
Russia's Eastern Energy Policy: A Chinese Puzzle for Rosneft



Nina Poussenkova

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Abstract

In the past decade Russia set a strategic goal: to develop the Eastern vector of its energy policy and strengthen oil and gas cooperation with the Asia-Pacific countries. While dialogue on gas with China was stalled, Rosneft, the country's number-one oil company, made a breakthrough in petroleum relations. Rosneft received credits from Chinese banks against guaranteed supplies of oil; lobbied for the construction of a spur to China from the Eastern Siberia—Pacific Ocean pipeline system; dramatically increased oil exports to China; let CNPC and Sinopec enter the Russian upstream; cooperated with them abroad; sold some of its shares to CNPC, and consolidated its position in China's downstream. The state company is fulfilling the government's strategic plans on the diversification of markets for hydrocarbons and the development of the East of the country, while simultaneously influencing state energy policy. Rosneft has its own long-term plans to become an international energy corporation and it is pursuing the internationalization of its business, including in the Asia-Pacific markets. Yet thanks to China, Rosneft is also supporting its short-term corporate interests: the first two loans were used to pay for the acquisition of Yukos, and now it plans to attract the Chinese money to buy TNK-BP. Therefore, the key question remains: Do its corporate interests correspond to the long-term goals of Russia, in so far as they place the country in a position of dependence on China?

Introduction

The modern history of Russian oil and gas industry shows that in Russia it is not enough for the government to simply make a strategic decision, even in regards to state oil and gas companies. A plan may not be implemented if it encounters powerful opponents, or if it does not find strong allies with an interest in its being enacted. This trend is manifested more vividly in Russia than in other countries. On the one hand, business decisions in the Russian energy sector are very often influenced by short-term political considerations, which conflict with the long-term economic and commercial interests of the industry. On the other hand, Russia's complex system of diverse private-interest groups, which are closely connected to state decision-makers in various ways, exerts a heavy (and contradictory) influence on the oil and gas sector. That is to say, state decisions can come into conflict with private interests and be undermined by opponents or sabotaged by the party who implements it.

Such a situation often arose in the 2000s, when state power was strengthened in comparison to the 1990s. For example, in 2003 the government appointed Rosneft as the authorized company in the sphere of Production-Sharing Agreements (PSAs). President Vladimir Putin approved the idea in words, but in fact did not support Rosneft, which could have strengthened its then-modest position in the Russian petroleum sector thanks to its newly-given role. As a result, former Yukos head Mikhail Khodorkovsky won out over the previous president of Rosneft, Sergei Bogdanchikov; after a successful campaign against PSAs led by Khodorkovsky, the practice of their being signed in Russia was discontinued. Another example is the decision taken by the government in 2004 to transfer Rosneft to Gazprom in exchange for increasing the state's share in a gas monopoly to a controlling majority—the oil company still managed to maintain its independence thanks to the political influence of its then chairman of the board, Igor Sechin, and the active maneuvers of Sergei Bogdanchikov.

Finally, the government objective decided in the middle of the 2000s—to transition from the export of crude oil to that of petroleum products and to the building of refineries at the end point of each export pipeline—remains unfulfilled. In accordance with the government's instructions, in 2006 Rosneft proposed to construct an export-oriented refinery with a capacity of 20 million tons/year at the end point of the Eastern Siberia-Pacific Ocean pipeline (ESPO) by 2012. But Rosneft put those plans on the back burner because, at that time, global market

conditions for their implementation were unfavorable, and the company placed greater importance on achieving other corporate goals.

This trend continues to this day. One can cite the example of the project in 2011 to create a joint venture between Rosneft and BP, which was approved by Prime Minister Vladimir Putin, but foiled by the Russian shareholders of TNK-BP.

In contrast, the presence of a powerful lobbyist in the person of Rosneft facilitated the development of the eastern vector of state oil policy. In recent years, Rosneft has become the flagship enterprise of the Russian oil industry and aims to turn itself into an international energy corporation and world leader among public oil companies. In the sphere of liquid hydrocarbons, it has already become so. In 2011, it produced 114 million tons of petroleum, i.e. 22% of total Russian output (511 million tons). After the complete takeover of TNK-BP, the volume of its output will grow to 185 million tons/year, thus rising to 36% of the total Russian output for 2011. The state creates significant non-market competitive advantages for Rosneft in comparison with its private counterparts (for example, granting it and Gazprom exclusive access to offshore fields, or including it in the list of strategic companies whose bankruptcies would be handled according to a special scheme). It also promotes the international expansion of Rosneft in hopes of having a Russian petroleum "super-company" similar to Gazprom in the gas sector. Such a powerful player naturally holds enormous influence in the country and can promote its interests through strategic decisions in the energy sphere. Of course, it sometimes has to pay for such a close relationship to the state, which can compel it to implement political decisions that are not always in the commercial interests of the company.

Rosneft has become the primary moving force of Russian-Chinese petroleum cooperation. On the one hand, it's logical that a state oil company serves as the driver of government policies in regards to such a strategic partnership as that of Russia and China and in such a strategic sphere as oil relations—a sphere which advances with particular complexities that are outlined below. On the other hand, recent events have shown that Rosneft pursues not only long-term national interests (development of economic and energy dialogue with the Asia-Pacific countries) and long-term corporate interests (market diversification and transformation into an international energy company), but also short-term corporate interests. These are connected first of all with its desire to get "Chinese" money for the realization of its company goals, including the acquisition of other Russian players. But such pursuits do not always facilitate the establishment of equal and mutually beneficial energy cooperation with China, so long as Rosneft (and indirectly, Russia) remains dependent on Chinese creditors.

