

EXAMINING THE PROSPECTS OF A RUSSIA-CHINA OIL PIPELINE

In the last decade, China has become a net importer of oil, heavily dependent on the volatile Middle East region to fuel its increasing petroleum needs. As part of its energy security policy, China is actively diversifying its sources of petroleum imports. Meanwhile, the Russian economy has oil exports as its main source of foreign revenues, and is keenly interested in transporting Siberian resources to world markets. **Steve Wardlaw, Executive Partner, and John Kuzmik, Partner, Baker Botts, analyse the prospects of a Russia-China oil pipeline**

From both countries' perspectives, one or more cross-border oil or gas pipelines will serve both countries' interests and further strengthen the development of good relations between Moscow and Beijing. Although a number of such pipeline projects have been discussed, China is pushing for a pipeline route from Angarsk in East Siberia to Daqing in Heilongjiang. Japan also is competing both for the Siberian resources and the timing of the pipeline construction; in November 2005 Putin announced that a pipeline would be constructed from Taishet in East Siberia to Nakhodka facing the Sea of Japan. Significantly, however, it is currently thought that the pipeline to the Sea of Japan will be built in two stages through Skovorodino, which is far from the coast but only 69 kilometers from the Chinese border. Russia finds itself being courted by other states; this

time its attraction arises from being an energy supplier.

Tokyo worries that the bulk of Siberian reserves will go to China entirely and insists that the branch to Daqing be built only after completion of the Skovorodino-Sea of Japan line or preferably that the Daqing link not be built at all. Moscow has declined to set the schedule for the second stage, and Sergei Grigoriyev, vice-president of Transneft, has been quoted as saying that "we are building a pipeline across our own territory. No one will decide for us who gets oil through it first".

A third possible Siberian route, running directly between Angarsk and Beijing transiting through Mongolia, has been considered and since discarded by both Moscow and Beijing.

Regardless of whether the Skovorodino-Daqing branch will be constructed before or after the Skovorodino-Sea

of Japan line, the likelihood of a Russia to China oil or gas pipeline being built is high. For Russia it is a nearer, and therefore cheaper, market than, say, North America, supply to which is also a Russian strategic goal.

Legal structures

There are two basic structures for cross-border pipelines ownership. One involves a series of domestic pipelines connected at a border, with each domestic pipeline separately owned and subject to the laws of the country in which it is situated. Alternatively, a cross-border pipeline may be a single asset, owned by a single consortium of sponsors established in any appropriate jurisdiction, subject to the domestic laws of both the place of establishment as well as the country or countries in which any part of the pipeline lies. In either case, consider-

able levels of governmental control can be expected from both Russia and China. Both countries have a history of governmental market intervention and governmental involvement in cross-border commercial affairs. Moscow and Beijing will consider the project to be of significant national strategic importance. Chinese participation in the project is almost certain to be undertaken by one of the State-owned oil companies. Although a more corporate structure exists in Russia, it is likely that state-owned companies, particularly Transneft, will play a major part.

Regulatory issues both in Russia and China will need to be addressed -- from health, safety, and environmental regulations to more fundamental issues affecting the structure of the investment.

Some key issues for either or both countries are:

Pipeline Ownership. A variety of commercial and political factors need to be considered in determining the ownership structure for a pipeline. If a consortium, an incorporated joint venture with limited liability may be the preferred, but there are examples to be found of unincorporated joint ventures, partnerships and even unit trusts. Or separate entities established in Russia and China may manage pipeline arrangements contractually through coordinated agreements.

In Russia, the question of pipeline ownership is a politically complex one. While Transneft has traditionally had a monopoly on oil pipelines, other oil companies (most notably Yukos) have tried to break that monopoly. Transneft is viewed as a traditional 'old-style' entity, and it will be interesting to see whether Gazprom, now it has oil interests in the form of Sibneft, will view itself as an alternative potential operator.

In relation to the involvement of foreign oil companies in Russia, many observers are watching the current Shtokman tender with interest. The Russian state seems to have recognised the benefit of foreign involvement, for reasons of new technology and ability to manage a complex multi-party project. This will be an important test of Russia's ability to allow foreign oil

companies to assist in and benefit from large-scale commercial infrastructure projects without interference.

Construction. The project sponsors are likely to look to a single turnkey contractor for the pipeline construction. Under recent regulations issued by the Chinese Ministry of Construction, which apply to all construction, including pipelines, qualified foreign contractors must establish a joint venture or wholly-owned subsidiary in China in order to undertake construction work in China. The regulations are controversial, as they appear contrary to the spirit of China's market access obliga-

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tions under the WTO. The regime in Russia is less restrictive, although the level of foreign company involvement that will be allowed remains to be seen.

Land Use Rights. In China, land is owned by the State or by village collectives. Companies and commercial enterprises can own improvements on land, including fixtures such as pipelines, in which case the improvement owner must have "land use rights". Only some land use rights can be transferred, leased or mortgaged, so careful examination of the types of rights is essential. No law explicitly prohibits a foreign company or individual from acquiring land use rights, but it is generally accepted that a foreign entity can do so only through an FIE.

Given the State ownership of land, as well as the commercial difficulties involved in determining title and valuation, pipeline sponsors in China should be prepared for protracted negotiations on land use rights. Local land authorities along a pipeline route will have unique local concerns.

Treaties. Differing government interests can wreak havoc in cross-border commercial projects, particularly where issues of energy and national security are involved. A bilateral or multilateral treaty arrangement setting out the agreed "law" of a cross-border project, with clearly defined governmental responsibilities and dispute resolution mechanisms, is one approach which can provide a framework to deal with critical issues. Another approach could involve the use of harmonized host government agreements.

Russia has in recent years made announcements about moving away from a PSA regime for upstream development (which is similar to a host government agreement), preferring instead to rely on a licensing regime backed by domestic law. However, for a cross-border project, their view should probably be different.

The multilateral Energy Charter Treaty, signed in 1994 and in force from 1998, seeks to create norms for investment in the energy sector and to provide the means and mechanisms for dispute resolution. Russia has signed but not yet ratified the ECT, and China participates as an observer, but the ECT is likely to inform and influence the conduct of both Moscow and Beijing.

Furthermore, the two nations in 2001 entered into a treaty of friendship and cooperation. Under this bilateral agreement, Moscow and Beijing cooperate on economic matters, including energy, which are of mutual interest to the two nations. Subsequently, Beijing has also actively lobbied for Russia's accession to membership of the World Trade Organization.

These good relations, based on solid intergovernmental agreements, will be key in putting in place the specific arrangements between Moscow and Beijing to enable a Russian-Chinese oil pipeline to be built. 