Summary Points

- China's entrance in international oil and gas investment is an understandable and reasonable development.

- Chinese oil companies operating opportunistically outside of normal rules of commerce may be a temporary transitional phenomenon. In the long run, China has an important stake in the success of the international system.

- China and the United States have much to gain by seeking common ground and paths forward on international oil and gas investment precisely because of our import dependence. The two countries should not allow our overlapping interests to become a source of friction or destructive competition.

- There are many potential areas for cooperation; however, they require a shift in policy perspective, active dialogue, and concrete actions.

Overview

China shifted from a position as net oil exporter to net importer in the early 1990s. As it continues on its 30-year path of economic reform and opening to the outside world, China has become increasingly reliant on imported oil and gas. Although primary energy consumption continues to be dominated by coal, China is now the second-largest oil consumer in the world (after the United States) and the third-largest oil importer (after United States and, for now, Japan). Oil and gas imports are particularly important to the economically prosperous coastal regions of China, which have gained most from the reform process.

Perhaps it is natural then, as part of the globalization of the Chinese economy and because of limited domestic prospects, that Chinese oil companies increasingly look abroad for investment opportunities in oil and gas exploration and production. These plans have been actively encouraged by the Chinese government as part of its broader international policy and to promote Chinese participation in leading global industries such as aerospace, information, and biotechnology. The strategically important oil and gas industry is no different.

China's recent entrance into the international oil patch is occurring in a climate of heightened global competition for oil and gas resources, which are perceived to be diminishing, and of resource nationalism by producing countries, which is rapidly changing the rules of the game in
international oil and gas investing. Consequently it is often seen by the traditional players, namely Western companies and their governments, to be threatening to the international order.

The fact that almost all Chinese oil companies are majority owned and controlled by the state, albeit partially publicly traded, adds to the international concern. Chinese companies are perceived to enjoy the active support of their government in their commercial dealings, using diplomatic influence, official aid programs, a protected home market, and favorable financing. At the same time, Chinese oil companies are also constricted by the government on petroleum product pricing and other domestic measures. This serves to reinforce the impression that Chinese oil companies are instruments of state policy rather than free-market competitors.

Chinese oil companies come into the international marketplace with advantages of domestic petroleum industry experience and capabilities built during 50 years of the communist period, particularly in onshore production but also in offshore technology after 25 years of cooperation with Western partners in China. China’s oil services industry is increasingly competitive in international contracting. China also offers a large and rapidly growing domestic refining market to oil-producing countries. Thus, unlike Japan in the 1980s, China arrives at the international oil patch with a running start and is therefore seen as more threatening, even before taking political considerations into account.

The relevant policy question is whether China, because of its thirst for imported energy and ability to play by a different set of rules, will fundamentally alter the largely market-oriented international oil and gas game. Or will China’s willingness to pay a new-entrant’s fee by purchasing dearly oil and gas assets and by using state-provided incentives outside international commercial norms be a temporary phenomenon, much like the European entrance into the global oil competition during an earlier period? Today formerly state-owned and -controlled BP, Total, ENI, and StatoilHydro participate in the international oil market according to standards of market efficiency not unlike those of other international oil companies. There are even examples in emerging markets, such as Petrobras of Brazil and Petronas of Malaysia, when these national oil companies operate abroad. Are Chinese oil companies that are spreading their wings internationally—mainly CNPC, CNOOC, SINOPEC, and CITIC—going through a similar transitional phase?

So far it is probably too early to tell as Chinese activities abroad have been comparatively short in duration by standards of the oil industry and, therefore, the evidence is necessarily anecdotal. What we do know is that the majority of the Chinese oil companies’ relatively small equity production overseas is sold into the world market, just as international oil companies seek the highest-value market for their production, rather than automatically imported into China’s domestic market. For example, the largest importer of Sudanese crude in 2008 was Japan, not China, although it is a Chinese company that produces most of Sudan’s oil. This suggests that commercial drivers remain an important, if not overriding, factor in business decisions by Chinese companies. It also raises the question of whether China’s industry behavior internationally is dictated by the government or whether it is the other way around, that is, government support is more influenced by the needs of Chinese companies as an important political constituency from a key industrial sector.
Case Studies

Iran

With more than 10 percent of proven world oil reserves and vast but underdeveloped natural gas reserves, Iran is a primary target for Chinese activities abroad to secure future oil and gas supplies. China can use its diplomatic influence, as a permanent member of the U.N. Security Council, to shield Iran from what it considers overly aggressive international sanctions over Iran’s nuclear program. China is also not above appealing to Persian vanity as a fellow ancient culture to solidify their bilateral relations.

