

## CHINA RACES FOR ENERGY SECURITY TO KEEP PACE WITH GDP GROWTH

### Building New Silk Roads to Avert an Energy Crisis in 2010

Part One of a Two-Part Series



*China would like all silk roads leading back to its country to be laden with oil and gas.*

By James Finch

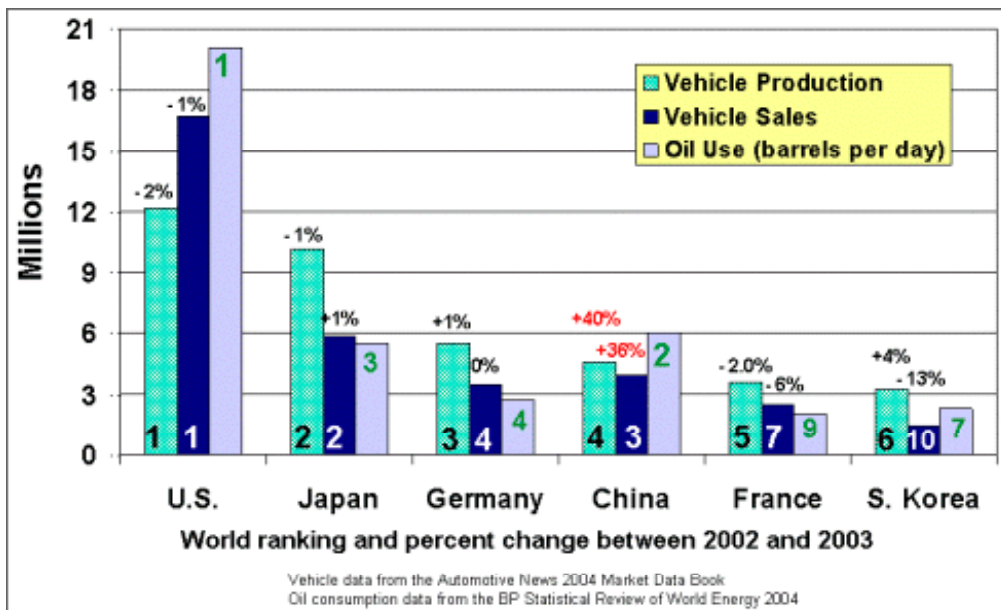
China embarked upon its remarkable GDP growth under the leadership of Deng Xiaoping, Mao's successor. Deng's message to his comrades: "To get rich is glorious." China responded by creating a middle class which is now nearly the same size as the entire population of North America. By meeting the country's energy demands to feed such rapid growth, China has engendered a worldwide race, most notably with neighboring India but also with others, to accumulate sufficient energy sources and raw commodities. Yet on the horizon, China has a serious energy crisis which could reduce its stunning GDP growth.

By the late 1990s, northeastern China's vast Daqing oil fields passed their peak, and no new oil fields of that magnitude were discovered. A net oil exporter until 1993, China's growing appetite for energy sources and other commodities has created what some call a 'super cycle' bull market in commodities. Now the world's second largest oil importer behind the United States, China's dependence on foreign oil jumped by 10 percent during the first six months of

2006, compared to the same period a year earlier. Oil imports during the first half-year grew to 47.3 percent.

In the context of previous years, the growth of oil imports clearly illustrates China's astonishing escalation of imported oil. According to the *Xinhua* news agency, the country's percentage of imported oil stood, in 2001, at slightly less than 27 percent of total consumption. As of 2004, this percentage had soared above 41 percent. By that year, China was driven to diversify its country-mix of energy sources. The Middle East supplies about 45 percent and Africa exports some 29 percent to China.

Having about 20 percent of the world's population, China only consumes four percent of what the world's oil fields produce. But, a growing middle class will simply consume more petroleum products as the decade comes to a close. Presently importing three million barrels of crude oil every day to fuel the growing number of automobiles, where will China find the oil to produce gasoline in 2020, when the country could have as many as 140 million cars on



its roads?

Because of China's Industrial Revolution, Beijing's streets, once overflowing with bicycles, are now jammed with nearly three million automobiles. The Chinese middle class want more energy to accompany their new wealth, but where will it come from? Since 2001, China has acquired more than 100 oil fields and companies to sustain its heavy flow of imported oil for this demand. Chinese state-owned oil companies have spent \$15 billion over the past five years to build up their oil reserves.

