A Grand Bargain

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In the run up to this week's meeting between Russian President Vladimir Putin and Chinese President Xi Jinping, expectations had run high that 20 years of discussions could be concluded with an agreement for Russia to pipe natural gas to China. Russia's deputy energy minister even stated last week that a contract was "98% ready." The long history of inconclusive China-Russia negotiations on the issue suggested that his was an overly optimistic view. As it turned out, Beijing and Moscow defied the sceptics and yesterday inked an agreement reportedly worth US$400bn under which China will receive 38 billion cubic meters (bcm) of gas annually in a 30 year arrangement that is slated to start in 2018.

Since 2006 Chinese imports of natural growth have risen from 1bcm to 53bcm

There has long been a clear logic for both Russia and China to do a deal on gas. Gazprom, the dominant Russian gas producer, has an imperative to diversify its exports away from Europe, where demand growth is sluggish, and countries continue to look for alternative supplies. In addition, the China pipeline is viewed in Moscow as a tool to spur economic and population growth in the Russian Far East, one of the least developed regions of the federation. For Beijing, the issue has been China's rising dependence on gas imports. Between 2006 and 2013, its gas demand tripled from 56bcm to 169bcm, and imports jumped from less than 1bcm to 53bcm. Deliveries from Russia would not only help fill China's supply gap, but also diversify its portfolio of natural gas imports.

This logic became even more compelling in the months before the summit. Putin's gambit in the Ukraine has left Russia isolated from the United States and Europe and upped the ante for Europeans to diversify their gas imports away from Russia (even though there are no short-term alternatives), making a gas deal with China even more attractive for short-term political and long-term economic reasons. The appeal of a bilateral gas pact has undoubtedly increased in China, too, thanks to the country's poor air quality, which prompted Premier Li Keqiang to declare a "war on pollution" during the National People's Congress in March. For many Chinese officials, expanding the use of natural gas is regarded as a key weapon in the fight for cleaner air.

It's all about the price

CNPC would not want another loss-making pipeline deal

Price had been a formidable obstacle to reaching an agreement. China National Petroleum Corporation did not want to pay more than it pays Central Asia suppliers who account for most of China's pipeline imports. Given that CNPC's internationally-listed subsidiary, PetroChina, lost US$4.5bn in 2013 on pipeline imports (plus another US$3.3bn on liquefied natural gas imports) due to low domestic sales prices that prevented the company from passing on the full cost of its imports. So CNPC's reluctance to pay a higher price for Russian gas than Central Asian gas is understandable. Gazprom, however, has been unwilling to sell gas to China for less than the price at which it sells to Europe. Moreover, selling natural gas to China at a price equal to or lower than that at which Turkmenistan sells gas to China would be a bitter pill for Gazprom to swallow. Not only did Turkmenistan beat Russia to the China market, but its gas exports to China have increased its autonomy from Moscow.

Both sides have a strong incentive not to reveal the agreed price...

Neither China nor Russia has revealed pricing details. There are two probable reasons for this: firstly, both sides will have had concerns about such information adversely impacting existing supply arrangements with third parties. For example, if CNPC agreed to pay a substantially higher price for Russian gas than it does for Turkmen gas, then the Turkmens might seek to renegotiate their own supply contracts. Second, there is an important element of political theatre to the deal. Keeping the price a secret allows Russia and China to present the agreement as an unambiguous "win-win". This is especially important for Putin given widely held assumptions in the weeks leading up to the summit that he was bargaining from a position of weakness (see **How To Lose The Eastern Front**). But it is also important for China not to be seen, at home and abroad, as having come off second best given the consensus among informed observers that Beijing held the better hand in the negotiations.

Failure to report a transacted price has forced analysts to try and back out an implied price, with estimates ranging from US$350 to US$390 per thousand cubic meters, a spread almost wide enough to encompass the long held negotiating positions of the two sides. However, a back-of-the-envelope calculation based on the reported deal value (US$400bn), volume (38 bcm per year) and contract term (30 years), yields US$350 per thousand cubic meters. If correct, one explanation for such a low price is that the deal does not involve equity participation in a Russian gas field for CNPC, something Chinese negotiators had reportedly sought.

...both sides can claim a win in the negotiations

Nonetheless, China and Russia both have reason to claim that they emerged victorious. For China, the pipeline implies greater natural gas security both in terms of a more diversified portfolio and more imports to fill the growing gap between domestic demand and supply. The deal also demonstrates the commitment of the Chinese leadership—and CNPC—to meet domestic demand for cleaner fuels. For Russia, the deal provides some security of demand at a time when European economic growth is sluggish and Europeans are talking about the desirability of non-Russian natural gas supply options.

The contract may also pay some short-term political dividends for Russia in terms of demonstrating to audiences at home and abroad that the country is not internationally isolated. Not only did the Chinese treat Putin to a state visit, but they also gave him a big diplomatic deliverable that more closely links Russia to the world's premier emerging power.