Although China is a major importer of Iranian crude oil, its attempts to take advantage of Iran’s international isolation by becoming a major investor-operator of oil and gas fields in Iran nevertheless have not been met with much success. This is largely due to Iran’s commercial unreasonableness and intransigence, enabled by steep rises in oil prices in recent years. It is not clear that China’s use of soft power in this case has actually gained it any commercial advantage in Iranian oil deals. It is possible that, with an equally steep drop in global oil price since July 2008, Chinese patience will be rewarded with more generous terms under Iran’s so-called buyback contract terms.

The potential of future Iranian liquefied natural gas projects and exports remains an important prize that all international oil players are watching. Whether China’s accommodating position toward Iran internationally will be rewarded in the future by Tehran remains to be seen. Iranians, however, have a reputation in the international industry as being tough commercial negotiators, leveraging their maximum bargaining power in the oil market of the day.

Venezuela

With the largest proven oil reserves in the world outside of the Persian Gulf, Venezuela is another prime target for China. Its current president’s vehement anti-Americanism presents both an opportunity and an embarrassment for China. Hugo Chávez has been a regular visitor to China. In his recent visit in September 2008, the Chinese foreign ministry spokesperson was careful to emphasize Beijing’s wish not to let ties with Chávez’s government complicate relations with Washington: “Our bilateral relations are not based on ideology, and not against a third party, and will not affect any other country’s relations with Venezuela.”

Nevertheless, for Chávez, China represents an alternative to the United States for investment funds, oil-field technology, an export market, and a development path. Chinese companies are not only investors in Venezuela’s oil patch but are also providers of important oil-field services. China’s recent launch of a telecommunications satellite for Venezuela and sale of trainer jets highlight its broad range of economic capabilities on offer.

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Nevertheless, 60 percent of Venezuelan oil exports continue to go to the United States because of the close proximity and ability of U.S. refineries to process and upgrade heavy Venezuelan crude oil into high-value light petroleum products. This situation is unlikely to change anytime soon even with the announced plans by Venezuela and China to build as many as three refineries in China capable of processing heavy grades of Venezuelan crude, to launch joint oil development in the Orinoco Belt, and to build oil tankers for Venezuela. Such multibillion-dollar investments in the oil and gas industry take many years to mature, and these projects are still in the study stage in spite of numerous recurring announcements.

Chávez’s stated intention is to increase oil exports to China from a current level of 300,000 barrels per day to 500,000 barrels by 2010 and 1 million barrels per day beyond. China’s provision this year of a $4 billion assistance loan focused on rural development, fisheries, and agricultural cooperation is designed to keep Venezuela interested and to demonstrate its ability to provide a balanced economic package beyond the oil and gas industry. Venezuela is an interesting case for examining the durability of bilateral economic relations that are based on temporary convergence of interests and convenience between Caracas and Beijing and whether this can serve as a basis for further expansion of the relationship. For example, would a Chinese company producing crude in Venezuela refrain from selling its oil to a higher-priced market on the U.S. Gulf Coast as opposed to shipping to a more distant market in China? If not, what is the value of the strategic relationship in which both the Venezuelan and Chinese governments are investing?

Nigeria

Nigeria is traditionally Africa’s largest oil producer although its leading position has been threatened recently by Angola. In Nigeria, as well as in other African countries, China has leveraged not only its assets mentioned previously in the cases of Iran and Venezuela but also the availability of easy financing, Chinese workforce in country, investment in nonpetroleum infrastructure, and assistance with fewer strings attached than with Western donors. Nevertheless, Chinese companies face fierce competition from Nigeria’s traditional major oil producers from the West. They have had to pay billions of dollars to participate in major offshore exploration plays and are equally vulnerable to kidnapping and violence against their workers in the Niger River Delta.

Indeed here, as elsewhere in Africa, limitations on China’s attractiveness as an alternative development model and a more generous business partner may actually be on display. After the initial appeal of the newcomer, it turns out that Chinese commercial demands are not much different from the West’s in exploiting African natural resources. Chinese chauvinism is similar to Western racism; the use of large numbers of Chinese workers on projects disadvantages local labor; and the import of cheap Chinese goods, such as textiles, competes against indigenous products. Expectations have been raised by high-level political engagement and rhetoric, but they are difficult to fulfill on the ground.

