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ENERGY SECURITY: IMPLICATIONS FOR U.S.-CHINA-MIDDLE EAST RELATIONS

CHINA'S NEW ENERGY FOCUS: STRATEGIC PARTNERSHIP WITH SAUDI ARABIA

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Overview

During the past decade, China has entered the global energy markets in earnest to secure energy resources needed to fuel its booming economic growth. China currently consumes approximately 5 million bbl/day of oil, of which only 3 million bbl/day are produced domestically. While China currently imports about 40% of its oil requirements, this percentage is expected to increase significantly over the next two decades and could reach 60% or more by 2025. With uncertainty over just how much recoverable hydrocarbons lie within China's borders, China is expanding its search for oil and gas outside the country with its three largely state owned oil companies: China National Petroleum Corporation (CNPC), China National Offshore Oil Company (CNOOC), and China Petroleum and Chemical Corporation (Sinopec).

China's efforts to secure production from foreign acreage began with fairly modest oil and gas exploration and production (E&P) activities in other Asian countries. Commencing in the 1990s, China pursued more substantial E&P activities in Sudan, Iran and Iraq – countries in which US and UN sanctions regimes were in place, thereby rendering them “off limits” to many of the international oil companies (IOCs). In recent years, China's foreign E&P activities have expanded significantly and now include energy investments in many of the world's major oil and gas producing countries. Moreover, China's outbound E&P investments are increasingly being counterbalanced by investments by Middle Eastern National Oil Companies (NOCs) such as Saudi Aramco and Kuwait Petroleum Corporation in various E&P activities and downstream refining and petrochemical ventures inside China. These are classic symbiotic relationships, with the Middle East producer states eager to secure long-term markets for their crude oil and liquefied natural gas (LNG), and China eager to secure long-term supplies of much needed imported hydrocarbons.

These new investments in China go well beyond “plain vanilla” foreign direct investment (FDI), however, and often take the form of significant refinery upgrades in China to process the heavier, sour crudes on offer by these Middle Eastern producers, whether as

single feedstock crudes or blending crudes. Other Middle Eastern FDI in China takes the form of joint venture E&P deals that involve a significant technology transfer component in oilfield services, reservoir management, etc. These investments are viewed by the Chinese as important not only to increase domestic hydrocarbon production but also to increase the efficiency and competitiveness in E&P activities outside China of CNPC, CNOOC and Sinopec.

China and Saudi Arabia

While the new Chinese approach to energy security is taking place with a number of Middle Eastern oil and gas producers including Iran, Kuwait, Oman and Qatar, it is perhaps most significant in respect of the Kingdom of Saudi Arabia, the world largest petroleum exporter. With proven crude oil reserves of 261.9 billion barrels¹ and current production of some 10.4 million bbls/day², Saudi Arabia is the hydrocarbon counterweight to China, with a population of some 1.3 billion people and a GDP growth rate of 9.1% in 2004³.

The significance of a strong bilateral relationship between China and Saudi Arabia, founded on energy but extending to other spheres, cannot be overemphasized in economic as well as strategic terms. Despite their obvious differences – China, a communist state with the world's largest population, and Saudi Arabia, a monarchy whose constitution is the Islamic *Shari'a* – the two nations share substantial similarities in geopolitical terms.

Saudi Arabia and China are both enigmatic states, with little transparency at the highest levels of government and diplomacy. Both states are dominant in their own regions, with Saudi Arabia the driving force behind the six-nation Gulf Cooperation Council (GCC) and China a major actor throughout East Asia. Both states are led by an older generation

¹ *Oil and Gas Journal*, as quoted on US Department of Energy website, Saudi Arabia page.

² This figure includes natural gas liquids (NGL) production of some 1.1 million bbl/day and also includes production in the Saudi-Kuwaiti Partitioned Neutral Zone.

³ US Central Intelligence Agency Factbook. <http://www.cia.gov/cia/publications.Factbook/geos.ch.html>

of leaders, many of whom witnessed or actually participated in the weaving of the basic fabric of their respective nation-states; these older leaders, with assistance from younger technocrats providing important international economic and geopolitical analysis, enjoy a rare perspective from which to make important strategic decisions for the good of their citizens. Both states also, due to their ideological underpinnings as well as their significant strategic positions, are often solitary actors on the world stage, eschewing regional and international coalitions and group diplomacy when they deem their own interests not to be fully aligned with those of other states.

