One Step Forward, Two Steps Back?
The Realities of a Rising China and Implications for Russia’s Energy Ambitions

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This paper reviews and summarizes some key issues examined in a two-year Brookings Institution research project focused on the broader implications of Russian-Chinese energy relations. It was conducted jointly by researchers at the Center on the United States and Europe and the John L. Thornton China Center.
INTRODUCTION

In the past decade, Russian-Chinese relations improved dramatically—reaching what appeared to be a high point in 2008 before Russia felt the full impact of the global economic downturn. Russia and China increased bilateral trade; concluded a range of economic and political agreements; and forged a new political institution in Central Asia, the Shanghai Cooperation Organization, all driven by a strong mutual interest in increasing their economic relationship, especially in the energy sphere. In 2008, after an often turbulent history marked by territorial grabs, an outbreak of war in the late 1960s, and tensions surrounding the migration of Chinese workers into Russia’s sparsely-populated Far East, Moscow and Beijing finalized a landmark border agreement. They resolved their last outstanding territorial disputes, reinforcing the agreement with a good neighborly relations treaty.\(^1\)

Against this backdrop throughout the 2000s, Russian and U.S. analysts debated whether Russia’s economic and energy relations with China would provide a longer-term alternative to Russia’s relations with Europe, and if a Russian-Chinese “authoritarian” model for economic development could eventually displace Western liberal capitalism given Russia’s and China’s impressive growth rates. The two countries’ seeming convergence on a number of political issues—such as questioning U.S. primacy in global political and financial matters, preserving the authority of the UN Security Council, institutionalizing the G20, opposing the independence of Kosovo, and resisting international efforts to impose sanctions on Iran and take harsh measures against North Korea—also encouraged speculation that improved Russian-Chinese relations could eventually translate into a “strategic partnership” that would act as a counterweight to the United States and the transatlantic alliance.\(^2\) Frequent cordial summits and high-level visits, and often enthusiastic Russian rhetoric about the excellent state of relations, seemed to put China at the top of Russia’s economic and strategic agenda.\(^2\)

The decade ahead, however, seems more challenging for Russian-Chinese relations than 2000-2010, given economic and demographic disparities between the two countries and a number of other trends tracking in China’s rather than Russia’s favor. China has recovered more quickly from the effects of the economic crisis and seen both its economic and political weight increase relative to other major regional and

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global powers. Russian concerns that Moscow does not have the capacity to compete economically with a rising China, and may even eventually be relegated by Beijing to the status of “junior partner” politically, have come to the surface.4

Bilateral energy cooperation, which has been the most visible and commented-on feature of the Russian-Chinese relationship, is likely to continue to feature a one step forward, two steps back dynamic especially given increasing competition between Moscow and Beijing over access to energy resources in the Caspian region and Central Asia. Other differences in foreign policy and security perspectives make it difficult to envision the creation of a sustainable strategic partnership. Fears of an energy-fueled Russian-Chinese alliance against U.S. interests that darkened some American analyses of the relationship in the 2000s may fade to more nuanced shades of gray in 2010-2020, as Russia and Chinese interests begin to diverge.

**China’s Raw Materials Appendage?**

Behind the scenes, Russian analysts have fretted for some time about China’s lack of interest in goods beyond commodities and armaments, and the risks of Russia becoming a “raw materials appendage to China”—assisting China’s development without receiving much beyond cash in return. As Russia exported crude oil, timber, and minerals to China over the last decade, China flooded Russia with consumer goods. Russian-Chinese trade turnover reached $58 billion in 2008, with about half of Russian exports comprising crude oil and oil products, and only two percent consisting of high-value-added goods including consumer electronics, heavy machinery, and automobiles. Russia has had few options to change the structure of trade with China and, in 2010, its primary exports remain raw materials, metals, electricity, military hardware, and some limited technologies in aerospace, including jets and jet engines.5

In the energy sector, Russia has also not been as successful as might have been anticipated in its dealings with China. To be sure, sales of Russian crude to China increased from less than 1,000 barrels per day (b/d) in 1995 to more than 300,000 b/d in 2009.6 However, the cross-border infrastructure needed for the cost-effective delivery of large volumes of oil and natural gas from Russia to China has not yet materialized, despite more than a decade of bilateral negotiations involving senior leaders from both countries. Both internal Russian disputes and tough bargaining by the Russians and Chinese have slowed progress on plans to build oil and gas pipelines. Apart from the construction of a spur from the East Siberian-Pacific Ocean (ESPO) pipeline to the

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6 In June 2010, the Russian Ministry of Regions approved an initial set of eight joint Russian-Chinese economic projects in response to a September 2009 agreement to promote cross-border investment and cooperation between Russia’s Eastern regions and China’s Northern regions. The terms of the agreement provide for a total of 205 projects with 94 of these planned for the Russian side of the border. Most of the projects, however, are expected to be funded by Chinese, rather than Russian, enterprises. Given the small size of the Russian population and consumer market in the Russian Far East, regional experts and residents fear that most of the Russia-based projects will be resource extraction-oriented, contributing even further to Russia’s trade imbalance with China. Anna Chechel, Maksim Tovkailo and Natalia Kostenko, “Green Light to the Chinese,” *Vedomosti*, June, 24, 2010, accessed at <http://www.vedomosti.ru/newspaper/article/2010/06/24/238455>.

7 Data from the General Administration of Customs of the People’s Republic of China, cited in “Table – China’s December crude oil imports and exports,” *Reuters*, January 21, 2010 and provided by EIA CSS Information Service Center, Hong Kong, January 31, 2007.
Chinese border that is expected to be fully operational by 2011-2012, it remains unclear whether and when other Russian pipelines to China will materialize. It is also not clear if Russia will develop the capacity to move beyond crude to export more refined oil products both to China and the rest of Asia. As a result, Russia may have lost its advantage in the energy relationship with China and may face a more difficult set of choices ahead as China forges ahead with energy and pipeline projects in Central Asia. Beijing’s energy deals in the 2000s with countries like Kazakhstan and Turkmenistan—in combination with 1990s U.S.-led efforts to construct pipelines from Azerbaijan to Turkey and Europe—have effectively broken Moscow’s control over the transit of Caspian energy to China and other global markets.

**Strategic Vulnerabilities in the East**

Outside the commodities sector, in military circles, Russian experts fear that Moscow may have sown the seeds of a long-term strategic dilemma. Moscow may eventually squeeze itself out of the Chinese arms market by helping Beijing create its own military industrial complex, and Chinese-designed and produced weapons could soon compete against Russian arms in other global markets. Furthermore, Moscow’s assistance in modernizing and building-up the Chinese military may eventually be reciprocated with a Chinese military threat against Russian interests in the Far East as Beijing flexes its muscles. In addition to the glaring and growing discrepancies between the size of the Chinese and Russian populations on their respective sides of the border in the Russian Far East, military analysts in Moscow have noted the fact that the Chinese army has continued to conduct exercises with Russia as a target, in spite of the resolution of territorial and other bilateral disputes. In August 2008, Beijing also pointedly refused to join Moscow in recognizing the independence of South Ossetia and Abkhazia after the Georgia war, sending a clear signal that China and Russia are not, and will not be, always on the same page in foreign affairs.9

Against this background, in July 2010, Russia conducted a series of military exercises in Siberia, the Russian Far East, and off the Pacific coast—Vostok 2010 (East 2010)—that provoked a great deal of scrutiny and debate about the new Russian security concept, which continues to single out the expansion of NATO as the main source of threat to Russia. Over the course of the exercise, the Russian military simulated a full-fledged conventional war rather than simply following what observers anticipated would be a response scenario to a regional conflict or an antiterrorist operation. Vostok 2010 was, in fact, the largest exercise east of the Urals since the collapse of the Soviet Union, with the full-range of Russian military forces participating and large numbers of troops deployed. The adversary was not specified although large-scale Russian naval maneuvers around the still-disputed Kuril Islands with Japan provoked some muted diplomatic protests from Tokyo.