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Angola

China’s involvement in Angola traces back to the civil war shortly after independence in the 1970s. The relationship, therefore, is a mixed bag for the MPLA-led government in Luanda, which was supported by the Soviet Union and Cuba, whereas China initially supported UNITA forces led by Jonas Savimbi. China, however, has skillfully taken advantage of the gap left by International Monetary Fund and World Bank conditionality on transparency requirements to satisfy Angola’s numerous development needs and to expand on its trading relationship as the second-largest importer of Angola crude oil (after the United States).  

China offers billions of dollars worth of development aid and noninterference in Angola’s domestic affairs in exchange for access to Angola’s oil resources. SINOPEC in particular has been able to acquire major positions in exploration blocks in Angola, which is the OPEC country in which production has grown most rapidly in recent years.

Further expansion of China’s oil relationship with Angola will be limited, however, by the country’s absorptive capacity and increasing demands by Angolan authorities on the Chinese to meet local content, training, and technology transfer requirements. It will be interesting to see whether China can avoid the effects of the resource curse in its dealings with the highly corrupt and dysfunctional Angolan government.

Southeast Asia

In the case of Southeast Asia, China’s oil and gas relations are both enhanced and complicated by a much longer historical relationship with countries in the region as well as with the presence of large and influential overseas Chinese communities. China’s proximity to Southeast Asia also adds important security and regional leadership components to the picture. For example, in 2007, Indonesia’s defense minister, Juwono Sudarsono, called on Northeast Asian countries, namely Japan, China, and South Korea, to help provide maritime security in the Strait of Malacca. This also affects the traditional role of the U.S. military in securing shipping lanes in the area, along with China’s increased stake as a major importer of energy from Southeast Asia, Australia, and the Persian Gulf. These broader concerns are probably more important than direct energy relations between China and Southeast Asian countries. With significant growth in population and economy, Southeast Asia as a region is rapidly developing into a net energy importer. The lone exception may be Burma, where China has skillfully taken advantage of gaps left by Western sanctions to position its companies to play a major role in the country’s gas sector and for future gas imports into China.

What’s at Stake

As the two largest oil consumers in the world, China and the United States have a common interest in increased investment flows to maintain the availability of affordable imported energy and

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in the security of that supply. China has pursued overseas oil and gas ventures opportunistically where it perceives temporarily weakened Western interests. This is understandable given that wherever China views the global oil patch—Persian Gulf, North and West Africa, South America, Canada, even Russia and Central Asia—its Western oil company competition has had a decades-long head start. The success of China’s own 30-year economic reform process has been based on integrating into a globally competitive market and on conforming its economic behavior gradually to international norms, epitomized by its accession to the World Trade Organization. There is little reason to believe that this will be different in the natural resources and petroleum sectors.

The United States as the leading economic power and biggest oil importer in the world has a strong vested interest in accelerating China’s integration into global oil markets. China’s oil companies’ international investments should be welcomed rather than feared, as long as they conform to international rules of the game in which China itself will have an increasing stake once it tires of paying late-entrant fees. Increased investment from whatever source leads to incremental supply available for the overall world market in which the United States is a principal beneficiary. A mercantilist Chinese outward investment policy in a global market like oil would be self-defeating and weaken economic competitiveness, lessons that the United States can help teach by example. This means avoiding unfortunate episodes, such as over politicization of the failed CNOOC takeover of Unocal, that send the wrong signal.

The United States must also shift discussion of energy independence to global interdependence, in which China and the United States have the greatest stakes. Jointly the two countries can strengthen the policy framework for international investment in oil and gas to serve the global market. Our companies in various partnership combinations should compete on an even playing field while our governments should cooperate for the overall benefit of both economies.

Recommendations

- Expand the Strategic Economic Dialogue to include traditional oil and gas investment on a global basis. Discussions to date have focused on energy efficiency, technology sales, and transfers that can sometimes be seen as intrusions on Chinese domestic policy and avoided opportunities for international cooperation outside of China and the United States.
- Promote China joining the International Energy Agency mechanisms, particularly on strategic stock sharing and on data transparency, in order to show how the international system can directly benefit China’s energy security.
- Encourage international partnerships, such as the SINOPEC-Saudi Aramco-ExxonMobil Fujian refinery upgrade project, that demonstrate the win-win-win potential of international cooperation in oil and gas investment. In general, more commercial partnerships between major Western oil companies and budding Chinese multinational companies in investments abroad would solidify international rules of the game.
- Broaden diplomatic dialogue inside regions where there are significant oil and gas investments in order to identify overlapping interests, such as stable investment conditions, and possible areas for cooperation, including in foreign assistance.
- Avoid unilateral economic sanctions that leave room for Chinese opportunism; use an active dialogue that promotes more effective multilateral economic sanctions where they are called for.