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Russia – China Energy Nexus

Energy Research Paper

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China has leveraged Russia's shift in energy trade focus from Europe to Asia, in the wake of Western sanctions imposed over the invasion of Ukraine. Chinese companies have seized the opportunity presented by discounted prices, increasing purchases of Russian energy. They are promoting the use of Chinese currency for trade settlement and contributing equipment to Russia's Arctic LNG II project. However, Chinese entities have remained cautious and compliance-driven, ensuring they steer clear of violating sanctions.

What is driving the Russia–China energy relationship? How have energy trade flows and bilateral upstream and midstream oil & gas developments evolved since the invasion of Ukraine?

ENERGY RESEARCH PAPER

This research paper is part of a 12-month series published by the Al-Attiyah Foundation every year. Each in-depth research paper focuses on a current energy topic that is of interest to the Foundation's members and partners. The 12 technical papers are distributed to members, partners, and universities, as well as made available on the Foundation's website.

Introduction

- The Russian invasion of Ukraine and the collective response from the West have subjected the Russia – China energy nexus to its most critical test. China finds itself at a crossroads; on the one hand, it may deepen cooperation, serving as an economic lifeline to its strategic partner while securing affordable supplies for its own needs; on the other hand, it might adopt a more cautious stance, transactionally balancing its interests with Russia's role as a long-term aligned party.

Energy Trade Flows, Sanctions, and Trade Settlements

- Since the invasion of Ukraine, Chinese oil imports from Russia have experienced a slight increase. In 2022, Russia's share of Chinese oil imports expanded to 17% from 15% in 2021, with daily imports reaching 1.7 Mbbl / day, trailing behind Saudi Arabia, China's largest oil supplier. However, in H1 2023, China imported 2.1 Mbbl / day of Russian oil, establishing Russia decisively as China's primary oil supplier. During the same period, the average price of China's Russian oil imports stood at US$ 73 / bbl, in contrast to the average price of US$ 80 / bbl for non-Russian oil imports.

- In the short-term, China is expected to observe the sanctions imposed on Russia, insofar as these do not affect it directly. Additionally, China will avoid involving its primary state-owned tanker fleet in the Russian oil trade. Instead, it will likely persist in purchasing Russian oil above the Western price cap, albeit through third-party intermediaries or smaller private Chinese companies.

- In 2022, Chinese pipeline gas imports from Russia rose by 39% y-o-y to 14.7 BCM / year, increasing Russia's share of Chinese pipeline imports from 18% in 2021 to 25%, making Russia the 2nd largest gas supplier to China after Turkmenistan. Additionally, China's purchases of Russian LNG surged by 33% y-o-y totalling 6.1 MT / year, raising Russia's share of China's LNG imports to 6% in 2022 and positioning it as the 3rd largest LNG supplier to China after Australia and Qatar.

- Russia and China actively promote using the Chinese Yuan (Renminbi) in trade settlements. Russia aims to decrease its dependence on the US dollar. This trend began after the annexation of Crimea in 2014 and escalated when Western nations excluded Russian banks from the SWIFT payment system following the invasion of Ukraine.

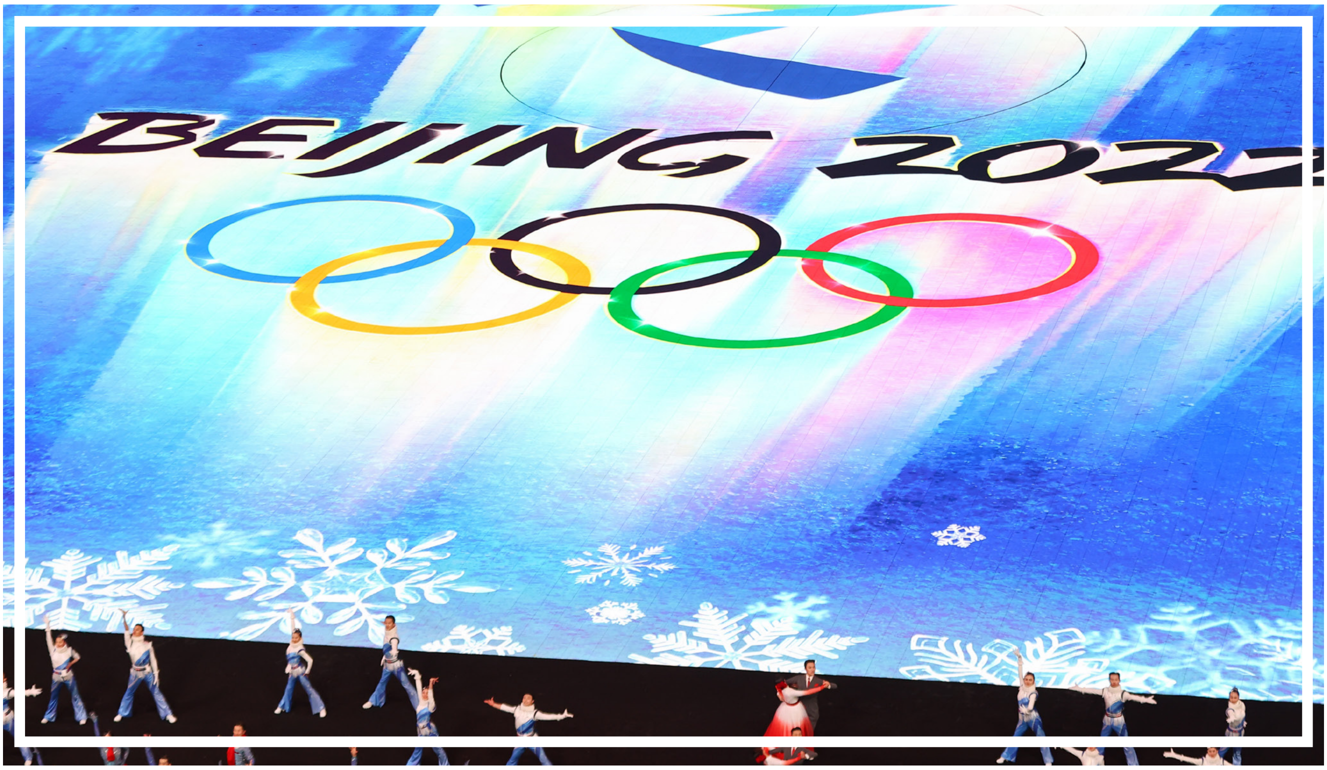
Upstream and Midstream Infrastructure Developments