Most observers concluded that the point of the exercise was not to deter Japan’s territorial claims, nor was it simply to prepare for the possibility of renewed conflict on the Korean Peninsula given heightened tensions between South and North Korea. Analysts

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8 Over the last decade, China has succeeded in reverse-engineering and copying a number of Russian jet fighters including the Su-27, Su-30, MiG-29, and—most recently—the Su-33. See “Kitai skopiroval eshyo odin istrebitel’ – Su-33,” (China Copies Yet Another Jet Fighter – The Su-33), RBC Daily, June 4, 2010, accessed at <http://top.rbc.ru/economics/04/06/2010/416237.shtml>; and “Gendirektor Sukhogo: kitaiskaya kopiya Su-33 ne sravnitsa s originalom,” (Sukhoi General Director: The Chinese Copy of Su-33 is Incomparable to the Original), RIA Novosti, July 20, 2010, accessed at <http://www.rian.ru/defense_safety/20100720/256683492.html>; As Russia has fallen behind in updating its own military technologies, including UAVs, helicopter carriers, and light armor, Moscow has become more reluctant to transfer technologies to Beijing and increasingly wary of arming the Chinese military. To safeguard the propulsion technology for its latest generation of jet fighters, for example, Russia has equipped the fully-assembled engines it has sold to China with built-in “traps” and “caveats” to minimize China’s ability to copy them. China, however, has already begun to compete with Russia in arms sales to developing countries, to the considerable alarm of the Kremlin and its arms export agency, RosOboronExport. For more details see Viktor Myasnikov, “Pekin zanimaet chuzhoe mesto na rynke VVT prakticheski bez boya,” (Beijing is Taking Others’ Place on the Air Arms Sales Market Practically Without a Battle), Nekotrimyye Vneshnie Obzorenie, July 16, 2010, accessed at <http://nvobyang.ru/armament/2010-07-16/8_china.html>.


**Modernization—not made in China?**

“Modernization”—including military reform and rearmament, the overhaul of Russia’s decaying infrastructure and its deteriorating public health and education systems, and the diversification of the economy away from its heavy reliance on the energy and commodities sectors—is now the top domestic and international priority for the Russian government. Unlike European countries such as Germany, and the European Union itself, China has shown no significant interest in assisting Russia in its economic modernization efforts even as it benefits from Russian technology transfers.

In May 2010, an article published in *Russian Newsweek*—purporting to lay out a new Russian foreign policy program presented by the Russian Ministry of Foreign Affairs to President Dmitry Medvedev in February 2010—seemed to recognize these realities and the fact that Europe, and even the United States, were most likely to be serious partners for Russia’s modernization program, not China.\footnote{Programma effektivnogo ispol’zovaniya na sistemnoi osnovie vneshnepoliticheskikh faktorov v tselakh dolgosrochnogo razvitiya Rossii razrabotana na podporyu Generalnogo Shchota Rossii, 2010, accessed at <http://www.runewsw.ru/country/34184>.

In two 2010 articles in Nezavisimaya Gazeta, Vinogradov and his Russian counterparts argued that China’s growing military presence in the region might undermine Russia’s long-standing partnership with the United States. See, for example, “China Has Started to Import LNG from Kazakhstan by Rail,” LawTek, June 17, 2010, accessed at <http://www.lawtek.ru/news/tek/66355.html>.

In a July 2010 speech to Russian diplomats, Russian President Dmitry Medvedev also laid a heavy stress on the importance of cooperation and partnership with the United States and Europe, see Denis Dyomkin, “Kremlin Seeks Investment Alliances with U.S., EU,” Reuters, July 12, 2010, accessed at <http://www.reuters.com/article/opecAndOtherOil/idUSTRE66R27V20100712>.

In addition to pipelines, China has engaged in a series of road, rail and other infrastructure construction projects that will connect China to Central Asia, bypassing Russia. See, for example, “China Has Started to Import LNG from Kazakhstan by Rail,” LawTek, June 17, 2010, accessed at <http://www.lawtek.ru/news/tek/66355.html>.

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The article advocated that Russia should prioritize forging closer economic and political ties first with the European Union, then with the immediately neighboring former Soviet states in the Commonwealth of Independent States (CIS), and then with North America and the United States to secure investment, technology, and other sources of innovation to modernize its economy. The Asia-Pacific region and China were reviewed after the other three priority regions, with the stress on improving the trade balance and increasing exports of Russian high-value added goods instead of receiving investment and technology.\footnote{See, for example, Jacob W. Kipp, “Unlocking the Economic Potential of the Russian Far East,” Foreign Policy at Brookings No. 4, June 2010, accessed at <http://www.brookings.edu/papers/2010/06_us_eu_cooperation>.}

**Competition in Central Asia?**

Compounding Moscow’s concerns that China may not be an asset for Russian modernization, China is now actively expanding its economic footprint in Russia’s “back yard” in Central Asia. Over the last decade, China has made massive investments in Central Asian energy resource and infrastructure development—including oil and gas pipelines from Kazakhstan and Turkmenistan to China—that Russia is not likely to match.\footnote{See, for example, Jacob W. Kipp, “Unlocking the Economic Potential of the Russian Far East,” Foreign Policy at Brookings No. 4, June 2010, accessed at <http://www.brookings.edu/papers/2010/06_us_eu_cooperation>.}

China National Petroleum Corporation (CNPC), which has been building its
companies were left empty handed.  CNPC is also the dominant foreign player in Turkmenistan, where it is the only international company awarded a production sharing agreement by the Turkmen government for the development of the country’s onshore natural gas resources.  CNPC also won a service contract worth $3.28 billion to build a gas treatment plant at Turkmenistan’s South Yolotan field, which ranks among the world’s five largest natural gas fields, based on an assessment of its reserves by the UK’s Gaffney, Cline and Associates.  The Chinese firm, along with companies from South Korea and the United Arab Emirates, won contracts worth almost $10 billion, while major international oil companies were left empty handed.  

Chinese investment activity in Central Asia has raised questions about the future role of the Shanghai Cooperation Organization (SCO), and whether China and Russia are both still ultimately committed to the success of the institution they jointly developed with the Central Asian states. The possibility that latent Chinese-Russian competition in Central Asia might evolve into a Chinese and Russian version of the “Great Game” has become a recent feature in press reports.  There is also ample evidence to suggest that Russia is keen to keep its own institutional options open in Central Asia, and more broadly, and to find ways to dilute Chinese influence.