China: Russia's New Energy Partner?

The Push to the East

At the end of 2009, "The Energy Strategy of Russia to 2030" was adopted. It reads as follows:

"...the share of European energy markets in the total volume of Russian energy export will steadily decline due to export diversification to Eastern energy markets (China, Japan, Republic of Korea, other countries of the Asia-Pacific region). ... by the end of the Strategy[s] third implementation phase, the proportion of Eastern energy markets in the Russian energy export of liquid hydrocarbons (oil and oil products) should grow from the current 6 to 22–25%, while natural gas export should grow from 0 to 19–20%."¹

The development of trade relations in the energy sphere with the Asia-Pacific region, and the re-orientation of oil and gas flows from Europe, with its stagnating demand, toward the East and most of all toward the quickly-developing Chinese market, obviously became an important element of Russia's official energy strategy. A similar growth in attention to the eastern vector of Russian energy policy relates to the necessity of securing quick economic and industrial development in East Siberia and the Russian Far East (including that of the oil and gas sector), raising the standards of living there, and stopping the outflow of the population from the region—currently one of the most important tasks on the Russian national agenda. In addition, to support the status of Russia as an energy super-power, they have put forth the long-term goal of creating new oil and gas provinces that could partially replace declining reserves in Western Siberia, and Eastern Siberia and the Far East should be among those provinces.²

Three years later it is possible to conclude that gas cooperation with China has stalled in so far as Gazprom is obviously not particularly interested in it (or is not capable of establishing it). On the other hand, oil relations are being actively developed, even if there are problems and conflicts, and Rosneft has turned out to be their main driver.

¹ *Energicheskaya strategiya Rossii do 2030 goda* [Russia's Energy Strategy to 2030], Moscow, 2009. <<http://minenergo.gov.ru/aboutminen/energostrategy/>>.

English version: <[www.energystrategy.ru/projects/docs/ES-2030_\(Eng\).pdf](http://www.energystrategy.ru/projects/docs/ES-2030_(Eng).pdf)>.

² For details, see: N. Poussenkova. "Russia's Future Customers: Asia and Beyond," in J. Perovic, R. W. Orttung, A. Wenger (eds.), *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation*, Routledge, 2009.

It would seem that Russia and China are ideal, complimentary partners in the oil and gas sphere: one is the holder of enormous hydrocarbon reserves, a leading exporter, and the other is a quickly-developing, and even the world's second largest, consumer and importer of hydrocarbons. However, Russia's primary counterpart in the oil and gas sphere is still Europe (to which 78% of Russian export gas flowed in 2011, while a total of 16% was directed to Asia and 6% to Central and South America).³ All of Russia's pipeline gas goes at the present moment to Europe and the CIS and only an insignificant volume of liquefied natural gas (LNG), produced on Sakhalin, to Japan, China, South Korea, Thailand and Taiwan. And China still more effectively establishes cooperation with other petroleum-producing countries.

Russian-Chinese energy relations were not developed without difficulty. Russia began to nurture projects of constructing oil and gas pipelines to China in the late 1980s, shortly after the normalization of relations between the USSR and the PRC. But Beijing looked at these projects rather indifferently: oil prices had not then risen above \$20/barrel, and there was an excess of supply on the market. Moreover, considering the economic and internal-political difficulties that Russia was going through in the 1990s, it was not up to the task of conquering new oil and gas markets. The situation changed in the 2000s, as oil prices rose (and as China had become a net importer of petroleum in 1993), the search for foreign sources of crude became a priority in China's energy strategy. The Chinese policy of looking abroad for energy supplies began officially in 2001. In the petroleum sphere it was carried out in four directions: the buying of assets and companies, alliances, and deals of the type "resources for market access" and "credit for oil," which were employed toward Russia.⁴

In the beginning of the last decade, China conducted talks with Yukos about the laying of a petroleum pipeline from Angarsk to Daqing, and with Gazprom about the construction of a gas pipeline. However, at that time Moscow was dragging its feet. The Kremlin was not rushing after new markets, so much as playing the Chinese card in negotiations with the European clients of Gazprom and the oil industry. In March of 2006, when relations between Gazprom and its consumers in the EU were complicated following the first gas conflict with Belarus, Vladimir Putin visited China. During his visit, memoranda were signed on the construction of a branch of the ESPO to China, as well as gas pipelines: the protocol on gas deliveries to China, which were supposed to have started in 2011, foresaw sales of up to 68 billion cm/year. Frightened, Russia's EU consumers renewed the long-term contracts that had been Moscow's aim. But gas exports to China have still not begun, despite long and intense talks, as the parties have been unable to reach a compromise on prices.⁵ Obviously in the long-term, as stated in Russia's Energy Strategy to 2030, Russia is interested in the

³ EIA. Country Analysis Briefs. Russia. Last Updated: 18 September 2012.

⁴ See: X. Xu, "Chinese NOC's Overseas Strategies: Background, Comparisons and Remarks," in *The Changing Role of National Oil Companies in International Markets*. J. Baker Institute for Public Policy, March 2007.