- Since the invasion of Ukraine, Chinese companies have refrained from making any new upstream investments or acquisitions in Russia. As Western companies have exited the Russian energy sector, China's existing investments in Russia have made it the single largest foreign resource holder in Russia. Conversely, Russia occupies only a 7th spot in China's overall foreign oil & gas investments, accounting for a mere 6% of China's foreign energy holdings.

- Similarly to the upstream sector, there have been no new announcements regarding bilateral oil & gas pipeline deals or long-term import contracts since the war in Ukraine. Russia has indicated that the Power of Siberia 2 gas pipeline is nearing its final agreement stage, yet China refrains from commenting on the project.

The Future Russia – China Energy Nexus

- The future of the Russia – China energy nexus depends on China's relations with the West. In one scenario, diplomatic and economic ties between the United States and China remain relatively stable. In that case, China may persist in its delicate balancing act, which would lead to moderate growth in energy trade with Russia. However, in other scenario where relations deteriorate, a more robust and asymmetrical Russia – China alliance could emerge, which will intensify their mutual oil & gas trade, increase Chinese investments in Russia, and encourage deliberate efforts to undermine existing sanctions.



On February 4, 2022, China's President Xi Jinping met with his Russian counterpart Vladimir Putin in Beijing on the opening day of the Winter Olympics[i]. In a joint statement, both leaders emphasised their countries' collaborative international leadership in a "new era"[ii]. They expressed reservations about the United States-led global system and highlighted their cooperation on various issues, including energy and trade[iii]. The leaders asserted that the friendship between the two nations knows "no bounds" and there are no "forbidden" areas of cooperation[iv]. Additionally, the two countries agreed on a new long-term gas deal, supplying 10 BCM / year of pipeline gas from Russia's Far East to China for 25 years[v]. This deal complements the existing Power of Siberia 1 agreement, which provides 38 BCM per year for 30 years and was signed in 2014[vi]. Deliveries began in September 2019.

A few weeks later, Russia launched its full-scale invasion of Ukraine. Initial Chinese reactions were ambiguous. China acknowledged that the sovereignty of all countries should be respected on the one hand, while declaring an understanding of the historical complexities of the Ukraine issue and Russia's security concerns, on the other[vii]. In addition, Chinese Foreign Minister Wang Yi China warned of retaliation if hit by the fallout of Western sanctions on Russia[viii]. During that period, Russia persistently made "increasingly frustrated requests" for greater support from China[ix]. Despite President Xi assigning his advisers to find ways to financially assist Russia without breaching Western sanctions, this effort fell short from the Russian perspective[x].

Later that year, in September 2022, President Putin and Xi convened for the first time since the invasion at the 2022 Shanghai Cooperation Organisation (SCO) Summit in Samarkand, Uzbekistan[xi].

Their discourse was more subdued than in the February "no limits declaration." However, China expressed "questions and concerns" regarding Russia's purported special military operation[xii].

In the subsequent two months, both leaders exchanged congratulatory letters during the 4th Russia-China Energy Business Forum[xiii]. President Xi expressed China's readiness to strengthen their partnership in energy cooperation, which serves as a vital cornerstone in the practical cooperation between Russia and China[xiv]. Despite this positive tone, no significant energy deals were finalised.

Textbox: Background on Russia – China Bilateral Relations

Three overarching themes underscore Russia – China relations: positive developments, countering the United States, and balancing perspectives. Proponents of the relationship emphasise positive bilateral developments, at times normative convergences, in political, economic, and energy since the end of the Cold War, in contrast to critics that highlight the underlying tensions, mutual suspicion, competing regional interests, economic limitations, and differing geopolitical approaches.

Secondly, the growth in Russia – China cooperation is partly driven by threat perceptions. Both countries seek to counterbalance the United States' global hegemony, especially its influence in Eurasia and the Indo-Pacific. And thirdly, Western analysts often focus on the Russian side of the relationship, but it's essential not to overlook significant drivers on the Chinese side.

The Russian invasion of Ukraine and the collective response from the West have put the Russia – China energy relationship to its most critical test. China stands at a crossroads: it can either deepen cooperation, acting as an economic lifeline to its strategic partner while securing affordable supplies for its own needs, or it may choose a more cautious approach, transactionally balancing its interests with Russia's role as a long-term aligned party.

Russia's abundant energy supply and China's ever-increasing demand create a seemingly natural synergy for energy collaboration and trade. However, large-scale energy trade between the two countries is relatively recent. Their oil trade gained momentum after 2013, following a slower start in the early 2000s. LNG exports started in 2009 but averaged only about 0.5 BCM / year during 2009 – 2018 or less than 2% of China's total LNG purchases, despite the proximity of Sakhalin II, Russia's first LNG export facility.

As for pipeline gas deliveries, they only commenced in 2019[xv]. If the pre-invasion Russia – Europe energy trade is a benchmark, then there remains untapped potential in the Russia – China energy relationship.

The bilateral energy relationship has experienced varying levels of interdependence and trade asymmetry between the two countries. Russia could devolve into a mere resource puppet state for China, bolstering the ascent of its economic superpower neighbour. Despite these apprehensions, energy trade remains one of the last domains through which Russia maintains economic significance for China. Still, its economic importance to China is perceived as diminishing over the long-term.

