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China fuels energy cold war

By Chietigj Bajpae

HONG KONG - A notable feature of 2004 was the volatility in oil prices - New York light sweet crude prices reached a peak of US\$55.67 on October 25, ending the year up 33.6% at \$43.45 per barrel. While a number of supply-side and supply-chain factors have contributed to this situation, the most significant long-term factor contributing to rising oil prices is an increase in Asian demand, most notably from China. China's unprecedented growth not only makes it a driver of a long-term increase in energy prices, but also the most vulnerable to rising oil prices.

China, which has been a net oil importer since 1993, is the world's number two oil consumer after the US and has accounted for 40% of the world's crude oil demand growth since 2000. China's proven oil reserves stand at 18 trillion barrels, and oil imports account for one-third of its crude oil consumption.

China has initiated numerous policies to cope with its increasing energy needs, including stepping up exploration activities within its own borders, diversifying beyond oil to access other energy resources, such as nuclear power, coal, natural gas and renewable energy resources, promoting energy conservation and encouraging investment into energy-friendly technologies such as hydrogen-powered fuel cells and coal gasification.

China has also joined the United States and Japan in developing strategic petroleum reserves, with the creation of 75 days of emergency reserves in four locations in Zhejiang, Shandong and Liaoning provinces.

Nevertheless, in the face of sporadic power shortages, growing car ownership and air travel across China and the importance of energy to strategically important and growing industries such as agriculture, construction, and steel and cement manufacturing, pressure is going to mount on China to access energy resources on the world stage.

As a result, energy security has become an area of vital importance to China's stability and security. China is stepping up efforts to secure sea lanes and transport routes that are vital for oil shipments, and diversifying beyond the volatile Middle East to find energy resources in other regions, such as Africa, the Caspian, Russia, the Americas and the East and South China Sea region.

However, just as China has for centuries engaged in competition for leadership of Asia, the developing world and status on the world stage, so the need for energy security has now raised the possibility of further competition and confrontation in the energy sphere.

This competition has so far been limited to the economic sphere through state-owned oil and gas companies such as China Petroleum & Chemical Corporation (Sinopec), China National Petroleum Corporation (CNPC), its subsidiary PetroChina and China National Offshore Oil Corporation. However, as oil prices rise and China imports an increasing amount of its energy needs, the competition is likely to spill over into the political and military spheres. There are already indications of this.

China's quest for energy resources on the world stage is creating a destabilizing effect on international and regional security. Fueled by the lack of a coherent multilateral approach to energy security in Asia and by China's already tense relations with neighboring states, the competition for energy resources may prove to be the spark for regional and international conflict.

In many cases, China is vying for energy resources in some of the most unstable parts of the world. Its involvement in regions with raging conflicts could potentially draw it into the disputes, escalating a regional conflict into an international conflict.

Sino-Japanese energy competition

While Sino-Japanese trade has reached unprecedented levels in recent years, the economic progress could be unraveled by political and military confrontation, and by energy competition. China continues to have tense relations with Japan as a result of a number of issues. These issues include, but are not limited to, Chinese opposition to a Japanese permanent seat on the United Nations Security Council, former Taiwanese president Lee Teng Hui's visit to Japan at the end of 2004, and Japanese Prime Minister Junichiro Koizumi's annual visits to the Yasukuni Shrine that honors Japan's war dead, including 14 Class A war criminals.

There has also been discussion in Japan about cutting its overseas development assistance to China in the presence of China's improving standard of living, high growth levels and confrontational relations with Japan. These tensions are likely to be further enflamed by both states' quest for energy security. Both states are net oil importers, with Japan importing as much as 80% of its oil needs.

In an attempt to access energy resources closer to home and diversifying beyond the Middle East, Japan and China have been actively lobbying Moscow for an oil pipeline. Beijing is pushing for a 2,400 kilometer route from Angarsk in Siberia to Daqing in China's northeast Heilongjiang province, while Tokyo favors a 4,000 kilometer pipeline from Taishet to the Pacific port of Nakhodka.

