

# ***THE RISE OF CHINA*** ***AND ITS ENERGY IMPLICATIONS***

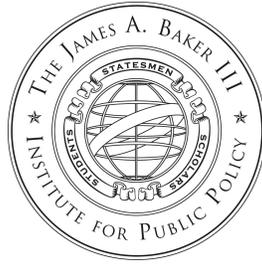


## **China's Relations with OPEC: Challenges for U.S.–Sino Relations**

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# CHINA'S RELATIONS WITH OPEC: CHALLENGES FOR U.S.-SINO RELATIONS

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*The Rise of China and Its Energy Implications* is a major research initiative to investigate the implications of China's oil and natural gas policies and domestic energy market development on global energy markets. This study focuses on the influence of China's energy development on U.S. and Japanese energy security and global geopolitics. Utilizing geopolitical and economic modeling and scenario analysis, the study analyzes various possible outcomes for China's domestic energy production and its future import levels. The study considers how trends in China's energy use will influence U.S.-China relations and the level of involvement of the U.S. oil industry in China's domestic energy sector.

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Throughout the last two decades, China has championed an international energy strategy that until recently has enabled its rapid economic rise. This “going abroad” strategy, coupled with a staunch policy of non-interference, has led China to acquire a vast array of foreign oil holdings with little apparent concern for geopolitical risk. In the 1990s, China’s risk appetite stemmed from simple economics. Unable to compete with established Western oil firms, the newly formed “going abroad” strategy focused on international markets Chinese firms could most easily penetrate—particularly those facing US economic sanctions. Countries such as Iran, Iraq, Venezuela, Sudan, and Myanmar became ideal targets for China’s foreign acquisition campaign, and Chinese trade with Africa increased more than 350 percent over the course of a decade.

While the pragmatism of China’s dual-pronged approach—pursuing a “going abroad” strategy while adhering to a non-interference policy—was initially met with praise, the sustainability of this approach has come into question in Beijing policy circles in recent years. As domestic conflicts in Sudan and Libya and burgeoning political tensions in Iran and Venezuela force China to reevaluate the security of valuable energy assets and Chinese expatriates, China’s non-interference approach faces a test of durability.<sup>1</sup> Rising geopolitical risk among its Organization of the Petroleum Exporting Countries (OPEC) suppliers has embroiled China in diplomatic scuffles and opened up the possibility of contract renegotiation and expropriation. Though still void of the ideological constraints indicative of a US alliance, the newfound risks facing Chinese investments, companies, and workers abroad will by virtue of a changing geopolitical scene force a significant reevaluation of China’s “going abroad” policy. China’s response to new oil strategic challenges is also influenced heavily by its own negative perceptions about US hegemony in the Middle East and China’s increasingly visible concerns about a US policy that “favors democratization” over Middle East “peace and stability.”<sup>2</sup>

China’s emerging policies toward the Arab Spring and brewing Middle East conflicts are an emerging source of tension in US-Sino relations. Over the past year, the United States and Europe have intensified efforts to contain Iran’s nuclear program, putting the West increasingly at odds with China, which has to date declined to abandon its support for Tehran. In July 2012, the United States led a new initiative to strengthen economic sanctions against Tehran.

In January 2012, the European Union (EU) froze the assets of the Iranian Central Bank and imposed a ban on the sale of all Iranian crude, petroleum products, and ship insurance. The ban on crude products came into effect on July 1, 2012. The EU embargo followed US President Barack Obama's decision in December 2011 to enact stringent sanctions on countries buying large volumes of crude oil products through the Iranian Central Bank. Under the new US sanctions law, foreign banks handling Iranian oil transactions would be cut off from the US financial system.

Cracking down further, in August 2012, the US government passed additional sanctions targeting companies involved in Iran's oil and gas sectors, financial sector, insurance, infrastructure, services, consulting activities, and doing business with National Iranian Tanker Company (NITC) and National Iranian Oil Company (NIOC). The new bill, signed into law on August 10, includes a human rights aspect that targets the Islamic Revolutionary Guard Corps.

Twenty countries have qualified for exemptions from the US law. Initially, China was not among them, announcing its refusal to comply with the US restrictions on Iranian oil import volumes. Reports had surfaced in early 2012 that Iran had agreed to accept Chinese payments in gold, allowing China to bypass US sanctions.<sup>3</sup> However, Beijing's position seemed to change by June, when officials allegedly pledged to cut oil imports by around 18 percent in an effort to win a sanctions waiver from the US government.<sup>4</sup> In March 2011, comments by State Department Special Adviser for Non-Proliferation and Arms Control Robert Einhorn indicated that Chinese firms were likely sharing sensitive technology that aided nuclear arms development.<sup>5</sup>

In September 2012, the US State Department announced that the Obama administration had renewed waivers on Iran sanctions for Japan and 10 European countries because they had demonstrated that they had cut their crude imports from Iran. What this means is that banks in the 11 countries were granted a second 180-day reprieve from the threat of being cut off from the US financial system under the American sanctions targeting Iran's nuclear program. The United States, which granted waivers to South Korea and India in June 2011, is expected to renew those two waivers in December 2012.<sup>6</sup> As for China, which also received a waiver from Washington in June 2011 and therefore has an extension review set for December 2012, it will

depend on how much Beijing continues to import from Iran in the remaining months of 2012 and whether the Obama administration feels it must send a stronger political and economic message to China and Iran.

The EU sanctions against Tehran effectively blocked European insurers (who are the dominant players in the marine insurance sector) from offering coverage on Iranian crude. The lack of shipping insurance coverage quickly disrupted flows of Iranian barrels to Tehran's major Asian customers at the same time that EU nations stopped buying its oil altogether. Japan initially curtailed Iranian oil imports in July because of the lack of shipping insurance, and Beijing reportedly asked Iran to deliver oil with NIOC's own tankers while pressing Iran hard on freight pricing. Since then, Asian buyers have been exploring other options to deal with the shipping insurance ban, with Japanese insurers increasing their maritime coverage to allow more domestic tankers to transport Iranian crude. India has been forced to depend on Iranian tankers to deliver crude, while South Korea initially stopped importing from Tehran altogether,<sup>7</sup> but subsequently resumed with reduced volumes.

China has publically reiterated its opposition to military intervention in the Syrian civil war, particularly from the West. But in contrast with its position of neutrality in regard to the passage of the UNSC resolution in March 2011 that established a no-fly zone over Libya, Beijing has repeatedly vetoed UNSC resolutions targeting the regime of President Bashar Assad throughout 2012. The fact that the Libyan no-fly resolution had been requested by the Arab League may have helped sway Beijing to adopt a more neutral stance. Reports in the Arab media surface in July 2012 that three Chinese ships loaded with weapons had recently passed through the Suez Canal en route to Syria. Egyptian officials denied the reports, claiming that the ships were carrying food and materials to the Ukraine.<sup>8</sup>

China's response to the US-led initiative on Iran highlights Beijing's highly ambiguous goals in the Persian Gulf. Denying it has a commodity-driven policy, China has tried to straddle the fence in its Iran policy. It has offered its cooperation to US requests and Gulf Cooperation Council (GCC) diplomatic carrots by downgrading its investment activity in Iran and somewhat reducing

its purchases of Iranian oil. But it continues to shield Iran diplomatically and has firmly backed Tehran's geopolitical interests in Syria.

China continues to stand by Iran, even as international sanctions targeting the OPEC producer have proved hard for both Beijing and Tehran to elude. In a very public show of support, Beijing invited Iranian President Mahmoud Ahmadinejad to attend a June 2012 summit in Beijing of the Shanghai Cooperation Organization (SCO), in which the 11-member organization issued a statement warning against United States or other military force against Iran regarding the nuclear program dispute. The statement, in part, stated that any effort to settle the Iranian nuclear issue by external force was "unacceptable" to the SCO and would "lead to unpredictably serious consequences, which would threaten stability and security in the region and the entire world."

During the Iranian leader's visit to Beijing, Chinese Premier Wen Jiabao told Ahmadinejad that "Iran is a traditional friend of China and expansion of relations with Teheran is important for Beijing." In addition, Iran's Fars News Agency reported that the Chinese premier recommended that Beijing and Tehran further work with Iran on energy, infrastructure, and trade issues.<sup>9</sup> Beijing's motivations in the Middle East appear to be complex and multifaceted. Access to oil cannot be ruled out as a feature of Chinese involvement in the region.<sup>10</sup> China says its long-term dependence on foreign oil imports means it cannot afford to relinquish bilateral energy relations with any major Middle East energy producer, including Iran. But China has paid a geopolitical price for betting incorrectly in and around the Middle East, and its support for Iran and Syria's Assad regime currently puts its improving relations with Saudi Arabia and Kuwait in some jeopardy. Saudi Arabia and Qatar have taken active steps to support the overthrow of Syria's Assad regime and to contain Iran's regional influence. Riyadh and Doha have been supplying arms to the rebel Free Syria Army (FSA)<sup>11</sup>, and since April, the two Gulf nations have begun paying the salaries of the FSA with logistical support from Turkey.<sup>12</sup> In February, the GCC announced that its member states were recalling their ambassadors from Damascus in light of the worsening crisis and demanded that Syrian diplomats leave the GCC nations.<sup>13</sup> Saudi King Abdullah was one of the first Arab leaders to protest the Assad government's brutal crackdown on its population, stating on August 7, 2011, that the Syrian leadership must "stop the killing machine and bloodshed ... before it is too late."<sup>14</sup> The Saudi monarch's statement at the time was

widely interpreted as a warning to Iran, Syria's strongest regional ally. Riyadh in the early months of 2011 accused Iran of supporting Shi'ite dissent in Bahrain, and both Saudi Arabia and Iran are competing for influence inside neighboring Iraq via proxies.