The country's state-owned media arm refers to China's exploration and acquisition expeditions for new oil fields beyond its borders as developing "new silk roads." These roads have led to Central Asia, South America and Africa in China's quest to establish more and more energy sources. Is this strategy working fast enough or not?

### Are China's New Silk Roads Filled with Pot Holes?

China's creation of new silk roads of energy sources has been challenging. Emerging in the mid 1990s as an economic powerhouse to be taken seriously, in the wake of Japan's economic slowdown and the collapse of the Soviet Union, China has all but dictated world commodity prices in a frustrating drive to continue fueling the country's rapid growth. Unfortunately, both Russia's resolve to monopolize energy assets in Central Asia and U.S. political paranoia about China's global ambitions have led to a number of disappointments and setbacks.

Remember China's failed attempt to takeover of UNOCAL? Had China National Offshore Oil Corporation (CNOOC) bought UNOCAL, the acquisition would have impaired U.S. economic influence in both Thailand and Burma. Despite this setback, China continued investing heavily in Burma. The Chinese hope to someday export their neighbor's hydroelectric power, by helping the Burmese build a dam across the Salween River.

By acquiring rights to Daewoo's recently discovered offshore oil and natural gas in Burma, China will probably build another pipeline into its country. With each major stride forward, China is fre-

quently pushed back a step. China has grown accustomed to the habit of settling for less in order to meet the country's demand for energy security. Meanwhile, China has been criticized for buying marginally producing oil fields, overpaying for commodities and doing business with unsavory nations.

### Trouble in Central Asia

In Kazakhstan, China was delayed for seven years in building an 1800-mile oil pipeline across the Kazak border into neighboring Xinjiang province. After China's acquisition of PetroKazakhstan, an oil company whose assets were in Kazakhstan but which was registered in Canada, the Kazak government passed legislation declaring strategic control of the oil assets would be determined by its lawmakers.



Today's "Silk Roads" are pipelines which deliver oil and gas to an energy-hungry China.

China began developing its relationship with the Kazaks in the wake of the Soviet Union's disintegration into several sovereign countries. After an initial meeting with Kazak president Nursultan Nazarbayev, China helped create the Shanghai Cooperative Organization (SCO) in 1996 signing a "mutual trust" agreement with Russia, Kazakhstan, Kyrgyzstan and Tajikistan. Pejoratively known as the Shanghai Five mechanism, the bombastic Nazarbayev called the pact, "the most substantial political move in the Asia-Pacific region of this century."

How long does a handshake with Nazarbayev last? On January 11, 2006, Nazarbayev and Chinese Vice President Zeng Qinghong celebrated the completion of the Sino-Kazakh pipeline, vowing to



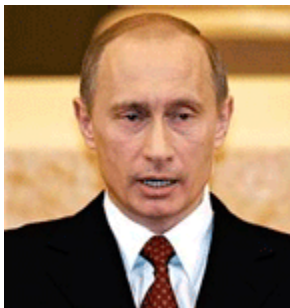
*Will Russia and China someday battle over Kazakhstan's energy resources?*

strategically partner in future energy deals. But before China's Premier Wen Jiabao inked a deal with Australian Prime Minister John Howard to buy Australian uranium in early April, Russia quietly began negotiations with uranium-rich Kazakhstan.

It was evident China would reach for Central Asia's uranium, second only to Australia's known recoverable reserves. In June, three weeks before the G-8 Summit in St. Petersburg, Russia, Kazakhstan's president and Russian President Putin announced a uranium production deal, worth about \$1 billion and lasting through 2020. A month later, on July 25th, the two countries announced a \$10 billion joint venture to build three nuclear reactors in Kazakhstan and a joint venture for further uranium exploration at the Zarechnoye deposit in southern Kazakhstan near Kyrgyzstan and Uzbekistan.

After more than a decade of China's cultivating a relationship with President Nursultan Nazarbayev, Russian President Putin has somewhat undone China's diplomacy for energy security from this country in a matter of months. On January 13th, the Moscow Times reported Vladimir Putin was rebuilding the nuclear energy ties of the old Soviet states, having first invited the Ukraine and Kazakhstan into the fold. Putin has also built up the Eurasian Economic Community, which is comprised of Russia, Kazakhstan, Uzbekistan, Kyrgyzstan, Belarus and Tajikistan. All are former Soviet states.

The same members also belong to the Collective Security Treaty Organization, of which Uzbekistan's Islam Karimov announced his country would soon join. His country's large natural gas fields are being developed in the western part of the country by Russia's Gazprom to help satisfy European demand. In other words, Russia is slowly edging China out of Central Asia's prolific oil and gas assets. One might expect China's hopes for Kazakh uranium are fairly well dashed.