⁵ *Kommersant*, 17 June 2011.

development of energy relations with China, taking into account the size and the speed of development of the Chinese market. But at the time, short-term interest prevailed in this sphere: Russia secured concessions from the Europeans, having demonstrated that it had other attractive export opportunities. However, having missed the chance to consolidate its position in China, it was overtaken by other players. Seeing that Russia was in no rush to implement the agreements reached, China began to actively seek other suppliers of oil in Central Asia, the Middle East, Africa and Latin America.⁶ Shortly after, Beijing secured supply of Turkmen gas and finalized sales contracts of liquefied petroleum gas as well.

Against the background of the practically complete lack of progress in gas relations, a breakthrough in the oil industry began to take shape, although at times the question also arose of the price of delivery, which has not always been decided in the interest of Russia.

Yukos' China Plans

It was Mikhail Khodorkovsky who first began the policy of petroleum cooperation with China. Before the "Yukos affair," the company was the lord of "big petroleum" in Russia's East. At the end of the 1990s, Yukos became one of the first Russian oil companies to develop an interest in Eastern Siberia, and who saw a potential major sales market in China. Yukos, which by 2004 had become the main exporter of Russian crude to China, had begun to cooperate with the PRC in 1999: in that year the first oil shipment was delivered to China by rail—12 thousand tons. Yukos' exports to the PRC by rail quickly grew, and the company decided to build the Angarsk-Daqing pipeline.

Yukos, Transneft, and the Chinese National Petroleum Company (CNPC) already began to prepare documents for the construction of a pipeline from Russia to China in 1999. In the summer of 2002 Yukos obtained a pledge from the CNPC to finance 50% of the construction expenses. CNPC also indicated a readiness to buy all the crude that would go through the new route. In May of 2003 the heads of Yukos and the CNPC signed a long-term contract on the pumping of petroleum through the future pipeline: 20 billion tons/year for the first five years, and 30 billion tons/year after 2010.

For a time, the Angarsk-Daqing pipeline planned by Yukos competed with an alternative Angarsk-Nakhodka pipeline, promoted by Transneft. The Yukos line, extending 2,247 km, would have cost \$1.7 billion, while the Transneft project, at 3,764 km, would have cost \$5.2 billion. The Angarsk-Daqing would have been profitable with throughput of 20 million tons/year, and the Angarsk-Nakhodka of 50 million tons/year. It was simply unclear if petroleum reserves in Eastern Siberia would be sufficient to fill the Transneft pipeline. But at the same time, the delivery of crude to the port of Nakhodka would allow for the diversification

⁶ *Kommersant*, 14 June 2011.

of end-markets, whereas the Angarsk-Daqing option would have left Russia dependent on the monopoly buyer—China. The choice between the two routes would be defined by political considerations.⁷

In the spring of 2003, a Solomonic judgment was laid out: Russia would build the Angarsk-Nakhodka petroleum pipeline with a spur to Daqing. In fact, the Ministry of Natural Resources soon rejected both projects over environmental considerations. At the beginning of the "Yukos affair," the government of Mikhail Kasyanov, who supported the Angarsk-Daqing option, was forced to resign, and for a time the oil pipelines were forgotten.

⁷ *Neftegazovaya vertical*, No 12, 2002. p. 40-42.

Rosneft—The Driver of Russia-China Energy Cooperation

The Renaissance of Rosneft

But the neglect of the oil pipeline projects was brief. A new, influential lobbyist showed an interest in the eastern vector of Russia's oil policy: Rosneft. While in the 1990s Rosneft had been a small and weak player in a Russian oil sector in which powerful private competitors continually grabbed at the most valuable assets, in the 2000s the company became much stronger. In principal, the company's rebirth began already in 1998, when Sergei Bogdanchikov was named its President. But after Vladimir Putin was elected President of Russia in 2000, he embarked on a course of state intervention in the economy, first and foremost in the oil and gas sector; Rosneft, with strong state support, began to fight aggressively for a position in the petroleum industry.⁸

This process unfolded swiftly when in 2004, the then deputy head of the presidential administration, influential Russian bureaucrat Igor Sechin, became the Chairman of the board of directors for Rosneft.⁹ Sechin for a long time was (and remains) one of the leading figures of the energy industry. In 2008, he became Deputy Prime Minister with responsibility for the whole sphere. This gave rise to a definite conflict of interest in so far as Sechin, as overseer of the energy industry, served as "arbiter" in the relations between the state and the oil companies, while at the same time being head of the board of directors of one himself. Analysts assessed the entry into the government of Sechin, an obvious patron of Rosneft, as a strengthening of the company. After the Russian presidential elections in 2012, Igor Sechin increased his ties to Rosneft even further, becoming its President. Time will tell if this was a promotion for the former vice-premier or an honorable exile. As a poll on the energy industry by the magazine *Neftegazovaya vertikal'* shows, the majority of leading Russian experts expect further consolidation and strengthening of Rosneft's position.¹⁰ Obviously, after clinching the "deal of the century" on the acquisition of TNK-BP, Rosneft achieved a new qualitative surge in its growth.

⁸ For details, see N. Poussenkova, "Lord of the Rigs: Rosneft as a Mirror of Russia's Evolution," in *The Changing Role of National Oil Companies in International Energy Markets*, James Baker Institute for Public Policy, March 2007.

⁹ *Vedomosti*, 28 July 2004.

¹⁰ *Neftegazovaya vertikal'*, No 12, 2012. p. 12-83.

