

# Russia's Energy Leverage over China and the Sinopec-Rosneft Deal

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The bilateral relations between China and Russia have attracted much attention in recent years. This is partly due to the uncertainty surrounding the relationship, some arguing that relations are at an all-time high, while others stress the underlying tensions involved and the volatile history between the two. The energy sector has been identified as an area of particular uncertainty where disagreements are frequent, although employed rhetoric and the tendency of both to downplay their differences may suggest otherwise. Conflicting interests particularly pertain to equity stakes in energy exploration and transportation which is of major strategic importance to both. Russia tries through all means to retain control over energy resources and its transportation networks while China hunts globally, including in Russia, for equity shares in energy resources and pipelines. As such, Moscow has vehemently opposed Beijing's attempts to become a shareholder in Russia's energy industry.

In view of this, a deal of major importance was signed this year between the two largest oil companies in Russia and China, Rosneft and the China Petroleum & Chemical Corporation (Sinopec), who struck an agreement to jointly explore oil wells in the Russian republic of Udmurtia. The deal is significant in the sense that it is the first time Beijing gets to be a shareholder of assets in Russia's oil industry without the Kremlin's interference,<sup>1</sup> and it came as a result of the announced tender of TNK-BP's 96,9 percent share of OJSC Udmurtneft. Considering the centralization of Russia's energy assets that has occurred in recent years with the crack-down on the oligarchs, opposition to foreign ownership, and use of energy as leverage, many doubted that the deal would eventually go through. Especially when considering that

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<sup>1</sup> "Rosneft, China's Sinopec sign deal to buy Russian oil co." *RIA Novosti*, November 17, <<http://en.rian.ru/russia/20061117/55732887.html>> (November 17 2006).

China's energy acquisitions have been viewed as a threat in the Russian Duma and in the Kremlin.<sup>2</sup>

Stratfor, for instance, predicted that: "A more likely outcome than a straightforward Chinese acquisition is an internal knife fight that lands Udmurtneft in the hands of one of Russia's own state firms."<sup>3</sup> Not least in view of the fact that the Russian Duma had blocked a similar attempt by CNPC to purchase Slavneft in 2002. This, however, did not happen in this case and the deal went through smoothly. The key question here is: why did Russia not interfere and block the deal considering the leverage that it has over China? To answer this question it is first necessary to appreciate the full extent of this leverage, and what China has to abide with in order to get access to Russian energy assets. However, this leverage is not endless and Russia has to provide some concessions to prevent the strategic partnership from reversing. Russia does so when potential gains are optimized and strategic risks minimized, and the sale of Udmurtneft represents such a case.

### **Russia's Energy Leverage over China, the Sinopec-Rosneft Deal, and Rosneft's China Connection**

To begin with, there is a need to understand the interests of both parties. The primary factor accounting for China's interests in the Russian market relates to an urgent need for energy diversification, and to avoid paying the premium added to Middle Eastern oil. The Middle East currently supplies 45 percent of China's imported energy, while Russia accounts for a mere 8 percent despite the geographical proximity and abundant resources of Russian Siberia.<sup>4</sup> The rapid economic growth of China, estimated to reach 9.9 percent in 2006, necessitates a substantial increase in energy supplies to sustain Beijing's modernization drive. Russia has been disinclined to assist in these efforts, due both to geo-strategic factors, costs, trade composition, and leverage. To this end, the Kremlin has used energy as a foreign policy tool and continuously short-changed Beijing in its energy exports. Russia would also rather see itself as an exporter of technology and machinery to China rather than just raw materials and energy. The latter comprised almost 90 percent of Russia's total exports to China in 2005.<sup>5</sup> Ever since Beijing started to show an increased interest in Russian energy assets, Russia has persistently used energy as leverage and forged agreements on its own terms. This has

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<sup>2</sup> See for example, Stephen Blank, "China, Kazakh Energy, and Russia: An Unlikely Ménage à Trois," *China and Eurasia Forum Quarterly* 3, 3 (2005): 106.

<sup>3</sup> "Russia: The Political Threat to China's Acquisition," *Stratfor*, June 20 2006.

<sup>4</sup> "China and Russia to focus on oil," *Taipei Times*, March 20 2006.

<sup>5</sup> Sergei Blagov, "Russia Pledges to Up Trade With China," *Eurasia Daily Monitor*, November 7 2005.

excluded Beijing's potential in acquiring equity stakes in the Russian energy industry.