*Have strong oil and gas prices made Vladimir Putin more arrogant than before?*

### China's Problem: Putin's Desire for Superpower Status

With Putin's star rising, Russia has aspired to block China's energy ambitions in Central Asia. When China embarked on a Sino-Kazak strategy, Boris Yeltsin was still president. Since then, Putin and his inner circle of Chekists (named after the Soviet Union's first secret police squads) have begun tightening the noose around the ex-Soviet states. The mandate driving Putin's fellow ex-KGB insiders is Russia's return to superpower status.

This became evident on October 26th 2005, when SCO's top officials met in Moscow for their annual conference. Because India's Foreign Minister and Pakistan's Prime Minister attended as SCO-invited observers, Putin boasted the populations represented by SCO member states and observer countries exceeded three billion people. He bragged he had gathered "half the planet" at the Kremlin. At the top of the SCO agenda were energy issues, such as expanding the oil and gas sector and exploration of new hydrocarbon reserves. Of course, these are the issues which are clearly foremost on the mind of the Chinese.

But has Putin's mood swung further toward impudence? When Chinese Prime Minister Wen Jiabao announced the Sino-Russian bilateral trade turnover might surpass \$28 billion, Putin challenged, "I hope this happens." While even Russia's media suspected Putin used the SCO conference as his egocentric publicity showcase, Russia depends upon China's economic prowess to uplift its own economy. Will there come a time when Russia is less fearful of China's economic might? This might be well into the future. Russia's economy continues to require



*Chinese Premier Wen Jiabao is determined to avert an energy crisis in this decade.*

an ally in China. Politically, Russia depends upon China politically as a buffer from the U.S. The September EU-China Summit to be held in Helsinki should offer clues about the tentative Sino-Russo

alliance. Chinese Premier Wen Jiabao will give the keynote address, and possibly helping to forge closer alliances with Russia's neighboring Finland. After all, Nokia is based in Finland, and China is the world's largest consumer of mobile phones and services.

One has to wonder if Russia has been slowly closing China's door to Central Asia over the past few years. Gazprom's press secretary, quoted in a 2004 interview in *Vedomosti*, announced, "... sharing mineral resources with foreign countries is against our policy... In fact, sharing oil with the Chinese would be even more inappropriate." Gazprom, for example, is now developing Uzbekistan's gas fields for export to the West, and not to China. (See part two of this series.)

The delicate equilibrium between Russia and China – one where both countries hope to maneuver against further U.S. meddling (or as cynics call it, imperialism) in the Middle East – requires yielding as few concessions to the other as need be conceded. When China moves too boldly, Russia plays upon its alliance with Japan to keep China in check. Both use their U.N. Security Council vetoes as negotiation tools in carving out petroleum, and other commodity interests, to preserve their energy security issues.

China serves Russia's political aspirations in quelling U.S. expansion into the Middle East. Having decades-long ties with Iran and other Muslim states, Russia has a convenient ally in China, when using Iran as a thorn in Washington's backside. And China still remembers the oil concessions it lost in Iraq, after the U.S. invasion of that country. China likely frets about the unending squabble over Iran's uranium enrichment aspirations in light of having lost those Iraqi oil concessions.



*China hopes to protect Iran from suffering the same fate as Iraq, where China lost valuable oil concessions after the U.S. invasion.*

### Pragmatic China Resorts to Trading with Rogue Nations for Energy Security

At the mercy of a ruthless global energy market, pragmatic China has turned to nations which are shunned by U.S. interests. One productive Silk Road leading to China begins in Iran. More specifically, it starts in the Yadavaran oil fields where the Chinese oil company Sinopec plans to import about 150,000 barrels of crude per day, after it has developed these oil fields. Initially, the October 2004 deal was reportedly valued at \$70 billion. However, additional developments and China's substantial purchase of Iran's vast natural gas

reserves may increase the value of this multi-decade energy deal to more than \$200 billion. What could go wrong? Look at the daily headlines: Iran wants to enrich its own uranium. Unless this situation is resolved, escalated political tensions could impair China's ability to import oil and gas. Obviously, China would take great pains to avoid an Iraqi rerun in Iran.

