

A photograph of a person on a ladder working on a red wall. The wall features large white numbers and Chinese characters. The person is silhouetted against the bright red background. The numbers visible are '24 小时' at the top, '97#' and '93#' on the left, and '5', '4.', and '#', '4.' on the right. The person is reaching up towards the '93#' sign.

China-Russia energy relations **A CHANGING OUTLOOK FOR CHINESE ENERGY SECURITY**

China's changing energy profile and the availability of alternative supplies of oil and gas at declining prices mean that Beijing will not want to lock itself into Russia's embrace.

Global oil and gas prices are heading lower than many had anticipated even two years ago, and look likely to remain there for longer. For producer countries around the world, this situation presents numerous challenges. But for China, the world's largest oil consumer and emerging gas guzzler, this has been a boon. Energy producers are competing for market share in China, allowing Beijing to diversify its import sources and increase its strategic reserves. Indeed, the country's dramatic economic growth over the past two decades

RECOMMENDATIONS

- The International Energy Agency should enhance its dialogue with China on perceptions of energy security as well as on Strategic Petroleum Reserve management.
- Governments and companies should collaborate with their Chinese counterparts on moving toward more liquid gas markets and market-driven prices.
- Engage China on joint responses to maritime threats, risk mitigation strategies with Chinese oil and gas traders and shippers, and encouraging tie-ups between Chinese and Western oil and gas firms in third markets.

Despite deeper and more frequent engagement between Russian and Chinese leaders, mistrust between the two sides still lingers

For China, increasing supplies of oil and gas from Russia is a strategic goal aimed at capping seaborne imports from the Middle East and reduce Beijing's anxieties regarding Washington's ability to cut off China's economic lifeline.

has propelled it from self-sufficiency in energy to relying on imports for one third of its gas supplies and more than half of its oil requirements. Not only has the economic toll been high, but, more importantly, energy dependence means that the lifeline of China's economy relies on the stability of oil and gas producers in the Middle East and Africa, and on maritime transit routes dominated by the US, China's strategic competitor.

Over the past decade, as Beijing faced rising oil prices and surging demand, Chinese policy makers searched for ways to mitigate these vulnerabilities and responded through a host of measures: enhancing their dialogue with key oil producers in the Persian Gulf in order to avoid becoming the target of an oil blockade akin to the 1973 embargo; building a Strategic Petroleum Reserve (SPR) to hedge against supply shortages or rising oil prices; diversifying supply sources and building pipelines from Russia and Central Asia that would allow them to reduce the risks associated with seaborne transportation.

Shifting balances

The above-mentioned policies helped mitigate some of China's supply insecurities. Yet just as Chinese planners dealt with a host of security vulnerabilities, the country's expanding global footprint generated new risks and concerns: Chinese investors have been confronted with issues related to worker safety, operational and contractual challenges as well as regime change and civil war.

The most significant shift in China's energy security outlook occurred in the summer of 2014, when global oil and gas prices went into free fall. The current rut in oil prices has allowed Beijing to fill its SPR at an astounding rate and at a low cost. In 2014, for a

months' worth of oil, roughly 6.6 million barrels per day (mbpd) Chinese importers paid over \$20 billion. In mid-2015, with oil prices significantly lower, the import bill reached an estimated \$11 billion for a staggering 7.4 mbpd. In the scope of two years, China has probably filled half of its SPR.

Finally, the changing supply and demand fundamentals are also enhancing Beijing's ability to diversify its import sources: Producers looking to secure an outlet for their barrels must outbid each other for a share of the Chinese market. Saudi Arabia, China's largest crude oil exporter, is struggling to fend-off supplies from fellow Gulf producers, Iraq and Iran. Many producers are now competing to sell to China, allowing Beijing to pick and choose its suppliers in a way that it could never do previously.