The Japanese-backed proposal was announced the winner at the end of 2004. However, with the sometimes tense relations between Japan and Russia, as seen most recently over Koizumi's sail around the disputed Northern Territories/ Southern Kurils on September 2, and Japan and Russia not having signed a formal peace treaty ending the hostilities of World War II, the construction of the pipeline may still experience several delays. Furthermore, China is not yet out of the picture as there are still discussions to build a branch from the Japanese pipeline to China by 2020.

Closer to home, a territorial dispute between China and Japan in the East China Sea, which both sides claim as their exclusive economic zone (EEZ), is being further fueled by reports of vast supplies of oil and gas in the region. The disputed territory includes the Diaoyu or Senkaku islands and the Chunxiao gas field northeast of Taiwan, which, according to a 1999 Japanese survey, holds 200 billion cubic meters of gas. Japan regards the median line as its border, while China claims jurisdiction over the entire continental shelf. In 2003, China began drilling in the area after the Japanese rejected a Chinese proposal to develop the field jointly. Although the Chunxiao gas field is on the Chinese side of the median line, Japan claims that China may be siphoning energy resources on the Japanese side.

The competition recently took the form of a military confrontation following the incursion of a Chinese nuclear-powered submarine into Japanese waters off the Okinawa islands on November 10 last year. The intrusion was followed by a two-day chase across the East China Sea. While China offered a swift apology for the incursion, this was soon followed by the intrusion of a Chinese research vessel into Japanese waters near the island of Okinotori. The vessel is believed to have been surveying the seabed for oil and gas drilling purposes. This was the 34th maritime research exercise by Chinese vessels within Japan's EEZ in 2004, up from eight in 2003, with China not giving prior notification in 21 of the 34 cases.

Adding to these tensions is Japan's shift from its post-war pacifist and defensive posture toward a more active military role in the region, as seen with the current deployment of its Self Defense Forces to Iraq. Furthermore, Japan has for the first time identified China as a potential security threat in its National Defense Program Outline released in December 2004. Three issues have been identified that could spark a conflict between China and Japan: natural resources in the disputed East China Sea, the disputed status of the Senkaku or Diaoyu islands and Japanese support for the US in a conflict with China over Taiwan. Mistrust and animosities rooted in

Japanese atrocities during World War II combined with a confrontation over tangible issues, such as territory and energy resources, and a more active role by both states on the world stage create a recipe for a volatile situation.

Securing sea lanes

To China's south, another long-standing maritime territorial dispute in the South China Sea over the Spratly and Paracel islands threatens to be further enflamed by China's quest for energy security. The 130 islands making up the Paracel islands, which have been occupied by China since 1974, are also claimed by Vietnam and Taiwan. The 400 islands of the Spratly islands are claimed partially by the Philippines, Brunei and Indonesia, and are fully claimed by Vietnam, Taiwan and China.

Relations between China and the Association of Southeast Asian Nations (ASEAN) have improved with China signing up to ASEAN's Treaty of Amity of Friendship and Cooperation in 2003 and all sides signing the Declaration of the Conduct of Parties in the South China Sea in 2002. Nevertheless, tensions remain. In violation of the 2002 agreement, five states have permanent military garrisons on the atolls in addition to surveillance facilities under the guise of "bird watching" towers, weather huts and tourist facilities. The fact that Taiwan is not a signatory to any of these agreements is also a cause for concern.

A particular source of tension derives from the sometimes volatile relations between China and Vietnam. Most recently, China has commenced joint pre-exploration studies with the Philippines in the South China Sea, which has been openly opposed by Vietnam. China, meanwhile, has protested to PetroVietnam welcoming international bids for drilling and exploration activities in the disputed waters and Vietnam starting commercial flights and tours of the disputed territory.