Since its inception in 2001, the SCO has evolved into a large functional organization, regional security forum, and a framework for Russia and China to balance and coordinate their interests and policies in Central Asia and the immediate neighborhood as well as to minimize the political reach of the United States and other outside players in the region. However, the SCO operates alongside a number of overlapping Russian-led regional organizations that include the former Soviet Central Asian republics but not China. Russia seems as heavily invested in the survival of these regional institutions as China is in regional infrastructure. The Moscow-dominated Collective Security Treaty Organization (CSTO), for example, and the Eurasian Economic Community (EurAsEC)—which includes all the Central Asian states except Turkmenistan and several other former Soviet republics—both pick up the same themes and jurisdictions as the SCO. The Russia-Kazakhstan-Belarus Customs Union that was launched in July 2010 creates another new economic organization that excludes China and seems to increase Russia’s profile in Kazakhstan after several years of increased Chinese investment.  In a June 16, 2010 interview with Russia’s Vedomosti newspaper, Kazakhstan’s Prime Minister, Karim Masimov, was eager to point to the creation of the customs’ union with Russia as a sign that—contrary to increasing claims—Kazakhstan was not drifting economically toward China.  

Masimov’s assertions notwithstanding, China’s growing energy footprint in Central Asia is gradually undercutting Russia’s political leverage and economic influence over its Central Asian neighbors. For example, the Central Asian Natural Gas Pipeline, which runs from Turkmenistan to China via Uzbekistan and Kazakhstan, provides these countries with a non-Russian export route and has boosted their bargaining power in natural gas price negotiations with Russia. Even with the Central Asian Natural Gas upstream portfolio in Kazakhstan since 1997, is now Kazakhstan’s third largest liquids producer behind KazMunaigaz and Chevron.  

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Pipeline still under construction in 2008, Central Asian states were able to use the prospect of growing competition for their gas and increased sales to China to secure higher prices for gas sold to Russia's gas monopoly, Gazprom.22

Furthermore, in 2009, as the global economic downturn hit investment in Central Asian energy sectors, both Kazakhstan and Turkmenistan turned to China first for financial assistance before approaching Russia for bailout funds.23 The Chinese government brokered “loans for energy” deals with both countries through the China Development Bank (CDB), providing $10 billion to Kazakhstan and $4 billion to Turkmenistan.24 These lines of credit further increased China’s energy interests in the region, with Kazmunaigaz, the Kazakh national oil company, inviting China’s CNPC into a joint purchase of another major Kazakh oil producer, Mangistaumunaigaz.25 The loan Turkmenistan received from the CDB is earmarked for the development of the giant South Yoloton natural gas field, which should eventually provide supplies for the natural gas pipeline from Turkmenistan to China.26 The Turkmen approached the Chinese for another $4 Billion loan for South Yoloton in the summer of 2010.27

In 2009-2010, increased notes of apprehension about the long-term implications of a rising China and China’s “real” intentions in Central Asia, and beyond, crept into Russian analyses.28 Russian nationalists and members of Russia’s security establishment have frequently trumpeted the threat from China over the past decade. Russian politician Dmitry Rogozin, currently Russia’s representative to NATO, for example, often referred to China as a “demographic threat to Russia” when he was the leader of the prominent Russian nationalist political party, Rodina (Motherland).29 Popular concerns about the shrinking population in Russia’s Far East and increased migration from China have also fueled episodic expressions of Russian nationalism and Sinophobia. In summer 2009, growing public demand for a stronger stance against the perceived influx of Chinese goods and people spurred several crackdowns by local authorities on Chinese vegetable farms near Siberian cities, as well as a well-known and highly-frequented market in Moscow.30 Russian regional and national officials, including Prime Minister Vladimir Putin, however, have been quick to downplay the significance of these incidents for the bilateral relationship, resorting to some superficial and low-key efforts to regulate imports of

28 Iain Mills, “China’s Patience Paying Off in Central Asia,” World Politics Review, July 14, 2010, accessed in Russian at <http://www.centrasia.ru/newsA.php?st=1280347800>; Andrzej Gorkow, “V Germanii ozabocheny agressivnoi ekspansii Kitaya v Tsentral’noi Azii,” (Germany Concerned about the Shrinking Population in Russia’s Far East and Increased Migration from China, as well as a well-known and highly-frequented market in Moscow, Russian regional and national officials, including Prime Minister Vladimir Putin, however, have been quick to downplay the significance of these incidents for the bilateral relationship, resorting to some superficial and low-key efforts to regulate imports of

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FOREIGN  POLICY  AT  BROOKINGS
Chinese goods, check Chinese migration, and engage in negotiations with Beijing to harmonize trade.\footnote{To downplay the significance of demolishing the Cherkizovskiy Market, as well as raids by Russian police, customs, and immigration authorities at other Chinese-dominated markets, the Russian and Chinese governments held several high-level negotiations aimed at legalizing and regulating trade between the countries, although there was no publicized outcome from the series of meetings. Russia and China further agreed to conduct separate sets of discussions to address the issue of illegal migration in Russia’s Far Eastern regions and in cities near the Russo-Chinese border, including Irkutsk, Blagoveschensk, and Vladivostok.}

In general, in 2010, Russia is waking up to the range of potential challenges a rising China poses and seems to be re-evaluating its relationship with China. Russia, afraid of becoming a “raw material” or “energy appendage” to China, may be extremely ambivalent about literally fueling China’s continued economic development—given the potential demographic and military threat China poses to the Russian Far East—and may not want to become the junior partner in the relationship. However, there is little indication that Moscow is willing or able to go beyond “business as usual” with Beijing. Russian leaders seem cognizant of Russia’s weaknesses and limitations vis a vis China, and Moscow shows every sign of believing that Russia would likely be on the losing end of a major confrontation with Beijing over trade or immigration. Russian leaders across the board are even reluctant to openly discuss the prospect of China as a security threat to Russia (as evidenced in the July 2010 Vostok exercise), which some analysts cite as an illustration of how unnerved Moscow has become by China’s rise.\footnote{See, for example, Roger McDermott, “Russian Military Doctrine Looks East,” Jamestown Foundation, Eurasia Daily Monitor, February 23, 2010, Volume 7, Issue 36. Prominent Russian security scholar Aleksei Arbatov’s latest book on Russian security also reflects the general cautious thrust of Russian elite assessments of the Russian-Chinese relationship. See “Rosissiya-Kitay: Bespokoinoe partnersstvo,” (“Russia-China: Uneasy Partnership”), Chapter 8, pp. 139-144 in Aleksei Arbatov, Uratnenie bezopasnosti (Security Equations), Moscow, 2010, accessed at <http://www.yabloko.ru/books/arbatov_equation.pdf>.

When Russia looks at China, the potential economic opportunities also seem too great to consider stepping back even a little, let alone to contemplate turning away from what has been such an important and productive relationship for Moscow over the last decade.\footnote{For a detailed discussion of the importance of the relationship for Russia, see Alexander Lukin, “Rosissyo-kitayskije otnoshenija: ne oslablyat’ usilja,” (Russian-Chinese Relations are not losing their force), MGIMO Expert Paper, December 17, 2009, accessed at <http://www.mgimo.ru/news/expert/document130656.phtml>.}

Moscow analysts underscore that Russia will have to find new formulas and mechanisms, beyond its current bilateral agreements and the SCO, to manage relations with China in the next decade. The idea of Russia as a “Euro-Pacific power” proposed by prominent political scientist Vyacheslav Nikonov, and calls for the establishment of dual CIS-EU and CIS-China forums by President Medvedev’s “pocket think tank,” the Institute of Contemporary Development (INSOR), in spring-summer of 2010, are signals that the search for new formulas has begun in earnest.\footnote{Vyacheslav Nikonov, Georgy Toloraya, et. al., “Tikhookeansкая strategia Rossii,” (Russia’s Asia Pacific Strategy), July 8, 2010. Summary accessed at <http://www.riocenter.ru/files/INSOR%20Russia%20in%20the%2021st%20century_ENG.pdf>.