China now runs the risk that it will damage its own important oil and natural gas relationship with Saudi Arabia and Qatar by backing the wrong side in the brewing regional battle for supremacy between these important Sunni Arab states of the Gulf region and Shi'ite Iran and its satellite regional proxies. China's increasingly strained relations with the new government in Libya is a cautionary tale about the vagaries of backing the wrong side in today's rapidly shifting sands of Middle East politics, post-Tunisia. As the conflict between Saudi Arabia and Iran intensifies, China's support for Iran will put it squarely in the crosshairs of the Saudi leadership, which views the suppression of Iran's nuclear and regional military aspirations as existential to the Saudi regime's survival.

In the 1990s, the Chinese oil industry's campaign to attain oil and gas assets abroad seemed increasingly focused on countries with emerging geopolitical risks or human rights problems, such as Iran, Iraq, Libya, Sudan, Burma, and Venezuela. The strategy was not ideological per se but reflected initial difficulty in competing with Western firms in prolific oil areas where American and European firms were already well established. The solution, Chinese strategists felt, was to focus China's international exploration drive on countries where Western, predominantly US firms, could not easily get in the way of Chinese deal-making. That meant in the mid- to late-1990s, many countries under US sanctions became ideally placed to target Chinese investment by state run firms that had little international experience at the time. Chinese policy analyst Yishan Xia describes the Chinese energy policy conundrum in the 1990s in terms of simple market penetration:

Western monopoly capital, with the support and assistance of their governments, has scrambled and seized the main oil and gas resource markets in all parts of the world. Almost all good resources markets in the world have been occupied and possessed by them. There is intense competition among different groups of

Western monopoly capital. All of them will certainly try even harder to impede Chinese companies from obtaining these oil resources.<sup>15</sup>

The solution, Chinese strategists felt, was to focus China's international exploration drive on countries where Western, predominantly US, firms could not so easily get in the way. That meant in the mid- to late-1990s, many countries under US sanctions became ideally placed to target Chinese investment.

This policy, which was initially greeted in Chinese leadership circles as pragmatic and profitable, is now increasingly presenting problems. Since the early 2000s, China's "going abroad" strategy has come to include hefty loan packages, with Beijing lending more than \$32 billion to Caracas, \$15 billion to Luanda, and approximately \$15 billion to Khartoum prior to Sudan's split. The combination of its oil investments and loan packages has rendered China an international stakeholder vulnerable to geopolitical complications, international pressure, and political backlash. Amidst structural upheaval in Sudan and Libya and the ongoing political uncertainties in Iran and Venezuela illustrate, China is learning that equity oil ownership in regions with high levels of political and contractual risk may not be as clear a conduit to energy security as it had previously imagined.

China's relations with the new Libyan government remain strained, and Beijing is now enmeshed in domestic conflicts within the newly divided Sudan. For all its philosophical declarations of steering clear of interfering with another country's internal affairs, Beijing—having for all intents and purposes supported the regime of Moammar Gadhafi until virtually the last possible moment—had fallen afoul of Libya's interim National Transitional Council (NTC)<sup>16</sup>—which was dissolved in August 2012 after handing over power to a newly-elected national assembly<sup>17</sup>—and may lose out on business opportunities in the new Libya. That possible debacle follows the unfamiliar twin challenges of having the Libyan facilities of Chinese state oil firm China National Petroleum Corp (CNPC) come under attack and having hostilities escalate to the point where Beijing was forced to arrange for the evacuation of thousands of Chinese citizens working in the North African nation. China, it turns out, was also on the wrong side of conflict between North and South Sudan. The South eventually seceded based on a referendum supported

by the international community, leaving China, whose oil properties are located mainly in the South and were attained in the 1990s, to scramble diplomatically to save its deals from the “reevaluation” announced by Juba for oil deals signed before the Sudan Comprehensive Peace Agreement went into effect in 2005. In late October 2011, China announced that it was granting South Sudan \$31.5 million for improvements in education, agriculture, health, and water supplies. China also faces great uncertainties in Venezuela, where the serious illness of President Hugo Chavez is casting great uncertainties about the country’s future politics and the fate of China’s massive multibillion-dollar loans-for-oil arrangements.

Moreover, increasingly, China is worrying about the entanglements that the growing number of Chinese businessmen and workers in the Middle East region could entail. Will instability in the Middle East mean that China will have to provide protection and evacuation services for its citizens, as became necessary in Libya during the civil war there? At present, China is not equipped to meet this new potential challenge.

Realizing that its prior risky oil deals are less than ideal, China has been trying to diversify its holdings by shifting investments to the Americas and Australia. The shift to the Americas, however, has not been without its own risks. Increasingly, China has found that investments in Africa and Latin America can become problematic due to political and social instability, sensitive issues related to human rights, problems arising from resource nationalism, and the difficulty of managing local community relations and local environmental problems. More recently, China has faced greater political difficulties and local government opposition to its bids for new Africa acreage, being turned away by Angola and Nigeria on recent efforts, foreshadowing possible new challenges in Africa in the coming years.

Finally, China faces rising risks to its investments in Iran and elsewhere from its overarching interests to maintain healthy and durable economic ties with the United States. US Middle East policy is now perhaps the single biggest inhibitor to China’s successful implementation of its “going abroad” strategy. Most recently, US-led sanctions policy against Iran has forced Beijing to pull back on its commitments in the Iranian oil and gas industry. Instability in Iran that thwarts it from being a reliable oil and gas supplier, combined with the disincentives to confront head-on

US efforts to sanction Iran for its nuclear aspirations, have prompted China to pressure its firms to slow activities in Iran to minimal tasks such as appraisal studies instead of active drilling and construction related to existing deals. In moves designed to be face-saving, China has cited lack of access to equipment from third-party countries as the reason its lack of progress at the North Azadegan field where CNPC was supposed to invest \$2 billion to raise production to 75,000 barrels per day (b/d) in the coming four years. In the midst of the delays in the summer of 2011, Tehran threatened to rescind China's deals. At the time, Iran did not appear to accept CNPC's claim that lack of financial resources had delayed Phase 11 development. National Iranian Oil Company (NIOC) in October 2011 suspended CNPC's North Pars deal as a means to put pressure on the Chinese firm to move forward on South Pars Phase 11.<sup>18</sup> While CNPC finished FEED work on Phase 11 of the South Pars field development in early 2012, continued delays on this phase appear certain. CNPC may now be questioning whether Chinese gas demand will be sufficient enough to justify its commitment to the project. From the Iranian perspective, NIOC is reportedly uncomfortable with CNPC's lack of LNG expertise, which was a similar concern in the North Pars project. There are reports that NIOC would prefer freezing the Phase 11 work and there has been speculation that NIOC may have suspended its contract with CNPC over the Chinese state firm's feet-dragging.<sup>19</sup> Iranian officials this month accused CNPC of stalling on South Pars because the Chinese firm is demanding a higher price for the natural gas it will help produce from the field.<sup>20</sup> To date, China seems content to avoid the risk of additional investments, giving the United States some leverage with all concerned. However, China continues to buy Iranian crude oil despite the tightening of economic sanctions against Tehran.

As sanctions choke off Iran's ability to ensure tanker shipping for its oil, Tehran has tried to relieve the pressure on its limited state-owned tanker fleet by filling Malaysian-flagged floating storage units (FSU) so it can better supply its key Asian customers. In September 2012, one tanker owned by the National Iranian Tanker Co. (NITC) reportedly discharged crude into an FSU near Labuan Island off East Malaysia while another NITC vessel unloaded 270,000 tons of fuel oil into an FSU at the Malaysian port of Tanjung Pelepas. In the second instance, which occurred on September 18, the Pioneer—a NITC-owned VLCC previously called Hadi—transferred the fuel oil into the Hercules, a VLCC that had been converted into a floating storage unit. The Pioneer was reported to have then returned to Iran.<sup>21</sup>

Given tightening Western sanctions, Iran's Asian customers have had difficulty finding ship owners willing to send their tankers to load crude and product from Iranian ports. The sanctions have put NITC under increasing pressure because the state tanker firm does not control sufficient tankage to both transport its exports to Asian customers China, India, and South Korea and simultaneously store the close to 1 million b/d of remaining production that cannot be sold.

NITC's fleet includes 25 VLCCs, each with a 2 million barrel capacity, as well as nine Suezmax, five Aframax, and various other vessels. It would take at least 16 VLCCs for NIOC to supply Chinese and Indian export commitments. Shipments to South Korea, if alternative shipping is not available, require another four VLCCs from NITC, leaving the Iranian company strapped to meet the needs of other customers.<sup>22</sup>

This paper will discuss the recent challenges of China's "going abroad" policy of oil investments and trade and its important geopolitical implications for Beijing's relationship with OPEC countries and for Sino-US relations. Through the prism of China's oil endeavors, we hope to reveal new insights into China's foreign policy, its shifting geopolitical role and its competitive relationship with the United States. In particular, we find that China's policies toward the Middle East are multifaceted and only partially commodity driven. As a result, even though China and the United States have a common strategic interest in maintaining the free flow of oil internationally and, in particular, from the Persian Gulf, China perceives that its overall strategic interests in the Middle East diverge widely from those of the United States. China is pursuing goals in the region that are in direct conflict with the US interests and therefore these differences need to be managed diplomatically and strategically.

As will be discussed in this paper, we recommend that the United States needs to elevate communications between the United States and Chinese military. The nature of conflicts in the Middle East and Asia calls for a more proactive, high-level strategic dialogue between the US and Chinese militaries. At present, this dialogue is more tactical in nature. Even at the height of the Cold War, such consultative lines of communication between top US and Russian military brass were critical to avoiding escalation of conflicts in the Middle East to avoid dire global consequences. The same utility would be beneficial in the Sino-US relationship.

The United States also needs to rethink its cooperation with China on energy technology issues. Specifically, the United States might want to reconsider whether sharing advanced shale exploration and development technology—an initiative currently on the books as program of the US Department of State—is in the long-term US interest. The United States gains substantial strategic advantages to reducing its own vulnerability to geopolitical events in the Middle East while at the same time leaving the Chinese economy more exposed than the US to instability in global oil and gas markets, until which time China shows a more significant commitment to partnering with the United States on Middle East conflict resolution. The Obama administration was effective last year when it linked Chinese commercial intentions to invest in US domestic shale natural gas plays with Beijing's greater cooperation in abiding by US sanctions policy on Iranian investment and trade.