Saudi Arabia and China began their strategic relationship slowly, commencing with Chinese purchases of Saudi Arabian crude oil. In the 1980s, China supplied a total of some US \$5 billion in military goods to Saudi Arabia, including in 1988 some 50-60 CSS-2 intermediate-range surface-to-air missiles and 15 mobile launchers valued at US \$3 billion⁴. This particular arms deal – China’s first sale of missile technology – took the United States and other traditional military allies of the Kingdom by surprise. This deal may have been deemed necessary by the Saudis to counter similar missile buildups in Iran and Iraq during the same period. Ironically, it took another two years before Saudi Arabia established formal diplomatic ties with China, in 1990.

During the decade of the 1990s, economic ties between Saudi Arabia and China grew considerably, particularly in the area of crude oil purchases, which reached a peak of 86,000 bbl/day in 1999⁵. Chinese-Saudi cooperation in the defense sector, however, actually decreased in the 1990s in the aftermath of the first Gulf War, with Saudi Arabia procuring much of its defense upgrades and replacements from member states of the Coalition Forces assembled to expel the Iraqis from Kuwait. Chinese arms exports to Saudi Arabia likely did not exceed US \$1.5 – 2.0 billion throughout this decade⁶.

⁴ A. H. Cordesman, Saudi Arabia: Guarding the Desert Kingdom, Westview Press 1997, at 108-110, 178.

⁵ J. Calabrese, “Dragon by the Tail: China’s Energy Quandary,” Middle East Perspective (23 March 2004).

⁶ *Id.*, at 110-111.

The importance of Saudi Arabia in China's eyes was highlighted by Chinese President Jiang Zemin during a state visit to the Kingdom in 1999 at which he pronounced a "strategic oil partnership" between China and Saudi Arabia. Commencing with that state visit, Chinese strategic and economic ties to Saudi Arabia have increased dramatically, fueled in large part by China's recognition that it must secure energy resources necessary to sustain its phenomenal economic growth. This has been coupled with Saudi Arabia's desire to diversify its strategic energy partnerships following the collapse of the much-heralded Strategic Gas Initiative projects with IOCs in 2003. Inaugurated by HRH Crown Prince Abdullah bin Abdulaziz Al-Saud in Washington, D.C. in October 1998, these integrated well-to-wire E&P projects for non-associated natural gas were widely promoted as the answer to Saudi Arabia's need for power generation and water desalination plants for the next several decades. They were also attractive to the IOCs, who, despite the clearly defined limits in the formal agreements, saw these as a necessary first step toward Saudi Arabia opening its doors to the IOCs to E&P activities in the highly coveted oil sector. Investment in the Core Venture 2 and Core Venture 3 projects were expected to reach US \$4 billion each, while total investment in the Core Venture 1 projects was slated to be US \$15 billion.

Despite all the initial excitement over the three Core Venture projects in the Saudi Gas Initiative⁷, the negotiations between the various IOC consortia and the Saudi Arabian Government soon bogged down over investment returns, the role of Saudi Aramco in the various projects and other issues. In June 2003, the Kingdom terminated the original Saudi Gas Initiative (SGI-1) and announced that it would re-tender the Core Venture I acreage to a greater number of IOCs in three separate blocks. This revised initiative, known as SGI-2, included a new structure that guaranteed Saudi Aramco a minimum 20% stake in each consortium.⁸ SGI-2 was structured with very lean terms for the

⁷ Core Venture 1 in the northern *Rub Al-Khali* was composed of ExxonMobil (35%), BP (25%), Royal Dutch/Shell (25%) and Phillips (15%); Core Venture 2 in the Red Sea and the Western Province was composed of ExxonMobil (60%), Occidental (20%) and Marathon (20%); and Core Venture 3 in the Southern *Rub Al-Khali* was composed of Royal Dutch/Shell (40%), TotalFinaElf (30%) and Conoco (30%). Of the three original Core Venture projects, only Core Venture 3 is moving forward, with Saudi Aramco having acceded to Conoco's 30% stake.

⁸ Saudi Aramco is required to invest its own capital for this 20% stake.

successful bidders, with Saudi Aramco to purchase all “saleable natural gas” under long-term take or pay contracts of US \$0.75 per million BTUs, which would actually produce a “netback” of on US \$0.65 per million BTUs after the US \$0.10 per million BTU pipeline transportation charge. Other than strategic regions, the greatest upside to the bidders is in respect of NGLs, which are to be sold by the joint venture operators to Saudi Aramco at free-market export prices.