In 2010, energy remains the primary driver in Russia’s calculations about China. As a major energy producer and exporter, Russia seeks “security of demand.” Historically, Europe has provided this, especially with respect to natural gas, but the global geography of energy is changing rapidly. Over the next two decades, Europe’s ability to offer Russia “security of demand” will decline, while China’s ability to do so will increase (although mostly likely on China’s terms). According to the International Energy Agency (IEA), in the period from 2008-2030, all growth in world energy demand will come from non-OECD countries, while OECD demand will fall.\footnote{International Energy Agency, World Energy Outlook 2009, (Paris: Organization for Economic Co-operation and Development/International Energy Agency, 2009), p. 42.} China’s oil demand is expected to increase from 7.7 million b/d in 2008 to 16.3 million b/d in...
2030, accounting for 42% of the growth in world oil demand over this period. In contrast, Europe’s oil demand is projected to fall from 13 million b/d in 2008 to 12 million b/d in 2030. While the IEA expects natural gas demand in both Europe and China to grow over the next two decades, China’s demand is projected to grow faster. The IEA expects China’s natural gas demand to increase from 73 bcm in 2007 to 242 bcm in 2030 and Europe’s gas demand to grow from 544 bcm in 2007 to 651 bcm in 2030.

Unfortunately, Russia’s oil and natural gas export capacity has not kept pace with the new trends in global energy demand. All of Russia’s major oil export pipelines flow west, with 80% of Russian oil exports and almost all of Russian gas exports flowing to Europe through Russia’s extensive Soviet-era energy export and pipeline systems, as well as new pipelines across the Black and Baltic Seas. To meet rising demand in Asia (Japan, and Southeast Asia as well as China) Moscow must diversify Russia’s export markets and develop new routes as well as new energy resources in East Siberia and Sakhalin Island that can supply the Asia-Pacific region. In this respect there is considerable confluence of Russian and Chinese interests. Beijing regards increasing energy imports from Russia as important to China’s own “security of supply” by diversifying its oil suppliers and transport routes away from the volatile Persian Gulf. Russia occupies a prominent place in Chinese thinking about energy security not only because it is located outside of the Persian Gulf, which supplies China with about 45% of its crude oil imports, but also because oil can be delivered overland, avoiding the sealines of communication through which more about 90% of China’s crude oil imports pass.

**BECOMING A EUROPEAN AND ASIAN “ENERGY SUPERPOWER”**

For Moscow over the longer-term, ensuring long-term security of demand through closer energy ties to China should also help cement Russia’s position as a Eurasian (or European and Asian) “Energy Superpower.” Until the global economic and financial crisis coupled with low commodity prices hit Russia, its foreign policy was largely driven by an expansionist energy policy. The concept of Russia as an “Energy Superpower” was identified and discussed in policy circles in 2003-2004, before being formally launched by Deputy Head of the Russian Presidential Administration Vladislav Surkov in February 2006. It found widespread popular appeal inside and outside Russia as energy prices continued growing and resource nationalism tendencies increased among other big global oil producers, including Venezuela and Iran, in 2007-2008. While the concept was initially rejected by President Putin and his successor Dmitry Medvedev as too simplistic, it reflected Russian energy decision-making logic and Moscow’s dual focus on maintaining Russia’s position as the dominant energy supplier in Eurasia and increasing state control over the energy sector. Indeed, Putin himself argued in his doctoral dissertation and subsequent articles in the late 1990s that Russia’s energy resources were an important vehicle for revitalizing Russia’s economy and restoring Russia’s great power status.

Changes inside the European Union (EU) over the last several years, however, have made Russia increasingly insecure about its European gas customers, and led Moscow to view Russia’s energy ties to Europe as a potential hindrance to its “Energy Superpower”
ambitions. Energy pricing disputes between Russia and the Ukraine in 2005-2006 and 2009, and Belarus in 2006-2007 and 2010—resulting in brief supply disruptions to Europe when Russia temporarily suspended pipeline deliveries—have raised considerable doubt in the EU about Russia’s reliability as an energy supplier. Since 2006, the EU has engaged in a critical reassessment of the implications of European dependence on Russian gas, produced a raft of analytical reports about diversifying energy imports away from Russia, and begun to push gas market liberalization and pricing changes that could potentially undermine Gazprom’s dominant market position.42

Russia has tried to push back by playing the “China Card.” Russian leaders have routinely pushed and highlighted their negotiations with Beijing to construct natural gas pipelines to China, and have frequently threatened at the highest levels to divert Russian gas from Europe to China to respond to increasing Chinese demand.43 But, after almost a decade of negotiations, there has been little progress in developing either the fields or the pipelines for Russian gas exports to China, leaving Moscow’s threats to Europe and promises to China ringing hollow.44

One of the major factors delaying the construction of a cross-border natural gas pipeline has been disputes over the gas pricing formula. Gazprom—the Russian state gas monopoly and the only Russian player with the right to export gas to China—has tried to tie the gas price to an energy mix or market spot price for gas. The price of the gas Gazprom sells to Europe, for example, is linked to the price of oil. In contrast, the Chinese have long insisted on tying the gas price to a much cheaper fossil fuel abundant in China, coal. However, the Chinese, who already pay internationally competitive prices for liquefied natural gas (LNG) imports, may be willing to pay higher prices for Russian gas. In March 2010, Zhang Guobao, the head of China’s National Energy Administration, announced that the price at which China would buy natural gas from Russia would be linked to the price of oil, although a final agreement has yet to be signed.45 The persistent price disputes have left Russia’s gas export projects far even from the drawing board, and given Gazprom no incentive to move forward. The only successful Russian export-oriented gas project east of the Urals linked to China is the Sakhalin Island LNG plant off the Pacific Coast, which came into operation in summer 2009 and involves a consortium of international energy companies, not simply Gazprom.46 Given the uncertainties of gas demand in Europe, powerful domestic voices in Russia, such as First Deputy Prime Minister Igor Sechin, continue to press Gazprom to expand gas export capacity in the Far East—but Gazprom demurs.47

RESOURCE RENTS AND UNFULFILLED POTENTIAL

Should Moscow actually succeed in building gas pipelines to China, Russia would be in a position to exert more leverage over Europe. Until then, however, Russia’s pipeline machinations and efforts to play China off against Europe stand instead as an example of the unfulfilled potential of the Russian-

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43 In March 2006, Russia signed a non-binding agreement with the Chinese for the construction of two pipelines to deliver up to 80 bcm of natural gas from West and East Siberia to China. In late 2009, the latest formal agreement between Gazprom and a Chinese company, CNPC, was reached, stipulating the delivery of about 70 million cubic meters of pipeline gas to China starting in 2014-2015. See, Yulia Nazarova, “Sobaka Na Gazovom Sene,” RBC Daily, June 15, 2010, accessed at [http://www.rbcdaily.ru/2010/06/15/tek/486300].
47 As Sechin stressed in a June 10 speech, “As market conditions show, Gazprom must increase the effectiveness of its work by diversifying its markets... We also see the risks linked to one market, and … Gazprom will continue to work with the aim of entering new markets,” cited in Katya Golubkova and Polina Devitt, “Sechin Says Gazprom Must Raise Game,” Reuters, June 20, 2010, accessed at [http://www.reuters.com/article/idUSTRE65J0GA20100620].
Chinese bilateral energy relationship in the 2000s. The most potent symbol of this unfulfilled potential has been the lack of a cross-border oil pipeline. Here domestic Russian constraints—specifically sectoral struggles over rent sharing—played the key role in slowing progress.