As such, it came as a surprise when in March, 2006 it was announced that officials from Sinopec and Rosneft had met in Beijing to sign a memorandum of cooperation regarding the bidding on Russian oil-company's TNK-BP's 96,9 percent share of OJSC Udmurtneft, which was put up for tender. The memorandum specified that if Sinopec won the tender on the acquisition it would give Rosneft 51 percent of the shares, while the Chinese would get the remaining 49 percent and be obliged to finance the entire deal through a loan agreement from the Bank of China.<sup>6</sup> Rosneft would in due course pay back this loan as revenues started pouring in. The purported starting price of bidding was \$1 billion, and Sinopec managed to outbid such firms as Gazpromneft (formerly Sibneft), India's ONGC, as well as Hungary's MOL by placing a US\$3.5 billion bid and was subsequently declared the winner in June. In mid-November the two parties signed the shareholder agreement, developed a business plan and a five-year development program for the company.<sup>7</sup> This also coincided with Russian Prime Minister Mikhail Fradkov's visit to Beijing on November 10 where he met with Chinese President Hu Jintao and other Chinese officials.

To understand the basis of the agreement between Sinopec and Rosneft there is a need to appreciate the history of Rosneft, its "China connection", and how it uses its leverage. Although the Sinopec-Rosneft deal is the first time that China gets an equity stake in the Russian oil industry, it is not the first time that China has stepped in and financed Russian energy acquisitions. In 2004, Chinese banks financed Rosneft's acquisition of Yuganskneftegaz (Yukos' flagship before it was stripped by the Russian government) with a US\$6 billion loan in exchange for long-term supply contracts of oil.<sup>8</sup> This acquisition of Yuganskneftegaz was crucial for Rosneft in reasserting its status in the Russian oil industry.

The humiliating part of this deal for Beijing was that Yukos, the previous owner of Yuganskneftegaz, had agreed to build a pipeline to China from the Russian Far East (Nakhodka-Daqing). However, instead of getting a pipeline it was forced to finance the expropriator's stripping of Yukos, in exchange for meagre raise of oil exports in comparison. The 2,400 kilometre pipeline was planned to carry up to 20 million tons of oil representing a significant 12 percent of China's total oil consumption. But the crack-down on the oligarchs and private interests in the Russian energy industry prevented this as Yukos assets were seized and later sold

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<sup>6</sup> "Rosneft, China's Sinopec sign deal to buy Russian oil co." *RIA Novosti*, November 17 2006.

<sup>7</sup> "Rosneft and Sinopec to Jointly Control Udmurtneft," *Rigzone*, November 17 2006.

<sup>8</sup> "The Ties That Bind China, Russia and Iran," *Asia Times*, June 4 2005.

to Rosneft at a fire sale financed by the Chinese. With the incorporation of the company, Rosneft became Russia's second largest oil company, and has since then reached the position of number one.<sup>9</sup>

This is a significant transformation as Rosneft has been a heavy debt-ridden and inefficient company with little liquid capital. In the late 1990s, Rosneft's problems were of such a magnitude that its shareholder, the Russian state, considered liquidating the company. At this point in time the company was valued at just over US\$500 million, as compared to Rosneft's estimated market capitalization value of US\$60-80 billion today.<sup>10</sup> The company managed however to stay in business, and a major factor accounting for Rosneft's emergence today as an oil giant and its turnaround in profit is the bargain price for which it seized the assets of Yuganskneftegaz. This, indeed, would have been impossible without China's willingness to finance the deal on such favourable conditions.

Despite this bargain, Rosneft remained in heavy debt and was forced to sell a fraction of the firm to external investors. Prior to the initial public offering (IPO) in July 2006, Rosneft had debts reaching US\$11 billion. These debts were settled at the end of July as Rosneft placed 13 percent of its shares, worth approximately US\$10.4 billion, on IPO on the Russian Trading System and the London Stock Exchange.<sup>11</sup> The China National Petroleum Corporation (CNPC) showed great interest in seizing as much as possible of this offering but was only allocated a modest US\$500 million share, despite reports that CNPC was prepared to pay US\$3 billion.<sup>12</sup> This should be viewed in context of the US\$1 billion shares allocated to such competitors as Petronas and BP.<sup>13</sup> As such, apart from having to swallow financing Rosneft's stripping of Yukos, which was the sole Russian company that have given a glimmer of hope to Beijing, Rosneft short-changed Beijing once again. Finally, even though Rosneft had managed to pay-off its debts and gain access to an immense cash-flow, Beijing still had to take all the risks and be the sole financier of their joint purchase of Udmurtneft.

However, Chinese President Hu Jintao and other Chinese officials seem to give minor emphasis to its history with Rosneft in official statements. As the deal between Sinopec and Rosneft was to be finalized in Beijing, Hu Jintao stated that Fradkov's coinciding visit would "push

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<sup>9</sup> Rosneft Background at Russiaprofile.org <<http://tinyurl.com/y9g54y>> (November 5 2006).

<sup>10</sup> *Ibid.*

<sup>11</sup> To be fair, this was not solely because of liquidity problems but also because the company aimed for the position as an A1 company at the Russian Trading System where a diversified ownership structure is required.

