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China's Energy Crossroads

By Dr. Stephen Blank

China's energy hunger has become a driving factor in contemporary world politics and a precondition for sustaining China's continuing high economic growth, which is the government's self-proclaimed major task and the basic rationale for its continuing legitimacy. Therefore, reliable access to energy is a vital Chinese interest that cuts to the heart of the Chinese leadership's most primal domestic and foreign policy obsessions. Indeed, China approaches the question of energy security primarily from a geopolitical oblique strategic standpoint.

Hitherto, Chinese energy policy has been *dirigiste* and mercantilistic, aiming at physical ownership of energy sources from wellhead to terminals in China and a legatee of the socialist tradition of state ownership concurrent with the subsidization of mass consumption of artificially cheap energy. Chinese energy policy, accordingly, has been a political and strategic rather than market-driven policy. For example, one recent analysis of Chinese energy policy observes that China protects its energy firms: SINOPEC, PetroChina, and CNOOC at home and supports them abroad, because their main purpose is to be an arm of national foreign policy, not profit-maximizing corporations. (1) Indeed, several recent Chinese energy deals, e.g. with Saudi Arabia, cannot be justified on strictly economic considerations but rather on strategic grounds. (2)

Thus, Chinese policy is primarily strategic. Indeed the requirements of ensuring energy security, e.g. by keeping the Malacca Straits open and preventing America or other states from interdicting Chinese energy flows, are factors that apparently drive China's long-term military modernization. (3) Obviously China, as a large energy importer, must

always be able to count on reliable supplies of gas, oil, electricity, etc. (4) But since 2003, the urgency of finding a satisfactory answer to the problems of ensuring reliable energy supplies has become much more acute. First, the US invasion of Iraq forcefully showed China the danger of relying on energy supplies from the Persian Gulf. Moreover, it is not merely a question of any instability there placing reliable energy supplies at risk. Most disturbingly, this invasion reminded Beijing that it depended enormously on the good graces and capability of the US Navy to ensure the accessibility of sea lanes carrying the energy bought by China so that the latter could obtain reliable and timely energy supplies. Worse, Washington showed that it was not bound by anything other than considerations of its national interest, which many in China regard as dangerously expansive. For Beijing this is intolerable since, ultimately, it puts China's economic growth at the mercy of its main strategic and ideological adversary. (5)

China's policymakers fear that energy vulnerability gives America a potential weapon with which to "contain" China or that strife in the Gulf and elsewhere in the Indian Ocean, if not Taiwan, could cut off its vital energy sources. (6) Indeed, Under Secretary of State Robert Zoellick recently warned China that pursuing energy deals with Iran risks conflict with Washington. Since it could not "lock up energy resources" by pursuing deals with states considered troublesome by America and its allies, China would be better advised to pursue cooperation with Washington. (7)

Events with Russia in 2003 likewise underscored the intolerable nature of China's dependence upon foreign energy supplies when it became clear that Russian President Vladimir Putin would destroy Yukos for domestic political reasons, and therefore that the pipeline from Angara to Daqing that Yukos wanted to build in order to sell China Siberian oil would not be built. At the same time, in the winter of 2002-2003 reports of China's interest in buying equity interest in Slavneft, a Russian oil firm, triggered a nationalist backlash comparable to the same US reaction when in mid-2005 China National Overseas Oil Company (CNOOC) announced a bid for the American firm UNOCAL.

Despite subsequent deals in Latin America, Africa, Central Asia, and Australasia, and protracted negotiations with Russia, China still must rely ever more on enhancing its domestic economic and energy efficiency, developing domestic supplies, and on competing successfully with other Asian consumers like India, Japan, and South Korea. More than a decade of negotiations with Russia over large oil and gas deals has produced few results, due mainly to internecine Russian bureaucratic wrangling and Russia's own mercantilistic and *dirigiste* policies, the inefficiency of which becomes ever more visible. (8) Russia also has systematically obstructed China's efforts to obtain independent access to Central Asian oil and gas fields or firms. (9)

Russia's obstructionist tactics, despite the current Sino-Russian strategic and political alliance to resist American pressure and policy throughout Asia, as well as American obstruction of the Chinese attempt to purchase UNOCAL in 2005, have begun to influence Chinese energy policies. Indeed, some Chinese analysts already had begun advocating a more cooperative approach to association with other Asian energy consumers in the hopes of reducing the leverage of suppliers and mitigating Beijing's tendency to pay more than top dollar for energy supplies which turn out to be unavailable or ruinously expensive.

