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Cash-rich China courts the Caspian

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The global downturn is spreading to Central Asia. It may lead to a marked shift of fortune in the Great Game for control of Caspian energy reserves. On the surface, the intensity of the rivalries may appear to have subsided, as the principal protagonists - Russia and the West - brood over the precarious state of their own finances and prioritize fixing their domestic economies.

But the slowing down of the Great Game bears a deceptive appearance. China gains out of any changing equations. Of all the major economies of the world, it is in China that the government's 4 trillion yuan (US$585 billion) stimulus package may have begun showing results, which puts the economy in a "better-than-expected" shape, as Premier Wen Jiabao said on Thursday.

China's prospects as the first major economy to recover gives it a crucial role to lead the world economy as a whole and the Central Asian region in particular. Following up on a $25 billion loan to Russia that China dished out in February, it has agreed to lend $10 billion to Kazakhstan. China expects both the recipients to reciprocate by bolstering their energy supplies to China.

We may be witnessing the signs of a seismic shift in the geopolitics of Central Asia. The region faces a grim economic outlook and it instinctively looks up to China to help it figure a way out. That provides a big opportunity for China to take the region under its wings. The implications are deep for the Caspian energy sweepstakes.

In its latest regional report, the International Monetary Fund (IMF) has projected a stark economic forecast for Central Asia. The IMF predicts that the economic growth which stood at 12% in 2007 and 6% in 2008 will slow down to less than 2% in 2009 as a "great recession" takes hold. A senior IMF official said, "Until recently, the region had been awash with commodity-export receipts, capital inflows and remittances. This had led to significant economic gains in recent years with real per capita GDP [gross domestic product] growing impressively."

However, the conditions are deteriorating. The point is, oil and gas exporters are heavily affected by the decline in global demand and the sharp fall in their prices. At the same time, Central Asian countries are hit hard by the financing constraints of the international financial markets, which translate as difficulty in obtaining foreign capital.

At a summit meeting of the Eurasian Economic Community in Moscow in February, Russia initiated the creation of a bailout fund of $10 billion financed by Russia and Kazakhstan to help the economies of the member countries - Belarus, Kazakhstan, Kyrgyzstan, Russia and Tajikistan. But the capacity of Russia and Kazakhstan to play such lead role is in serious doubt. February seems a long time ago already as the crisis deepens in Russia and Kazakhstan.

Russia's statistical agency, Rosstat, reported in late March figures that all but suggest the economy is in trouble. The output of essential goods and services declined in February by 11.6% while export earnings - of which oil and gas exports account for the bulk - registered a 40% drop. The World Bank has forecast a 4.5% contraction of the economy in 2009 and that it may take time to recover. Russia has already committed $85 billion into stabilization efforts.

Russia's crisis is directly related to the sharp decline in revenue from oil and gas exports. Energy giant Gazprom recently revised its price forecast for the export of its gas to Europe to $257.9 per thousand cubic meters (tcm) of gas. The price stood at $409 tcm in 2008. The Russian newspaper Vedomosti estimates that at an average price of $260 tcm, Russia's revenues from gas exports in the current year will work out to $44 billion, as against $73 billion last year.

The business newspaper Kommersant reported that with demand for Russian gas declining, Gazprom faces a liquidity problem, which in turn could seriously affect Russia's urgently needed investment program to explore new gas fields.

Russia's biggest Soviet-era gas fields are past their prime. Moscow expects that through development of giant new fields, the decline in production can be made up. The fields at Bovanenkovskoye on Yamal were expected to produce their first gas by 2011, and Shtokman by 2015. But the financial crisis in the West affects fresh investments.

Meanwhile, Gazprom's gas production is expected to decline to 510 billion cubic meters (bcm) in 2009 from a level of 550 bcm in 2008. Thus, Gazprom may be constrained to limit its exports to 170 bcm in 2009, as compared to 179 bcm last year. Russia's gas shortfall seems to have set in earlier than expected.

Therefore, Central Asia's importance as a source of cheap energy has increased for Russia. Gazprom is currently buying roughly 50 bcm of gas from Turkmenistan, 15 bcm from Kazakhstan and 7 bcm from Uzbekistan. Central Asian producers accounted for about 14% of Gazprom's total production last year. However, Central Asian producers would now assess that Russia lacks the financial resources to follow through on its commitments in the field of energy cooperation.

In late March, when Turkmen President Gurbanguly Berdymukhamedov visited Moscow, it was widely expected that the talks would result in a decision to kick-start the so-called Prikaspiiski pipeline network expansion which was agreed to over two years ago. The project is of immense importance for Russia to make increased gas purchases from Turkmenistan. It involves the expansion of the Soviet-era gas pipeline along the east coast of the Caspian Sea via Kazakhstan to Russia. But Berdymukhamedov balked.

Beijing would have taken into account these emergent circumstances when it signed an unprecedented "oil-for-loans" agreement with Russia on February 17. In terms of the agreement, China Development Bank will lend $25 billion at 6% annual interest to Russia's state-owned oil company Rosneft and oil pipeline monopoly Transneft. In return, China will receive roughly 20 million tons of oil annually from Russia starting from 2011 for a 20-year period. The total volume of the Russian oil supplies within this framework is the equivalent of about 4% of China's current consumption of oil and about 8% of China's present imports. Rosneft receives $15 billion out of the Chinese loan.

On its part, Transneft receives the remaining $10 billion out of the Chinese loan towards the cost of building a spur from the East Siberia-Pacific Ocean (ESPO) pipeline originating from Skovorodino in eastern Siberia to China's Daqing petrochemical hub. China had earlier funded the project's $37-million feasibility study.