Oil imports now flow to China from all corners of the world. Whereas in the past, Beijing relied heavily on the Middle East and Africa, now, imports from Latin America have also become extremely popular. Some of them are linked to producers' need to repay loans that Chinese banks offered them in the wake of the global financial crisis. The downside, of course, is that now that oil prices are so low and producers' budgets are tight, their ability to repay Chinese loans is diminishing. Venezuela is a case in point.

Russia rising

Chinese loans to Russia, dating from 2009, have also led to oil flows from Russia to almost double between 2013 and 2015. Russia's need to secure an ever growing share of the Chinese market is amplified by the current competition between oil and gas suppliers as well as by Russia's international isolation following the Ukraine invasion. Beijing, in response, pledged loans and investments to support the Russian

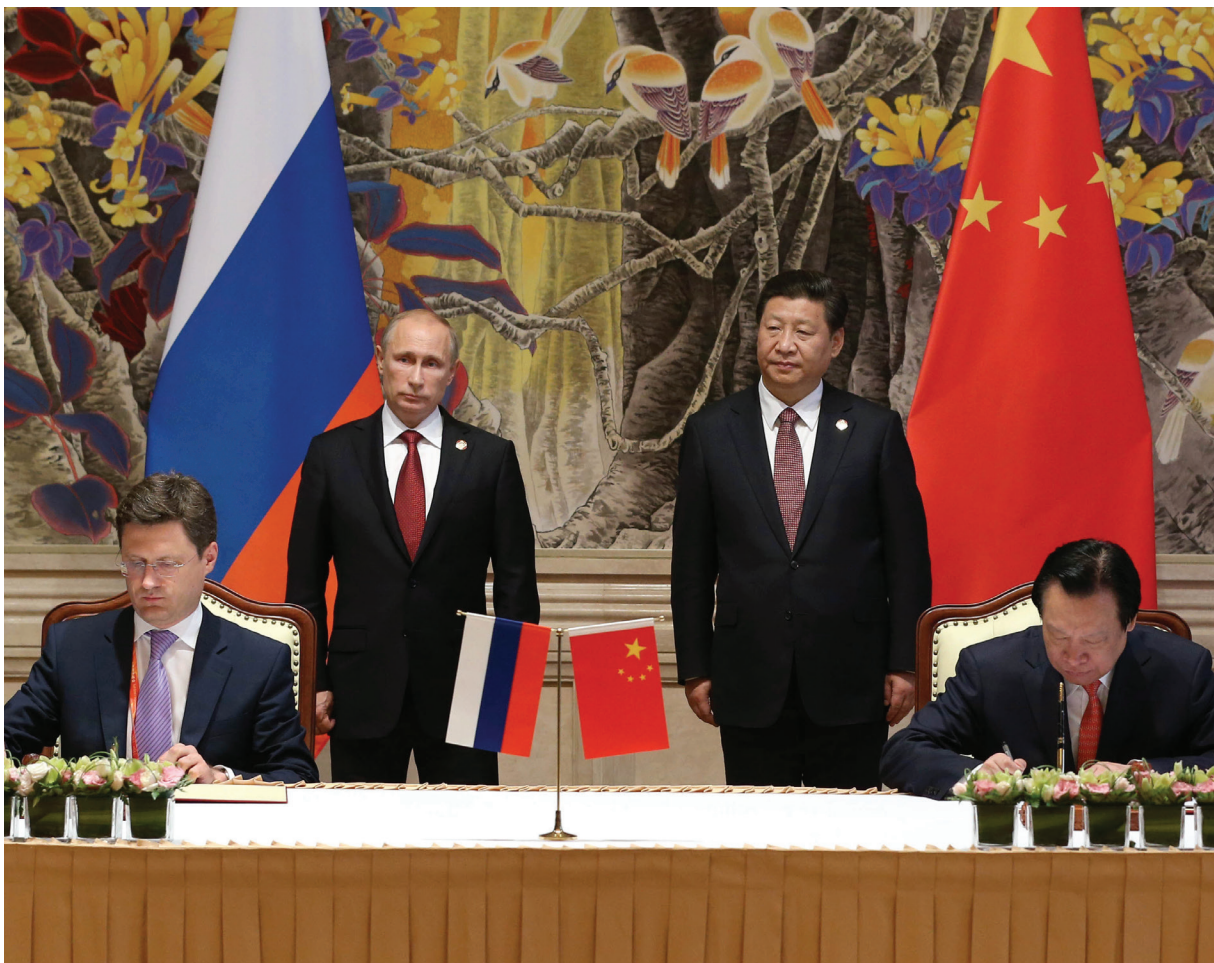
economy, a geopolitical act of goodwill that has yielded substantial results for China. Indeed, the most significant sign of Moscow's eastward shift was the signing, in May 2014, of a long-negotiated gas supply deal between Russia and China. Negotiations had been stalled for over a decade due to several disagreements, including on prices. But as Russia's isolation grew, so did its willingness to concede to Chinese negotiators on pricing and terms.