<sup>12</sup> Rosneft Background at Russiaprofile.org.

<sup>13</sup> *Ibid.*

forward our strategic partnership."<sup>14</sup> Moreover, in apprehending the Sinopec-Rosneft deal, a Chinese official stated that: "It's a pact about an integrated partnership."<sup>15</sup> Similarly, as CNPC was snubbed from buying more than a US\$500 million stake of Rosneft, CNPC's official statement after the purchase proclaimed that: "the purchase of the shares will deepen the long-term relationship between the two companies."<sup>16</sup> That China and Russia use rhetoric to smoothen over their differences is no news, however. Chinese officials know very well the background behind Yukos, its financing of Rosneft's success, that Moscow would rather see anyone other than Beijing in its energy fields, and that Russia sets the conditions. This has caused major strains in bilateral relations, although these are not voiced publicly. This episode illustrates well the complexity and rhetoric involved in Sino-Russian energy relations and the leverage that Russia holds over China. But it also complicates the question of why Russia gives into Chinese pressures when it enjoys this amount of leverage.

### Striking a Compromise

There are three main answers as to why Russia gives into China's pressure which relate to commercial considerations, an interest in keeping the strategic partnership floating, and improved Sino-Russian relations. There should be no doubt that the deal is one step forward in energy relations between Russia and China, and it indicates that Moscow has started to make some concessions to Beijing in the energy sector. Although Beijing had to overpay, the deal was a step ahead for Beijing in the sense that it actually got some degree of influence in exchange for its financial risks. This was not the case in 2004 when Chinese banks financed Rosneft's acquisition of Yuganskneftegaz with a US\$6 billion loan and only received a pledge of long-term supply contracts via rail in exchange. But one should be careful in drawing premature conclusions that the geo-strategic aspect of energy in the partnership is abating. Especially when considering the room to manoeuvre that Russia has, and its ability to strike a deal on almost whatever terms it wishes.

On the basis of its energy engagements with China, Russia knows that Beijing will agree to almost anything that involves it getting energy access, and therefore Russia is reluctant to play the energy card prematurely since it is the only lever that it has. This is why Russia, in the main, delays pipeline constructions, does not fulfil settled

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<sup>14</sup> "Energy tops agenda as Russian premier meets Chinese leaders," *AFP*, November 10 2006.

<sup>15</sup> "UPDATE 1-Rosneft, Sinopec expand alliance to China refining," *Reuters*, November 14 2006..

<sup>16</sup> "China/Russia: CNPC Denied Intended Stake In Rosneft," *RFE/RL*, July 19 2006.

agreements, and is obstructive in its energy engagements with China. The reason why it yielded to Beijing's pressures in the Sinopec-Rosneft deal is explained by a Russian realization that it has to give something to keep the strategic partnership on course, and so that it does not unravel. Not to mention that Rosneft made the deal of the century by letting China finance its acquisition of Yuganskneftegaz in times of severe cash problems. Russia probably realized that it was forced to give in to Chinese equity shares in its oil industry sooner or later, and gave up 49 percent of Udmurtneft for this purpose. As it involved no financial risks whatsoever from Rosneft's side, plus a payment to the Russian company TNK-BP far above market value, Russia had much to gain by striking a deal at this particular moment when gains were optimized.

With the Chinese being obliged to pay a "premium" for access to Russian energy resources the Russian oil-company TNK-BP predicted that it would get a price far above market value. This turned out to be the case. The price of US\$3.5 billion, US\$2.5 billion over the starting price, has been considered way above the market-value of the company and its oil fields which reportedly are in decline.<sup>17</sup> Perhaps by learning from Sino-Russian engagement in the arms industry where Russia was forced to supply Beijing with endless amounts of arms to keep its military-industrial complex floating, China seems to have realized that the only way to access Russia's strategic interests is to offer substantial cash incentives. In a similar way as Russia gave up its long-term national interest for short-term economic incentives by opening up its arms industry, Chinese hard currency is today needed in the Russian energy sector.<sup>18</sup> As revealed in Russia's Energy Strategy 2001-2020, there is a need for around 450-600 billion euros to be invested in an ageing capital stock in this period, and in order to realize the projected growth of 4 to 5 percent.<sup>19</sup> To keep energy assets within Russian control while simultaneously maintaining a relationship on relatively good footing with China, the Russians have started to pursue a two-pronged strategy when needed: let Beijing provide the financing while Moscow maintains the majority share.

The deal between Rosneft and Sinopec should be seen in context of this. What the deal means is that Russia and China have found a compromise where both can realize short-term rather than long-term gains. Long term-gains for China means having a controlling share over

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<sup>17</sup> "TNK-BP Agrees to Sell Russian Production Unit to Sinopec," *Global Insight*, n.d. (same-day analysis)

<<http://www.globalinsight.com/SDA/SDADetail6181.htm>> (November 7 2006).