Finally, we find that given common interests in moderating volatility in the oil market, the US should still try to fashion a joint China-US diplomatic strategy toward the Organization of the Petroleum Exporting Countries (OPEC). For example, a joint communiqué from the United States and China citing a joint commitment to lower oil use through bilateral or global agreements on corporate average efficiency standards for automobiles or other coordinated conservation methods, or to coordinate on a release of strategic emergency stocks during a time of supply disruption, would certainly counterweigh OPEC's ability to act in concert to lift oil prices.

### **History of Chinese-OPEC Relations**

In recent years, China's growth in energy demand has been one of the first factors that economists and industry analysts as well as OPEC examine when making their demand forecasts for the coming quarters and years. For example, in its October 2010 monthly oil market report, OPEC warned that global oil demand growth in 2011 would be "highly sensitive to China's energy policies," and that "should China emphasize its energy consumption policy ... then this move would negatively affect world energy usage."<sup>23</sup>

## China's Relations with OPEC

After becoming a net oil importer in 1993 when its domestic demand began to outstrip its crude output, China increasingly turned to Persian Gulf, African, and Latin American producers within OPEC to satisfy its burgeoning domestic oil needs. Most notably, OPEC kingpin Saudi Arabia has ratcheted up its crude volumes to China in the last five years. Riyadh continues to be the top crude supplier to China, averaging 1.13 million b/d in oil exports to the Asian giant during the first half of 2012, which reflected a 147,000 b/d year-on-year build. At current volumes, Saudi Arabia accounts for approximately 20 percent of China's total crude imports. Newer OPEC member Angola is a long-standing supplier of China.<sup>24</sup>

China's OPEC alliance has undergone distinct phases, but economic self-interest was the unquestioned principle to which China adhered while navigating earlier relations.<sup>25</sup> Prior to becoming a net oil importer, China had virtually no formal relations with OPEC. Rather, through the 1980s, China was a competing independent crude oil producer and exporter. In April 1988, when China's crude output was averaging 2.68 million b/d, the Asian producer joined in a coalition of seven non-OPEC producers that negotiated with OPEC to cooperate on cutting output in an effort to stem a collapse in international crude prices. But circumstances prevented China from having to follow through with its promised output reduction commitment when negotiations between OPEC and the non-OPEC group broke down. Negotiations between the non-OPEC contingent and several OPEC members resulted in a proposal for the independent producers to collectively reduce output by 183,000 b/d in exchange for OPEC to trim 300,000 b/d from its supplies. However, Saudi Arabia effectively scotched the plan within OPEC by insisting that any cuts OPEC made should be distributed equally among 12 of the 13 members of the group (Iraq was exempt from observing its quota). Riyadh also called on the independent producers to offer larger output cuts, given that OPEC had consistently reduced its production over several years to the benefit of the non-OPEC players, arguing it was time for the independent producers to shoulder the responsibility for shoring up prices.<sup>26</sup> As a result of the Saudi position, the deal broke down and China was never called upon to reduce production in concert with OPEC.

A decade later, when several non-OPEC producers did go so far as to cooperate with OPEC and trim their output in 1998 and 1999 to help crude prices recover, China was not among the collaborating non-OPEC group.

During the 1990s, Beijing undertook a foreign strategy policy toward the Middle East of “never claiming leadership, maintaining a low profile, and making some contributions,” which meant China’s role in the region was defined as “being detached generally and involved appropriately.”<sup>27</sup> During that period, rather than challenging the United States in the Middle East and the Gulf, in particular, China favored quiet diplomacy and promoting trade relationships, including arms sales, and interdependence.<sup>28</sup>

China’s economic ties to the Gulf accelerated in the 2000s. Chinese national oil companies (NOC) spent approximately \$15 billion in oil and gas acquisitions in 2009 and more than \$26 billion in 2010 as a means to diversify their energy investment portfolios and benefit from an appreciation in assets in the coming decade. OPEC members situated in the Gulf contributed the majority of China’s oil imports.

The recent manifestations of a forged closeness between China and OPEC—a closeness that likely began in the early 2000s<sup>29</sup>—are visible in the increased visitations between high-level authorities. In 2005 China and OPEC agreed to begin a more formal relationship when the organization sought a “road map” to better comprehend China’s surging demand growth. The formal ties between Beijing and OPEC have been slow to develop, but the Asian giant has had more success over the past three decades cultivating strong bilateral commercial and trade ties with key OPEC members that are among its largest crude suppliers. This has included China’s NOCs striking exploration and production deals in major oil and gas producing countries, including Iraq and Iran; welcoming Gulf producers like Saudi Arabia and Kuwait into China’s lucrative downstream sector; and selling military weaponry to Baghdad, Tehran, and Venezuela. In late December 2005, OPEC officials traveled to Beijing to initiate the first formal talks between China and the group. Then-OPEC president and Kuwaiti oil minister Sheikh Ahmad al-Fahd al-Sabah noted that China’s rapid economic growth had been having a great impact on the oil market. “They started to play a main role in the market and they even succeeded in changing

the culture of the market in 2004 and 2005 ... We started this dialogue to ... try to have some co-operation, especially for the future and to know what will be the situation of growth of demand in China,” al-Sabah said.<sup>30</sup> About a year later, a Chinese official speaking at a conference in Dubai explained that Beijing was intent on creating “a negotiating mechanism with OPEC.” In his speech at the Arab Strategy Forum, Zhai Jun, assistant minister of foreign affairs, noted that “Only through this can we maintain security and stability of our oil imports.” He went on to say that “Currently we’re making preparations to establish a dialogue mechanism with oil producers ... We want to participate as much as possible in some of the big decision processes on the world stage.”<sup>31</sup>

Then in December 2006, China hosted a gathering of top oil consuming nations—which was seen as a surprising leadership move for Beijing—to take on global energy issues. Still, though, discourse centered around discussions of cost. When OPEC officials traveled to Beijing in October 2007 for the first formal meeting between the two sides, China made it clear to the producer group that it believed current oil prices of \$85-90 a barrel were too high. Although oil prices had jumped about \$25 a barrel since the 2005 Sino-OPEC talks, the price rise had no real impact on Chinese consumers, given state-controlled Chinese fuel prices at the pump. Unlike the United States, it is rare to hear China publicly complain about OPEC; it makes sense instead that Beijing would make its views clear to those within the group with which it has strong bilateral commercial—especially energy-related—interests, such as Saudi Arabia, Iran, Iraq, and Venezuela.

Both its bilateral economic ties with oil producing countries and political participation in multilateral institutions have thrust China into the geopolitical arena beyond Asia Pacific over the past decade. Prior to the 1990s, China could afford to take a relaxed attitude toward oil geopolitics, as oil prices inside the country were set by state central planners and domestic oil demand pretty evenly matched output, insulating China from external features of global oil markets. In 1990, when China’s domestic demand stood at 2.1 million b/d, it was exporting 500,000 b/d of its crude.<sup>32</sup> By 1993, its falling domestic crude production and rising demand had forced it to import crude for the first time in several decades, initially from Iran and Oman. By 1999, when Chinese demand had ballooned to 3.95 million b/d, the Asian nation began to

average imports of 500,000-700,000 b/d.<sup>33</sup> In the decade since, China's booming economy has prompted domestic oil demand to soar.

China's oil demand growth has averaged 7.2 percent over the past decade, but this pace of demand growth is expected to ease in the coming years to a yearly average of 5 percent to 6 percent. Growth in apparent demand for gasoline, diesel, and other oil products has continued to trend downward. In 2011, the average annual oil product growth rate dropped from 12 percent in 2010 to an average 5.4 percent.<sup>34</sup> By mid-2012, the pace of apparent demand growth slowed to a rate of just 3.5 percent year-on-year,<sup>35</sup> with net product import totaling 430,000 in the first half of the year.<sup>36</sup>

According to data from the General Administration of Customs of China, in 2010, China imported 4.7 million b/d of crude oil, accounting for around 53.8 percent of total demand. China Oil, Gas, and Petrochemicals (China OGP) reported that China imported more than 5 million b/d in 2011. China continues to be highly dependent on the Middle East, which accounted for more than 50 percent of the Asian nation's total crude oil imports in 2011, followed by Africa (around 24 percent). By country, Saudi Arabia (20 percent of the total) was the biggest import source of crude oil in 2011, followed by Angola (12 percent), Iran (11 percent), Oman (7 percent), Russia (7 percent), Sudan (5 percent) and Iraq (5 percent).<sup>37</sup>

Accelerated by the expansion drive of the country's strategic petroleum reserve, China's demand for imported crude in the first half of 2012 rose by 10 percent compared with the same period in 2011. Imports of OPEC crude rose by 17 percent to 3.77 million b/d over the same period, offsetting the drop in Iranian and Sudanese/South Sudanese crude volumes, with losses amounting to 114,000 b/d and 195,000 b/d, respectively, compared with the previous year. The spike in OPEC shipments in the first six months of 2012 was led by Angola with 846,000 b/d, up 217,000 b/d from the previous year. Angola is the second-largest crude supplier to China, behind Saudi Arabia, which as previously mentioned, remains China's top supplier, at 1.13 million b/d for the first half of 2012. China also received an extra 90,000 b/d this year from Venezuela, 81,000 b/d from Libya, 40,000 b/d from Iraq, 28,000 b/d from Kuwait, 26,000 b/d from the United Arab Emirates (UAE), and 23,000 b/d from Ecuador, bringing imported crude volumes to

an average of 349,000 b/d from Venezuela, 168,000 b/d from Libya, 331,000 b/d from Iraq, 218,000 b/d from Kuwait, 171,000 b/d from the UAE, and 32,000 b/d from Ecuador.<sup>38</sup>

