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Russia's Energy Shift to the East: Should Europe Be Worried?

Should the West worry about Russia's growing oil and gas exports to the Asia-Pacific region? Michael Bradshaw doesn't think so. While Vladimir Putin may want to shift his energy business from Europe to China, Gazprom needs Western revenues to build the desired pipeline infrastructure.

By Michael Bradshaw for ISN

The 30-year gas deal between Russia's Gazprom and China's National Petroleum Corporation (CNCP), signed last May, for the supply of 38 billion cubic meters (bcm) of pipeline gas from 2018 onwards, marks the culmination of a decade of negotiations. Last year it was announced that everything was agreed but the price. No doubt the West's reaction to events in Ukraine focused minds in Moscow to make sure the deal was done. Although the financial details of the agreement are unknown, the price is thought to be in the range of $350-$380 per thousand cubic metres -- about the average price that Gazprom charges to its European customers. At the time, Gazprom stated that the contract contains a "price formula linked to oil prices" and a "'take-or-pay' clause,'" which suggests an agreement akin to those that dominate Gazprom's exports to Europe. An investment of $55 billion is required in Russia to develop the fields at Chayanda (in Sakha-Yakutia) and Kovytka (in Irkutsk) and to build the 'Power of Siberia' pipeline to the border at Blagoveshchensk. To assist in the development phase, China will provide a loan of $25 billion. To prevent Russia from being reliant on a single buyer, the pipeline will also continue to Vladivostok where it will feed Gazprom's planned Vladivostok LNG (Liquefied Natural Gas) plant.

Not surprisingly, this agreement has been dubbed Gazprom's 'Deal of the Century.' Nevertheless, there may be much more to come.

More on the way

There are indications that an agreement for the additional 30 bcm may be signed by the end of the year. The original inter-governmental agreement signed in 2006 envisaged a total of 68 bcm of gas being exported via two corridors: the eastern corridor that is the basis of the initial agreement and a western corridor that would bring gas from West Siberia to China via the so-called Altai route. The gas from West Siberia would feed into an expanded 'West-East Gas Pipeline' that would bring additional gas from Central Asia. To help address the country's chronic air pollution problems, the Chinese Government has demanded a substantial increase in the domestic use of natural gas. Securing such a substantial amount of pipeline gas to supplement domestic production and the import of LNG into

coastal regions will go some way towards doubling the amount of gas used – from 5 percent today to 10 percent by the end of this decade, and again to 20 percent by 2030.

The Chinese Government also hopes that domestic shale gas production can make a significant contribution, but so far progress has been slow and production estimates have recently been downgraded. Dr Keun-Wook Paik, from the Oxford Institute for Energy Studies, estimates that between 2020-25 the total volume of pipeline gas imported into China could be as high as 160-165 bcm, with 68 bcm coming from Russia (in 2013 Russia exported 130 bcm to Europe). As China also has ambitious plans to expand domestic production and can always build additional LNG import capacity, it can easily hedge against Russia, using its gas supplies for geopolitical gain. China has clearly seized on Russia's current problems with the West to strike a good deal on gas.

Siberia for sale

Russia's desire to expand its economic ties with the Asia-Pacific region is a long-standing theme. In fact, it goes back to the Soviet period when a series of inter-governmental agreements between the USSR and Japan opened up trade in forestry and coal and financed the initial oil and gas exploration offshore of Sakhalin. Expanding energy ties with the Asia-Pacific is enshrined in Russia's Energy Strategy and the targets were recently revised ahead of publication of a new strategy next year. The aim now is to increase the share of total Russian oil and gas products going to Asia from 12% to 23% by 2035 (including 32% of crude oil exports), and to increase gas exports from 6% (which is the Sakhalin-2 LNG project) to 31.5% by 2035, with the volume of LNG exports rising to 30 mtpa (41 bcm) by 2020 and to 100 mtpa (138 bcm) by 2035.

Expansion of oil exports to the Asia-Pacific predates the current gas deals. In the aftermath of the 2008 crisis the completion of the East Siberia Pacific Oil pipeline (ESPO) was financed by deals with Rosneft and Transneft that saw Chinese finance provided in return for deliveries of oil. Rosneft has since expanded this agreement and most recently offered 10 percent of its Vankor oilfield to CNCP. This latest deal, worth $1 billion, has likely been prompted by Rosneft's need to raise finance in the light of Western sanctions. Again, an example of how Western sanctions are promoting the expansion of Russia's energy relations with Asia. Rosneft is also reported to have offered India's ONGC a share in its Yurubcheno-Tokhomskoye oilfield in East Siberia. It almost seems as if the current situation has prompted a garage sale of Siberia's oil and gas resources**.**

The race for LNG exports is on

In late 2013 the Russian Government approved a limited liberalization of LNG exports. Previously Gazprom had a monopoly on all of Russia's gas exports. The legislation permits LNG exports from Novatek's Yamal LNG plant, which is currently under construction, and from Rosneft's planned Far Eastern LNG plant on Sakhalin Island, where Gazprom has already made a final investment decision on the Vladivostok LNG plant and is also considering the expansion of Russia's only operational LNG plant at Prigorodnoye on Aniva Bay in the south of Sakhalin, which is part of the Sakhalin-2 project. By 2020 there could be 15 mtpa of new LNG capacity in the Russian Far East, to add to the 10.8 mtpa currently in operation. The Yamal LNG plant in West Siberia is also targeting Asian markets during the summer months via the Northern Sea route and could add at least another 5 mtpa. However, it remains to be seen if they will all be built on time. Gazprom and Rosneft are involved in a very public argument over the best way to bring Sakhalin's additional gas to market. For various reasons, there may not be enough gas available in time for all the projects to be completed by 2020. If we were to assume that the 30 mtpa target is met and that a second pipeline deal is done, then in the early 2020s Russia could be exporting over 100bcm of gas to the Asia-Pacific region.

Should Europe be worried?

Does the eastward expansion of Russian oil and gas exports present a challenge to Europe? In the case of oil, the real issue is whether or not Russia can satisfy the contracts it has with China, plus exports to the Pacific, in addition to domestic demand and exports to Europe. The current sanctions may hamper Russia's ability to develop new fields, and the existing old fields are rapidly declining. The result may well be a fall in Russian exports to world markets. The situation with gas is rather different as there is currently a gas glut in Russia, and Gazprom has slowed the pace of new field development in the face of competition from Novatek and the oil companies. Gazprom has more than enough reserves to meet its obligations to Europe—where the market is unlikely to grow and may yet decline—and its new supply commitments in Asia. The question is whether it has the capacity to finance and complete all of these projects in a timely and cost-competitive fashion.

Putin may wish to link the pipeline networks so that he can threaten to send Europe's gas to Asia. The reality, however, is that Gazprom cannot afford to lose revenue from its exports to Europe, as that is needed to finance its new projects including the South Stream pipeline to bypass Ukraine. When it comes to LNG, there are likely to be delays in completing the projects and there is stiff competition from established suppliers as well as new projects in Australia, North America and East Africa. When it comes to pipeline gas, this means that Europe has little to worry about in relation to Russia's plans in the east. Furthermore, if the expansion of gas exports to the Asia-Pacific helps to slow the rate of coal consumption, then everyone wins as it will help to reduce global carbon emissions.

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