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China's Geostrategic Search for Oil

In 2000, Asia analyst Robert A. Manning presciently argued that the likelihood of future conflict over energy resources would increase as rising Asian giants such as China shifted away from an economic toward a strategic approach to energy security.[1] Since then, as China's energy consumption has expanded and its rise has become the dominant geopolitical issue of our time, Beijing's energy security policy has become one of the major discussion topics.

The evidence that China has primarily chosen a politically-driven and geostrategic (rather than economic) approach to energy security policy is based on two factors, one domestic and the other external. First, the domestic structure of China's political economy, especially in the energy sector, means that it relies heavily on state-owned enterprises (SOEs) to achieve the country's national economic objectives, namely securing foreign supplies of oil and refining oil products for domestic use. Within this state-dominated approach, commercial decisions take place within a framework designed to entrench the dominance of SOEs, and the Chinese Communist Party's (CCP) influence within these SOEs. One upshot of this politicized approach to energy policy is that the role of market forces in determining supply, pricing, and distribution of energy resources throughout its economy is limited.

Second, Beijing pragmatically participates in international commodity markets, but simultaneously attempts to guard against supply and price disruptions. Unwilling to trust and rely on these markets to fulfill ongoing and future energy needs, subsequent attempts to hedge against sub-optimal developments in the international oil market have led Beijing to pursue an economic nationalist, or "China-first," agenda in many parts of the world. This

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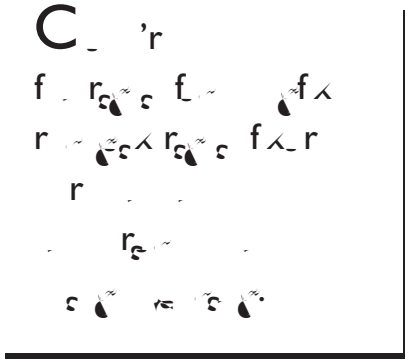

is evident in Beijing offering extensive political and economic assistance to its SOEs in the search to own offshore oil assets in many sidelined or pariah states, or else conclude deals to lock up guaranteed supplies from offshore oil fields.

Even so, and despite legitimate international concern about Beijing's uncompromising China-first energy security mindset, the actual capacity for Beijing to deliberately or inadvertently exacerbate the energy insecurity of other countries is limited. Nevertheless, China pursuing a geostrategic approach to energy security will detrimentally affect efforts by Western governments to improve governance standards, human rights, and economic reform in resource-rich authoritarian states around the world. In other words, although competing for energy resources is unlikely in itself to lead to conflict over territory (with the possible exception of competing claims in the South China Sea), Beijing's China-first geostrategic approach will exacerbate relations between China and Western liberal democracies over resource-rich states.

China's Rising Dependence on Foreign Oil

Coal still meets the majority of Chinese energy needs providing about 70 percent of total energy consumption for the country in 2011.[2] Currently, oil makes up only around 20 percent of the country's energy requirements. Even so, China's external search to secure an oil supply rightly dominates discussion of its energy security policies largely because the country's growing dependence on foreign oil is seen by Beijing as an area of potential strategic vulnerability.

While coal is sufficiently abundant in China to meet its current and future needs, China's self-sufficiency in oil ended in 1993. This is a concern to China because renewable and other resources such as solar and hydro power will provide China with only a tiny fraction of its current and future energy needs, and oil is a significantly cleaner and more efficient energy resource than coal. It is estimated that its 20.4 billion barrels of proven domestic reserves amounts to only around 1.2 percent of the world's proven total reserves.[3] Today, China relies on foreign imports for over 50 percent of the oil it consumes, expected to rise to 60–70 percent of total consumption by 2015, according to International Energy Agency (IEA) estimates. Outpacing overall rates of Chinese GDP growth, consumption of oil has increased by around 12 percent each year since 1980.[4] In 2009, China overtook Japan to become the second largest importer of oil after

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countries, securing such access is also essential for mitigating risks to the survival of the regime in China. In other words, the politicization of energy security in China occurs in a manner that does not apply to oil-importing democracies.

Conflating economic risk and risk to the regime in China stems from the fact that the modern CCP largely stakes its legitimacy on the capacity to continually deliver rapid economic growth. A disruption of China's supply of oil could lead to twin forces of mass discontent: a stagnating economy and inflation caused by spikes in domestic energy prices. As Premier Wen Jiabao explained to colleagues during the National People's Congress in March 2011, ensuring GDP growth of around 8 percent each year and keeping inflation below 4–5 percent is linked to social stability imperatives required for regime security.[7] At a minimum, such rapid growth is required to generate sufficient jobs to keep unemployment (and therefore discontent) under control; it is not lost on modern Chinese authorities that double-digit inflation was one of the major reasons behind countrywide protests in 1989 leading up to Tiananmen Square.