Despite Beijing's erstwhile commitment to accommodate US requests to cut back on Iranian crude imports, Iranian crude remained an important supply to China during the first half of 2012, with Iranian exports to China averaging around 432,000 b/d for the period. Iranian crude imports to China had dipped in February and March to 290,000 b/d and 255,000 b/d respectively, but this appears to have been more associated with contract disputes over pricing than any political moves by Beijing. Following its pledge to Washington in June to cut its Iranian crude supplies by 18 percent, to around 450,000 b/d, in order to receive a sanctions exemption from the US government,<sup>39</sup> it initially looked like China was honoring its promise. In July, data suggests that China had cut its Iranian crude imports by about 160,000 b/d to 490,000 b/d. But August levels seem to have rebounded to 600,000 b/d.<sup>40</sup> Indeed, tanker movements indicate that despite significant reductions in Iranian import volumes in the early months of 2012, China has increased import volumes in recent months and continues to purchase around half of Iran's total sales, potentially via disguised tankers.<sup>41</sup>

### **Recent Challenges to China's Going Abroad Strategy**

#### *CNPC and the Sudanese Split*

China, it turns out, was on the wrong side of conflict between Khartoum and its newly independent, oil-rich neighbor to the south. With Beijing a longtime ally of the regime in Khartoum, the newly formed government of South Sudan is forcing Chinese firms to renegotiate oil contracts inked prior to Sudan's split, since approximately 75 percent of pre-referendum Sudan's oil reserves are now solely controlled by the new southern country. Among a host of disputes, Sudan and South Sudan are in disagreement over their borders, with key oil fields falling into the equation.

In the disputed areas lie CNPC's largest blocks—Block 1/2/4 and Block 3/7—while its three other blocks fall entirely in Sudan. Although South Sudan has control over three-quarters of the oil that used to be produced in Sudan, the new country must use northern sections of the

pipelines in Sudan to transport the oil to market. Both countries have been at odds over transportation, port, and refining fees, with Khartoum currently charging Juba exorbitant fees that are the equivalent of approximately \$32 per barrel of exported oil, allowing Sudan to grab a large share of economic rents.

In September 2012, CNPC reported that it had resumed oil output from the Sudanese portion of its Block 1/2/4, but signs are that a rebound in production from the South Sudanese section (which accounts for 75 percent of the field's output) is still months away. Analysts estimate that it could be up to a year before South Sudanese crude oil exports to China rebound, given damage caused by fighting between Juba and Khartoum earlier in 2012. While CNPC has suggested that it anticipates production to be back on online in South Sudan by late September or early October 2012, it is likely that it will take at least three or four months to get even the undamaged Blocks 3 and 7 back on stream. CNPC is looking at extensive repairs on its South Sudanese Blocks 1, 2, and 4, and it doesn't see production from these blocks to reach more than 30,000 b/d by the end of 2013. At present, it appears that Sudan's crude production is only large enough to meet the needs of the Khartoum refinery with nothing left for export. China imported 260,000 b/d of crude from Sudan and South Sudan in 2011, most of it emanating from South Sudan.<sup>42</sup> Indicative of the perils of doing business in Sudan's oil sector following South Sudan's independence is an incident that occurred in August 2011 that involved a ship stopped at Port Sudan carrying 600,000 tons of oil reportedly bought by CNPC and pumped from South Sudanese wells. The shipper was accused by Sudan's government of not having paid customs fees. The ship was subsequently released just before Chinese foreign minister Yang Jiechi visited Khartoum. A day after stopping in Sudan, Yang held meetings with South Sudan President Salva Kiir, but the Chinese official came away from Juba without having locked in an oil agreement that would have secured the existing oil deals that CNPC had originally signed with Khartoum.<sup>43</sup>

Sudan and South Sudan are now facing the repercussions of letting a significant clause in their 2005 Sudan Comprehensive Peace Agreement expire. That clause stipulated that oil revenues were to be divided 50-50 between the north and south until South Sudan's formal independence, which occurred on July 9, 2011. The two sides are squabbling over sharing the revenues from the oil, most of which now is produced in South Sudan. And, just days before independence, the

South Sudan government declared that it would re-evaluate all contracts—with a particular emphasis on oil contracts—that were signed with foreign companies before the Sudan Comprehensive Peace Agreement went into effect in 2005. The South Sudan government had indicated that it has problems with some existing contracts, especially those involving blocks that Juba thinks are too large.<sup>44</sup> In September 2011, Juba declared it would respect previous oil contracts signed between the Sudanese and foreign investors before the independence of South Sudan.<sup>45</sup> However, after Juba accused Khartoum of oil theft earlier this year (see below). South Sudan said it was reviewing all oil contracts signed before its independence.

Beijing has been working to cultivate ties with Juba and re-secure its substantial oil interests in the new country. In August 2011, just a month after South Sudan achieved independence, Chinese foreign minister Yang stressed China's desire to continue to develop “friendly cooperation” with South Sudan, including providing aid, and he commented that Beijing and Juba should enhance cooperation in the fields of oil, mining, agriculture, and infrastructure construction. Not surprisingly, in late October 2011, China announced that it was granting South Sudan \$31.5 million for development projects covering improvements in education, agriculture, health, and water supply.<sup>46</sup>

In April 2012, China hosted South Sudanese President Kiir, during which time Beijing reportedly pledged additional loans for more infrastructure development. However, the South Sudanese leader apparently failed in his mission to garner Chinese financing for a pipeline that Juba would like to build through Kenya to a port on the Indian Ocean, which would provide South Sudan with a different port than Port Sudan in the north to export its oil.<sup>47</sup>

Since South Sudan has gained independence, not all has run smoothly between Juba and Khartoum. In January 2012, South Sudan shut down its oil production oil—approximately 350,000 b/d—after [accusing Sudan of stealing](#) some of its oil intended for export. Khartoum says the oil was being confiscated because of unpaid transit fees. This led to an escalation of tensions between the two sides, with Sudanese war planes dropping bombs and South Sudanese forces temporarily occupying the oil-rich Heglig region in Sudan. Also in January, rebels abducted 29 Chinese workers as part of a raid in the volatile South Kordofan Province in Sudan that ended up

with one Chinese worker killed. The Red Cross secured the release of the Chinese workers about 10 days later.

In February 2012, South Sudan expelled Liu Yingcai, the Chinese president of the Chinese and Malaysian pipeline operating consortium Petrodar, after Juba carried out an investigation into Khartoum's \$815 million "oil theft." Liu was accused of siding with Sudan in the oil dispute and of giving "limited cooperation" in following through with Juba's decision to cut off oil production.<sup>48</sup> Although Juba and Khartoum came to an agreement in August over pipeline fees, which will lead to South Sudan resuming its production, border and security issues must be settled before the agreement goes into effect.<sup>49</sup>

### **Chinese Security and the Libyan Crisis**

The recent political overhaul in Libya provides China with a similarly drastic illustration of the perils of involvement in another country's domestic affairs, and what happens when China misjudges which side of the conflict to back. For all of its philosophical declarations of steering clear of another country's internal politics, Beijing—having for all intents and purposes supported the regime of Moammar Qaddafi until virtually the last possible second—had fallen afoul of the interim NTC and may lose out on business opportunities in the new Libya. Given that China was an incidental player in Libya's energy sector, it is unlikely that the Chinese NOCs would ever have scored any big upstream development deals, but China did have a large presence in other sectors within the North African country.

Slow to support the Libyan uprising, China was further damned when rebel forces accused Chinese state firms of negotiating with members of Qaddafi's government over arms supplies in the last gasps of the civil war. Through its missteps in Libya, the Chinese government is discovering the pitfalls of operating in a country that becomes embroiled in political turmoil—forced to quickly evacuate a large number of its citizens, potentially lose out on existing business investments, and more than likely be refused future opportunities.

While China admittedly does not have substantial energy investments in Libya with the North African producer's upstream sector dominated by European and American oil firms, Beijing did have some 30,000-35,000 nationals employed with Chinese firms operating in Libya on projects primarily focused on housing and railway construction, oil field services and telecommunications.<sup>50</sup>

China's three main NOCs had limited operations in Libya. Prior to the beginning of the Libyan uprising, CNPC was reportedly moving toward ridding itself of its one known upstream asset in the North African nation, the offshore 17-4 Block, which it was awarded in 2005.<sup>51</sup> According to CNPC's website, the contract for Block 17-4, which is located off the northwestern coast of Libya, is an exploration and production sharing agreement that encompassed five years of exploration and 25 years of production.<sup>52</sup> CNPC, CNOOC, and Sinopec were all reportedly involved in engineering projects in Libya, with no oil production.<sup>53</sup>

Shortly after the onset of full-scale fighting between rebel forces and the Qaddafi regime in late February 2011, the three Chinese NOCs reported that they had evacuated their employees. CNPC announced at the time that it had halted production operations, sealed equipment, and evacuated its 391 Chinese employees. This came after the Chinese firm had declared the previous week that several of its sites had been under attack. CNOOC also stated that it had evacuated its 77 Chinese nationals, while Sinopec reported that it had recalled its seven Chinese employees back to Beijing. The exact scope of Chinese oil operations in Libya is unclear, with CNPC only indicating that many of its projects were in the Libyan desert.<sup>54</sup>

China, along with its fellow permanent UNSC member Russia and three nonpermanent members, abstained in voting on Council Resolution 1973 in mid-March 2011 that effectively gave NATO forces the authority to impose a no-fly zone and "all necessary measures" barring foreign occupation to protect civilians under threat of attack by the Qaddafi government. Following NATO's intervention, the Chinese government initially called for an immediate cease-fire and accused the coalition members of "the abuse of force." According to a statement made by Chinese foreign ministry spokeswoman Jiang Yu on March 21, 2011, "Libya's sovereignty, independence, unity, and territorial integrity should be respected." Jiang had previously justified

why Beijing had abstained from voting and had not vetoed Resolution 1973, noting that Beijing considered the “concerns and stances of Arab countries and the Africa Union as well as the current special situation in Libya.”<sup>55</sup>

However, China's ambiguity toward Resolution No. 1973 and coming late to recognizing the NTC did not sit well with the rebel forces. On September 12, 2011, China was the last of the UNSC permanent members to formally recognize the NTC. For the traditionally overcautious Beijing, it may have seemed a rushed move to acknowledge the transitional government, but it was behind the official recognition made by other UNSC permanent members, namely France, which recognized the NTC's legitimacy in March 2011; the United Kingdom, which formally acknowledged the NTC in late-July 2011; and the United States, which recognized the NTC in mid-August 2011. Although the United States and the United Kingdom may not have moved as quickly as the council might have preferred in recognizing the rebel government, they along with France were active participants in the NATO forces that supported the rebel cause in Libya against Qaddafi. Moscow gave the NTC diplomatic recognition on September 1, 2011.