Sinopec was the highest bidder on the 40,000 square kilometer Block B, with Sinopec’s Chairman stating that initial investment would likely reach US \$300 million.⁹ Many industry professionals were surprised at the size of the bids submitted by all of the winners, including Sinopec, given the substantial uncertainty that sufficient volumes of non-associated gas would be discovered in this acreage.¹⁰ Indeed, many business leaders and diplomats in Saudi Arabia who witnessed the SGI-1 negotiations and the SGI-2 tender process have remarked that the SGI-2 winners seem more interested in establishing long-term strategic relations with Saudi Arabia than they are in reaping any immediate economic benefits from their SGI-2 projects.

While Sinopec has invested in the Kingdom, Saudi Aramco and Saudi Basic Industries Company (SABIC), the large Saudi conglomerate that is the country’s largest petrochemical producer, are investing in China’s energy sector. The largest of these investments is Saudi Aramco’s participation, along with ExxonMobil and Sinopec, in the US \$3.5 billion Fujian integrated refinery and petrochemical project. This represents the first FDI in China’s refining sector in almost 20 years. This complex, which includes an upgrade of Sinopec’s existing 80,000 bbl/day refinery to 240,000 bbl/day and a new 800 KT / year naphtha cracker, is to be owned 50% by a joint venture between Sinopec and the Fujian provincial government, and 25% each by ExxonMobil and Saudi Aramco. A

⁹ Lukoil was the highest bidder on the 30,000 km² Block A with a minimum investment commitment of US \$215 million. ENI and Repsol, with a 40% stake each, submitted the highest bid on the 52,000 km² Block C.

¹⁰ Under the terms of the Upstream Agreements entered into between each SGI-2 consortium and the Saudi Arabian Government, the consortium is required to transfer to Saudi Aramco all fields producing crude oil and associated gas in exchange for a repayment of the capital investment made in the particular field.

key element in the deal is a marketing joint venture for refined products coming from the new integrated facility, which includes more than 600 retail gasoline stations, including many existing Sinopec stations. The marketing joint venture is owned 55% by Sinopec and 22.5% each by ExxonMobil and Saudi Aramco.

In addition to the Fujian deal, Saudi Aramco announced on 17 January 2005 that it is contemplating an investment in Sinopec's US \$1.17 billion Shandong refinery. After the proposed upgrade of this facility, its refining capacity would be increased to 200,000 bbl/day, commencing in 2007¹¹.

The Fujian project represents the new model of energy sector FDI in China, with NOCs and IOCs joining forces with a Chinese oil company in upstream and downstream projects. The NOCs benefit by securing long-term offtake arrangements for their crudes and the IOCs benefit by gaining access to the Chinese market while at the same time extending their cooperation with the major NOCs. The Chinese oil firms benefit by securing steady long-term crude supplies from the NOCs and by obtaining critical technology and know-how from the IOCs.

These cross-investments in the energy sector are supplemented by more traditional bilateral trade arrangements in goods and services such as telecommunications, engineering & construction, vehicles and a wide range of consumer products, as well as military sales. Bilateral trade between Saudi Arabia and China increased more than ten-fold from 1990 to 2000, when it reached US \$3.098 billion,¹² and has certainly grown significantly since that time. The net effect of these new relationships is the creation of a powerful bilateral strategic-economic link between China and Saudi Arabia,¹³ no doubt altering the Kingdom's view of its strategic relationships with its traditional allies the United States, Great Britain, France and Germany. This is particularly true after 11

¹¹ "Capacity Pinch Pumps up Price", National Post, Don Mills, Ontario, at FP8.

¹² "Chinese State Councilor Hails Chinese-Saudi Economic Ties," People's Daily, 1 April 2002.

¹³ This pattern is, or course, being repeated with other Middle Eastern oil producers, most notably Iran.

September 2001 when Saudi Arabia's longstanding strategic partnership with the United States was severely tested.

Given this new strategic framework, it is likely that China will provide Saudi Arabia with an increasing amount of weapons systems, along the lines of the CSS-2 missile sales in 1988 and possibly including nuclear technology¹⁴. This shift to China as a major military hardware provider to the Kingdom will result not only from price considerations, but also from concerns about the ability of US defense companies to supply Saudi Arabia with the most sophisticated aircraft and other defense articles, which are often subject to Congressional approval. In the post-11 September world, the reliability of the US as a weapons provider to the Kingdom is less than certain to Saudi Arabia, and this has no doubt been taken into account by the leadership in Beijing and Riyadh as they expand their ties in the energy sector.

¹⁴ China has sold nuclear technology to Iran including a 27 megawatt research reactor in 1991 and two 300 megawatt pressurized water reactors in 1995. Source: Middle East Quarterly, September 1997, Volume IV, Number 3.