Respective domestic energy market landscapes could significantly influence energy relations between Russia and China. These include conflicts within the Russian energy sector between state-owned and the remaining independent companies and, probably more importantly, between state-owned companies controlled by different power centres (for example, Gazprom, Rosneft and Rosatom). There are also broader tensions related to state regulation and planning and the need to liberalise specific Russian energy sector segments. These internal dynamics could lead to small changes in Russian economic efficiency and industrial profitability and ultimately refresh or determine its new foreign policy priorities.

Similar dynamics also exist in China, although independent companies play a different role in its energy landscape. They are much less active in oil and gas production and transport, and electricity generation and transmission, but they are more prominent in refining and manufacturing than their counterparts in Russia.

China also encompasses diverse energy sectors, particularly a large coal industry. The recent anti-corruption purges in China targeting factions opposed to President Xi within the powerful oil companies have likely influenced China's appetite for and attention to additional Russian energy deals. Corruption, particularly on the Russian side, has emerged as a significant constraint on collaboration and investment from the Chinese side.

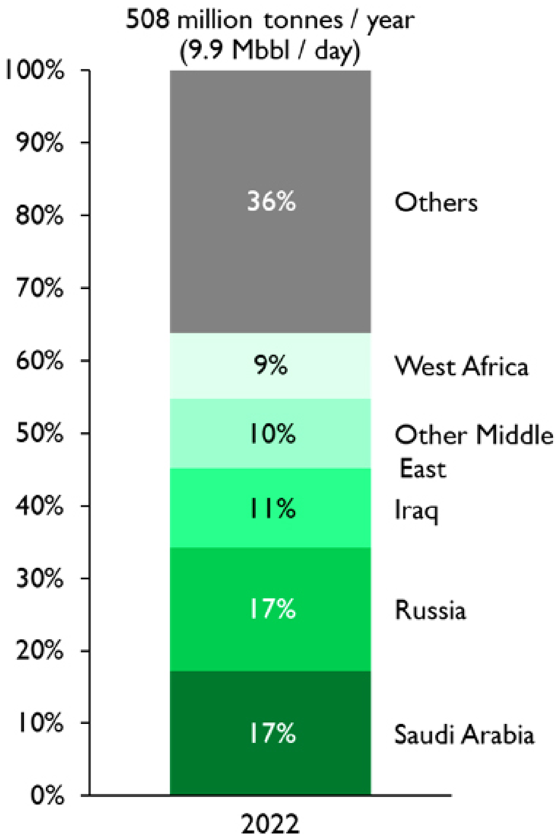
Since the invasion of Ukraine, various commentaries have analysed the impact on and future of Russia – China energy relations. Some assert that the invasion has strained relations, prompting China to be more discerning in its engagement and support. Meanwhile, others argue that the relationship between the two countries is growing stronger. Some perceive China as striking a balance between preserving the Russian – Chinese partnership and maintaining ties with the West.

However, a prevailing view is that the bilateral balance of power is shifting in favour of China. Experts frequently view Russia's future energy prospects with pessimism. The country's status as an energy superpower is perceived to be diminishing, with China standing to gain from Russia's isolation through appealing energy agreements. Significant deals, such as the Power of Siberia 2 gas pipeline, has yet to materialise, indicating a constraint on Chinese involvement. Possible reasons include sanction-related caution, China's pursuit of economic and energy diversification, its wait-and-see approach regarding its relationship with the West and how Western energy sanctions against Russia will evolve in the short-to-medium term.

Russia is also very weakly placed in the emerging low-carbon industries, other than nuclear power, while China has become the leader in sectors including solar, wind, batteries, electric vehicles and ultra-high voltage transmission.

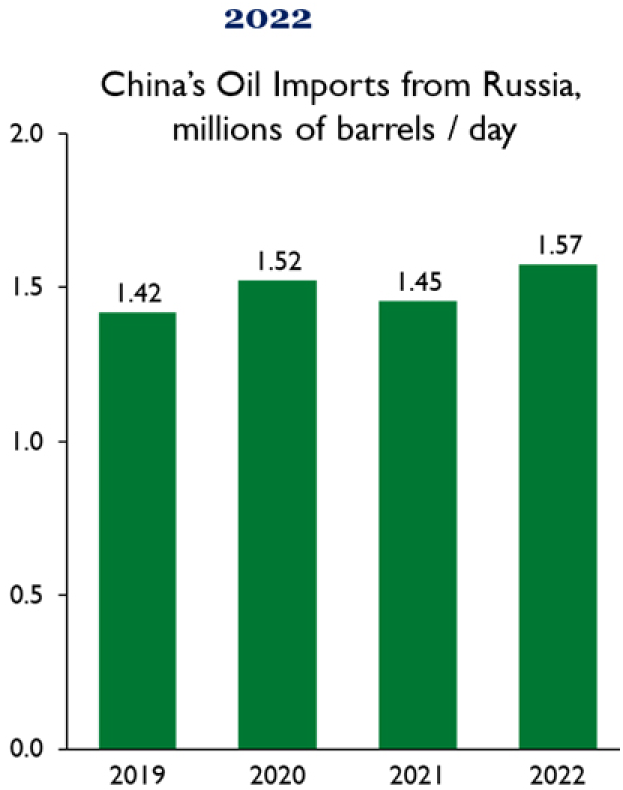
Chinese oil imports from Russia have slightly increased in market share, but more so volumetrically since the Ukraine invasion. In 2022, Russia's share of China's oil imports expanded to 17% from 15% in 2021, with daily imports reaching 1.7 Mbbl / day, slightly lagging behind Saudi Arabia, the largest oil supplier to China[xvi]. However, in H1 2023, China imported 2.1 Mbbl / day of Russian oil, making it China's single largest oil supplier[xvii]. Over the same period, the average price of China's Russian oil imports was US$ 73 / bbl compared to the average price of US$ 80 / bbl for non-Russian oil imports[xviii].