In August 2011, a comment from an official at the Libyan rebel-run oil firm, AGOCO, to a news agency not only caused consternation in Beijing but also sent the Chinese into diplomatic overdrive. Abdeljalil Mayouf, the AGOCO information manager, suggested that there might be a backlash for those countries that had not moved quickly to support the rebellion against the Qaddafi regime, potentially resulting in a loss of oil contracts for those nations. “We don't have a problem with Western countries like the Italians, French and UK companies,” said Mayouf, adding, “But we may have some political issues with Russia, China, and Brazil.”<sup>56</sup>

At a press conference a day later, Wen Zhongliang, the deputy head of the Chinese Ministry of Commerce's trade department, responded to the potential economic and political retaliation by the rebels in power against Beijing, saying that, “China's investment in Libya, especially its oil investment, is one aspect of mutual economic cooperation between China and Libya, and this cooperation is in the mutual interest of both the people of China and Libya.” Wen continued, saying, “We hope that after a return to stability in Libya, Libya will continue to protect the interests and rights of Chinese investors and we hope to continue investment and economic

cooperation with Libya.” The same day as the Chinese commerce official’s comments, the Libyan embassy in Beijing began flying the red, black, and green flag preferred by the Libyan rebels.<sup>57</sup> The NTC had made it clear that it will honor Qaddafi-era oil contracts, which for the Chinese only really pertained to CNPC’s block 17-4, which the Chinese state oil firm had reportedly been trying to sell.

Despite earlier warnings from the NTC about repercussions against Beijing and others for being late to recognize the transitional government, China’s top state oil firms did come to agreement with Tripoli over 140,000 b/d of Libyan oil supplies earlier this year under two-term deals covering 2012. Unipec, Sinopec’s trading arm, contracted with Libya’s state oil firm National Oil Corporation (NOC) to lift about 100,000 b/d while Chinaoil, PetroChina’s trading arm, agreed to buy another 40,000 b/d from NOC. China’s crude imports from Libya had plunged about two-thirds from 2010 levels to around 52,000 b/d in 2011 because of the collapse of Libyan oil production and exports during the country’s crisis.<sup>58</sup>

It does appear that the Chinese government had been hedging its political bets in dealing with the Libyan crisis. An early and vocal proponent of political dialogue and diplomacy to resolve the eight-month crisis from the outset, the Chinese were reluctant to condemn Qaddafi but as the civil conflict continued, Beijing began reaching out to the rebels. In June 2011, the Chinese welcomed a visit by Mahmud Jibril, the NTC’s then-top foreign affairs representative and subsequent interim prime minister for Libya until September 2012. The meeting with Jibril had followed on a visit to Beijing earlier that month by then-Libyan foreign minister Abdelati al-Obeidi as well as meetings conducted between Chinese diplomats and NTC chairman Mustapha Abdul-Jalil in Doha and Benghazi.<sup>59</sup>

Perhaps the most damaging to China’s credibility in dealing with the NTC was news that in the waning days of the Libyan conflict, Chinese state-owned arms firms offered visiting representatives from the Qaddafi regime some \$200 million worth of weapons, a clear violation of UNSC Resolution 1970, which was passed in February 2011 and imposed a weapons embargo on the Qaddafi regime. According to documents obtained by Canada’s *Globe and Mail* newspaper, China North Industries Corp. (Norinco), China Precision Machinery Import-Export

Co., and China Xinxing Import and Export Co. met with visiting officials from the Qaddafi regime in July 2011, with the state firms offering up rocket launchers, anti-tank missiles, and other weapons and suggesting that the deals could be made through third-party countries such as Algeria and South Africa. While rebel officials contended that Chinese guns had likely been delivered to the Qaddafi forces, the Chinese government was forced to make the embarrassing admission through a spokeswoman that it had not known about the meetings between the state-owned arms firms and the visiting Libyan representatives. The Chinese foreign ministry conceded that Libyan officials did indeed travel to Beijing to buy arms in July, but insisted that no contracts were signed and no Chinese weaponry was delivered to Libya.<sup>60</sup>

### China's African Challenges

China is discovering the downside of not paying enough attention to local community relations when it has generated a large labor presence in a country like Angola, where critics argue that Chinese workers are stealing Angolan jobs. Some 50 Chinese state-owned firms and 400 private companies are currently operating in Angola, with an estimated 60,000 to 70,000 Chinese expatriates working there. This is despite bilateral agreements that stipulate that at least 30 percent of the work force on such projects should be comprised of Angolans.<sup>61</sup>

In a relatively brief amount of time, Luanda has become Beijing's largest trading partner in Africa and has cemented itself as one of OPEC's leading suppliers to China (Angola is one of the newest members of OPEC, having joined the group in 2007). In 2010, trade between the two countries was just under \$25 billion.<sup>62</sup> In turning to Angola, the Chinese seized on economic- and energy-related opportunities that opened up following the end to the civil strife as Luanda entered an era of dramatic reconstruction. Beijing over the past decade has provided Luanda with around \$14.5 billion in loans from three state banks—the Export-Import Bank of China, the Industrial and Commercial Bank of China, and the China Development Bank—with repayment in crude.<sup>63</sup> These loans have aided the Angolan government in rebuilding basic infrastructure—including roads and rail networks, housing, airports, hospitals, government offices, and schools—as well as addressing communications, energy, and water projects. Chinese financing may be preferable for Angola because the Asian giant presents less stringent conditions than

commercial loans, lower interest rates, a lengthier repayment window, and of course, the ability for Angola to pay back that credit through crude supplies.<sup>64</sup> Angola's prior financial problems were aggravated by its pre-financed oil sales to the West in the 1980s and 1990s. The pre-financed oil banking deals created cash flow problems for Luanda by mortgaging future revenue streams for immediate spending.

The spike in OPEC shipments to China in the first six months of 2012 was in fact led by Angola, which exported 846,000 b/d of its crude to the Asian nation, an increase of 217,000 b/d from 2011 levels. Angola continues to be the second-largest OPEC supplier to China as well as the second-largest overall supplier to the Asian country, behind Saudi Arabia in both instances. China is the largest buyer of Angolan crude, accounting for approximately one-third of Angola's oil exports every month.<sup>65</sup> Two of China's NOCs have entered into Angola's upstream sector since the civil war has ended. In March 2010, Sinopec announced that it was buying 55 percent of an Angolan joint venture, Sonangol Sinopec International (SSI), for \$2.46 billion from its state-owned parent company, China Petroleum Corp., in a move to raise reserves and output. The other 45 percent of SSI is held by China Sonangol International Holding. SSI has a 50 percent interest in Angola's deepwater Block 18, which holds the Greater Plutonio field and has a production capacity of 240,000 b/d. BP owns the other 50 percent share in Block 18. Sinopec owns an effective stake of 27.5 percent in the block and the acquisition marked its first upstream asset overseas.<sup>66</sup>

In 2009, Sinopec and CNOOC agreed to form a joint venture to purchase a 20 percent stake in the Angolan ultra-deepwater Block 32 from a subsidiary of US Marathon Oil for \$1.3 billion. French Total is operator of the block with a 30 percent majority interest, with Marathon holding a reduced 10 percent share, ExxonMobil a 15 percent stake, Portugal's Petrogal a 5 percent interest, and Sonangol the remaining 20 percent. The consortium forecast initial output of 130,000 b/d after 2012.<sup>67</sup>

Yet as in the case of Libya, China's Angolan operations are not without political consequences. In an interview with *Agence France-Presse* in March 2011, China's ambassador to Angola, Zhang Bolun, claimed that "Chinese companies can't employ 30 percent Angolans. It's

impossible, it's not realistic." The Chinese diplomat added that, "In our contracts here, we have a very short time frame and a high requirement for quality. The majority of Angolans can't satisfy that demand." While the quality of some Chinese-constructed Angolan projects have been put in question after building flaws have been exposed, Zhang argued that the problem was not Chinese construction but the lack of training on the Angolan side to adequately take over the distribution and management of the projects.<sup>68</sup> The role of China in Angola is being discussed widely in the South African nation as a number of concerns are being raised by critics, including increasing dependence on imported labor, a lack of local job or skills creation, and no transparency on how the credit lines are managed, including suspicions of misappropriation.<sup>69</sup> In 2009, Angolan gangs began targeting Chinese workers, committing robberies and other acts of violence.

### **China's Expensive Bet on Venezuela's Chavez**

The fate of Beijing's enormous commercial stake in Venezuela is highly dependent on its close relationship with authoritarian leader Hugo Chavez. To hedge its bets, the Chinese have been aggressive in insisting on a strong role in how Beijing's loans to Caracas are spent, with joint decision-making on projects and a guarantee for hiring Chinese firms to be included in agreements. But because the Venezuelan government is highly personalized, China fears that if Chavez is taken out of the political picture Beijing could lose its preferential treatment and access to investments and financing could be directed elsewhere. And, Beijing could suffer to the tune of billions of dollars if a new Venezuelan government fails to honor those investments and loans.<sup>70</sup> The Chinese have taken on a clear role in the Chavez regime beyond their loans and investments, offering advice on energy, agriculture, and industrial policies as a means to safeguard their investments.