Both states have engaged in sporadic clashes on at least four occasions, the most violent of which took place in 1988 in which the Chinese sank three Vietnamese naval vessels, killing 76 sailors. Sino-Vietnamese tensions have recently taken a back seat to the burgeoning trade relationship between both states, with China now becoming Vietnam's third-largest trading partner. A hotline was also established between both states in August 2004 as part of a commitment to resolve land and sea border disputes by peaceful means. However, as China expands its naval power projection capabilities and becomes increasingly desperate to access potential energy resources in the region, conflict may once again overtake cooperation.

These regional territorial disputes also have the potential to escalate into international conflicts, given the importance of the waterways to international trade and the number of bilateral security commitments between regional states and major world powers, such as between the US and the Philippines, Singapore and Thailand, and between numerous Western powers and their former colonies (eg the British to Malaysia and Singapore, the French to Vietnam). For example, following the Chinese occupation in February 1995 of the Mischief Reef, which is 135 miles west of the Philippine islands of Palawan, the US conducted naval exercises with the Philippines close to the disputed territory. The joint exercises may be regarded as a warning to China's increasingly aggressive posturing in the region.

Also in Southeast Asia, China is pushing to secure the narrow Malacca Strait, which experiences 40% of the world's piracy. As much as 80% of China's oil imports flow through the 630 mile-long strait, which is just 1.5 miles wide at its narrowest point. Like Japan and the US, China is pushing to acquire a national fleet of very large crude carriers, or VLCCs, that could be employed in the case of supply disruptions brought on by an accident or terrorist attack along the Malacca Strait or a US-led blockade during a conflict over Taiwan. Currently, only 10% of China's crude oil imports come aboard Chinese vessels. China's growing anxiety over the security of its oil imports was demonstrated in June 2004, when China conducted its first anti-terror exercise simulating an attack on an oil tanker.

China is also looking into bypassing the straits with discussions for a pipeline to Myanmar, as well as possibly Bangladesh, Pakistan or Thailand. Pakistan looks like an unlikely candidate given the threat of terrorist attacks on pipelines traversing its territory. A pipeline through Bangladesh would

have to cross the territory of strategic competitor India. Increasing sectarian violence in southern Thailand coupled with the country's close relationship with the US make a pipeline through Thailand unlikely as well. This leaves Myanmar as the most likely option, with a 1,250 kilometer pipeline from the deepwater port of Sittwe on the Bay of Bengal to Kunming in Yunnan province. Coupled with India's desire to access energy resources within Myanmar and Myanmar's proximity to India's troubled northeast insurgencies, Myanmar has become a potential stage for Sino-Indian energy competition.

Central Asia: The new great game

On its western borders, China has been an active player in the new great game. As part of its "Go West" development policy, China's longest pipeline, the 4,200 kilometer Tarim Basin to Shanghai gas pipeline, came online in August 2004. China's west-to-east pipeline could potentially be extended to Kazakhstan and Turkmenistan and even further to Iran and the Caspian Sea. In October 2004, construction began on a 988 kilometer pipeline from Atasu in northwestern Kazakhstan to Alatau Pass in China's Xinjiang province, which will carry 10 million tons of oil a year once it is completed in 2005. The Chinese are also helping to develop oil fields in Uzbekistan and hydroelectric power projects in Kyrgyzstan and Tajikistan.

China's growing engagement with Central Asia has been motivated by a number of strategic interests. China led the creation of the Shanghai Cooperation Organization (SCO), which began as the Shanghai Five in 1996. This body was formed in the presence of a civil war in Tajikistan, Taliban rule in Afghanistan, a series of terrorist attacks in Xinjiang, and Islamist revivalism in Uzbekistan under the Islamic Movement of Uzbekistan/Turkestan (IMU/IMT) and more recently by Hizb-ut Tahrir.

SCO has moved from resolving border disputes to fighting the "three evils" of extremism, terrorism and fundamentalism and promoting greater economic integration and development in Central Asia and China's west. The Central Asian states have agreed to China's "Five Principles of Peaceful Coexistence", as well as subscribing to China's viewpoint on numerous regional and international issues, including Taiwan, Tibet, Xinjiang and the need for a multipolar world. Under the aegis of the SCO, China has also expanded its military presence in Central Asia, establishing an anti-terror center in Tashkent and engaging in its first joint military exercises with a foreign army in Kyrgyzstan in 2002.