The link between energy security and maintaining rapid growth has deepened due to the evolving drivers of China's growth in place since the mid-1990s. In the first decade of economic reform (1979–1989), growth was largely driven by land reforms, which led to dramatic productivity increases in rural China. It was not until the mid-1990s that mass, large-scale industrialization took place. From the late 1990s onwards, fixed-asset investment (and exports) replaced domestic consumption as the driver of economic growth.

Indeed, fixed-asset investment was behind around 40 percent of Chinese growth at the turn of this century, rising to current levels of around 50–60 percent. During the global financial crisis (2008–2010), it drove over three quarters of GDP growth. At current levels, the contribution made by fixed-asset investment is the highest of any major economy in recorded history. China is literally building its way to sustaining its economic miracle.[8] Fixed-asset investment is an immensely energy-intensive form of economic activity, especially in an economy that still uses energy extremely inefficiently compared to Western industrialized ones. Examining Chinese oil consumption over the last two decades makes this clear. From 1993–2010, oil consumption increased from about 140 million tons to about 440 million tons.[9]

China's gradual realization that access to foreign oil was becoming an issue of utmost importance must be understood alongside the evolution of the Chinese political economy from being largely private-sector driven (prior to 1989) to

state-sector driven (since the mid-1990s). This is where the structure of China's authoritarian, state-dominated political economy tends to conflate political with commercial interests, and in doing so more intimately links energy policy, regime security, and national interest.

The Return of the State in China's Political Economy

China's economic success over more than three decades might lead some to

withdrawal.'' This includes resources from the formal fiscal budget, but more importantly loans from state-owned banks as well.[15]

Other measures are also telling. The corporate giants emerging from China are almost all state-controlled enterprises. All but approximately 100 of the 2,037 firms listed on the two Chinese stock exchanges are majority-owned by SOEs. The ten largest Chinese firms by revenue and/or profit are all state-controlled. In 2009, two SOEs China National Petroleum and China Mobile

decision-making throughout the country's political economy. But the case that SOEs ultimately remain instruments of the Party or more precisely, have become one interlocking branch of CCP power is strengthened by examining links between SOE executives and the CCP.

Meticulous research by Professor Minxin Pei revealed that the senior managers of all central SOE enterprises are almost all senior members of the CCP.[18] The three most senior positions (party secretary, chairman, and CEO) of the 50 centrally-managed SOEs are appointed directly by the CCP's Central Organization Department (COD), after review and approval by the Standing Committee of the Politburo. The current head of the COD is Li Yuancho, who is a member of the Politburo as well. Almost all appointees are CCP members, and in many cases the CEO and party secretary is the same person. Many of the appointees at these levels were formerly top level provincial officials. The appointments of all remaining senior executives are carried out by the SASAC, which consults with the COD. Once again, the process of appointing officials at these senior levels is replicated in provincial and local SOEs.

Tracing the leadership of China's national oil champions confirms the above

mindset in the domestic market and a China-first mindset in international oil markets. In other words, efficient pricing and distribution is secondary in Chinese energy policy to priorities of the party and the state. The lack of clear chains of authority in the labyrinthine Chinese system means that a predictable and coherent energy security remains elusive. But it is evident that the rationality of markets is only one comparatively minor factor shaping Chinese energy policy.

Iraq, Kazakhstan, Ecuador, Indonesia, Iran, and Myanmar. When President Hu assumed power in 2003, Beijing expanded into African countries such as Algeria

gives China the option of hedging, or of bypassing, commodity markets should they deteriorate.