China's strategy for energy security makes Latin America an attractive area for its NOCs, though the region is yet to be a major supplier of oil for China. For Caracas, China has proven to be a significant financial lifeline as Hugo Chavez's "Bolivarian Revolution" has led Venezuela and its oil industry into dire economic straits. While Beijing's oil and economic ties with Caracas existed prior to Chavez first taking office in 1999, China has become increasingly invested in Venezuela in the past decade and has built a unique relationship with the Chavez regime—so

much so that Chavez's current battle with cancer has raised concerns among the Chinese leadership about what will happen to the Asian giant's investments and returns on its sizable loans should the Venezuelan president either succumb to his illness or be too incapacitated to continue to lead or run and win the presidency again in the October 2012 election.

In recent years, Chavez has been forced to boost borrowing to cover expenditures and debts across the board. It is estimated that since 2005, China has provided \$49.5 billion worth of hard asset investments and loans as well as pledges for additional loans and investments to Caracas. Some of the loans have reportedly been paid back in oil, and about \$10 billion worth of loans will reportedly be delivered in yuan. Faced with a critical national housing shortage, a failing electricity system, and an energy sector characterized by extreme mismanagement and underinvestment, Chavez has increasingly relied on China as much for its financial backing as for Beijing's political support.

China and Venezuela established diplomatic ties in 1974. It wasn't until a decade later, though, that Beijing and Caracas began their energy relationship in earnest. In November 1985, China and Venezuela signed a five-year agreement to cooperate on oil exploration. CNPC established its Americas division in Venezuela in 1997<sup>71</sup> and subsequently secured its first two operating rights in the Orinoco heavy oil fields in 1998.<sup>72</sup> In October 1999, nearly a year after winning the Venezuelan presidential election, Chavez traveled to Beijing, where in meeting with then-Chinese premier Zhu Rongji, the two agreed to form a joint working group of high-level officials to draft a strategic vision for comprehensive economic and political relations between the two nations. Then-Chinese president Jiang Zemin subsequently visited Caracas in April 2001, with the two leaders inking a memorandum of understanding (MOU) to establish a "high-level joint commission" to shape the developing relationship.<sup>73</sup>

Since Chavez took power, bilateral trade between the two countries has soared, from \$85.5 million in 1999 to about \$9 billion in 2008, according to Venezuelan state bank Bancoex.<sup>74</sup> As the Venezuelan leader pushed forward with his "Bolivarian Revolution"—which from the outset took a decidedly anti-Washington political and economic stance—forging closer political, energy, and financial ties with China clearly meshed with Chavez's agenda and message.

Although Venezuela has stated that it wants its crude exports to China to reach 1 million b/d by 2013, that figure appears grossly unrealistic, given that China imported an average of 349,000 b/d in the first half of 2012, up 90,000 b/d YOY.<sup>75</sup> In April 2010, Chavez declared that China had agreed to lend \$20 billion to Venezuela, on the heels of a visit by Chinese President Hu Jintao to Caracas. Following Chavez's statement, oil minister Rafael Ramirez announced that the OPEC producer would be sending 100,000 b/d of crude to China for the next 10 years as repayment for the \$20 billion loan.<sup>76</sup> The loan, financed by the China Development Bank (CDB), is intended for energy, agriculture, railroad, and housing projects.

The Chinese government itself stated in April 2010 that it had signed seven cooperation accords with Venezuela, in particular "a framework agreement" on financing under which the CDB would offer Venezuela a \$10 billion loan and an additional credit worth roughly 70 billion yuan (\$10.4 billion). As stipulated by the Venezuelan law that was passed to endorse the financing, Caracas is to reimburse China with "no less than 200,000 b/d of crude in 2010, no less than 250,000 b/d in 2011, and no less than 300,000 b/d in 2012."<sup>77</sup> In 2008, Caracas and Beijing established a \$6 billion joint development fund, which later was raised to \$12 billion. Venezuela has contributed \$4 billion into the fund, while China has anted up \$8 billion. The fund, which was intended to finance Venezuelan projects, including railroads and oil production facilities, has largely been depleted.<sup>78</sup>

In August 2012, oil minister Ramirez declared that Venezuela's crude exports to China had reached 640,000 b/d, accounting for about 20 percent of the South American country's total crude production. Ramirez suggested that approximately 264,000 b/d, or 41 percent, of that volume are dedicated to paying off China's loans.<sup>79</sup> This figure is substantially larger than the figure of 349,000 b/d that the Energy Intelligence Group (EIG) reported Venezuela had averaged for the first half of 2012,<sup>80</sup> and in fact, belies the July monthly figure of Venezuelan supplies to China of 325,000 b/d that EIG's flagship publication *Petroleum Intelligence Weekly* reported in late August.<sup>81</sup> However, it appears that not all of the crude deliveries lifted by Chinese companies in Venezuela end up in China. Some cargoes purchased by CNPC are diverted to Singapore, where CNPC affiliate PetroChina has a large storage, refining, and trading presence. Only a handful of CNPC's refineries have the capability to process the heavy Venezuelan crude,

and only after blending it with other grades. It is estimated that Chinese refineries can only accommodate up to 200,000 b/d of Venezuelan crude.<sup>82</sup>

CNPC operates two oil fields in Venezuela: the Caracoles field in El Tigre, located in the state of Anzoategui in the East Venezuela Basin; and the Intercampo oil field on Maracaibo Lake in the state of Zulia. In August 2006, the Venezuelan government required that the operation of these oil fields be reorganized into a joint venture with PDVSA, with CNPC's share reduced to 25 percent.<sup>83</sup> In May 2006, PDVSA signed a \$1.3 billion agreement with China State Shipbuilding Corporation and China Shipbuilding Industry Corporation to purchase 18 oil tankers as a means to boost its ability to ship more oil to Asia.<sup>84</sup>

In 2007, the Venezuelan and Chinese governments agreed that CNPC and PDVSA would establish several "mixed" companies. All of the CNPC-PDVSA mixed companies operating in Venezuela involved a 40 percent share to the Chinese state firm and 60 percent to the Venezuelan NOC, with the reverse proportion applied to those operations in China. One of these mixed companies, Petrozuamo S.A., is to develop oilfield test drillings, with another to develop the Junin-4 Block's oil production, and a third to take control of the extension of the MPE3 Block, production from which would go to the Chinese market. Future plans involving these mixed companies included construction of three refineries in China with a capacity of 800,000 b/d. Other aspects of the 2007 agreement called for CNPC participation in the Venezuelan gas sector to contribute to the Latin American nation's domestic supply, as well as in assessing petrochemical projects.<sup>85</sup>

In December 2010, China's three major NOCs signed six agreements with Venezuela on cooperation in the oil and gas sector, with the agreements covering projects previously initialed by the two sides. Included in these projects is a deal that was inked between CNPC president Jiang Jiemin and Venezuelan oil minister Ramirez for joint cooperation on the Junin-4 block in Venezuela's Orinoco heavy crude belt. The CNPC-PDVSA joint venture, which is expected to spend upward of \$16 billion on the project, hopes to begin production at 50,000 b/d by 2012, rising to 400,000 b/d by 2016.

The two other Chinese NOCs have also committed to projects in the Orinoco region: Sinopec has an agreement to work on the Junin-1 and Junin-8 blocks, while CNOOC has contracted to work on the Bocaya-3 block.<sup>86</sup> In addition, CNPC and PDVSA have signed onto forming a joint venture to explore for oil in southern Venezuela, with the goal of producing as much as 400,000 b/d. Oil minister Ramirez suggested that CNPC would need to pay \$1 billion to move that venture forward.<sup>87</sup>

In September 2008, the two countries signed agreements essentially trading Chinese military equipment for Venezuelan crude.<sup>88</sup> This most likely covers Venezuela's 2008 order of 18 Chinese-built K-8 light attack and training jets. In March 2010, Chavez officially received the first six jets and announced three months later that Venezuela would be spending \$82 million on the second tranche of planes. The United States imposed an embargo on the sale of US weapons parts to Venezuela in 2006 and has charged that Chavez is knowingly starting an arms race in Latin America. Venezuelan officials have argued that the K-8 planes will be used to train pilots and to intercept drug traffickers who use the country as a stop-off point in smuggling cocaine to the United States, Europe, and Africa. Chavez has declared that he wants a fleet of 40 K-8 jets.<sup>89</sup>

### **Slowing the Pace of Sino-Iranian Ties**

Trade between Iran and China boomed from \$4 billion in 2003 to more than \$20 billion in 2009, according to the International Monetary Fund. However, this trade is now at risk to US-led efforts to isolate Iran from the global economy. China's commercial relationship with Iran, whose escalating nuclear standoff with the West and damaged economy place in the face of international sanctions have rapidly elevated country risk, appears to be declining; Iran's obscure negotiating practices, pariah status in the international community, and enmity with Saudi Arabia—China's primary source of energy imports—is attenuating the economic benefits for China of Iranian trade and investment.<sup>90</sup> China favored involvement with Iran in part because it is the only Middle East oil producing country that China could theoretically reach with troops by land. China lacks the naval carriers to transport significant air and other military assets directly to the Persian Gulf theater. Chinese strategic oil analysts, however impractically, often refer to the importance of a "land bridge" for China to Middle East and Caspian oil supplies via Iran.<sup>91</sup>

However, as investment in Iran becomes less accessible and Tehran's conflicts with the United States and Saudi Arabia escalate, increasingly, China will have to consider its vital oil relationship with Saudi Arabia and its political and economic interests in the United States in shaping future relations with Iran.