In any event, having become the number one oil company in Russia by acquiring the primary assets of Yukos, Rosneft picked up the baton in the plan to develop petroleum cooperation with China. The company is developing it in four inter-connected directions: attraction of Chinese credits, lobbying for the construction of the ESPO and a spur to China, the right of access of Chinese companies to the Russian upstream and a push into China's downstream.

In the Beginning Was the Money...

In fact, Russian-Chinese petroleum cooperation achieved a breakthrough in 2005, when Rosneft bought Yuganskneftgaz, having borrowed \$1.8 billion from state banks and having issued promissory notes for \$6.1 billion. The bills of credit were refinanced thanks to an upfront payment of \$6 billion for the delivery of oil to China.¹¹ For the first time a situation arose under which Chinese financial resources had become involved in a redistribution of property in strategic sectors of the Russian economy.

To pay back the debt Rosneft pledged to export to China 48.8 million tons by the year 2010. The conditions of the contract were not disclosed, giving rise to speculation that the price was set too low. In the deal Rosneft was in such a hurry to get money from the Chinese that it agreed to terms that were not completely profitable for itself: the price of oil was tied to Brent, first with a discount of \$3. In November 2007 the state company achieved a reduction of the discount to \$2.325. In February 2008 Rosneft expected to obtain a new increase in price from the Chinese as well, but the negotiations proved very difficult.¹²

On the whole the contract price was slightly higher than the market one: the average discount on the price of Urals oil for Brent in the period from 2005-2007 came to \$3.80/barrel. But according to estimates of analysts, due to transportation costs of the delivery, Rosneft's supply to China could be less profitable than that to Europe. Even accounting for an increase in price, Rosneft reported lost profits for a long time, and the contract with the CNPC remained problematic, especially with regards to the delay of the launch of the ESPO. However, considering how acutely the company needed money upon the purchase of Yuganskneftgaz, the conditions of the contract with the Chinese could have been even harsher.¹³

¹¹ *Vedomosti*, 5 July 2005.

¹² *Vedomosti*, 11 April 2008.

¹³ *Vedomosti*, 29 January 2008.

And Then There Was the Pipeline

On 31st December 2004, the then Prime Minister, Mikhail Fradkov signed a decree on the laying of the ESPO pipeline in the period from 2005-2020.¹⁴ This geopolitical project, in the words of Vladimir Putin, should have officially "broken open a window" to the East. Unofficially it should have exerted pressure on Europe, which, to use the expression of the former Transneft president Semyon Vainshtok, "we over-fed with our oil."¹⁵

In Russia's east there has long been a vicious circle: oil fields were not developed, as there was no oil pipeline to export oil, and no pipeline was built because there was no crude to fill it. The ESPO broke that vicious circle and Rosneft, and Sergei Bogdanchikov personally, made a weighty contribution to the process, lobbying for the construction of the pipeline and commissioning the fields in Eastern Siberia. For now the state company was the proprietor of the richest oil reserves in the region (the Vankor, Verkhnechonsk, and Yurubcheno-Tokhomsk fields).

Until the middle of the last decade Rosneft was looking at two alternatives for transporting oil from the gigantic Vankor field in northern Krasnodarsk krai, which it was just beginning to work on exploiting at that time. The first was called the "northern" variant and consisted of constructing its own oil pipeline from Vankor to the port of Dikson on the Arctic Ocean, which would afford the opportunity of diversifying the sales markets of Vankor oil by means of its shipping by tankers. The second, "southern" variant included the construction of an oil pipeline to Purpe to connect to Transneft's trunk pipeline, through which Vankor oil had to travel to the east of the country. The northern option seemed more profitable commercially. But in sum, Bogdanchikov still went with the southern option because the political decision to build the ESPO had already been made, and there was not enough oil to fill it.¹⁶ Thanks to Vankor, the question about the filling of the pipeline—the construction of which was taking much longer than planned, indeed partly because of the uncertainties about the resource base—was resolved. After that Bogdanchikov repeatedly lobbied actively for the speeding up of the construction of the ESPO, and appealed to Putin to instruct Fradkov to push the implementation of the oil pipeline project. After all the delays the ESPO was launched in 2009, one year later than intended.

Rosneft became not only a catalyst for the laying of the ESPO in general, but also an indirect lobbyist for a spur to China. Indeed, for a long time the question—whether to build a spur to China through which initial deliveries of 15 million tons/year would be possible—was left unresolved.

Already in 2006 Transneft and the CNPC signed a protocol about the construction of the oil pipeline from Skovorodino to the border of the

¹⁴ For more on the construction of ESPO, see: S. Tabata, X. Xu Liu, "Russia's Energy Policy in the Far East and Siberia," in P. Aalto (ed); *Russia's Energy Policies: National, Interregional and Global Levels*, Edward Elgar Publishing Inc., 2012.

¹⁵ *Vedomosti*, 29 December 2009.

¹⁶ *Neftegazovaya vertikal'*, No. 14. 2005. p. 62-62.