Implications of a "China First" Hedge

Even though other countries such as India use NOCs to acquire resources and technology in international energy markets, many western governments are uniquely wary and even distrustful of Chinese intentions for several reasons. The intimate and opaque role of the CCP in shaping the commercial activities of SOEs in domestic and international markets creates suspicion.[27] China's 2001 ascension into the World Trade Organization (WTO) heightened international expectations for China to accelerate market-based reforms, which would include extensively separating the regime and state from commercial activity. But the opposite has occurred, giving rise to legitimate fears that Chinese NOCs exist to further Chinese strategic interests abroad, in addition to engaging in normal commercial activity. For many, Beijing's apparent attempt to strong-arm Tokyo by halting exports of rare earth metals to Japan, following a 2010 confrontation in disputed waters in the East China Sea, illustrates the blurred line between resource policy and strategic policy in China.[28]

Upstream acquisitions by Chinese SOEs tend to cause the most alarm because Chinese NOC ownership of below-ground assets plays into fears that China will lock up oil supplies and distort international oil markets to the detriment of other economies. These fears are exacerbated because Beijing's standard modus operandi is to pursue a political route for its NOCs to gain favored access with host governments, fueling suspicion that energy security is but one sub-component of broader Chinese geostrategy.

All these concerns should be considered in the context of the ongoing debate as to whether authoritarian China can emerge as a "responsible stakeholder" in a pre-existing liberal economic order. That the broad strategic competition between the United States, the leader of this liberal order, and China appears to be deepening, even as China's importance and integration into the global economy intensifies, isn't helping the situation.

Limited Implications for Energy Markets

Although Chinese NOCs have sold a significant proportion of their offshore equity oil on local and international commodity markets, that has done little to assuage fears that China could lock up equity oil supplies and potentially disrupt supplies to other markets in the future. After all, "going global" is an explicit component of the country's energy security strategy. NOCs must be treated to some degree as tools of the state, considering that Beijing periodically instructs state-owned banks to rush cheap loans to them. In the event of a significant

disruption to oil markets, the political imperative of economic growth probably means that as much offshore equity oil as is needed would be redirected to the

commodity markets or other countries). Beijing has facilitated similar loan-for-oil deals between Chinese NOCs and oil interests in Angola, Bolivia, Brazil, Ecuador, Ghana, Kazakhstan, Russia, Turkmenistan, and Venezuela. By the end of 2010, such 'locking supply' deals were worth at least $90 billion.[33]

A closer inspection of the available information on loan-for-oil deals confirms that these arrangements are not sufficient to threaten supply to other major oil importers.[34] The largest known Chinese long-term loan-for-oil deals signed since 2009 include a $10 billion agreement with Brazil in February 2009, a $4 billion agreement with Venezuela in February 2009, and a $15 billion agreement with Kazakhstan in April 2009. Terms include Chinese NOCs buying 200,000–250,000; 200,000; and 300,000 barrels per day, respectively, at market prices.[35] Other deals include around $10 billion in a long-term financing plan to help state firms in Venezuela develop the Junin 4 block field, which could produce 2.9 billion barrels of oil over the next 25 years (or about 317,000 barrels per day.)[36] Once again, China's capacity to significantly disrupt supply to other major oil importers is extremely limited at these volumes.

Finally, as peak crude oil production is reached in many existing oil fields, new fields will have to be found to meet rising oil demand. The IEA predicts that current crude oil production in existing fields, which produced 69 million barrels per day in 2010, will only produce 22 million in 2035. This means that additional capacity from new fields will need to increase by around 17 million barrels per day by 2020, and 47 million barrels per day by 2035.[37]

From 2010–2035, Iraq, Saudi Arabia, Kuwait, Brazil, and Kazakhstan will be able to significantly increase production from new fields. Countries such as China, Russia, and Venezuela are projected to suffer significant declines in oil production during this period. Africa, which will supply approximately 12 percent of global oil resources leading up to 2035 (based on currently known recoverable oil resources),[38] will not be a dominant player in the future. Moving forward, the significance of the majority of Beijing's supposed portfolio of compliant states willing to sell significant oil assets to Chinese NOCs will decline in their role in global oil supply.

Skepticism about the wisdom of China's geostrategic approach to energy security,

and inadequate domestic refining capabilities make the costs of shipping these assets home exorbitant. Loan-for-oil agreements carry considerable political and economic risk, as argued earlier. Despite the size of the firms,

decimate the appetite in many capitals for hosting U.S. naval assets, and wreak enormous damage to the U.S. and global economy.

In the face of such realities, it is tempting to conclude that Chinese energy insecurities are grounded on a senseless paranoia and misunderstanding, and therefore it should be a relatively easy argument to convince Beijing to abandon its geostrategic mindset in the search for oil. Yet, Beijing's mindset needs to be placed alongside enduring domestic and geopolitical factors that work against a more "enlightened" market-based view of securing its energy needs. Domestically, markets are designed to ensure that state-owned interests e 418b [illegible] (d)]TJ0 -1.3

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