However, China's increasing presence in Central Asia has been accompanied by a Russian reengagement with the region, an increasing US presence following September 11 as well as an increasing role by India (using its historical links), Saudi Arabia and Pakistan (using their religious links), Turkey and Iran (using their cultural links) and South Korea and Japan (that are relying on economic links to the region).

Numerous overlapping power blocs are emerging in the region, which spill over into the energy arena. For example, improving Sino-Indian relations have manifested in the energy sphere, with the chairman of Xinjiang autonomous region, Ismail Tiliwandi, making a trip to India in October 2004 to discuss transport links and a Sino-Indian natural gas pipeline project. With a growing military presence in the region and increasing desperation to access the region's energy resources, it is conceivable that Central Asia could re-emerge as the stage for future great power conflicts.

China expands in the Middle East

China has also attempted to improve relations with its already-established oil suppliers, such as Saudi Arabia and Iran, by selling them military technology, investing in their industries and energy infrastructure and looking the other way with respect to their human-rights records.

Currently, China derives 13.6% of its oil imports from Iran. In March 2004, China signed a \$100 million deal with Iran to import 10 million tons of liquefied natural gas over a 25-year period in exchange for Chinese investment in Iran's oil and gas exploration, petrochemical and pipeline infrastructure.

Growing Sino-Iranian relations are undermining US sanctions against Iran. The Bush administration has sanctioned Chinese companies 62 times for violating US or international controls on the transfer of weapons technology to Iran and other states.

The US Central Intelligence Agency has submitted a report to US Congress stating that Chinese companies have "helped Iran move toward its goal of becoming self-sufficient in the production of ballistic missiles". In the ongoing controversy over Iran's uranium enrichment program, China has also opposed bringing the issue before the UN Security Council, and has even threatened to veto any resolution that is brought against Iran.

As Saudi-US relations have soured in the post-September 11 world, the Saudi-US strategic partnership may be supplanted by a Sino-Saudi partnership. Saudi oil shipments to the US declined in 2004, while they increased to China. Sinopec has won the right to explore for natural gas in Saudi Arabia's al-Khali Basin and Saudi Arabia has agreed to build a refinery for natural gas in Fujian in exchange for Chinese investment in Saudi Arabia's bauxite and phosphate industry. Cooperation in the economic and energy spheres complements an already burgeoning relationship in the military sphere, as seen with China selling Saudi Arabia Silkorm missiles during the Iran-Iraq War in the 1980s, and both states having strong relations with Pakistan.

Russia: Revival of the strategic triangle

Russia is China's fifth-largest crude oil supplier, with LuKoil now replacing Yukos as China's main supplier of Russian oil. China is expected to import at least 10 million tons of oil from Russia in 2005 and 15 million in 2006, while Russian rail shipment capacity is expected to increase from 20 million tons in 2004 to 60 million tons by 2006.

The controversy over the sale of Yugansk, which produces 60% of Yukos' oil output and pumps 11% of Russia's oil, has also highlighted the increasing presence of Chinese energy companies in Russia. While the mysterious buyer, Baikal Finance Group, ended up selling its stake in Yugansk to Rosneft in December, which may be acquired by Russian state-owned Gazprom, this does not preclude the possibility of Yukos' assets being acquired by China. China's CNPC has allegedly been offered a 20% percent stake in Yukos and provided a \$6 billion loan to Rosneft to purchase Yugansk.

China's support for Russia's accession into the World Trade Organization and growing Sino-Russian trade and cooperation in the fight against terrorism is further cementing Sino-Russian relations. Sino-Russian energy relations appear to be mirroring political and military relations. Just as China increasingly relies on Russian energy resources, so it also constitutes Russia's biggest buyer of Russian military hardware. Russia and China are also to engage in their largest joint military exercises later this year.