PRC. The project was planned to begin in 2007 and to be completed by 2008, simultaneous with the launch of the first stage of the ESPO. But its progress was held up again, primarily due to disagreement on both sides about the price of Russian crude. Besides, Vladimir Yakunin, the influential head of the Russian Railways, stood against the project: without an Eastern pipeline, oil supplies to China were delivered by rail. The railway monopoly feared that the construction of an oil pipeline would force them to concede part of the crude shipments to Transneft.¹⁷

In March 2008 the president of Transneft Nikolai Tokarev addressed the vice-premier Sergei Naryshkin a demand to make a decision on the spur to China. Transneft's anxiety was understandable, as the projection of the second stage of the ESPO and the capacity of the port Kozmino depended on the availability of the spur.¹⁸

Progress began to take shape only in October of 2008, when a memorandum was completed by both sides stipulating the apportionment of credit by China to Russia for the construction of the pipeline and future deliveries of oil. They were already expected to sign the documents by the end of November 2008.¹⁹ But the process began to drag (as discussed below).

The complete resolution of differences was worked out only in February 2009, when Vice-Premier Igor Sechin visited China. Apparently a breakthrough was reached mainly thanks to the global financial crisis and Rosneft's and Transneft's growing need for cash. Four documents were then signed: two agreements between the Russian companies and the China Development Bank on long-term credit amounting to \$25 billion, a 20-year contract on the delivery of oil between the CNPC and Rosneft, and also an agreement between the CNPC and Transneft on the construction and operation of a Skovorodino-Mokhe pipeline. At first, the plan was to export 15 million tons/year of primarily Western Siberian oil. The throughput capacity of the pipeline could be increased to 30 million tons/year. This would depend, above all, on the pace of Rosneft's development of its Eastern Siberian fields.

After that, events unfolded at an unbelievable pace. Premier Putin reported in a presentation to the State Duma that the preparations for the Russian-Chinese pipeline project had reached the final stage. A few days later Rosneft and Transneft concluded a bilateral agreement, according to which Transneft would buy from Rosneft 6 million tons/year for re-sale to China, and a remaining 9 million tons/year would be delivered by Rosneft itself. At the end of April, Igor Sechin and his Chinese counterpart Wang Qishan signed an inter-governmental agreement on petroleum cooperation for 23 years. Within a week, in the presence of the vice-premiers of both countries, the directors of Transneft and Rosneft, and the governor of Amursk oblast, the first section of the 64-km Skovorodino-Mokhe pipeline system was welded 40 km from Skovorodino.²⁰ This situation once again

¹⁷ *Neft i kapital*, No. 11, 2008. p. 21.

¹⁸ *Vedomosti*, 11 April 2008.

¹⁹ For details, see: *Neft i kapital*, No. 3, 2009. p. 42.

²⁰ For details, see: *Neft i kapital*, No. 5, 2009. p. 41.

showed that large-scale projects in Russia are implemented especially efficiently when an influential lobbyist gets behind them.

In September 2010 the construction of the Skvorodino-Daqing pipeline was completed. Deliveries through it began in January of 2011. According to Article 13 of the Accord between the Government of the RF and the Government of the PRC on cooperation in the oil sphere, Transneft and Rosneft would receive exclusive right of access to the pipeline for the delivery of oil to China over the course of 20 years.²¹ This immediately gave the state company undeniable competitive advantages over its private rivals working in the east. They had to use the route to Kozmino that is longer by 2000 km. Naturally their costs were much higher. As experts calculated, Rosneft saved \$20/ton.²²

As a result Rosneft's exports to the Asia-Pacific countries steadily grew (in accordance with the goals set by the Energy Strategy of Russia until 2030), reaching 10.53 million tons in 2009 and 16.90 million tons in 2010. In 2011 Rosneft exported in total 69.9 million tons, including 18.9 million tons to the Asia-Pacific countries (of that 15 million tons to China),²³ that is, 27% of all exports, which even exceeds the level designated by the Strategy.

However, despite striving to decrease its dependence on Middle East oil, China is not planning to become dependent on its northern neighbor: indeed in the Chinese energy strategy Russia is apparently not at all a first priority. Chinese petroleum sources are generally well diversified—this includes the Middle East, Africa, and Latin America. Russia supplies about 8% of all the petroleum imported into China, and in 2010 it occupied the fifth place after Saudi Arabia, Angola, Iran and Oman. However, in 2011 it moved to the fourth place, having overtaken Oman.²⁴ Evidently, due to internal political games, Russia began exporting its petroleum to the Chinese market a bit late.

Russian Upstream

Thanks to the help rendered to Rosneft for the purchase of Yuganskneftgaz, Chinese companies were able to penetrate the Russian oil industry²⁵: in 2005 Rosneft offered Sinopec (its working partner in the Aday region of Kazakhstan) 25.1% of shares in the Veninskii block of Sakhalin-3 project, a five-year license for which it received in 2003. Sinopec

²¹ Soglashenie mezhdru Pravitel'stvom Rossiskoi Federatsii i Pravitel'stvom Kitaiskoi Narodnoi Respubliki o sotrudnichestve v neftianoi sfere [Inter-governmental agreement on oil cooperation between People's Republic of China and the Russian Federation], Beijing, 2009.

²² *Neftgazovaia vertikal'*, No. 15-16, 2009. p. 21.

²³ *Rosneft, godovoi otchet za 2011 god* [Rosneft, Annual Report 2011], <www.rosneft.ru/Downstream/crude_oil_sales/>, p. 54-55.

²⁴ EIA. Country Analysis Briefs. China, last updated: 4 September 2012.