As Tehran's relations have deteriorated with the West over the conflict over Iran's nuclear aspirations, Chinese state firms have filled in the gaps left by Western and other Asian companies that have either departed or shied away from Iran thanks to international and US sanctions.<sup>92</sup> Still, despite the opportunity for MOUs valued at around \$120 billion, Chinese investments have yielded little output.<sup>93</sup> There is certainly enough evidence to back up Jean Francois-Seznec's claims that

China's extensive relations with Iran today are mostly based on talk with little action. In fact, China's overall trade with Iran is relatively limited compared to that with Saudi Arabia .... So far, only two sizable investments have actually been made in two of Iran's oil fields, which have yet to yield any crude.<sup>94</sup>

The output from the two Iranian fields in question—the Yadavaran oil field and the North Azadegan oil field—has amounted to only 115,000 b/d, compared to the more than 1 million b/d that China received from Saudi Arabia in 2010.<sup>95</sup> The Yadavaran deal stipulated that Sinopec invest in developing the oilfield in two phases, with the first phase to produce 85,000 b/d within four years and an additional 95,000 b/d to be produced in the second phase in the three years following.<sup>96</sup> The development of the Yadavaran field has been fraught with delays, taking until 2007 until a final deal valued at \$2.6 billion was hammered out and another two years before early production from the field began. Development of the North Azadegan oil field has experienced similar delays. While CNPC was supposed to invest \$2 billion to raise production to 75,000 b/d in the coming four years, China has blamed lack of access to equipment from third-party countries for thwarting its progress at the North Azadegan field.

China's South Pars natural gas project is currently derailed. CNPC reportedly informed NIOC that financial issues are making it difficult for the Chinese state firm to come up with the \$5

billion investment needed to carry out the project.<sup>97</sup> In mid-June 2011, the Iranian state oil firm National Iranian Oil Co. (NIOC) warned CNPC that the Chinese energy concern faced having its South Pars contract cancelled if CNPC did not honor the terms of the agreement, which included initiating project development within the first half of 2011. Although CNPC has recently completed FEED work, both China and Iran are at loggerheads over a number of issues and no substantive progress has been made on developing Phase 11, nor is it clear whether the Chinese firm will keep its contract.

These delays are likely symptomatic of a growing Chinese reluctance to conduct business with Iran, resulting in bureaucratic bottlenecks on the Chinese side. Iran is proving an increasingly volatile negotiator. Meanwhile, Beijing is attempting with increasing difficulty to balance its trade ties between regional rivals Iran and Saudi Arabia. Although CNPC expressed readiness to resume its North Pars development work earlier in 2012, there appears to have been no response yet from the Iranian side.

US Middle East policy is clearly affecting China's ability to manage its own Middle East strategy, especially vis-à-vis Iran. Beijing cannot afford to alienate the US over its Iran trade policy and has an increasingly difficult balancing act to both satisfy US demands for cooperation and defend its separate interests in the Middle East. More recently, given its own internal political problems, China has been more assertive in resisting US diplomatic pressure on Iran. China's leaders cannot afford to be perceived as weakly bowing to the US agenda for the Middle East and must assert China's own rising stature on the global stage. Younger generation Chinese support growing Chinese nationalist sentiment and want to project a more assertive and globally powerful China, especially in relations with neighboring allies of the United States, such as the Philippines, Vietnam, Japan, and South Korea. This trend colors Chinese policy as far away as the Middle East as well as China's interactions with the United States. Significantly, senior Communist Party leadership feel that they must resist US meddling in the affairs of other countries, particularly when it comes to US visions for democratization in the Middle East and elsewhere, given the possibility of localized protests against corruption and mismanagement inside some of China's more distant provinces. How China and the United States resolve their differences over Iran is a testing ground for these geopolitical trends and could prove a pivotal

element to future US-Sino relations. Indeed, the Iranian issue could, if not properly managed, be a defining feature regarding whether the two superpowers continue on the path of cooperation or devolve slowly into a more competitive geopolitical framework.

The potential for cultural misinterpretation is high as Chinese and American concepts of “peace and stability” are far apart and require careful communication to bridge differences. China views “peace and stability” in the Middle East as a “vital interest” and defines “peace and stability” narrowly as a lack of conflict and avoidance of war in the region, allowing the free flow of commodity shipments. Chinese analysts, however, say the United States is pushing democracy onto the Middle East as a means to increase its own power and to contain China.<sup>98</sup>

### Sino-US Relations and the Middle East

China remains highly critical of US Middle East policy, including what China characterizes as an inconsistent application of support for democratization. As authors Garver, Leverett, and Leverett explain: “... Chinese analysts and the leaders they advise simply do not believe arguments advanced from Washington that American leadership in the Gulf and the ‘greater Middle East’ has contributed to peace and stability in these critical regions. From a Chinese perspective, China’s interest in stable and uninterrupted flow of Persian Gulf oil has more often been hurt, not helped, by the exercise of American power in the Gulf.”<sup>99</sup> Previous Chinese concerns about US “hegemonism”<sup>100</sup> in the region have more recently given way to alarm that US democracy promotion policies are acutely dangerous to Chinese interests, and China’s leaders have proactively warned against US military intervention in the region and specifically in Iran. In April, a Chinese official expressed the Asian country’s objection to a potential Western attack on Iran over the nuclear crisis, warning of the impact not only on regional security but on the struggling global economy. Commenting in a web chat hosted by *People’s Daily*, the Chinese Communist Party’s official newspaper, Chen Xiaodong, head of the foreign ministry’s West Asia and North African affairs division, argued that, “If force is used on Iran, it will certainly incur retaliation, cause an even greater military clash, worsen turmoil in the region, threaten the security of the Strait of Hormuz and other strategic passages, drive up global oil prices and strike a blow at the world economic recovery.” Chen added that, “There may be 10,000 reasons to go

to war but you cannot remedy the terrible consequences of plunging the people into misery and suffering and the collapse of society and the economy caused by the flames of war.”<sup>101</sup>

China's official stance is that it prefers diplomatic resolution of Middle East conflicts such as Iran's problems with the West, and its backing for Iran is often interpreted as Tehran serving “as a potential partner in countering US power.”<sup>102</sup> But China's so-called “balance of power” approach has a military tinge of its own, with Beijing offering arms sales as a means to keep itself relevant in the Persian Gulf region. China has emerged as Iran's principal arms suppliers, with transfers including cruise missile and ballistic-missile capabilities.<sup>103</sup> More recently, China seems to be hedging its bets with discussions of ballistic arms sales to Saudi Arabia.<sup>104</sup> The utility of arms sales to various Middle East players is sometimes described in China as “seeking stability” through balance of power. But it may also partly reflect the realities of Chinese internal politics. Senior Chinese officials from the foreign ministry seem to be waning in power and Chinese human capacity building for diplomacy is declining, not expanding as might be consistent with the public preference for diplomatic solutions. Rather, the top positions in the Chinese leadership are increasingly captured by officials with military backgrounds and power bases and the PLA's parochial interests seem to drive foreign policy more than China's economic considerations.

It is hard to see the benefits to China's long-term economic interests to arming Syria's Assad, given the open positions to depose him by China's major energy suppliers such as Saudi Arabia and Qatar. China's arming of combatants in the region also seems to actively contradict its stated interest in stable and uninterrupted oil flows from the region. One interpretation of China's arms supplying strategy is geopolitical. If the United States is tied up containing conflicts across the Middle East, it will be harder pressed to focus its attention in East Asia. Notes John Garver, “A strong Iran resistant to US dictates and at odds with the United States would also force Washington to keep large military forces in the region, limiting the ability of the United States to concentrate forces in East Asia, where China's core interests lie. The 9-11 attacks on the United States were a strategic windfall for China, diverting US attention away from China and East Asia toward the Middle East and Islamic World. That the United States bogged itself down in protracted wars in Afghanistan and Iraq was a further blessing for Beijing. If Washington now

were to wade deeper into conflict in the Middle East—this time with Iran—the chances for China's successful rise without having to confront the United States would increase. In this regard, it would not benefit China to help the United States coerce Iran into de-nuclearization and corresponding docility.<sup>105</sup>

China gains another benefit from a United States that must remain militarily engaged in conflicts in the Middle East. Costly repeated US military intervention in the region has weakened the US economy considerably by substantially adding to the US deficit and also indirectly through higher costs for oil.

Finally, Chinese leadership has a direct stake in asserting a principled stance against US-led “internationalized” intervention on behalf of the protesters of the Arab Spring. Western support for grassroots democratization movements could easily be interpreted as a direct threat to the longevity of the Chinese Communist Party, which itself is facing challenges from regionalized dissent and social activism against official corruption and mismanagement.

It seems clear from these ongoing policy concerns that China's interests in a stable flow of oil from the Middle East are taking a back seat to other considerations, leaving less space for a constructive US-China dialogue and partnership regarding the Middle East. But given China's long-term interests in Middle East oil and gas supply and its economic exposure to the fate of the US economy, it remains to be seen if China's present path will continue to make sense as time wears on. Already, Chinese strategists are beginning to worry about US foreign policy shifts, as the United States becomes less dependent on Mideast oil due to an expected rise in US domestic shale oil supplies and declining oil demand as a result of improved efficiency of the US automobile fleet. Greater future US energy independence calls into question China's strategy to bog the United States down in the Middle East. Perhaps ironically, Middle East instability could hurt China more in the long run than the United States.

The Baker Institute projects that Chinese oil demand will rise to 19 million b/d by 2040 as the number of cars on the road in China expands exponentially with the country's continued economic growth and development.<sup>106</sup> At present, roughly 50 percent of China's oil imports

come from the Middle East. China's dependence on Middle East oil is expected to continue to rise in the coming decades, forcing it to rely on the US Navy to protect the free flow of oil from the Middle East.

By contrast, some US analysts are projecting that US oil production could rise significantly over the next decade as increased drilling in shale formations translates into higher domestic output. Estimates range from an increase on of 3 million to 10 million b/d of oil and natural gas liquids production from shale by 2020, with some analysts projecting that the United States could become an exporter of natural gas liquids over time.<sup>107</sup> Should this potential come to pass, the United States could cease to be a major oil importer from the Middle East, possibly lowering the political will in the United States to finance singlehandedly the protection of sea-lanes from the Persian Gulf. Such a scenario would almost certainly alter the dynamic of the Sino-US dialogue regarding the Middle East and possibly change American public attitudes regarding Chinese free riding off the United States' expensive commitment to guarantee the free flow of oil from the Persian Gulf to Asia. Were the United States itself to cease to be a major importer of oil from the Middle East, moreover, the adverse effect of a disruption in oil supplies and subsequent oil price increases would have a more deleterious impact on China's trade balance as the major user of Middle East oil than it would on the United States' trade deficit, since the US oil import bill would be greatly reduced.