The ESPO's first stage is expected to have a capacity of 30 million tons annually and the second stage will have a capacity for transporting 80 million tons. Transneft is expected to complete the first stage (Taishet to Skovorodino) by the end of this year and to commence the construction of the second stage (Skovorodino to Kazimo) in December. The entire project will be completed by end-2010.

Clearly, the Chinese loan comes as a great relief to the two cash-strapped Russian energy companies to realize their refinancing loans in 2009 as well as to continue with their capital expenditures. The loan also goes to some extent to make up for the flight of Western capital from Russia. Without doubt, China has made a smart move.

One, it is always a wise thing to tie up long-term energy supplies. Two, the price of the Russian oil will definitely be cheaper than the prices on the spot market, where China buys the bulk of its imports at present. Three, China has got Russia to deliver oil by a single-destination pipeline to China. Four, China is reducing its reliance on Middle Eastern oil. Five, China is reducing its dependence on the stretched-out transportation route via the Malacca Straits.

Above all, China has persuaded Moscow to commit significant quantities of its oil away from its traditional European market. Moscow often held out the prospect of a diversification to the Asian market, but remained fixated on the Western market. That mindset is changing. Again, China may have at long last galvanized an all-round energy cooperation program with Russia. Sino-Russian energy cooperation had lately shown signs of fatigue after the promising start during the landmark visit by then-Russian president Vladimir Putin to China in March 2006.

Putin, now prime minister, had proposed to export up to 40 bcm of Russian gas to China via the new 6,700-kilometer, $10-billion Altai pipeline. But virtually nothing has happened on this front since then, ostensible amid squabbles over a mutually agreeable gas price formula, while Moscow remained focused on the European gas market. This attitude is changing.

In February, the Kremlin decided to revive the Altai project when President Dmitry Medvedev wrote to Chinese President Hu Jintao offering comprehensive cooperation in bilateral energy projects. Gazprom has since shown interest in forming a gas-trade joint venture with the China National Petroleum Corporation, which would allow the Russian firm to participate in retail gas sales in the Chinese market as a quid pro quo for favorable pricing.

Kazakhstan, Central Asia's number one energy producer, also faces a financial crisis similar to Russia's. Kazakh Prime Minister Karim Masimov underscored this recently by comparing the crisis to wartime conditions, which needed a response on a war footing. He wasn't exaggerating.

With the oil price falling to $50 per barrel as compared to $150 in July last year, there is a severe resource crunch. Besides, Kazakhstan has reason to worry that the crisis may turn out to be drawn out. True, Kazakhstan is spending almost $15 billion or 14% of its GDP on stimulus packages. But the government has nonetheless begun cutting jobs in state enterprises. A ban has been imposed on new hirings. The initial hopes on new infrastructure projects keeping wages stable have faded. Unemployment is rising, which is a matter of major political concern.

In this scenario, China has responded to the Kazakh request for help. Two agreements were signed in Beijing on Thursday during a five-day visit (April 15-19) by Nazarbayev providing for a Chinese loan amounting to $10 billion to Kazakhstan in return for the right, among other things, to take a big stake in the Central Asian country's energy sector. China's Eximbank will lend the state-owned Development Bank of Kazakhstan US$5 billion. China's state-run Chinese National Petroleum Company (CNPC) will in turn extend a $5 billion loan to KazMunaiGas, the Kazakh national oil company.

The two oil companies also signed a separate agreement giving CNPC a 49% stake in MangistauMunaiGas (MMG), a local oil producer. (Kazakhstan and China also signed an initial accord to build a "road transport channel" linking western China and Europe. Other agreements include accords to cooperate in agriculture, education, finance and telecommunications.)

Beijing's intentions are quite transparent: China will tap its $1.95 trillion currency reserves to buy overseas exploration rights wherever available in Central Asia. Nazarbayev told Xinhua news agency on the eve of his departure for China that China's role was of global significance. Its huge market, abundant foreign exchange reserves and "effective crisis response" constitute an "enormous support for the world economic revival", he said.

Kazakhstan is a safe investment destination, too. It holds over 3% of the world's proven oil reserves. It received $21 billion in exploration and production investment in 2007 before the financial crisis erupted. Curiously, China is stepping into the purchase of MMG, outbidding Russia's Gazprom and India's ONGC (Oil and Natural Gas Commission), both state-owned enterprises. CNPC won the race by offering the $10 billion investment package which neither Russia nor India could match. China evidently took a long-term view. The MMG has estimated crude oil reserves of 1.32 billion barrels and also holds a 58% stake in the Pavlodar oil refinery, apart from operating a chain of retail stations.

China is not a new investor in Kazakhstan's energy sector. It already owns Aktobemunaigas, which produces 120,000 barrels of oil per day (b/d) and China holds 67% of PetroKazakhstan, which produces 150000 b/d. It is also an equal partner, along with the Kazakh state oil company KazMunaiGas, in the 200,000 b/d oil pipeline from the Caspian to China's Xinjiang border.

Meanwhile, work on the gas pipeline project from Turkmenistan via Uzbekistan to China is on target. China is financing this. The Turkmen portion of the pipeline runs 188 kilometers and will be completed by end-2009. More than 1,200 km of the pipeline has already been laid in Kazakhstan and Uzbekistan.

It shouldn't come as surprise if Beijing now begins flexing its financial muscles to ensure that the pipeline optimally delivers gas on China's western border. Indeed, gas deliveries to China via the new pipeline will signify a major diversification of the Central Asian region's gas exports away from Russia and Europe.