²⁵ The Chinese tried to participate in the privatization of Slavneft, in the auction of Yuganskneftgaz, and wanted to purchase the Orenburg company Stimul.

pledged to take upon itself Rosneft's expenses for geological exploration and a definite amount of the financing of the subsequent development.²⁶

In August of 2006, Sinopec purchased from TNK-BP 96.86% of the shares of its subsidiary Udmurtneft, which produced 6.4 million tons in 2011, through the company Promleasing. In December 2006, Rosneft succeeded in acquiring 51% of Promleasing from Sinopec.²⁷ Interestingly, besides Sinopec, Gazpromneft, Hungary's MOL, and a consortium of Intera and the Indian ONGC were also interested in Udmurtneft. Afterwards, Gazprom complained that a "political decision was taken in favor of a state oil company." A representative of the Ministry of Energy explained at the time that they were implementing two strategies of relations with foreign companies in Russia: first, an exchange of assets for foreign assets but under Russian control, the policy pursued by Gazprom, and the second, "your money for our assets, but still under our control," by Rosneft.²⁸

Furthermore, during Putin's visit to Beijing in 2006, Rosneft and CNPC signed an agreement about the creation of a joint-venture and the cooperation of Russian and China. In the middle of 2006 Rosneft (51%) and CNPC (49%) formed the joint venture "Vostok Energy," for the exploration and production of hydrocarbons in Russia. At that time Rosneft was preparing to stake its claim to rich subsoil deposits that had yet to be allocated, but did not have enough money, so it needed to attract a financially solvent partner. For its part, the Chinese company could not independently gain access to significant reserves in Russia due to the limitations on the participation of foreigners in the development of strategic fields.

In the summer of 2007 "Vostok Energy" beat Surgutneftegaz and Oleg Deripaska's BazEI in a fight for two small deposits in Irkutsk oblast, located near the ESPO. The Chinese interest in western Siberia was understandable, in so far as oil from there would go through the pipeline into China.

Thus the Chinese strengthened their ties to Rosneft even more, having become a shareholder: in the course of Rosneft's IPO, CNPC acquired 0.6% of the state company's shares for \$500 million.²⁹ Following the acquisition of TNK-BP, Chinese companies might get another chance of further securing their positions in Russia's upstream: Rosneft plans to invite them into its projects for the development of the continental shelf.³⁰

But even with the help of Rosneft the advance of the Chinese state oil companies in the Russian oil sphere was not simple and less successful in comparison to their activities in other petroleum-producing countries.³¹

²⁶ <www.rosneft.ru/Upstream/Exploration/russia_far_east/sakhalin-3/>.

²⁷ <www.rosneft.ru/Upstream/ProductionAndDevelopment/central_russia/udmurtneft/>.

²⁸ *Vedomosti*, 21 June 2006.

²⁹ *Neftegazovaya vertikal'*, No. 13, 2006.

³⁰ *Vedomosti*, 19 February 2013.

³¹ Currently Chinese oil companies work in 31 countries, participating in production in 20 of those. Most of all they have consolidated their position in Kazakhstan, Saudi Arabia, Venezuela and Angola. The size of the Chinese companies' equity oil production abroad grew from 140 thousand barrels/day in 2000 to 1.5 million barrels/day in 2011. Chinese oil

Chinese companies are undoubtedly interested in penetrating Russia's oil upstream and gaining access to equity oil³², but the Russian oil industry (especially considering its depletion of the resource base, the complicated climatic and geologic conditions of work, and the high production costs) is far from the only attractive opportunity for them.

Chinese Downstream

Russia and China's energy relations should be founded on the principle "our upstream for your downstream." At the end of 2007 Rosneft (49%) and CNPC (51%) created the joint venture "Chinese-Russian Eastern Petrochemical Company" for the construction of a Chinese refinery and a network of 300-500 filling stations. Then it was expected that the cost of the refinery would be about \$3 billion, and it would be commissioned by 2011.³³

However, Rosneft encountered problems in gaining access to the Chinese downstream. The company still expected in the fall of 2009 to sign an agreement about the construction of a refinery with a capacity of 15 million tons in Tianjin. Rosneft led negotiations with the CNPC on this project in 2006, but it was stalled for a long time because of disagreements on a number of issues, including the financing of the project. At first the plan was for Rosneft's and CNPC's joint venture to finance 35% of the refinery's construction and for the remainder to be granted by Chinese banks; later China proposed increasing the costs borne by the joint venture. Discussions also centered on the capacity of the refinery and the sources of crude. In the end China was unhappy with the development of the joint project on oil production in Russia: to this day "Vostok Energy" has only acquired two small fields in Irkutsk oblast.³⁴

A new problem arose in February of 2010, when the Chinese side announced that it was necessary to double deliveries of Russian oil. It was expected that these volumes would go, in part, to the refinery in Tianjin, but representatives of CNPC said that because of the growth of demand for oil in China, the refinery would need supplies that were independent of the contracted 15 million tons/year. Yet the agreement on the increase of exports was a precondition of the refinery's construction beginning in 2010. If Rosneft did not have an available volume of crude for CNPC, then the Chinese company would have to search for it on the world market.

After all the delays, in 2010 Igor Sechin and Wang Qishan laid the first stone of the future refinery in Tianjin. Capital investment would come to \$5 billion. The refinery's capacity would be 13 million tons/year and the

companies are very successful in pursuing commercial goals abroad, especially when their goals coincide with the geopolitical goals of the Chinese government. S. Lewis, "Chinese NOCs and World Energy Markets: CNPC, Sinopec and CNOOC," in *The Changing Role of National Oil Companies in International Energy Markets*, J. Baker Institute for Public Policy, March 2007.