Figure 1: China's Oil Imports Mix in 2022



Amid the nCOVID-19 pandemic in 2020, Chinese demand for oil imports was temporarily curtailed and even saw a minor dip. Throughout this period, the Russian share remained relatively steady at 15%, leading to a similarly modest decrease in both Russian and non-Russian oil imports[xix]. In 2022, the Russian share rose to an average of 17%, driven by moderately increased Russian imports and slightly reduced non-Russian imports[xx].

Figure 2: China's Oil Imports



During the COVID-19 pandemic, China's Russian oil imports experienced a significant surge in value from pandemic-related lows of US$ 1.6 billion / month in May 2020 to a post-invasion peak of US$ 5.6 billion / month in August 2022, driven by volatile global oil prices, and the changing discount on Russian supplies[xxi]. However, the value of this trade has subsequently declined as world oil prices have reverted to lower levels.

Following the invasion, China's average import price of Russian oil diverged from the average import prices of non-Russian imports, mainly driven by a price discount on Russian supplies.

In July 2022, the Chinese discount on Russian oil, compared to non-Russian supplies, reached US$ 19 / bbl[xxii]. Since December 2022, China has consistently paid an average monthly price above US$ 70 / bbl for Russian oil. This is likely because most of Chinese oil imports from Russia are East Siberia Pacific Ocean (ESPO) crude, which has consistently traded above the price cap since sanctions were imposed[xxiii].

China's purchases of additional Russian supplies will depend on various factors. For instance, state-owned refiners will consider the extent to which other suppliers can replace Russian supplies, the availability of excess Chinese oil processing and storage capacity, and how the discount rates on Russian oil supplies will evolve. Meanwhile, Chinese independent refiners will continue prioritising opportunistic buying, focusing on low-cost supplies[xxiv]. Some have already halted Russian oil purchases due to uncertainty surrounding sanctions. And those unable to obtain trade financing are exploring alternative payment methods, which will also impact short-term purchases[xxv].

In the short-term, China is expected to comply with the sanctions on Russia and refrain from using its primary state-owned tanker fleet in the Russian oil trade. Instead, it will likely continue purchasing Russian oil above the Western price cap, albeit through third-party intermediaries or smaller private Chinese companies.

Whilst there are potential ways to bypass Russian sanctions, China and other non-Western buyers of Russian oil cannot formally bypass Western sanctions (including secondary sanctions, if imposed) without facing penalties. As they stand, the sanctions specifically target Western countries and companies. However, Chinese companies risk losing access to Western tanker services if they do not comply with the price cap.

Still, China could bypass the sanctions by purchasing substantial quantities of Russian oil above the price cap through non-compliant intermediaries or by utilising its tanker fleet for trade with Russia. Such aggressive deviations from the sanctions' intent may provoke a response from the West.

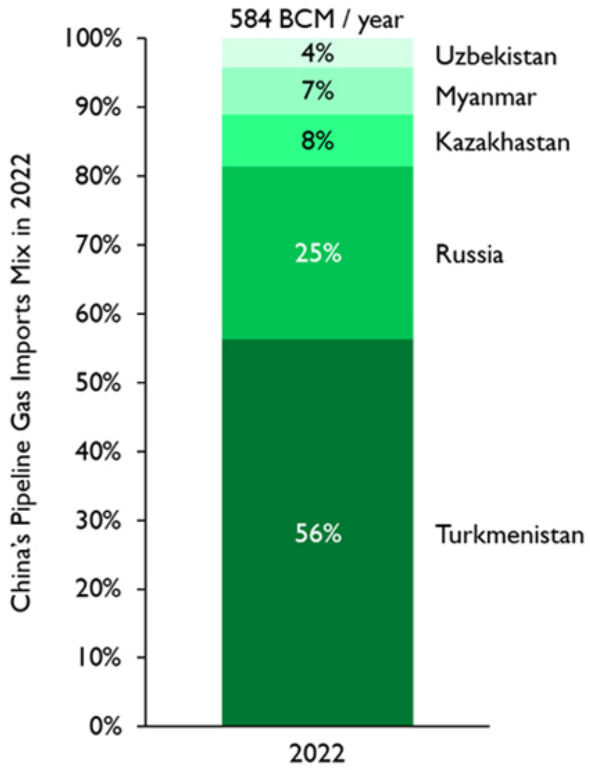
Traditionally, Chinese importers prefer using companies other than China Ocean Shipping Company (COSCO) to deliver Russian oil to China. COSCO owns China's state-owned tanker fleet and has ceased shipping Russian oil since December 2022 due to sanctions-related concerns[xxvi].

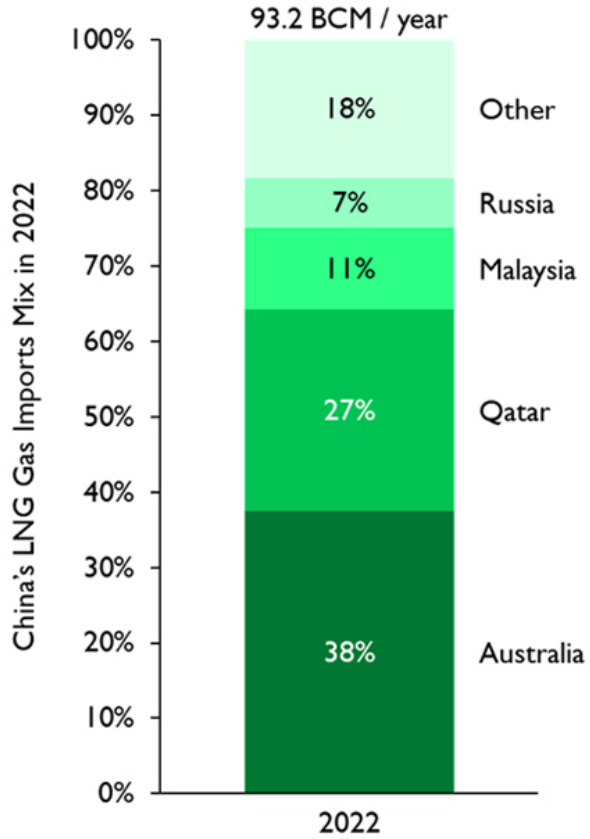
If China directly involved a significant portion of its fleet in the Russian oil trade, it could substantially reduce its transportation costs, enabling it to take a large part of the value represented by the Russian discount. Additionally, China could consider selling some of its older tankers to the third parties currently handling Russian oil, thereby increasing the size of the shadow fleet and driving down transport costs.