For Russia, the development and expansion of economic relations with China has become a critical focal point for both internal and external economic politics. Over the last decade, an increasing array of domestic actors has become involved in deal-making with China hoping to cash in on the burgeoning Chinese demand for Russian commodities. This has broadened and heightened the economic stakes in the relationship, but also brought degrees of complexity that have worked at cross purposes to Moscow’s goals of ensuring further progress in bilateral relations. In Russia, no major deal, especially one involving oil and gas, can be completed without factoring in a complex set of internal, often cross-sectoral and cross-regional, rent-sharing arrangements.48 A state-level Russian economic project—whether it be a pipeline, a railroad link, or a free economic border zone—is unlikely to succeed unless and until a critical number of interested parties secure their ’share’ of the economic pie, often by the government striking a compromise among them. The deliberations and machinations around one of the most important Russian energy export projects in the last decade, the East Siberia-Pacific Ocean (ESPO) pipeline and its spur to China, has been no exception.

Plans for an Eastern pipeline to terminate at the Pacific Ocean date back to the Soviet era and the mid-1970s. The plans were re-surfaced in the form of the ESPO pipeline in the early 2000s, when the then-CEO of Russian oil company YUKOS, Mikhail Khodorkovsky, began lobbying for the construction of a major privately-owned export-oriented oil pipeline to China given the growing potential of the Chinese energy market. At the same time, other energy entities with exploration and production licenses for gas deposits in East Siberia also began lobbying for the construction of a gas pipeline to China (notably TNK and later TNK-BP). These initiatives ran into resistance from the Russian state oil pipeline monopoly Transneft and gas monopoly Gazprom, and opened up a rent-sharing competition over the exploitation of Russia’s vast, but undeveloped, East Siberian mineral deposits and export corridors. YUKOS’s successor company, the state-controlled Rosneft, continued where Khodorkovsky had “left off” (or was forced to leave off when the Russian government arrested and imprisoned him and expropriated his oil company). Rosneft demanded new tax breaks for exploration and production from the Russian government along with infrastructure developments that would make oil exports to Asia profitable.

Subsequently other major economic players outside the tentative state-level bilateral agreements between Russia and China, but with a stake in the outcome, like Russian Railroads (RZD), joined the fray. The head of RZD, Vladimir Yakunin, for example, whose monopoly sector derived significant revenues from the rail transportation of oil as well as other commodities across Siberia to China and the Pacific, lobbied the Russian government in favor of the expansion of regional railroad networks and argued against the construction of the ESPO pipeline.49 RZD ships 20-25 million tons of oil per year to the Russian Far East and China from Western Siberia, and Yakunin and others have suggested that if oil prices remain high enough to absorb rail transportation tariffs, then pipelines are an unnecessary investment.50


The final decision on the ESPO pipeline's construction was a classic example of a Russian resource rent-sharing compromise. Prolonged construction delays and cost overruns for the ESPO pipeline mounted as infrastructural monopolists like Transneft and RZD and other economic players battled it out. The Russian government's decision to build the first phase of the pipeline only to the half-way point of Skovorodino in Russia's Amur Region, for example, allowed Russian Railroads to continue to capitalize on the absence of an oil export pipeline. It ensured RZD could collect additional revenue (rent) from oil shipments until at least 2012 when the ESPO pipeline is expected to be fully operational. The government's decision struck a balance between the interests of Transneft and the Russian Railroads, both major economic players in the region and across Russia. The interests of other key players such as the oil companies Rosneft, TNK-BP, Surgutneftegaz, and Russian regional elites in Siberia and the Far East were also factored in—including the fact that rail shipments imposed higher costs on oil producers than pipeline transit, but ultimately these players had less leverage in Moscow than the more powerful Russian infrastructure monopolies in the short-term. In the end, the global financial crisis spurred key Russian actors in the ESPO pipeline saga to make a final decision about constructing the spur to China, when Transneft and Rosneft found their bottom lines adversely affected by the global credit crunch and the dramatic fall in oil prices in the second half of 2008.51

For China, the lessons and insights the protracted ESPO pipeline negotiations provided for doing business with Russia may now assist Beijing in calling the shots in its future energy relations with Moscow. The Chinese began with a bet on the wrong horse on Khodorkovsky and YUKOS. The “YUKOS affair” taught the Chinese government that it should only negotiate cross-border pipeline projects with Russian state companies that have the clear backing of the Kremlin. After YUKOS’ demise, the Chinese made great efforts to persuade Moscow to still build an oil pipeline to China rather than a pipeline solely across Russian territory to Russia’s Pacific coast. China’s goodwill gestures included the CDB and the Export-Import Bank of China providing Rosneft with a $6 billion loan to pay for its acquisition of a YUKOS subsidiary, Yuganskneftegaz (which Rosneft secured against crude oil deliveries of 180,000 b/d to CNPC from 2005 through 2010), and CNPC subscribing to $500 million worth of Rosneft’s shares during the company’s IPO as well as funding the feasibility study for the ESPO spur and agreeing to reduce the discount on the price of oil for Rosneft’s supply contract.52

The fact that Russian progress on the ESPO pipeline spur to China stalled in spite of these gestures became a source of enormous frustration in Beijing. Chinese officials and oil company executives were generally careful not to criticize Russia publicly in

