

Mr Xi in Moscow

27 March 2013

Summary

Last weekend's Sino-Russian Summit was Xi Jinping's first foreign trip as Chinese President. The choice of Moscow was more than symbolism. It was a marker in a rapidly evolving relationship in which the politics and economics of energy are increasingly complex and central.

Emerging economy high politics will inevitably be dominated this week by the BRICS Summit in Durban, with its sweeping but notably non-committal promise of a realignment of the balance of global economic power. But the more interesting BRICS diplomacy of the week was the bilateral visit of Xi Jinping to Moscow last weekend. Given that he and Putin were scheduled to meet in Durban, the fact that Xi chose Moscow for his first international trip as President was a mix of symbolism and substance.

As he did in the US last year, Xi projected a good-natured openness and a respectful desire to please Mr Putin. Mr Putin in turn offered the not insignificant compliment of showing up on time, and conducting the meeting in the Kremlin with the full state trappings rather than at his residence outside Moscow, as has become the norm. The Summit concluded with the now-obligatory commitment to double trade flows (by 2020, in this case) and a large number of 'cooperation agreements' on everything from banking to rabbit husbandry. Last year's bilateral agreement on the protection of military intellectual property also helped encourage Moscow to agree the sale of 24 Su-35 fighter jets and four submarines to Beijing.

But the key questions at the summit were about the Russian Far East, and the economics of energy in particular. For Russia, China is increasingly looking like a key part of the financing mix for the development of its Far East, both as an investor and a

customer. For China, the relationship might be summed up in four words: oil, gas, coal and water.

Russian infrastructure, Chinese problem

In these key areas this summit reinforced some developing trends for Russia and China. China is still interested in the cash-for-commodities arrangements of the last decade, like the Rosneft/Transneft deal of 2009. These were usually based on long term loans for stable supply arrangements for coal or oil, often at prices that were highly advantageous to China, but which gave Russia long term demand guarantees. EN+ and Shenhua have just agreed a similar \$2bn loan for coal development. At the summit, China agreed in to buy at least 38bcm in gas over 30 years from 2018 (with an option to increase this to up to 60bcm), and for the first time accepted the principle that the price would be linked to market spot prices. However, the details of this deal - including whether it will include a loan for the development of the extension of the future 'Power of Siberia' pipeline that would make it possible - have yet to be agreed.

But what China increasingly wants now, in Russia as elsewhere, is participation in exploration and extraction markets. As a growing downstream price-taker in energy, it is looking increasingly for exposure to upstream price-making through extraction and refining both on and offshore and both in Russia and China. Russian oil and gas company, Rosneft, recently became the first foreign company allowed to form a

JV (49:51) with China's CNPC to build an export-licensed refinery in Tianjin. Rosneft has agreed to a joint exploration programme with CNPC in several fields in Eastern Siberia and the Arctic, and there is now talk of Sinopec extending its participation in the consortium exploiting the Sakhalin 3 field in Eastern Russia. As China determines the price for investment support or long term supply arrangements, this kind of upstream role will increasingly be part of the deal.

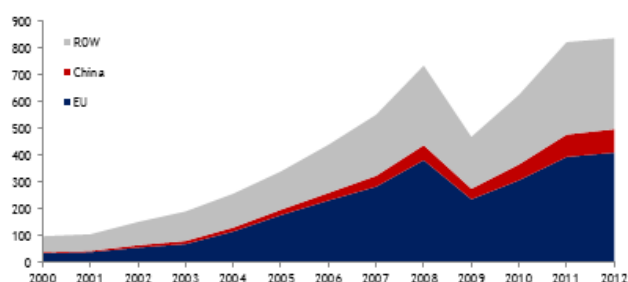


Fig 1: Evolution of Russian total trade volumes: EU, China and Rest of the World (\$bn)

Source: Russian Customs Service, Rosstat

In this respect, Beijing knows that Russia's infrastructure can become its strategic problem. For gas, the 'Power of Siberia' pipeline still does not cross the border. The only major oil pipeline is the East Siberia-to-Pacific Ocean (ESPO) pipeline which still operates at less than full capacity. Igor Sechin of Rosneft said during the summit this week that Russian oil exports to China could rise to more than 350 million barrels annually over the next twenty five years. This would imply serious new infrastructure capacity, or a dramatic up-scaling of routing through Kazakhstan, or oil shipping south out of pipeheads such as Kozmino in Primorsky Krai.

Hence the basic strategy of development loans for supply of the last decade, and the fact that China is probably pouring more investment into the Russian Far East than the Russian state is. China's has ten times more foreign investment in Russia than Russia does in China, and that investment is strongly focused in the Far East, where China now accounts for 15% of foreign fixed investment. Moreover, it is not just pipelines that concern Beijing. Last year, forty-six commercial ships sailed from China to Europe through the Northern passage north of Siberia - up from six in

2010. This trade route has the potential to transform trade links between China and Europe and it will depend on Siberian infrastructure for servicing, safety and supply. While it has been courting Norway and Iceland, Beijing knows the Arctic 'trade highway' question cannot be answered without Russia.

Russian water, Chinese solution?

Another interesting piece in this strategic picture will be water. Water is fundamental to most modern industrial life, chiefly through its role in electricity generation. It is also China's single most important deficit - some estimates suggest that China could be running a 200bn cubic litre water deficit by 2030. Eighty-five percent of Russia's water is east of the Urals, as are hundreds of billions of litres locked in the world's largest forests. It is not insignificant that the first major joint investment by the China Investment Corporation and the Russian Direct Investment Fund at the end of 2012 was a \$200mn stake in Russia Forest Products, Russia's second largest forestry company with substantial forest concessions in Siberia.

This kind of deal raises the prospect of 'importing' water from Russia embedded in timber products. As - or if - relations between China and the Russian Far East continue to warm, the logic of importing water in other energy intensive products such as paper, chemicals and aluminium is likely to be increasingly part of the calculus for far-sighted officials in Beijing. Although big players on both sides have started to explore possibilities, sectors like aluminium are probably still too politically sensitive for both sides. Nevertheless it is not lost on either side that there are cross-border supply chain possibilities that could spread resource use and energy costs in a more effective way.

None of this is to guarantee that relations between China and the Russian Far East will continue to evolve smoothly. Sensitivity over energy collaboration is certainly thawing as Moscow looks to diversify away from its dependence on European demand. But for Beijing there is still a version of 'Russian risk' for Chinese inward investment. Weak infrastructure, an uncertain and unpredictable business environment,

and a residual suspicion of migrant workers in border regions are all still important factors.

This week's BRICS Summit has moved onto the interesting question of whether the BRICS countries will choose to institutionalize the new bloc through the creation of a new secretariat or joint institutions like a BRIC Development Bank. While these things may happen, they are unlikely to change the essentially bilateral nature of BRIC geopolitics. For all the talk of the global picture, Sino-Russian relations for the next two decades are likely to be dominated by concrete issues of proximity, energy and economic reality. Russia wants Chinese investment and to sell energy and goods into the largest fast-growing market in the world. China wants to drive a hard bargain for those things. Mr Xi no doubt went to Moscow first because he knows that China's Russian choices may be defining ones.

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