Similarly, in November 2014, CNPC and Rosneft signed a number of deals aimed at providing China with additional Russian crude exports. More significantly, Moscow offered Chinese companies opportunities to acquire stakes in oil and gas blocks in Russia, a departure from Russia's past reluctance to offer Chinese companies upstream assets. Now that Russian energy companies are feeling the pinch of Western sanctions, Chinese financiers and companies are being welcomed, albeit cautiously. For China, increasing supplies of oil and gas from

Russia is a strategic goal aimed at capping seaborne imports from the Middle East and reduce Beijing's anxieties regarding Washington's ability to cut off China's economic lifeline. Russian oil supplies are also increasingly appealing to new, non-state, oil traders. During the second half of 2015, a number of independent refiners in China have been granted licenses to import oil. They have sought to increase imports from Russia given the close geographic proximity and the relative logistical ease associated with land-based imports, compared to more complex seaborne trading.

Are pipelines just pipe dreams?

While Russian oil exports to China are rapidly gaining momentum, the prospects of increasing gas supplies are dimmer. A combination of slowing economic growth and high domestic gas prices have weakened appetite for gas in China. This uncertain outlook for Chinese gas consumption combined with falling liquefied natural gas (LNG) prices are making Chinese



Russian President Vladimir Putin and Chinese President Xi Jinping during a signing ceremony in Shanghai in May 2014 of a 30-year, \$400 billion deal for Russia to deliver gas to China © AP Photo/RIA Novosti, Alexei Druzhinin

importers reluctant to commit to additional pipeline supplies that may well turn out to be in excess of demand, and more expensive than LNG until Beijing introduces new pricing reforms that will support longer term gas demand. But more importantly, Russia and China also have differing priorities on which of the two pipelines agreed upon to build first: Moscow would like to prioritize a 30 billion cubic meter (bcm) pipeline from West Siberia that uses gas from fields that currently serve European consumers. But this route overlaps with existing supplies to China from Central Asia and is therefore less appealing to China. Beijing for its part, prefers a 38 bcm pipeline from Eastern Siberia that will supply China's North-eastern provinces but the high costs of production and the reliance on China as a sole consumer makes Moscow nervous. Bridging these disagreements is not

impossible, especially since leaders in both Russia and China accept the need to pay a premium for their energy security. But the current convergence of geopolitical interests may not be enough to paper over the mistrust that still exists between China and Russia and the commercial challenges in today's volatile gas markets.

Finally, despite deeper and more frequent engagement between Russian and Chinese leaders, mistrust between the two sides still lingers. Russian companies do not want to be beholden solely to their Chinese consumers while Chinese investors are wary that their activities in Russia will preclude them from other markets in the US and Europe, which they increasingly see as less risky and more appealing.

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Cover photo: Workers change the display of gasoline prices at a gas station of PetroChina in Chengdu, southwest China © AP Photo/Color China