More recently, at the end of 2005 and in early 2006, we can see that China is approaching a crossroads in energy policy. Recent Chinese efforts indicate a rising interest in Central and South Asian pipelines and in cooperative and even more pro-market approaches to the perennial problem of securing reliable energy sources. Indeed, developments in early 2006, if anything, should reinforce skepticism that Russia will finish even one pipeline on schedule, or that there will be enough oil to satisfy China's or Japan's rising demand, not to mention the rising domestic demand of Russian consumers. Neither is it very likely that Russia will find crucial foreign investment forthcoming. The Russo-Ukrainian crisis of 2006, during which Moscow shut off gas shipments to Ukraine to compel it to accept an outlandishly high price (that it could not afford), in an attempt to force Ukraine to surrender control of its gas sector to Russia and to undermine the Yushchenko government, has raised global doubts about

the wisdom of relying upon Russia as a reliable provider of gas or oil whether in the CIS, China, India, Japan, or Europe. (10) Worse yet, Russia thereby unilaterally broke its own 2004 contract with Ukraine, a further sign of both its unreliability and its willingness to step on contract rights for putative political gains.

But beyond those weighty considerations lie others that are equally important for China. First, China knows now that it cannot rely on Russia to deliver either the amounts of oil and gas contracted at a reasonable price or to do so on schedule. Likewise, any hope of equity ownership in Russia is out of the question. Therefore China must reconsider its entire energy strategy, and there are abundant signs of its having done so even if the process is incomplete. Since 2003, it has started its own strategic reserve, made major deals for oil and gas with Iran, Saudi Arabia, Indonesia, Australia, Venezuela, several African states, and Central Asia.

In the latter case it, is not only the oil pipeline from Atasu in Kazakhstan to Alashankou. This 988 km pipeline is China's first import pipeline intended to import Kazakh and Russian oil to China by 2007, when China's domestic pipeline and refinery capabilities catch up to it. Only in 2007 will this pipeline deliver 100-200,000 barrels daily of crude oil to China, and it will have to ship Russian oil supplied by Rosneft as well as Kazakh crude because not enough Kazakh oil is likely to be available and because Russia otherwise will block or impede the project by threatening Kazakh energy interests elsewhere if it is not invited to ship its own as well.

China also has leaked hints recently that it expects the Shanghai Cooperation Organization (SCO) to set up an energy working group later this year to study proposals for the construction of pipelines among the members. (11) Since China has its own parallel negotiations with Russia for gas and oil pipelines, both of which have had a very checkered history, this suggests intensification of China's search for Central Asian energy, in part because it cannot rely on Russia living up to its past promises. For example, China now is discussing gas pipelines with Uzbekistan and Turkmenistan that would link up with a projected gas pipeline parallel to the Atasu-Alashankou oil pipeline

from Kazakhstan to China. This pipeline would bring Kazakh gas to China, but evidently a link could be built to allow Turkmen and Uzbek gas to link up with it. (12)

Neither is Central Asia the only focus of Beijing's activity. Indeed China is active everywhere. Even though PetroChina has found 2.4 billion tons of oil in addition to the amount expected within China (and internal pipeline construction to link up China's northwestern, eastern, and southwestern territories is underway to bring foreign gas and oil to the interior), China still is searching everywhere for energy sources. It just signed a gas deal with Nigeria and another with Myanmar, but the Central Asian sources promise greater security because of their proximity to China itself. Despite the agreement with Myanmar, which evidently came at India's expense since the latter has long sought to sign a gas deal there, China has sought to moderate its rivalry with India and filed a joint bid with ONGC for Syrian pipelines late in 2005. (13)

