to use the group to advance BRI and has therefore lobbied to broaden its membership as a way of diffusing Chinese influence. Russia has also launched, with only mild success, the Eurasian Economic Union, an alternative institution that is meant to counter China's rising economic clout in Central Asia.

This assessment should not leave U.S. policymakers complacent about the Sino-Russian relationship, which has experienced dramatic changes in recent years. The new energy ties that have blossomed make Russia significantly more dependent on China and are another manifestation of growing Chinese strength. This reality may be as detrimental to U.S. interests as the strategic relationship, particularly in the context of growing tensions between the United States and China over trade.

Conclusion

Although Russia's pivot to Asia predated its annexation of Crimea, the growing hostility between Russia and the West has underscored the importance of forging better ties with Asia if

²⁴ "China, Russia Agree to Jointly Build 'Ice Silk Road,'" Xinhua, July 4, 2017, http://www.xinhuanet.com/english/2017-07/04/c_136417241.htm.

Russia plans to continue relying on energy and natural resources to power its economy. Putin and Russian companies have worked hard to make inroads into Asian markets and build energy partnerships with their Asian counterparts, with some significant successes. However, Russia has not yet been able to fully substitute relations with Asia for its worsening relations elsewhere or build political and strategic partnerships that translate into meaningful cooperation outside the energy sector.

Yet despite the partially unrealized nature of Russian aspirations, U.S. policymakers need to watch Russia's growing influence in Asia carefully. Simply because Russia has not yet built a true strategic partnership with China—or with Japan—does not mean that one could not still develop. In fact, the rising tensions between the United States and China are a boon to Russia's ambitions to draw closer to China. The tariffs China placed on U.S. LNG in response to larger U.S. tariffs on Chinese products are good news for Russian gas exporters in two ways. First, they make the United States unattractive as a significant and rising competitor to meet the needs of the Chinese market. Second, they could damage the prospects of the United States' own growing LNG industry. Given that as much as a third of the anticipated global growth in gas demand is expected to come from China, being uncompetitive in this market could dampen the expansion of the U.S. industry.

Perhaps even more significantly, the souring relationship between the United States and China will affect a key calculation that thus far has worked in Washington's favor and to Moscow's detriment: while speaking warmly about its relationship with Russia, China has been unwilling to take steps that could jeopardize its vast economic relationship with the United States. It may be that the most important single factor in favor of Russia's foray into Asia is what appears to be the United States' willingness to upend its traditional relationships and roles in Asia.



Seattle and Washington, D.C.

1414 NE 42ND STREET, SUITE 300
SEATTLE, WASHINGTON 98105 USA
PHONE 206-632-7370, FAX 206-632-7487

1819 L STREET NW, NINTH FLOOR
WASHINGTON, D.C. 20036 USA
PHONE 202-347-9767, FAX 202-347-9766

NBR@NBR.ORG, WWW.NBR.ORG