Despite the sanctions, non-COSCO Chinese-owned tankers continue to transport Russian oil. These tankers belong to smaller independent companies, many registered in Hong Kong[xxvii]. Currently, most of the seaborne Russian oil shipped to China is undertaken by Russian companies or third parties.

The United Arab Emirates has become a leading country in fleet ownership due to the transfer of Russia's main state-owned Sovcomflot fleet to UAE-based companies, particularly SUN Ship Management, which the European Union recently sanctioned[xxviii].

Figure 3: China's Pipeline Gas and LNG Imports Mix in 2022





In 2022, Chinese pipeline gas imports from Russia increased by 39% y-o-y to 14.7 BCM / year, leading to Russia's share of Chinese pipeline imports rising from 18% in 2021 to 25%, making Russia the 2nd largest gas supplier to China after Turkmenistan[xxix]. Additionally, Chinese purchases of Russian LNG surged by 33% y-o-y to 6.1 MT / year, raising Russia's share of Chinese LNG imports to 6% in 2022, and positioning it as the 3rd largest LNG supplier to China after Australia and Qatar[xxx].

Since the initial gas deliveries in December 2019, Chinese pipeline gas imports from Russia have steadily increased, reaching 14.7 BCM in 2022[xxxi] and 22.7 BCM in 2023[xxxii]. This growth aligns with the terms outlined in the 2014 contract for the Power of Siberia 1 pipeline, which specifies a contracted amount of 22 BCM in 2023 and a gradual ramp-up to its total capacity of 38 BCM / year by 2025[xxxiii]. Meanwhile, non-Russian pipeline gas, primarily sourced from Turkmenistan, has been relatively stable at 32.9 BCM / year[xxxiv].

Currently, China procures its cheapest gas supplies from Russia through pipelines with long-term contracts indexed to global oil prices, at an average import price of US$ 6.1 / MMBtu in December 2021 (the last month for which both reported volumes and value data are available from Chinese customs)[xxxv]. Unlike spot LNG prices, the average import prices for pipeline gas have not experienced dramatic increases.

China's Russian and non-Russian LNG imports exhibit greater volatility than pipeline volumes. Specifically, China increased its Russian LNG imports from 4.6 MT / year in 2021 to 6.1 MT / year in 2022[xxxvi]. Figures for 2023 vary, indicating a rise of 5.5% but Russian state new agency TASS reported a 23% increase.

In contrast, LNG volumes from non-Russian sources experienced a substantial decline, dropping from 92 MT / year in 2021 to 87 MT / year in 2022[xxxvii].

However, in H1 2023, Chinese imports of Russian LNG increased by 66% y-o-y compared to the same period in 2022, solidifying Russia's position as China's 3rd largest LNG supplier, accounting for 12% of China's total LNG imports[xxxviii].

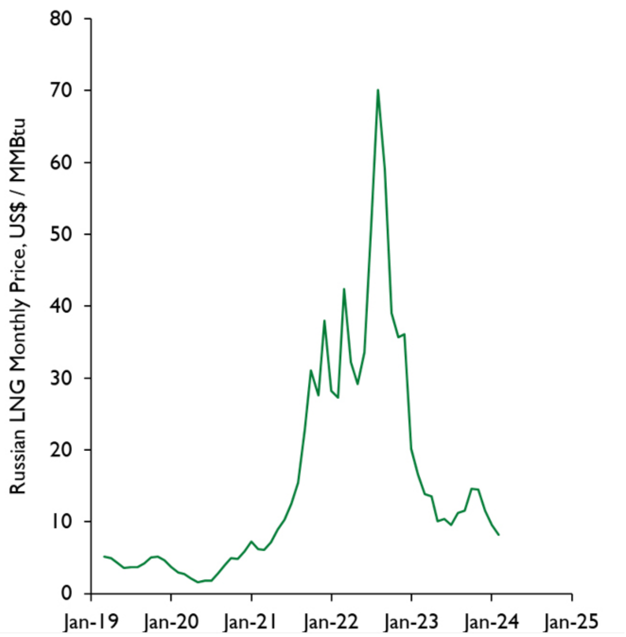
China has experienced significantly higher average import prices for LNG than pipeline gas. In October 2022, Russian LNG reached US$ 39 / MMBtu, whereas non-Russian LNG was comparatively more affordable at US$ 18 / MMBtu during the same month[xxxix]. It might appear peculiar to import costly Russian LNG while reducing purchases of the cheaper non-Russian cargoes; however, this phenomenon is partly attributed to China's practice of re-selling LNG cargoes (that are not destination restricted) acquired through long-term contracts at higher spot market prices in Europe and other markets. Qatari LNG supplies to China are destination restricted.

Importantly, most of Chinese LNG imports are governed by long-term contracts, which provide a cushion from spot market price fluctuations[xl]. Its cargoes from the Yamal plant in the Arctic are backed by long-term contracts, whereas those from Sakhalin are predominantly purchased on a spot basis[xli].