### **Conclusion**

Geopolitical risk factors have recently propelled China to undertake an aggressive energy diplomacy campaign, as evidenced in Libya and South Sudan over the course of 2011. The increased geopolitical challenges of being a global oil investor have the potential to bring Beijing closer in line with Western interests. Additionally, regardless of the attractions of a multi-faceted Iran policy, Beijing must still remain leery of causing an outright breach with Washington, its most important bilateral relationship. For this reason, as much as China may want to reap the geopolitical and economic rewards of linking with oil producing countries whose foreign policies are inimical to the United States, Beijing must tread lightly and try to balance all of its political and commercial interests. As Tehran and Tripoli discovered at their own expense, China has

shown an ability to change political course when it sees its diplomatic and commercial interests in the West might become too much at risk.

The shortcomings of China's "going abroad" strategy have clearly demonstrated that a strong international presence requires a strong military. Beijing is becoming increasingly dependent on the foreign military security already present in the Middle East due to its growing reliance on Gulf oil. Regardless of nationalistic elements of its public, Chinese leaders must face the fact that the country does not have the naval resources to become actively involved in defending those producers who are its main crude suppliers. Moreover, it is not clear whether China would want to take on that support role even if it had the adequate resources. Traditionally, China has devoted its military resources to protecting its interests in its own backyard, including the South China Sea and Taiwan Strait, largely relying on a US military presence to protect its interests abroad, and particularly in the Middle East.<sup>108</sup> There appears to be a growing appreciation of the need for indigenous military capabilities to protect national interest. For example, Chinese leaders sent military aircraft and chartered flights to Libya in February 2011, and they deployed a nearby frigate, in an operation to rescue nationals operating in the region. China's growing economic stake will likely entail a rising degree of political and military engagement on the part of Chinese authorities. On the other hand, Beijing is also taking a serious look at whether it should be permitting local and provincial level entities to commit the country to substantial geopolitical risks that those entities cannot manage on their own if and when thousands of Chinese workers and citizens might suddenly need to be evacuated.

Although China as the leader of the nonaligned movement has often stressed its official policy of noninterference in the domestic politics of the countries in which it has substantial business interests, it is now seeing more clearly how the consequences of that policy can backfire where it potentially hurts the most, in the pocketbook. A heightened awareness of risks facing CNPC and Sinopec's investments has already begun to transform Beijing's commercial and diplomatic ties with Tehran. A similar reevaluation could take place in Venezuela as well. Beijing's commercial stake depends on its close relationship with ailing authoritarian leader Hugo Chavez. Because the Venezuelan government of Hugo Chavez is highly personalized, China is cognizant that if Chavez is taken out of the political picture—whether by death or political change—Beijing could

easily lose its preferential treatment. In such a scenario, Beijing could suffer to the tune of billions of dollars if a new Venezuelan government fails to honor Chinese investments and loans.<sup>109</sup> If the past decade has taught anything about China's energy strategy, it is that China's role as an economic stakeholder inevitably is hard to implement without unintended political and military entanglements.

The vulnerability of China's increasingly tenuous oil import situation and emerging difficulties with its "going abroad" strategy offers the United States both risks and opportunities. The first step is to understand that China is not holding all of the cards when it comes to the United States' own precarious state of affairs regarding the deficit. The new US position with rising domestic oil and gas resources may offer strategic leverage for America to renegotiate the Sino-US equation in the Middle East. The Obama administration was effective last year when it linked Chinese commercial intentions to invest in US domestic shale natural gas plays with Beijing's greater cooperation in abiding by US sanctions policy on Iranian investment and trade. The United States can play that hand again with its marginal, but relevant, regulatory role in approving China's planned investment in Canadian firm Nexen.<sup>110</sup> And the United States might want to reconsider whether sharing advanced shale exploration and development technology—an initiative currently on the books as a program of the US Department of State—is in the long-term US interest. The US gains substantial strategic advantages to reducing its own vulnerability to geopolitical events in the Middle East while at the same time leaving the Chinese economy holding the bag.

China has shown through its recent policies toward the Middle East that it is not a partner to the United States in managing the repercussions of the Arab Spring and the United States needs to take that on board in its peer-to-peer military relations with Beijing. But at the same time, the United States should fine tune the messaging of its diplomacy with China to include discussion of a road map to elevate communications between the US and Chinese military. The nature of conflicts in the Middle East and Asia calls for a more proactive, high-level strategic dialogue between the US and Chinese militaries. At present, this dialogue is more tactical in nature. Even at the height of the Cold War, such consultative lines of communication between top US and Russian military brass were critical to avoiding escalation of conflicts in the Middle East to

avoid dire global consequences. The same utility would be beneficial in the Sino-US relationship. Sharply different perspectives on even the vocabulary of “stability” in the Chinese and American cultural lexicon raises risks of unintended misunderstanding that are thwarting better cooperation in the Middle East even when Chinese and American strategic interests are aligned. And where Chinese and American interests are not aligned, the risks of misinterpretation and miscommunication are high with potentially serious consequences.

The US should also support international NGO activities to increase the knowledge of China's citizenry about the risks and negative consequences of China's oil and minerals “going abroad” policy when it comes to both the physical risks to Chinese citizens, the financial risks to China commercial interests, and to China's image abroad in line with the Communist ideology of social justice (much the way international NGOs have assisted China's own nascent domestic environmental movement). China's internal political actors on Middle East policy are diverse and this can lead to more incoherence in responses on the global stage. By trying to influence the discussion inside China, the United States may be able to counter the influence of hardliners who will argue that China's increased vulnerability in oil producing countries means it should accelerate its military expansion and broaden its naval reach.

The mythology that somehow China has outpaced the United States in managing its energy challenges is more imagined than real, as this study demonstrates. Columnist Tom Friedman's wish from his book *Hot, Flat, and Crowded* to “be China for a day” in order to “simply order top-down ... sweeping change, like the green revolution, where you are competing against deeply embedded, well-funded, entrenched interests, and where you have to motivate the public to accept certain short-term sacrifices, including higher energy prices, for long term gains,” is more of a fantasy than it seems. China isn't that China for a day, either. As the plight of the NRDC on energy subsidies so pointedly shows, Beijing cannot raise energy prices for fear of the economic dislocation and potential sociopolitical risk that might result. China's massive effort to get more than a million “new energy vehicles” on the road would amount to less than 1 percent of the country's total future fleet of cars. Leadership selection processes for the Communist Party virtually guarantees that oil sector leaders will be able to utilize *guanxi* to protect their interests, certainly as, if not more, effectively than any industry lobby groups in the United States. And,

Chinese foreign diplomats and military leaders will have the same worries and challenges from the Arab Awakening and populism in Latin America as everyone else. In sum, central planning has brought China few advantages in energy, and has possibly limited the kind of innovation that is bringing at least an oil and gas technology renaissance in the United States, even if the rekindling of US interest in renewable energy solutions may take more time.

The United States and China have a lot more to gain from cooperation than rivalry in energy. China is not winning the energy race. It is suffering the same kinds of setbacks as the United States. That opens an opportunity to pursue collaboration with China at least on “green technologies” rather than block Chinese efforts to participate in renewable energy markets in the United States. When US President Barack Obama traveled to China in late 2009, he signed an agreement with China that began seven cooperative energy initiatives on scientific research, electric vehicles, energy efficiency, renewable energy, shale gas, research and investment by private companies, and coal with carbon capture and storage (CCS).

It would also be desirable to fashion a joint China-US strategy toward OPEC. For example, a joint communiqué from the United States and China citing a joint commitment to lower oil use through bilateral or global agreements on corporate average efficiency standards for automobiles or other coordinated conservation methods, or to coordinate on a release of strategic emergency stocks during a time of supply disruption, would certainly counterweigh OPEC's ability to act in concert to lift oil prices.

In the most recent 12th Five-Year Plan for the period 2011-2015, Chinese leaders called for a 16 percent reduction in energy intensity and a 17 percent reduction in carbon dioxide intensity by the end of 2015. Looking forward, some have speculated that China may implement a cap-and-trade program in the next five years, expanding on the voluntary markets in some major cities. Directionally, such developments bode well for future dialogue between China and the United States on the particularly thorny issue of a global climate deal. The United States should stay the course of keeping the bilateral Sino-US dialogue on climate change alive.

## **China's Relations with OPEC**

On the Middle East, under pressure, China has in fact yielded on its investment in Iran's energy sector. Whether fear of a new round of sanctions, greater interest in U.S. energy sector investments, or a desire to avoid a major conflict with the United States over Iran, China seems content to avoid the risk of additional investments in Iran. As Saudi Arabia's foreign policy focuses more squarely on containing the threat of Iran, it will press China for cooperation, perhaps in a quid pro quo for higher oil supplies. But that cooperation—from Beijing's point of view—will almost certainly fall short of support for a US or Israeli attack on Iran. In the end, again, the United States and China have the common interest (i.e., energy supply) to stave off a major conflict in the Persian Gulf region. But it remains to be seen if this will translate into a change in policy by either power or even a rationale for joint diplomacy to resolve the outstanding problem of Iran's nuclear aspirations. Just as the United States must back its regional allies, China has cast Iran as a client state. It remains to be seen whether Beijing will look introspectively at mistakes made in diplomacy over Libya and Sudan and read the parallels to its situation with Iran or, conversely, whether Beijing will recall the experience of Iraq, where the United States used concerns about proliferation to launch a destabilizing war. Combined with differences over currency adjustments and managing the international debt crisis, tensions over Iran remain a stumbling block to obvious synergies in strategic energy cooperation.

Notes

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