51 Chinese scholars have frequently flagged the risks Russia runs if Moscow fails to cement bilateral energy relations. See, for example, comments by Professor Lu Nantsyuan, Vice President of the Russia Center at the Chinese Academy of Social Sciences, at the Russian-sponsored WPF Dialogue on Civilizations in Shanghai on July 15-17, 2010, “China's energy market is immense, and for this reason the Chinese market is the most stable of all energy markets. For Russia, losing the Chinese market would be inconceivable,” (… kitayskiy rynok energii ob‘emny, poetomu kitayskiy rynok yavlyaetsya samyi stabil’nym rynkom energetiki. Poterya kitayskogo yavlyaetsya samyi stabil’nym rynkom energetiki. Poterya kitayskogo rynka dlya Rossii, nepostizhima), accessed at <http://www.wpfde.org/images/stories/conf_2010/shanghai_july2010/conference_shanghai_2010_texts.pdf?source=subscribe>. The Russian government’s decision to proceed with building the ESPO pipeline was taken on December 31, 2004. At this juncture, the Russian government did not foresee that other suppliers would emerge as strong competitors to meet China’s rapidly growing energy demand. In 2010, with the Eastern pipeline in its final construction stages, China has substantially diversified its oil import routes, and Russia now finds itself faced by strong competition from major Persian Gulf and Caspian oil producers like Saudi Arabia and Kazakhstan, who are also trying to consolidate their positions in the Chinese energy market. See, for example, the debate about an emerging competition over oil grades between Russia and Saudi Arabia: Sergei Kulikov, “Rossiiskaya Pershina vostochnaya truba nerviruet konkurentov: Saudovskaya kompaniya idet na skidki, chtoby ne ustupit’ Rossii dolu na aziatskom neftyanom rynke,” (… kitayskiy rynok energii ob‘emny, poetomu kitayskiy rynok yavlyaetsya samyi stabil’nym rynkom energetiki. Poterya kitayskogo rynka dlya Rossii, nepostizhima), accessed at <http://www.wpfde.org/images/stories/conf_2010/shanghai_july2010/conference_shanghai_2010_texts.pdf?source=subscribe>. The Russian government’s decision to proceed with building the ESPO pipeline was taken on December 31, 2004. At this juncture, the Russian government did not foresee that other suppliers would emerge as strong competitors to meet China’s rapidly growing energy demand. In 2010, with the Eastern pipeline in its final construction stages, China has substantially diversified its oil import routes, and Russia now finds itself faced by strong competition from major Persian Gulf and Caspian oil producers like Saudi Arabia and Kazakhstan, who are also trying to consolidate their positions in the Chinese energy market. See, for example, the debate about an emerging competition over oil grades between Russia and Saudi Arabia: Sergei Kulikov, “Rossiiskaya Pershina vostochnaya truba nerviruet konkurentov: Saudovskaya kompaniya idet na skidki, chtoby ne ustupit’ Rossii dolu na aziatskom neftyanom rynke,” (Russia’s Eastern Pipeline Unnerves Competitors: Saudi State Company Initiates Discounts not to Lose Share on the Asian Oil Market to Russia), Nezavisimaya Gazzeta, August 6, 2010, <http://www.ng.ru/economics/2010-08-06/4_tube.html>.

CNPC was further angered by attempts by Rosneft to change the terms of their 2005 crude oil delivery contract, which CNPC regarded as a well-deserved reward for helping Rosneft out in the company’s time of need. As oil prices rose in 2007, Rosneft tried a variant of Russian efforts to play China off against Europe in gas deals, by claiming that it was now more profitable to sell oil to Europe than to China. Rosneft pressured CNPC to reduce the contract price of a $3 per barrel discount on the price of Brent crude. A protracted dispute ensued, with Rosneft executives warning CNPC that the company would not extend the supply contract after its expiration in 2010 unless the oil price formula was revised. Fearing the ESPO spur would be even further delayed, CNPC agreed to reduce the discount by $0.675 per barrel.57

BARGAINING POWER SHIFTS TO BEIJING

This 2007 episode proved a bittersweet and short-lived victory for Moscow. In the second half of 2008, the global financial crisis and the collapse in the price of oil (from a high of $147 per barrel in July 2008 to below $40 per barrel in December 2008) shifted the bargaining power in the bilateral energy relationship from Russia to China. The lower oil price environment and the global credit crunch undermined both Rosneft’s and Transneft’s capacities to service short-term debt and maintain their investment programs, which for Transneft included the completion of the ESPO pipeline. The Chinese were quick to capitalize on their newfound position of strength—agreeing to lend a combined $25 billion to Rosneft and Transneft, in exchange for the construction of the ESPO spur and a supply contract for the delivery of 300,000 b/d from 2011-2030 to fill it. While many international media reports focused on the conclusion of the long-term supply contract—seeing it as an example of China “locking up” oil supplies around the globe—the real prize for Beijing was the cross-border pipeline.58

In many respects, the global financial crisis and other recent changes in global energy markets may have left Russia a slightly diminished “Energy Superpower” in 2010 than it was before. Both Europe and China seem to need Russia less to meet their energy supplies than they thought they did in the 2000s. European gas demand fell with the economic downturn, and China’s “loans-for-oil” deals with other major resource holders, including Brazil, Venezuela, Turkmenistan and Kazakhstan, reminded Russia...
that China has many options to ensure its long-term security of energy supplies. Recent developments in shale gas in the U.S.—although the full prospects and their implications are still far from clear—and additional prospects in Europe and Asia are adjusting scenarios for global gas production and demand even further.

If shale gas reserves in the United States are as extensive as they seem to be, the United States will not need to import large amounts of LNG from global gas suppliers, as previously projected. This reduces the competition in global LNG markets for both Europe and China—an energy niche where Russia remains, and is likely to remain, weak. China may also have significant shale gas, which—along with the availability of more gas from Central Asia and more global LNG supply—may reduce Chinese interest in gas imports from Russia. Over the long-term, if developments unfold along this scenario, Russia has fewer options for diversifying its gas exports and expanding into East Asian energy markets, and Moscow is left with an increasingly competitive European market as its primary gas export market. Shale gas deposits in Europe are still very much in the “potential” category, but could also over the longer-term portend a further decline in European demand for Russian gas.59

TRYING TO MOVE BEYOND “THE SIBERIAN CURSE”

These developments pose an acute dilemma for Russia as it seeks over the next decade to satisfy its ambitions to tap into the dynamism and growing economic potential of the Asia-Pacific region. The development of East Siberian resources and the broader development of Siberia and the Russian Far East has been a long-term strategic priority for Moscow, with elaborate plans dating back to the Soviet period.60 Since May 2008, high-profile and high-cost energy infrastructure projects in Siberia have been championed and driven by strong political, regional and industrial lobbies in the Kremlin and the Russian Government, as well as in the Russian parliament, and highlighted in presidential visits to the region.61 However, demographics are also a critical driver in all these plans for Siberia.

Russia’s natural population growth rates (in terms of the number of births over deaths) have been in decline since the early 1960s. From 1992-2009, the population itself—which currently stands at just under 142 million—declined every year by about 0.5%, in spite of considerable migration into Russia from neighboring states, including Central Asia.62 For Russia, the implications of a declining population are not simply in the raw numbers, which will have an impact on issues like military conscription and the future labor force. Russia’s regions have been differentially affected by the changes in population. While all Russian regions in the Urals, Siberia and the Far East, and even in the northwest around St. Petersburg, have suffered from significant population decline, two regions have seen a substantial population increase (both through internal migration and increases in birth rates), Moscow and southern Russia.

Over the next decade, Russia’s geopolitical profile will be dramatically altered by its population decline and shifts. The Russia of 2010-2020 will be increasingly concentrating (population-wise) in Moscow and the Southern Federal District, but with a more sparsely populated vast expanse of territory extending out from Moscow through a string of isolated

cities surrounded by empty hinterlands across the Urals to China and the Pacific. Under these circumstances, the “empty” Far East will be an area of great policy sensitivity for Russia. The population in the Russian Far East now totals 6.5 million across an area covering fully one third of Russia’s territory. In stark contrast, the Chinese province of Heilongjiang, just across the border along the Amur River has a population of 38.1 million (up from 36.9 million in 2000). As Russians have migrated from the Far East and East Siberia to West Siberia and European Russia, Moscow has tried to devise strategies to retain population in the East.63

These strategies and the imperative to develop energy resources have dovetailed into a costly long-term program for the reindustrialization of Siberia and the ‘re-connection’ of Russia’s East Siberian and Pacific regions to the European core.64 Notably, Gazprom and Russian Railways/RZD have embarked on major programs for gasification and railroad construction in the Russian Far East. Moscow is also investing billions of dollars developing “Russky Island” off the coast of Vladivostok in preparation for hosting the APEC 2012 Summit; and constructing infrastructure to support a major tourist resort and economic zone that will boost regional development as well as (Moscow hopes) send a signal that Russia intends to cement its position as an economic and political power in the Asia-Pacific region.65 “There is even an idea floated in some Russian political and analytical circles to build a new Russian capital from scratch in Southern Siberia or to relocate the capital from Moscow to the Siberian city of Tobol’sk to “re-balance” the country, and counter the growing economic and demographic presence of China.”66 China looms over all these endeavors, either as the spur to, or the specter behind, Siberian development.