In 2022, Russia emerged as China's 2nd largest coal supplier, trailing only Indonesia. It exported 29 MT of coal to China, constituting 18% of China's total coal imports[xlii]. Russia also initiated railroad expansions to enhance the efficiency of coal transportation to China. During January – June 2023, China significantly increased its imports of Russian coal compared to the same period in 2022, reaching 51 MT, which constituted 25% of China's total coal imports[xliii]. However, when China introduced import duties of 3-6% on coal from January 2024, Russia imports fell off, while those from Australia, with which China has a free trade agreement, rose. This was also aided by the end of China's ban on Australian coal imports in January 2023[xliv].

In addition to the fossil fuels trade, Russia has been providing highly enriched uranium to China for use in their fast breeder reactors. This cooperation began in September 2022, and by March 2023, three batches of enriched uranium were delivered. These batches contain uranium with a concentration of more than 30% uranium-235. The United States' Department of Defence has expressed concerns about this collaboration, emphasising that breeder reactors are associated with plutonium production.

Figure 4: Russian LNG Price

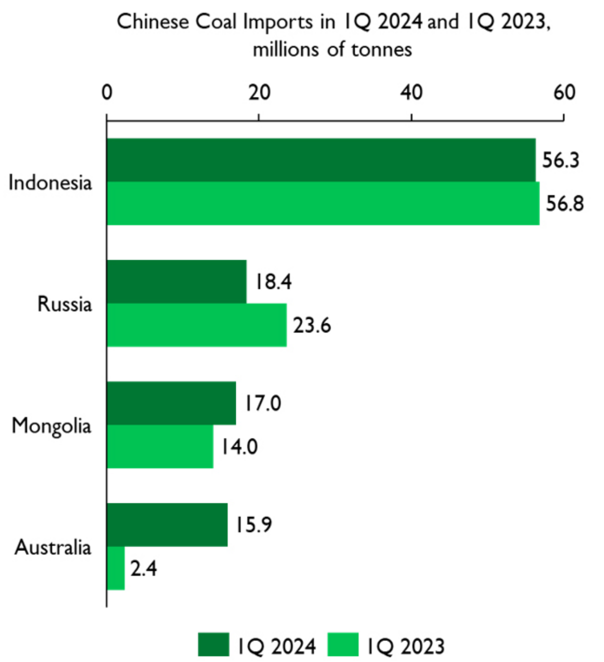


Russia and China have strong incentives to increase the use of the Chinese Yuan (renminbi) in trade settlements. Russia seeks to reduce its reliance on the US dollar. This trend started after the annexation of Crimea in 2014 and intensified when Western nations excluded Russian banks from the SWIFT payment system following the invasion of Ukraine.

Since the beginning of the war, China has ramped up its use of its currency to pay for Russian energy imports. In response to sanctions on the SWIFT payment system, Chinese banks have tightened restrictions on letters of credit for Russian energy purchases. As a result, trading is now shifting more towards the Chinese currency, facilitated by China's Cross-Border Interbank Payment Settlement System (CIPS).

China launched the CIPS system in 2015 as a yuan-denominated alternative to SWIFT. Despite its potential, CIPS remains relatively unknown among oil market participants, and its clearing volumes remain small. Implementing CIPS will require time, and whether Russian sellers are willing to embrace the yuan entirely remains uncertain.

Figure 5: Chinese Coal Imports by Country, 1Q 2024 vs 1Q 2023

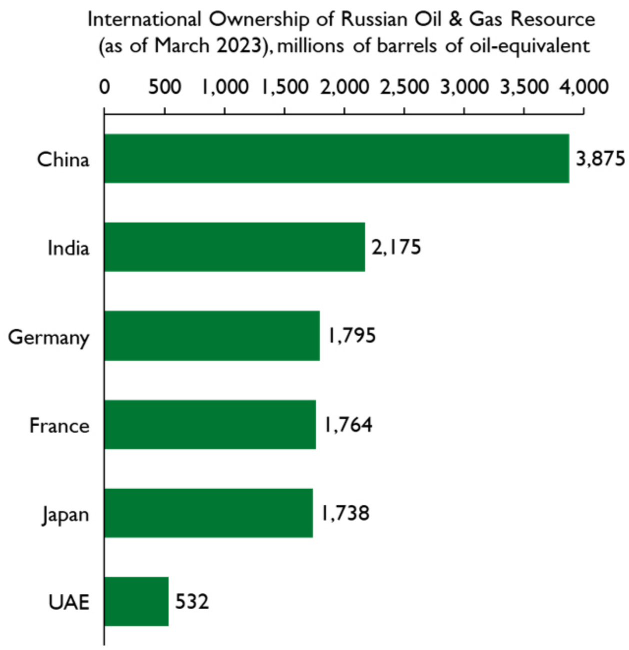


Additionally, while the Chinese government supports CIPS and yuan-denominated trading, China will tread carefully to avoid violating and risking secondary sanctions against its firms.

However, China aims to enhance the Renminbi's international status by increasing its use in purchasing Russian energy, aligning with Xi Jinping's currency internationalisation goals. The share of yuan in Russia's currency reserves rose significantly in 2022, but the central bank has not reported a breakdown for 2023. The share of yuan in trade rose from zero at the start of 2022 to 16% by the end of 2022, but dollars and euros still accounted for 48%, and most diversification came from boosting the use of the rouble[xlv].

Since the invasion of Ukraine, Chinese companies have abstained from making any major new upstream investments or engaging in new acquisitions in Russia. As Western companies have withdrawn from the Russian energy sector, China's existing investments in Russia have positioned it as the single largest foreign resource holder in Russia.