Out-manuevered by western oil companies in obtaining many of the world's proven oil reserves, China has cultivated the Sudan as its largest oil provider. Sudan depends upon the pragmatic Chinese for its economic and military strength. China is also the principal source of hard currency for Africa's largest country. Rejected by the world's community for the genocide it is committing in West Darfur, Sudan exports its oil to China for Chinese weaponry. China finds little competition for Sudanese oil. The Chinese are the largest single shareholders dominating Sudan's oil company consortium. It is the largest investor in a 1,500-kilometer pipeline delivering Sudanese oil to the Red Sea, which is then shipped by tankers to China.



*China is forced to deal with the likes of Venezuelan president Hugo Chavez to protect its future energy security.*

China has not limited its African oil purchases to one country. Another blighted nation, Angola believes it could soon surpass Nigeria as Africa's largest oil supplier. According to the World Bank, China may have recently offered Angola about \$9 billion in credits and loans. Two years ago, it was reported that China extended a \$2-billion loan to Angola for 10,000 barrels of crude oil per day. Now, it appears China is eager to help Angola build sufficient infrastructure in that country to develop another strong energy source.

Hoping to create a Silk Road across the Pacific from South America, China has continued its hunt for energy security by developing ties with Venezuela's Hugo Chavez. This may come to naught. Venezuela's highly sulfurous crude would first have to be refined in the United States. China lacks the refineries for handling the heavy crude oil. Over the past year, China's oil imports from Venezuela amounted to orimulsion from the Orinoco Tarbelt, mostly used for asphalt.

New refineries, however, can be built to remedy the heavy oil Venezuela might provide. According to a recent special edition of the *McKinsey Quarterly*, China will be forced to heavily invest in refineries for all the crude oil it has committed for, "To keep up with surging demand, the country needs to build a large, technologically world-class refinery every year for the next 15 years, at a cost of \$2

billion apiece.” China lacks the refining capacity to meet its current needs. In the first half of 2006, China’s imports of refined petroleum products jumped by nearly 50 percent, compared to the same six-month period in the previous year.

Although Venezuela hopes to become one of China’s top three oil suppliers, it is likely more hyperbole than a realistic possibility before 2010. As China’s proven oil reserves continue to deplete, it may very well have to turn to Venezuela at some point for this country’s vast oil reserves. Outside of the Middle East, Venezuela may have one of the last great oil resource – reportedly at greater than 80 billion barrels of crude. The question is not if, but how fast can Venezuela accommodate China’s ravenous appetite for its country’s oil?

Venezuela also has the largest natural gas fields in all of South America. Earlier this year, Brazil and Argentina (two of China’s favorite Latin American trade partners) discussed with Venezuela the possibility of building a gas pipeline across the Amazon. A 5000-mile gas pipeline would need a port destination for LNG tankers to supply China. Instead, talk of an oil pipeline through Colombia could be replaced by a gas pipeline.

China’s approach, in dealing with what the Anglo-American alliance call “rogue nations,” reflects one of reported non-interference in a country’s political affairs. It is a Chinese pragmatism, which many find amoral. By contrast, in what way is America judged around the world by its military invasion of Iraq? When U.S. President Bush recently criticized Vladimir Putin about democracy in his country, the Russian President pointed out that Russia’s democracy was quite different from the one the U.S. had created in Iraq for the Iraqis. One has to wonder how long China’s laissez faire doctrine will last. And whether China can continue developing new energy silk roads at the rate its GDP growth commands.

Some believe China doesn’t need so much oil right now. In the first half of 2006, according to *Xinhua* news, China’s refinery output was seven percent less than the country’s domestic crude-oil production. Despite producing 85 million tons of crude oil, China still imported 70 million tons of oil (on top of 12 million tons of refined oil). Is China hoarding to avert a future political crisis, or does it expect its energy ‘silk roads’ to soon close or become blockaded?

The *McKinsey Quarterly* researchers also reported if China continues at its current pace, it would need to buy up about three per-



*Venezuela holds one of the world’s largest oil resources and South America’s largest natural gas reserves.*

cent of the world’s proven petroleum reserves. That’s more than all of the reserves held by Chevron, ExxonMobil, BP, Shell and others. As we have been reminded by energy analysts, getting oil out of the ground costs more, the quality of oil is falling and more water is found in the oil. All of this has registered on not only the radar screens of Chinese energy advisors and politicians, but also at the gasoline pumps where filling up a tank should continue to increase every year. As Deng advised about getting rich, it can be glorious. But the furious process of getting there has not only been taxing for China, but also for the rest of the world.

#### Editor’s Note:

Please visit StockInterview’s disclaimer page <http://www.stockinterview.com/disclaimer.html> for full disclosure, forward looking statements, important links and cautions.