In fact, growing Sino-Russian energy cooperation resurrects former Russian prime minister Yevgeny Primakov's idea for a strategic triangle between Russia, India and China. These states are bound together by their shared interests in the fight against terrorism, the push for a multipolar world and respect for the principles of state sovereignty and non-intervention with regards to their respective "separatist" movements in Chechnya, Kashmir and Taiwan.

Now the energy sector can be added to this list of shared interests. India and China are already collaborating in the energy sphere, with India holding a 20% stake and China a 50% stake in the development of the Yahavaran oil field in Iran. China Gas Holdings has also established an alliance with India's largest energy conglomerate, Gail. With India and China vying for assets in Yukos, Sino-Indian-Russian collaboration in the energy sphere could be further cemented.

Stepping on US toes in Africa and the Americas

As China has made limited progress in accessing energy resources on its doorsteps due to poor relations with neighboring states, it has shown growing interest in accessing energy resources further afield.

For example, a consortium 40% owned by China's CNPC pumps over 300,000 barrels per day in

Sudan. China is also a major supplier of arms to the Sudanese government, which has just concluded a peace agreement with the main rebel group in the south, the Sudan People's Liberation Movement (SPLM), ending 20 years of conflict sparked over the allocation of oil revenues. The Sudanese government is still engaged in a conflict in the Darfur region of western Sudan using proxy militias. China is also vying for energy resources in Angola and other energy-rich African states by offering arms and aid for oil.

China is also acquiring energy resources in the Americas. While attending the annual Asia-Pacific Economic Cooperation summit in Chile in November 2004, Chinese President Hu Jintao announced an energy deal with Brazil worth \$10 billion, supplementing a \$1.3 billion deal between Sinopec and Petrobras for a 2000 kilometer natural gas pipeline.

China is also acquiring oil assets in Ecuador, as well as investing in offshore petroleum projects in Argentina. During Venezuelan President Hugo Chavez's visit to Beijing last December and Chinese Vice President Zeng Qinghong's visit to Venezuela in January, China also committed to develop Venezuela's energy infrastructure by investing \$350 million in 15 oil fields and \$60 million in a gas project in Venezuela.

On January 20, during Canadian Prime Minister Paul Martin's visit to Beijing, China and Canada also signed a joint statement on energy cooperation which included accessing Canada's oil sands and uranium resources. China's growing energy interests in the Americas have been accompanied by a growing involvement in the region's security.

In October, China sent a UN peacekeeping contingent to Haiti in its first military deployment to Latin America. Ironically, Haiti is one of only 25 states that recognize Taiwan rather than China. The US is looking on with caution as China encroaches on a region that has traditionally been under its sphere of influence and a major supplier of energy resources. Venezuela and Canada together provide the US with a quarter of its energy imports.

Conclusion

Friction between China and the West has so far focused on the question of China's undervalued exchange rate, its human-rights record and relations with "rogue" states. However, competition over energy resources is now becoming an additional area of contention.

China's growing presence on the international energy stage could ultimately bring it into confrontation with the world's largest energy consumer, the US. While China and the US have launched the US-China Energy Policy Dialogue, both states are also engaged in a competition for energy resources in Russia, the Caspian, the Middle East, the Americas and Africa. This competition could potentially combine with other areas of friction. For example, in the event of China engaging in a conflict with Taiwan, Japan or India or internal repression such as a repeat of the Tiananmen Square massacre of 1989, the US could censure China's actions by an oil embargo or by blocking vital sea lanes in the Malacca Strait, thus sparking a wider conflict.

It is not by coincidence that China has made progress in resolving its border disputes with India and Russia, while failing to make progress on territorial disputes with Japan in the East China Sea and in the South China Sea, given that the latter involve access to potential oil and gas resources. In this context, China's claim to pursuing a "peaceful ascendancy" policy and putting aside areas of disagreement in favor of creating a stable environment for economic development is limited to areas where China's vital strategic interests are not threatened.

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