Figure 6: International Ownership of Russian Oil & Gas Resources



Chinese entities have significantly impacted Russia's energy landscape by catalysing the development of Russian LNG export projects in the Arctic. These entities played a crucial role in ensuring the timely and cost-effective commissioning of the Yamal LNG project operated by Novatek, despite its being sanctioned by the European Union and the United States.

When Western banks withdrew from LNG projects following Russia's annexation of Crimea, Chinese banks pitched in US$ 12 billion in loans[xlvi]. China National Petroleum Corporation (CNPC) holds a 20% stake and China's Silk Road Fund has a 10% stake in the Yamal LNG project[xlvii]. CNPC is also an offtaker for the Yamal LNG project[xlviii]. Before the invasion, China Development Bank and the Export-Import Bank of China provided EUR 2.5 billion in debt financing to Novatek's Arctic LNG 2 project, in addition to China National Offshore Oil Corporation (CNOOC) and CNPC holding 10% stakes each[xlix].

Since the war in Ukraine began, there have been no significant new announcements regarding oil & gas pipeline deals or long-term import contracts. While Russia has indicated that the Power of Siberia 2 gas pipeline is nearing its final agreement stage, China has refrained from commenting on the project.

Since the start of the war in Ukraine, Russia and China have not announced any new pipeline deals or long-term oil import contracts. During meetings with President Putin and Xi at the SCO Summit in Samarkand in September 2022, Mongolian President Ukhnaagiin Khurelsukh expressed support for constructing pipelines through the country's territory[l].

President Putin openly emphasises progress on the Power of Siberia 2 pipeline, which he considers the "deal of the century.[li]" For Russia, the pipeline will partially offset the loss of Russian gas sales to the European market. Prior to Russia's invasion of Ukraine, Russia earned US$ 20 billion / year from sales of 150 BCM / year to Europe[lii]. Russian experts estimate that the Power of Siberia 2 pipeline could generate US$ 2.5 – US$ 4.3 billion / year in revenue[liii].

In 2014, less than three months after Russia annexed Crimea from Ukraine, President Putin met with President Xi in Shanghai. During this meeting, Gazprom and CNPC finalised an agreement for the Power of Siberia 1 pipeline after more than a decade of negotiations. The signing of this agreement, despite Russia's deteriorating relationships with Europe and the United States and the prospect of additional sanctions for its annexation of Crimea, demonstrated to the rest of the world that Russia was not internationally isolated and that sanctions would not hinder the development of its energy sector. Similarly, a potential agreement between Gazprom and CNPC on the Power of Siberia 2 will have similar favourable political optics for Russia.

China appears in no hurry to move forward with the Power of Siberia 2 pipeline. The country has geopolitical and commercial reasons for prolonging the Power of Siberia 2 pipeline. China can also use the delay to extract a better commercial bargain from Moscow. Historically, Beijing was not keen on a direct connection from the West Siberian fields to China, since that would mean it would compete directly with Europe and might have to pay higher, European-style prices. The end of most Russian gas exports to Europe have eliminated that motivation, at least for now.

Geopolitically, there may be concerns in China that signing a supply agreement while the war is ongoing might antagonise Europe when China is trying to improve its relations with the region, where its support of Russia during the war in Ukraine is resented. Indeed, in the wake of Russia's invasion of Ukraine, China is seeking to balance supporting Russia with stabilising its relationships with Europe and the United States. Additionally, China might worry that moving forward with such a large and high-profile project would run afoul of United States' sanctions.

In 2014, China secured a price for Power of Siberia 1 gas lower than it paid its Central Asian suppliers[liv]. Commercially, China is in an even stronger negotiating position as it aims to extract concessions from Russia, especially with new LNG supply deals between Chinese buyers and major exporters like Qatar and the United States, and renewed progress on the new Line D pipeline from Turkmenistan, potentially adding pressure on Russia to make an irresistible offer to China.

Figure 7: Power of Siberia 2 and Power of Siberia 2 (Planned) Pipelines

Over the next decade and beyond, China will continue to rely on seaborne oil imports from the Middle East, leaving room for further growth in the Russian oil trade, even though China's energy import diversification strategy constrains it. However, regarding gas, China's future demand for imports is more uncertain than for oil, stemming from variations in future demand and domestic gas production. Whilst China has long-term LNG contracts, this underlying uncertainty limits China's appetite for additional Russian gas pipeline imports.

Russia provides China with oil supply diversification in terms of source and route. However, if China's relations with the West, particularly the United States, deteriorate, the vulnerability of seaborne oil trade is likely to increase. Sanctions and blockades could also impact this trade route. In such a scenario, China is expected to actively pursue new land oil pipeline deals with Russia, further strengthening energy ties between the two countries. For Russia, having an oil outlet safe from Western shipping sanctions and reducing reliance on long and expensive sea routes would be advantageous. Meanwhile, China would secure a safe supply route in case of any future blockade.

Negotiating and constructing a new oil pipeline deal would be time-consuming, with obstacles relating to financing and price terms. Whilst there is an upper limit to potential additional pipeline capacity from Russia, China would still heavily rely on seaborne oil to meet current demand levels.

China is unlikely for now to commit to any additional Russian pipeline gas beyond Power of Siberia 2 due to uncertain future demand, existing LNG supply commitments, and the pursuit of diversification. Additional pipelines could lead to undesirable dependence on Russian gas, and existing contracts for

LNG imports would need to be reduced to accommodate them. Russia's actions in Europe have reduced its perceived reliability as a supplier, for instance in the case of a future deterioration in the relationship with China.

Russia faces a critical situation where the sole replacement for lost European gas exports is the Power of Siberia 2 pipeline. In 2021, 83% of Russian pipeline gas flowed to Europe, with only 4% going to China[lv]. However, due to geopolitical events, the flow to Europe has plummeted to just 20% of its pre-war level as of early 2023[lvi]. Meanwhile, the Power of Siberia 1 pipeline continues to deliver gas steadily, accounting for 25% of Russia's pipeline gas exports[lvii].