**CONCLUSION**

The challenges and opportunities that China presents to Russia are likely to increase as China continues its rise as a global economic and political power. Russia’s efforts to take advantage of the opportunities while managing the challenges of dealing with China are most visible in the energy arena. On the one hand, China has the ability to substantially expand its role as a guarantor of Russia’s “security of demand,” as demand in Russia’s traditional market, Europe, declines. On the other hand, a dramatic expansion of Russian energy exports to China will undoubtedly heighten fears in Russia about truly becoming a “resource appendage” to China—an unwelcome development that, in the minds of some Russians, would cement Russia’s status as the junior partner in the bilateral relationship.

Despite the 2009 groundbreaking “loans-for-oil” deal, the development of Russia-China energy relations is likely to continue to be a slow, bumpy road. Indeed, the “loans-for-oil” agreement took four

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64 Russian Minister of Industry and Energy Viktor Khristenko, for example, has called for turning Siberia into a “vostochnyi platsdarm” or eastern bridgehead for Russian development, while former Governor of Krasnoyarsk Alexander Khloponin (now the Kremlin’s envoy to the North Caucasus) has pushed for a “vторая индустриализация Сибири” or second industrialization of Siberia to rival the region’s development in the 1970s. See, for example, Viktor B. Khristenko, “Energeticheskaya strategiya Rossii: proryv na Vostok,” (Energy Strategy of Russia: Breakthrough to the East), *Vedomosti*, February 7, 2006, accessed at <http://www.vn.mid.ru/ru-p8.nsf/5866d44d0bd2dc7c3257110035f2d8/OpencDocument>; and Olga Proskurina, “Eto vtoraya industrializatsiya Sibiri,” (This is the Second Industrialization of Siberia), Interview with Alexander Khloponin, *Vedomosti*, March 16, 2005, accessed at <http://tayga.info/press/20050316/90790>.


66 See the discussion of a new Russian capital in Siberia in the political program of the Drugaya Rossiya (Other Russia) Party in *Rossiskaya Gazeta*, July 20, 2010, accessed at <http://www.rg.ru/2010/07/20/programma-dok.html>. In addition to the importance of “balancing” the geographic, economic, infrastructure and political “distortions” (perekosy) that pull Russia toward the West, the authors cite the potential benefits of creating millions of new jobs and reversing Russian unemployment with such a grandiose project. Stopping the expansion of China (“Ostanskiy ekspansiyu Kitaya”) is an explicit aim.
rounds of tough negotiations from October 2008 through February 2009 for the two sides to reach a consensus on the terms of the multiple agreements that comprise the deal, even though there was strong support from top leaders in both China and Russia. In addition to hard bargaining by both the Russians and the Chinese, Russian internal struggles over rents, and anxieties about literally fueling China’s rise given the threat China is perceived to pose to the Russian Far East, will probably sustain the “one step forward, two steps back” pattern, already established, in bilateral energy cooperation.

Moreover, the competition between Russia and China for control over access to Caspian and Central Asian energy resources is likely to increase. Oil and natural gas pipelines constructed between Central Asia and China over the past decade have bound the exporting and transit states closer to China, and have already begun to erode Moscow’s economic and political influence over its “Near Abroad,” especially Turkmenistan. China, at least in the near-term, is much better positioned than Russia to finance additional investments in Central Asian energy resource and infrastructure development, which will likely further weaken Russia’s grip on the economic and political fortunes of the region. China’s growing economic footprint in Central Asia dovetails with the objective of many regional states to balancing all the outside powers against each other. Central Asian states will probably continue to welcome China’s economic presence in the region as a counterweight to Russia, but they will also try to ensure that China does not eventually also occupy “too dominant” a position in their economies.

In spite of the evident improvement in Russia-China relations in 2000-2010 and the often effusive statements by top Chinese and Russian leaders in praise of the bilateral relationship, resentments and frustrations in both countries over energy, increasing competition for Central Asian energy resources and export routes, and Russian anxiety over China’s growing power, make it difficult to envision the development of a sustainable Russian-Chinese strategic partnership that offers Russia an alternative to its relations with Europe or the United States. Although the specter of a new Russian-Chinese alliance, lubricated by robust oil and natural gas trade, has haunted some Western analysts, Russia and China are no more natural partners than Russia and the United States, or China and the United States. As China continues to rise and the relative balance of power between the two countries continues to shift in China’s favor, patterns of competition will cast a shadow over those of convergence.
APPENDIX I

RUSSIAN-CHINESE ENERGY COOPERATION HIGHLIGHTS 1991-2010


1998-2000  Russia’s newly-formed and consolidated private oil companies and its state-owned gas monopoly, Gazprom, increase their oil and gas output. The most dramatic rise in output comes from ageing Russian oil fields in Western Siberia.

2001-2002  YUKOS Oil Company CEO Mikhail Khodorkovsky ships oil by rail to China and pledges to build the first Russian private oil export pipeline from Angarsk in Russia’s Irkutsk Oblast to Daqing in northwestern China. At the same time, the Russian Foreign Ministry and Russian energy companies begin a different game of energy diplomacy with Japan as well as China—pledging support for greater energy cooperation with both countries, and effectively playing the two Asian neighbors against each other for the next several years.

2003      YUKOS continues its lobbying efforts to export oil to China, but Russia’s state-owned oil export pipeline monopoly, Transneft, prohibits private ownership of the proposed Angarsk to Daqing pipeline.

2003-2004  Mikhail Khodorkovsky and other YUKOS principals are arrested and imprisoned on a range of charges, including fraud, tax evasion, and money laundering. A major state-owned oil company, Rosneft takes over YUKOS’ major subsidiary and its primary prospective source for oil exports to China, Yuganskneftegaz (YNG), in a late December 2004 auction. In the gas sector, the Russian government, Gazprom, and the government of Russia’s Irkutsk Oblast order the revision of another pipeline project, championed by TNK-BP, which would export gas from Siberia’s giant Kovykta gas field to China. Russian state and regional government structures insist that the “gasification” of Irkutsk Oblast’s electric power sector should first be a precondition for the approval of any export pipeline to China. The Kovykta project management (where TNK-BP is the majority stakeholder) resists the pressure to transform Kovykta into a domestic Russia gas project instead of an export-oriented project.