<sup>18</sup> It should be noted that Russia may use its arms-exports as a lever on China as well. See Blank, "China, Kazakh Energy, and Russia: An Unlikely Ménage à Trois," p. 107.

<sup>19</sup> The EC Delegation to Russia Website, Energy Section, May 2005 <[http://www.delrus.cec.eu.int/en/p\\_217.htm](http://www.delrus.cec.eu.int/en/p_217.htm)> (November 15 2006).

the ownership of wells, pipelines, and other means of energy transportation. Russia, in turn, wants complete control over its energy industry and retains its near monopoly status over Central Asian, Caucasian, and Caspian energy resources. These interests conflict and a viable solution seems distant considering the growing competition over energy resources, and the above-mentioned factors. However, a compromise was struck because neither side wants to jeopardize bilateral relations over an energy asset that is worth less than a reversal of the strategic partnership.

It is helpful to distinguish this case from the 2002 case when the Russian Duma blocked CNPC's purchase of Slavneft. On that occasion, a majority share of 74.95 percent was auctioned out, meaning the winner would control the company and its assets. In the Sinopec-Rosneft case, Moscow still retains the controlling share. Slavneft also differs substantially from Udmurtneft; while the latter possesses fields said to be in decline and is a relatively minor asset, Slavneft was the largest asset the Russian government still held at the time. This explains why the Russian Duma did not interfere this time and it also points to long-term thinking from the Russians.

The "knife-fight" did not happen because Beijing signalled its intention to surrender early on. As it signed a MOU with Rosneft in March specifying that the Chinese would carry all the risks involved while Rosneft would get the controlling share, there were few reasons for the Kremlin to miss out on this opportunity. Both parties knew that a compromise needed to be struck sooner or later, not least because of the symbolics involved and to keep the strategic partnership from reversing. Indeed, despite the consistent use of rhetoric of a "flourishing partnership" statements started to pour out of Beijing in early March that it was losing patience with the Russians in the energy sector. On March 8 this year, the vice-director of China's National Development and Reform Commission, Zhang Guobao, revealed in an interview with Interfax that Russia had, "complied with commitments on oil exports by rail to China, but as for cooperation in other areas, there had been a lot of contact and communication, but little actual progress."<sup>20</sup> This rare statement was likely intended to put pressure on Russia ahead of the tender for Udmurtneft and to get its signature on the MOU. Besides, later in the same month the two parties also adopted the declaration "Russia, China support energy diversification" specifying increased strategic cooperation in this sphere.

In view of signs in early March that the Chinese were losing patience, and considering the deteriorating ties between Russia and the West, the Kremlin could hardly afford losing its Chinese partner and be isolated.

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<sup>20</sup> "Interview with NDRC Vice Director Zhang Guobao," *Interfax China*, March 8 2006.

Not to mention the counterfactual situation and what could have happened if Moscow had blocked Sinopec's bid, which would have involved a significant risk for Russia as it could have been the straw that broke the camel's back. In fact, Russia could not have gotten a better opportunity to give in. This agreement was essentially as much of a win-win situation that could possibly be achieved within the "zone of possible agreements" between the two.

The agreement should also be seen in context of rapidly improving relations between China and Russia since 2003-2004, when Russia started to turn its back towards the United States and re-align with China. Both want internal stability and self-development, and neither of these interests is possible to realize without a healthy relationship with each other. China needs energy, arms, and raw materials in the pursuit of its modernization-program while Russia needs hard-currency, export diversification, and assistance in keeping its former satellite states within its orbit and away from Western influence. This is to retain access to energy and bases, achieve economic benefits, and use these states as buffers. Both also have a vested interest in containing Islamic radicalism: China in Xinjiang, Russia in the North Caucasus as well as jointly in Central Asia through the Shanghai Cooperation Organization. In the best of worlds, a compromise could be reached where both make incremental concessions. China could promote a diversification of its imports from Russia and purchase other items besides raw materials, while Russia could give increased entry to Chinese energy-investors.

In the end, however, the historical strains between the two together with Russia's use of energy as a foreign policy tool and the strategic interests involved suggest that it will take a while before China acquires a majority share in Russian energy assets. This will also most likely be a persistent feature in the times to come. As Putin leaves office after the 2008 presidential elections he is likely to install persons perpetuating the Kremlin's policy of retaining access to energy resources. Two such potential candidates are the Chairman of Gazprom, Dmitry Medvedev, and Defense Minister Sergei Ivanov. Thus, even if the Sinopec-Rosneft deal should be seen as one step forward in Sino-Russian energy relations one should not, at least in the short term, look at it as a breakthrough in Sino-Russian energy relations.