If the Power of Siberia 2 pipeline were to be constructed by the 2030s, China could account for a substantial 62% of Russian pipeline exports. It's likely that Russian gas flows to Europe will decrease further due to the European Union's commitment to phase out Russian gas, and the expiry of the Ukraine transit contract at the end of 2024. Regardless, China is poised to become the primary customer for Russian pipeline gas, likely benefiting from significant discounts.

China's relations with the West will significantly shape the future of the Russia – China energy nexus. If diplomatic and economic ties between the United States and China remain stable, China will continue its delicate balancing act, resulting in moderate growth in energy trade with Russia. However, if relations deteriorate, a more robust and asymmetrical Russia – China alliance (and energy cooperation) may emerge. This alliance would intensify oil & gas trade, boost Chinese investments in Russia, and involve deliberate efforts to undermine existing sanctions.

If China can maintain its current relations with the West, it will likely continue its balancing act. In the short-term, Russian oil imports are expected to increase, particularly as Chinese transport demand grows. Chinese entities could also gradually undermine the effectiveness of oil sanctions by potentially transferring tankers from the main state-owned fleet, COSCO, to Chinese independents or foreign operators. These factors will drive up the price of Russian oil. Looking ahead, the Power of Siberia 2 pipeline is expected to proceed in the medium-term, along with new upstream investments in Russia, both on terms that will be attractive to China.

China's engagement with Russia will have limits, driven by diversification and the threat of sanctions if the status quo in Ukraine remains. For Russia, this will result in lower oil & gas revenues. In the short-term, effective sanctions will play a role, and in the long-term, Chinese engagement won't fully compensate for the loss of European markets, technology, and capital for Russia. Consequently, Russia's energy superpower status and overall economy will likely weaken, making it more dependent on China as a customer, technology, and capital provider. This scenario provides China access to cheaper energy supplies while keeping its strategic partner economically afloat and maintaining economic ties with the West. This is likely the most preferred outcome for China.

However, in the event of deteriorating relations with the West, whether due to non-Russian factors or China's extended support for Russia, China will likely strengthen its ties with Russia. In this scenario, China has less to lose and more to gain. It may increase Russian oil purchases and step-up efforts to counter Western sanctions, using its main tanker fleet, whilst also providing its insurance and financing.

In the medium-to-long term, we can expect the development of land pipelines for both oil & gas, facilitated by Chinese financing. Further upstream acquisitions and investments will likely ensure a stable long-term supply for China. These measures aim to counteract the increasing decline in Russian production due to the impact of sanctions, including postponed projects, withdrawals by Western oil service companies, and restricted access to sanctioned technology. As a result, Russia's dependence on China will significantly increase. However, this strategic partnership will also provide Russia with a much-needed boost to its oil & gas revenues and access to capital for long-term supply expansion.

From China's perspective, this likely involves gaining further influence over Russia and increased access to affordable Russian resources. Still, the economic downsides of worsening relations with the West and heightened risks to its seaborne energy imports make this scenario undesirable. Despite these challenges, if China's relations with the West deteriorate irreversibly, this scenario remains the most probable outcome.

CONCLUSION

In summary, China faces a delicate balancing act. On one hand, it supports its crucial strategic partner in challenging the Western-led world order. On the other hand, it must safeguard its own self-interests, including maintaining economic ties with Western trade partners. However, this delicate balance may prove unsustainable, and the true impact of China's response lies ahead. This situation presents challenging policy choices for the United States, European Union, and observers in the Middle East, particularly regarding how to address potential Chinese actions to counteract Western energy sanctions on Russia.

China's broader relationship with the West will significantly influence the future of Russia – China energy relations. If diplomatic and economic ties remain at their current levels, China will likely continue its delicate balancing act, resulting in only modest growth in energy trade and efforts to bypass sanctions. However, should relations deteriorate, we may witness a stronger and more asymmetrical alliance between Russia and China, characterised by increased energy trade, investment, and active measures against sanctions.

Despite Russia's historical status as an energy superpower, its influence is waning. Meanwhile, the energy relationship between Russia and China is becoming increasingly asymmetrical, favouring China. This shift reinforces China's pivotal role in global affairs, further accentuating a defining trend of the 21st century.

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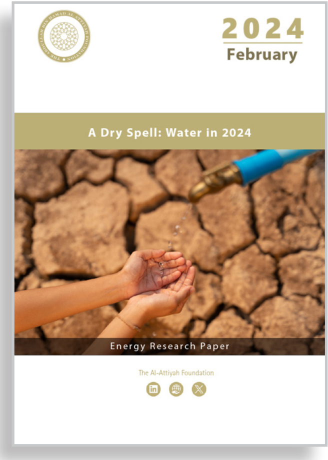

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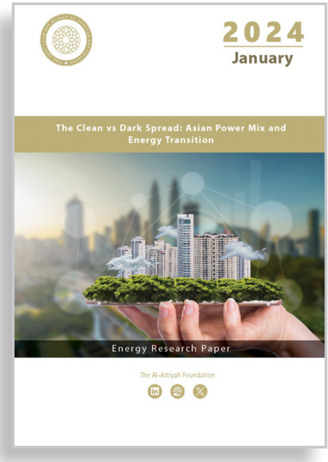

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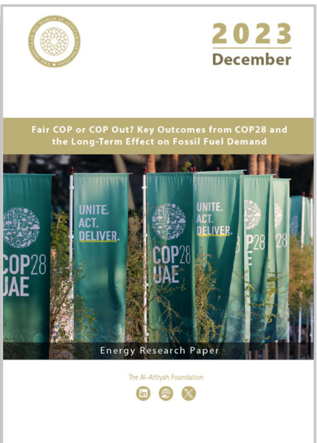

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