2004-2005  Rosneft gradually replaces YUKOS as the primary supplier of oil to China after taking over YNG and further expanding its operations in Eastern Siberia. Rosneft continues to ship oil to China by rail as global oil prices increase. The decision to construct a ‘more cost effective’ pipeline directly to China is put on hold by the Russian government and pipeline monopoly Transneft, and the Russian government instead proposes the construction of a pipeline across Eastern Siberia to a Russian port and terminal on the Pacific coast—the East Siberia-Pacific Ocean pipeline project, or ESPO.
<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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<tr>
<td>2006</td>
<td>Gazprom takes a stake in the Kovykta gas project, weakening the position of TNK-BP, and asserts its right to take charge of any prospective gas export pipeline to China. Then Russian President Vladimir Putin also proposes the construction of another gas pipeline, the so-called “Altai pipeline,” to China with a projected completion date of 2011. The project is subsequently shelved pending the resolution of gas pricing disagreements between Russia and China.</td>
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<td>2006-2007</td>
<td>Russian officials (President Putin, Minister of Energy and Industry Viktor Khristenko, Governor of Krasnoyarsk Krai Aleksandr Khloponin, Governor of Irkutsk Oblast Aleksandr Tishanin, and others) propose ambitious plans for the “second industrialization of Siberia,” including the development of critical infrastructure—roads, railroads, pipelines—to tap the rich mineral and hyrdocarbon deposits of East Siberia.</td>
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<tr>
<td>2008</td>
<td>The Russian economy is hit by the global economic and financial crisis and falling oil prices. Transneft and Rosneft borrow $25 billion from the China Development Bank to finance the construction of the ESPO pipeline and enable them to restructure their debts to Russian and Western banks. The loans are guaranteed against future oil deliveries.</td>
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<td>2007-2009</td>
<td>Russian state-owned monopolies Transneft and Russian Railroads (RZD) conclude an agreement to phase the construction of the ESPO pipeline. The first leg of the pipeline to Skovorodino will include a spur to the Chinese border (which will be extended to Daqing, similar to the original YUKOS proposal). The second leg of the pipeline will be built from Skovorodina to Russia’s Pacific coast. In the meantime, RZD will continue to transport oil across Russian territory to Kozmino Bay near the Russian Pacific city of Nakhodka, where oil is loaded onto tankers for further shipment.</td>
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<td>2010</td>
<td>Russian annual oil exports by rail and ship to China are projected to reach some 15 million tons. Russia is still on schedule to complete the pipeline spur to China by the end of the year, and on August 29, 2010, Vladimir Putin officially opened the Russian section of the ESPO pipeline spur to the Chinese border. Prospects for larger volumes of oil exports to China remain unclear, while gas pipeline construction is further delayed beyond 2015.</td>
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ADDITIONAL BACKGROUND INFORMATION

The East Siberia-Pacific Ocean (ESPO, or VSTO in its Russian acronym) pipeline was planned to deliver up to 80 million tons (mt) of Russian oil annually from West and East Siberia to Russia’s Pacific coast to connect with Asian maritime export routes, as well as to transport oil to China through a spur approximately half-way along the length of the 4800 km pipeline. On completion of the first stage of construction from Taishet to Skovorodino (2757 km) in 2011, Russia plans to export up to 30 mt of oil through the ESPO pipeline, of which at least 15 mt would be destined for China (equivalent to the volume projected for shipment by rail from Russia to China in 2010).1

The construction of the first stage began in 2006 and includes the spur pipeline to China, which will run from Skovordino to Daqing. After a number of technical, environmental, and financial delays, this first stage is projected for completion by the end of 2010. Construction of the second stage, from Skovordino to Russia’s Kozmino Bay Terminal (2046 km), began in January 2010.2 Russia’s state-owned pipeline monopoly, Transneft, which is in charge of all stages of construction, has set a completion date for the end of 2013. In an eventual third construction stage, the capacity of first leg of the pipeline to Skovorodina will be upgraded from 30 mt per year to 50 mt.

Since its inception, the ESPO pipeline project has been plagued by cost overruns. The final costs for the first stage of the pipeline are estimated at about 420 billion rubles, with an additional estimate for the second stage in the range of 350 billion rubles.3 The costs for the second stage will increase if the construction of the Kozmino Bay oil terminal, and the necessary associated infrastructure for laying the pipeline across multiple river crossings and other obstacles on its route, are also factored in.4 The total cost for the entirety of the ESPO pipeline project and all the supporting infrastructure may fall in the range of 900 billion rubles (30 billion USD). This would be an unprecedented figure for any post-Soviet Russian infrastructure project and triple the original Russian state estimates from the mid-2000s.5 Corruption has been a significant factor in these cost overruns at all stages of the project, as the pipeline construction company, Transneft, itself, has documented and cited in numerous internal and external reports.6

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1 Transneft President Nikolai Tokarev has projected that 29 mt of oil will actually be pumped through stage I of the pipeline to both China and Russia’s Kozmino Bay Terminal in 2011. See, Nikolai Tokarev, interview with Argus Media, February 18, 2010, accessed in Russian at <http://www.transneft.ru/news/newsitem/?id=9758&category=3838>.
2 Russia’s Kozmino Bay Terminal is already in use for the maritime transshipment of Russian oil brought to the port by rail. In the first 7 months of 2010, Russia exported 8.5 mt of oil through Kozmino Bay. See ANGI, August 13, 2010, accessed at <http://angi.ru/news.shtml?oid=2765511>.
4 That is at least 60 billion rubles in additional costs according to Russian media sources. See, for example, Expert, February 17, 2009, accessed at <http://www.expert.ru/news/2009/02/17/kredit_neft>.
5 Based on an average exchange rate of 30 rubles per 1 USD.
Once the second and eventual third stages of the ESPO pipeline are completed, actual export volumes will depend on a number of factors including oil demand in China and other Asian countries, fluctuations in global oil prices, and the Russian oil sector’s own capacity for intensifying oil production in new fields in East Siberia or diverting West Siberian oil from existing export markets in Europe to Asia. The oil pricing issues that have marred Russian-Chinese energy cooperation over the last several years appear to have been resolved for Russian oil exports to China through the ESPO Skovorodino-Daqing spur by a formula tied to the market price for oil. This formula was agreed on during negotiations over the China-Russia “loans-for-oil” deal in 2008-2009. New issues have emerged, however, that will require further scrutiny. Russia has established a new oil grade (“ESPO Crude”) for the blend of crude oil exported through the ESPO pipeline for the Asian market, which may also eventually set a new Asian oil standard. The potentially high-quality grade of East Siberian crude oil and the relative proximity of Russia’s East Siberian oilfields to China, Japan and South Korea will bring Russia into direct competition with the major Middle Eastern oil exporters to the Asian markets. Russia is also proposing to build refineries for ESPO pipeline oil on its territory and in China to expand its export options. All of these proposals will add new international dimensions to Russian-Chinese energy relations in the decade ahead.

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7 Given current domestic and export obligations, the Russian oil sector will need to step up production in existing oilfields and draw oil both from the large Vankor field in Krasnoyarsk Krai in Central-East Siberia and the Samotlor field in the Tyumen Oblast of West Siberia. In 2012, Transneft plans to build new East-West and North-South pipeline connectors from Vankor to Purpe (in the Yamalo-Nenets Autonomous Okrug, which falls within Tyumen Oblast) and then from Purpe to Samotlor. These pipelines will be capable of transporting up to 25 mt of oil per year and will ultimately connect to the ESPO pipeline. See Transneft press release, October 22, 2009, accessed at <http://www.transneft.ru/news/newsitem/?id=9014>.


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One Step Forward, Two Steps Back?

The Realities of a Rising China and Implications for Russia’s Energy Ambitions

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