

Gazprom and CNPC Made Step Forward to Final Gas Contract

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On September 5 in St. Petersburg where a Group of 20 Summit was under way, Russia's Gazprom and China National Petroleum Corporation announced that they reached a legally binding agreement on major terms and conditions of the long-pending pipeline gas supply from Russia to China, including the export volume and starting date, the eastern route from Eastern Siberia to China, and the gas delivery point.

The agreement was signed in the presence of Russian President Vladimir Putin and Chinese President Xi Jinping, indicating that the agreement was of significance to enhancing bilateral strategic relations and that the two leaders are celebrating the agreement.

Before the agreement, Gazprom and CNPC signed a memorandum of understanding in March this year, setting the annual gas sales volume at 38 billion cubic meters (equivalent to some 28 million tons in liquefied natural gas) (the volume could be expanded to 60 billion cubic meters in the future) and the starting year at 2018.

The new Gazprom-CNPC agreement at the G20 summit venue may represent a step forward to the final conclusion of their marathon negotiations that have lasted for more than a decade. Gazprom President Alexey Miller said, "The fact that the major terms and conditions were signed during the G20 summit indicates the parties' aspiration to successfully conclude the negotiations and sign the contract before the end of 2013."

Surely, the latest agreement was a step forward. But Gazprom and CNPC will have to resolve a major challenge before reaching the final contract. The challenge is an agreement on the price. The largest factor behind their prolonged "marathon negotiations" has been that they have failed to agree on the price.

In proposing the price, Russia has taken into account balancing the price with that for gas exports to Europe and costs for pipeline construction and upstream development for exports to China. China for its part has given top priority to domestic gas development, secured pipeline gas supply from Turkmenistan and Myanmar and attempted to expand LNG procurement, sticking to a lower price for Russian gas that must vie with China's competitive domestic coal.

It has thus been very difficult for the two parties to reach a compromise on the price. Their basic

relations have remained unchanged, indicating difficult negotiations toward the goal of reaching the final contract by the end of this year. On the occasion of the latest agreement, Gazprom refused to accept the adoption of U.S. Henry Hub price factors as requested recently by China for setting the price for the Russian gas exports to China. Twists and turns are expected before any agreement is reached on the price. No optimism can be warranted about the final contract.

While the basic relations between Gazprom and CNPC have remained unchanged, there have, however, been remarkable situational changes and new undercurrents.

First, the latest Gazprom-CNPC agreement was announced at the G20 summit venue. At a time when Russia is disputing with the United States over the Snowden problem and possible military interventions in Syria, Russia might have acknowledged that a message indicating its enhanced cooperation with China, which has a sensitive distance and a strategic relationship with the United States in the Asia-Pacific region, would be important not only from the viewpoint of energy problems but also from the viewpoints of international relations and geopolitics. Unless the basic U.S.-China-Russia relations change dramatically, the momentum may continue for Russia to enhance relations with China.

Second, we should pay attention to the fact that circumstances for Russia's external energy strategy have remained severe or grown severer. Russia's decisive weak point is that the Russian economy depends heavily on the oil and gas sector and its exports and on Europe for most of the revenues from the sector's exports. At a time when the European natural gas market (demand) has shrunk due to economic deterioration under a credit crisis and competition from coal and renewable energy, Russia has no choice but to enhance its "Look East" policy to explore the Asian market and diversify oil and gas export destinations. While negotiations on the final contract for gas exports to China are difficult, any progress toward the final contract can contribute to Russia's major objective of diversifying export destinations and check the European market. Even within the Asian market, any progress or any signal of progress in Russia's negotiations with China may back up Russia in its negotiations with other major Asian energy importers including Japan and South Korea.

Third, Gazprom, though having monopolized Russia's gas exports, has faced competition from new players including Rosneft and Novatek in gas exports since early this year. In this respect, it may be significant for Gazprom with the monopolistic right to make progress in dealing with Asian countries.

Fourth, China has recently demonstrated what can be taken as new aggressive moves for its natural gas import strategy. For example, CNPC on September 5 announced its official agreement to acquire a 20% stake in Novatek's Yamal LNG project.

How Gazprom and CNPC will deal with each other toward the goal of producing the final contract within this year will attract global attention. Particularly, we may have to pay attention to Gazprom's strategy and decisions since CNPC has little chance of finding any need for its major concession.

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