That was a portent of possible Indo-Chinese energy cooperation of a more formalized nature. Indeed, the idea of an Asian energy association has been floated by Chinese and European scholars well before India's former Minister Mani Shankar Aiyar formally pursued this as a matter of policy. And when Aiyar came to China in 2005 his Chinese interlocutors even engaged in admittedly speculative, but nonetheless revealing, discussions about connecting China in the future to the projected Iran-Afghanistan-Pakistan-India pipeline. Clearly, China has alternatives in mind regarding Central and South Asian energy. (14) And if a Turkmenistan-Afghanistan-Pakistan-India pipeline project that has been discussed for a decade gets off the ground, China probably will seek inclusion in that project too. Indeed, Pakistan's President Pervez Musharraf spoke positively about Pakistan becoming an energy provider to China during his February 2006 visit to Beijing. (15) Were this energy relationship to materialize, it too would heighten the existing nexus between energy, security and maritime power projection inherent in China's support for Pakistan's construction of a major seaport at Gwadar. Likewise, it would intensify Chinese efforts to help Pakistan become secure, integral, stable, and non-fundamentalist (given the existence of an uprising in the Balochistan

territory, which encompasses the new port of Gwadar that China is building on the Pakistani coast of the Indian Ocean). (16)

It is a measure of the urgency of China's quest for energy and its skepticism, if not outright disappointment, at Russian obstruction and unreliability, that these moves suggest putative reversals in its foreign policy. For example, despite rhetoric about multipolarity, China hitherto has shunned multilateral discussions about its access to energy. Now, it will do so evidently with both India and the SCO. This suggests a search for venues in which to discuss acquiring energy from both Russia and Central Asia—where Russia is not the only player at the opposite end of the table. It suggests also a rising interest in multilateral energy associations that would work against what has hitherto been a wholly unilateral approach to the question of energy security. Such multilateralization will take a long time to accomplish, but the signs of Beijing's interest in this, due to policy failures with regard to Russia, are unmistakable. At least in part, these moves are a result of Russia's consistent obstruction of China's quest for independent access to, or ownership of, Central Asian or Russian energy.

At the same time, these moves might also reflect a certain skepticism about the virtues of Beijing's previous unilateralist policy that aimed to establish long-term equity ownership in foreign firms or projects at fixed prices. This is reflected in China's call for collaboration with the EU on standards for cleaner energy and hints of a new, more market-friendly approach to energy policy emanating from Beijing. (17) The earlier unilateralism has proven to be expensive because it has led China to pay for equity ownership in fields at prices higher than the market suggests and often for disappointing energy yields. The new policy, if indeed it is going to be implemented in a multilateral format, could prove to be both cheaper and more reliable over time. It could also represent another example of Chinese interest in and learning from cooperative action as well as multilateral organizations. If indeed this does become reality, it will work to erode the Russo-Chinese strategic alliance, or partnership, against America. While there are solid political and military grounds, seen from Beijing and Moscow for such a partnership, in fact its economic foundation, and especially its energy dimension is

inherently precarious and likely will remain so for a long time to come. Likewise, the agreement with India to moderate competition for foreign energy fields and share information about potential foreign acquisitions and its recent moves vis-à-vis the EU have the potential to alter China's unilateralism and suspicion of market mechanism as a regulator of its energy policy. (18) If those trends do materialize and are allowed to realize their full potential, not only will they affect Sino-Russian relations and China's relations with Central Asia and South Asia, they will come undoubtedly to exercise a profound influence upon world energy markets. Although Russia's coercive tactics inevitably force China back to the Persian Gulf to obtain most of its imports, the China that gradually will appear in the Gulf may be a rather different player than the one we have known before.

That process will take time, however; in the meantime, there will be no alternative for China but to develop more energy at home, institute energy economies and efficiencies and to return to the Persian Gulf. As it is, OPEC remains eager to compete with Russia in China and the recent visit of Saudi Arabia's king underscores that readiness. (19) More importantly, the figures attached to China's voracious energy demand, Russian dilatoriness, and the availability of supplies and readiness of Gulf producers to ship to China are decisive for the short and medium term. These considerations undoubtedly will enhance China's profile in the Middle East and contribute to its quandary over how to deal with Iran's nuclear program. (20) The combined effect of these factors suggests that China stands at the crossroads of a new energy policy perched between the old statist, dirigiste, and mercantilist paradigm and a newer, more market-friendly paradigm. China will not become a market economy or liberal polity overnight. To the extent that it does turn in that direction, the repercussions of such moves will not be contained either within China's energy sector or within China itself.

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## End Notes

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