

Agreement Reached on Russia-China Pipeline Gas Deal

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

At last, final agreement has come on Russia's pipeline natural gas supply to China. On May 21, Russia's Gazprom and China National Petroleum Corp. announced that they reached agreement on a contract to supply China with 38 billion cubic meters in natural gas (some 28 million tons in terms of liquefied natural gas) annually over 30 years from 2018. Gazprom President Alexey Miller indicated gas sales under the contract would total \$400 billion. It may be called a grand in scale and historic agreement.

The reason I used the word "at last" at the outset of this report is that China and Russia had 10-year-long marathon negotiations on the gas contract. Russia has attempted to secure gas sales channels in Asia and diversify gas sales destinations in a bid to ease its heavy dependence on the European market, while China has tried to acquire gas supply to meet growing domestic energy demand. The large-scale gas deal is complementary and of strategic significance to the two countries. Nevertheless, they had remained wide apart particularly over the gas sales price, leading the negotiations to be so prolonged. They had reached agreement on the terms and conditions other than pricing last September. The latest agreement indicates that the two countries have finally overcome the last difficult pending problem.

Both parties fell short of specifying details on a solution to the last difficult pending problem. Based on the contract value of \$400 billion and the supply volume (38 billion cubic meters x 30 years), however, the average gas supply price turns out to be some \$350 per 1,000 cubic meters (about \$9.8 per million British thermal units). This price is almost equal to the price for Gazprom's gas sales to the European market (Western Europe). But the above estimated price is a simply calculated average. Gas supply volume changes from the project launch may have to be taken into account. In this respect, market players estimate a price range of \$370-380 per 1,000 cubic meters (\$10.4-10.6/MBtu). Russia pursuing a higher price and China seeking lower-price procurement might have compromised at the European sales price level that can be a reference for both countries.

To implement the contract, Russia will have to fully develop the Chayanda and Kovykta gas fields as supply sources and construct pipelines. Given that there are only four years left before the supply launch, Russia is required to implement the gas field development and pipeline construction at high speed. The Russian side has estimated that a large-scale investment worth \$55

billion would be required in the gas field development and the pipeline construction within Russia. Relevant financing would be a key point. Media reports said China has agreed to pay \$25 billion in advance. This Chinese concession might have been a key step inducing the final agreement. CNPC is set to undertake relevant pipeline construction in China.

Given the large-scale initial investment required for future gas supply, the net profit that Russia's Gazprom would gain at the just agreed price under the contract with China is dominantly seen as lower than that on sales to Europe (at almost the same price). Therefore, Gazprom might have had desperate negotiations with the Chinese side that had strongly sought to procure Russian gas at a price lower than that for Russian sales to Europe. It might have been very difficult for them to reach the pricing agreement. Nevertheless, it is significant for Gazprom to have secured the massive gas sales revenue through a non-European sales channel, even though the revenue will not come before 2018.

The China-Russia gas supply agreement may be described as grand in scale and historic as noted above. But the energy supply agreement is also of great significance for enhancing their strategic cooperation. We must pay attention to the fact that the agreement was timed to coincide with the May 20-21 Summit Conference on Interaction and Confidence Building Measures in Asia, which China hosted in Shanghai. At the CICA summit, the host country's President Xi Jinping in his address emphasized that security problems in Asia should eventually be solved by Asians themselves, indicating China's intention to take the initiative in building a new Asian security order. Among the summit participants were Russian President Vladimir Putin and Iranian President Hassan Rouhani. On May 21, they issued the Shanghai Declaration calling for building an Asian security framework through confidence-building efforts. The CICA summit and the Shanghai Declaration have undoubtedly been designed to counter the recent U.S. foreign policy that seeks to "rebalance" and "pivot" toward Asia to deepen U.S. engagement in Asia. At a time when Russia is undergoing Western sanctions and other heavy pressures amid the tense Ukraine situation, it is strategically and geopolitically important for Russia to demonstrate its enhanced cooperation with China. Under such situation, the large-scale gas supply contract came out of international politics surrounding China and Russia.

The latest China-Russia agreement is a key step toward actual Russian gas supply to China and enhancing bilateral interdependent relations. However, given that the deal contains gas field development, pipeline construction and other challenges to be tackled in the future while the details are not yet available, we may have to pay attention to relevant future developments. We may also have to watch how the China-Russia gas deal would influence China's gas and energy supply-demand balance, its natural gas/LNG procurement strategy and the Asia-Pacific gas/LNG market supply-demand balance. How Russia would tackle various natural gas/LNG projects for the Asian market including Japan would also be interesting. For Russia that has chosen to enhance strategic relations with China, balancing may grow more important as China's significance increases more and more. How will Russia implement its strategies for Japan and Asia under such conditions?

IEEJ : June 2014 © IEEJ 2014

How should Japan deal with Russia? We may be required to accurately analyze trends under the liquid international situation.

Contact: report@tky.ieej.or.jp

The back issues are available at the following URL

http://eneken.ieej.or.jp/en/special_bulletin.html