³² The proportion of production that a concession owner has the legal and contractual right to retain.

³³ *Vedomosti*, 22 September 2010.

³⁴ *Vedomosti*, 12 October 2009.

construction should be completed by 2015, 9 million tons of oil for the refinery would be provided by Russia, and the remainder by other countries. The then head of Rosneft Eduard Khudaynatov specified that the oil would come from fields in Eastern Siberia.³⁵ Then a network of 500 filling stations would be built in the north of the PRC, potentially increasing to 1000 stations in the future. But Rosneft admits that "subsequent implementation of the project depends on final arrangements to be reached between the two sides."³⁶

Rosneft's problems in China will be many, although it is a high-capacity and fast-growing market. The prices of petroleum products in China are regulated and moreover the laws often change. Only Sinopec and PetroChina have a license on the import and export of petroleum products.

The Chinese themselves are planning to develop their own oil refining capacities rapidly. Besides, on the Chinese market Rosneft must compete with global giants: China gladly invites such companies as ExxonMobil and Saudi Aramco, which can bring modern technologies to their oil refining.³⁷ China apparently looks at Russia only as a source of crude which it is capable of refining itself, and not as a supplier of higher value-added products or a significant player in its downstream.

And Again Money...

China sought for Rosneft to extend the contract on the supply of oil for the years from 2011 to 2030. The possibility of loans of \$20-25 billion in exchange for 20-year supplies of oil to China became known in October 2008, when Premier Wen Jiabao visited Moscow. Given the global crisis, attracting that kind of money on the global markets was generally impossible. So Chinese credit made Rosneft's life easier: after buying Yukos's assets, as of 1 July 2008 its net debt amounted to \$21.4 billion, of that \$13.4 billion in short-term loans.³⁸

Rosneft was the side most in need during the talks on credit. It was much more important for the Russian state company to get credit than for the Chinese to secure 15 million tons/year of Russian oil. Herein lay the principal difference between China's negotiating position and Rosneft's.

It seemed in 2008 that Rosneft and CNPC would already sign a long-term contract on Russian oil supplies to China, and reach agreements on the construction of the spur to China from ESPO, while Russian companies would receive Chinese credit. But in mid-November it became clear that the negotiations had been suspended. Moscow blamed Beijing for placing absurd conditions on the credit (a floating rather than a fixed

³⁵ *Neft i kapital*, No. 11, 2010, p. 21.

³⁶ <www.rosneft.ru/Downstream/refining/Construction/>.

³⁷ A. Troner, "China's Oil Sector: Trends and Uncertainties," in *The Rise of China and its Energy Implications*, J. Baker Institute for Public Policy, December 2011.

³⁸ *Vedomosti*, 7 November 2008.

interest rate) and demanding five types of guarantee. Earlier it was assumed that Moscow would provide state-level guarantees, Rosneft would offer guaranteed supplies of oil as collateral, and Transneft would offer infrastructure.³⁹ Aside from that, the launch of the ESPO was delayed a year; accordingly, the issue of the spur to China lost its relevance. The difficulties were connected with the fact that for a long time Rosneft was unable to reach an agreement with CNPC on the price of crude oil.

Only in February 2009 after arduous negotiations with China, led by Igor Sechin, did Rosneft obtain credit amounting to \$15 billion. At the same time, the Chinese granted \$10 billion to Transneft primarily for the construction of the ESPO, including the spur to China. In the official announcement of the deal, Sechin, who led the delegation in Beijing, said that over the course of 20 years Russia would deliver 15 million tons of oil to China annually on conditions of credit that would be set by both sides. In July 2009 the President of Russia finally signed a federal law "On the Ratification of the Agreement between the Government of the Russian Federation and the Government of the Peoples' Republic of China on Cooperation in the Oil Sphere."

The sum and time-frame of that credit is a record for Russia. But the conditions of the agreement were not disclosed. Peter O'Brien, then vice-president of Rosneft, announced: "The sum of credit is \$15 billion over a term of 20 years—at the same time a grace period is stipulated to take place, during the course of which only interest will be paid. I would call the price of credit obtained by the company unprecedentedly low."⁴⁰ The Ministry of Energy affirmed that the credit was good for Russia, as its interest rate was more than two times lower than the existing rate on world markets.⁴¹

"The Chinese contract is iron-clad, proof-read by both sides, and carries international jurisdiction," noted Igor Sechin at the time. He said that CNPC's cooperation with Rosneft was advancing successfully and the Russian company planned to begin talks about increasing supplies to the PRC—the additional volume for the refinery in Tianjin. But problems with the "iron-clad" credit arose, just as supplies of oil began in January 2011. The coefficient T, which defined the logistical expenditures of Transneft, was perceived differently by the parties to the contract. The CNPC began to underpay by \$13/barrel, as now it received oil by the spur from the ESPO, instead of by railway—a route that was half as long.⁴² The loss for Russian companies from the CNPC's position for the life of the contract could have amounted to \$30 billion.

Negotiating on the corporate level did not resolve the matter; by the summer of 2011 CNPC's debt reached \$200 million. A full resolution of the situation on the governmental level also failed. In the next round of the energy dialogue, which was headed by Igor Sechin, the CNPC agreed to

³⁹ For details, see: *Neft i kapital*, No. 17, 2010. p. 38.

⁴⁰ *Neftegazovaya vertikal'*, No. 17, 2010. p. 36.

⁴¹ <http://minenergo.gov.ru/press/min_news/421.html?print=Y>.

⁴² *Neftegazovaya vertikal'*, No. 22, 2011. p. 49.

repay a large part of the debt and decrease the coefficient T to \$3/barrel.⁴³ This gave Sechin cause to declare that "all conflicts have been resolved and mutual understanding has been reached." But at Transneft they warned: if CNPC does not repay the debt in full, the Russian company will settle their account with the China Development Bank ahead of schedule and turn to the international courts.

In October the sides again held negotiations within the framework of the energy dialogue. Igor Sechin again announced that "the market decision has been found and an arrangement, which allows us to remove all claims, has been reached." The Vice-Premier assured that on the corporate level everything would be fixed within a few weeks. But the companies' negotiations dragged on. Only in the beginning of 2012 did Rosneft, Transneft and the CNPC agree to new conditions of supply. Changes were brought to the contract according to which Rosneft and Transneft would offer a "country" discount to the CNPC of \$1.5/barrel. And the CNPC would have to repay the debt for supply of oil from the beginning of 2011—\$134 million dollars. The peaceful settlement of the conflict with the Chinese cost Rosneft \$3 billion.

Rosneft considers the changes in the contract a "victory for the Russian side." A representative of the company said, "From the start they wanted a discount from us of \$13.5 a barrel, and we managed to agree only on \$1.5." Rosneft assures that deliveries of oil to China are now very profitable.⁴⁴ But it seems, all the same, the argument was resolved in favor of the CNPC and such a turn of events could have been foreseen. After all, the spur from the ESPO was built with Chinese money envisaging oil supplies to the only consumer—China.

Nonetheless, Russian officials do not call into question the chosen strategy with regards to China. To the question posed by the newspaper *Kommersant* in the summer of 2011, why Russia is building pipelines to China and not transporting its oil by sea, Igor Sechin answered that "pipelines simply reduce the time of delivery" and are as safe for the RF as sea routes.⁴⁵

But now the State Prosecutor is concerning himself with changes to the "iron-clad" contract: in March of 2012 his office began an investigation into possible violations upon its review. In February State Duma deputy Nikolai Kolomeitsev from the Communist Party asked President Medvedev and the state prosecutor, Yuri Chaika, to check the legality of the new contracts between the state companies and China, and to evaluate their consequences for the economy of Russia. Kolomeitsev was not the first to try to examine the details of the Chinese contracts of Rosneft and Transneft. Unsuccessful attempts were undertaken by the Ministries of Finance and Energy, as well as the opposition leader, Alexei Navalny. The

⁴³ The Russia-China energy dialogue was established in 2008 in the course of the visit to the PRC of President Dmitry Medvedev. His fellow delegates were appointed Deputy Prime Minister of their respective governments with responsibility for the energy industry.

⁴⁴ *Kommersant*, 28 February 2012.

⁴⁵ *Kommersant*, 14 June 2011.

current reaction of the state prosecutor to the deputy's request may be connected to a re-shuffling of personnel in the government.⁴⁶

However, the practice of raising Chinese money for Rosneft's corporate purposes continues: it is expected now that China will again provide funds to the Russian state company, this time to help it pay for the acquisition of TNK-BP.⁴⁷

For Rosneft China was the only opportunity to get money during the crisis in 2009. And for China, Russian oil, again, was not the only choice: just in 2009, in exchange for oil supplies the country provided \$8 billion to Venezuela, \$10 billion to Brazil, \$10 billion to Kazakhstan, and \$1 billion to Ecuador.⁴⁸

⁴⁶ *Vedomosti*, 12 April 2012.

⁴⁷ *Vedomosti*, 14 February 2013.

⁴⁸ EIA. Country Analysis Briefs. China. Last updated: November 2009.

Conclusion

Rosneft, like a number of state oil companies from petroleum-producing countries, serves as an instrument of Russia's foreign policy, facilitating the advancement of its eastern vector. At the same time Russia's foreign policy enables the realization of the company's corporate interests, and the country's high-ranking state agents frequently helped Rosneft implement its Chinese strategy. Energy dialogue between Russia and China progressed primarily thanks to the powers of Rosneft. Time will tell if it has in large part served the corporate interests of Rosneft or the national interests of Russia.

The fact of the matter is that the oil relations between Russia and China do not appear very balanced. Above all, the Russian oil industry is characterized by an aging resource base and high production costs, in comparison with the many other petroleum-producing countries in which the Chinese oil companies operate. The Chinese oil market is very high-volume, but there are other petroleum exporters with greater competitiveness in oil prices already entrenched in it, which can override the advantages of the geographical proximity of Russia and China.

In the long-term plan, China is interested in developing energy cooperation with Russia, but it has other attractive opportunities among petroleum-exporting countries. Furthermore, there is currently no shortage of supply on the world market. Russia (in the first place, Rosneft) needs Chinese money keenly and urgently, and it simply does not have alternative options for getting such sums. Moreover, Russia lost time in establishing a petroleum dialogue with China, whose choice of reliable suppliers is significantly wider now. What is more, China is now developing much more dynamically than Russia and is economically much stronger. In the long term, Russia will have to adapt: the buyer (and creditor) has more power than the seller (and debtor). So, Beijing will indeed dictate the conditions of energy cooperation between the RF and the PRC, and as the situation in the Russian oil industry deteriorates, and its resource base depletes, this tendency is likely to intensify.