Cooperation and Conflict in the U.S.–China Petroleum Relationship

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ABSTRACT Current U.S. and Chinese petroleum import dependence differ sharply, and the respective vulnerability of each state to future supply disruptions should further strengthen the U.S. power position and weaken China’s power position. In an effort to minimize present and future petroleum vulnerability, China has been pursuing neo-mercantilist policies and favoring relations with states hostile to the United States. These policies continually place China in conflict with the United States, particularly since they challenge the international petroleum security and trading regime that largely was built by, and is currently supported by, the United States. While in the past, the United States and China have formally discussed “energy security,” these meetings tend to avoid the real points of difficulty in each country’s pursuit of petroleum supply security. Real dialogue on this issue could lead to less conflict over petroleum, especially given the United States’s improving petroleum power position relative to China. In particular, the United States may be able to give China greater access to global petroleum resources in exchange for reduced efforts on its part to undermine the international petroleum supply regime.

KEYWORDS China; energy security; mercantilism; oil; petroleum; resource nationalism

Many countries currently have a problem ensuring the adequacy and security of their petroleum supplies. But China faces a more severe problem than most countries and over the last decade its strategy for dealing with this critical vulnerability has not significantly contributed to its overall energy security. In fact, China’s “going out” strategy may have intensified its energy vulnerability by failing to reduce its dependence on fossil fuel and by significantly increasing its reliance on unstable foreign sources of petroleum. Ironically, over this same period the United States has seen its petroleum security situation gradually improve.

Both China and the United States now import just over half of the total petroleum they consume. But unlike the United States, which is set to see imports as a share of consumption decline over the next two decades, China will continue to see a rapid increase in its import dependency. While part of
this is due to the economic growth rate differential between the two countries, other factors are more important.

In the American case, there have been major improvements in oil recovery technology and a fundamental change in the structure of the economy (i.e., the shift toward services). America also just is naturally endowed with better geology and more hydrocarbons. As a result, the United States should significantly expand its domestic conventional and unconventional petroleum production.\(^1\) The United States already is the world’s largest producer of natural gas and it is likely to be the world’s largest producer of oil within seven or eight years. U.S. government policy, for a variety of reasons, can still stop this from happening, but the trend within the private sector is pushing the country toward this end.

During this coming period of rising domestic production, U.S. petroleum consumption should stagnate since many of the factors propelling past consumption have abated. Rapid population growth, urbanization, expansion of the auto fleet relative to population have all stalled or are now slowing in ways that suppress domestic consumption. Even average vehicle fuel efficiency finally is starting to rise.

China on the other hand will see few of these consumption suppressing trends. While total population growth has slowed, urbanization has not slowed (and it will not slow for many years), manufacturing as a share of Gross Domestic Product (GDP) is still increasing, the vehicle fleet just started to grow exponentially, and vehicle fuel efficiency already was at a substantially higher level than in the United States.

According to Energy Information Agency’s Annual Energy Outlook, 2011, China will move from importing 52 percent of its petroleum in 2009, to 78 percent in 2035. During this same period, the United States should go from importing 55 percent of its petroleum, to importing 42 percent. And the United States number understates the actual improvement to U.S. energy security because of a massive and concomitant increase in Canada production. During this period, Canadian conventional and unconventional petroleum production should go from over 3.5 million barrels per day (mmbd), to over 6 mmbd. And since Canadian oil, at least until now, really only can be delivered to the American market, and since Canada has a treaty obligation to supply the United States in a number of favorable ways in the event of a disruption, the future supply of petroleum to the American market is the most favorable it has been in decades.\(^2\)

But the good news for U.S. energy security does not end with its own and Canada’s increasing production. The next decade should see a substantial increase in western hemisphere petroleum production, primarily from Brazil, but also from Ecuador and Columbia. And while a substantial part of this incremental supply may not come to the United States, the proximity to the U.S. market and the logic of transportation place the United States in a very favorable position relative to the ultimate destination of this oil.

The two great western hemisphere negatives for U.S. energy security are Mexico and Venezuela. Mexican petroleum production has been dropping for several years and if nothing substantial changes that country should be a net importer of petroleum by 2020. While a declining Mexico supply is suboptimal from a U.S. security perspective, this change does open up a significant opportunity for U.S. refiners to sell refined petroleum products to Mexico.\(^3\)

The situation in Venezuela is more complicated but the future level of petroleum production in that country is very uncertain. A critical factor affecting future Venezuelan production concerns the access foreign companies will have to the Venezuelan resource base. Ultimately this is a political question and its final disposition will depend on the outcome of many unknown and perhaps unknowable future events in Venezuelan politics.

In Venezuela and Mexico’s cases, the production declines are the result of dysfunctional domestic political systems. They are not questions of geology and resource depletion. And in both cases, the ability of the United States to encourage each state to alter self-destructive oil policies is seriously limited. And specifically in the case of Mexico, the United States rarely even tries. There are just too many bilateral issues of greater importance.

When one compares the evolving U.S. petroleum security situation to that of China’s, matters look very different. China just does not have the domestic petroleum reserves on which to apply the improved recovery and unconventional technologies. And it does not have a neighbor like Canada. What it has is Russia, Venezuela, and the rest of the Organization
for Petroleum Exporting Countries (OPEC), and various and sundry small, unstable petroleum producers.

In the case of Venezuela, as noted earlier, getting access to the acreage is critical, but this is only part of the problem. While Hugo Chavez is very favorably inclined toward Chinese oil company participation in his country’s petroleum sector, the state oil company Petróleos de Venezuela (PDVSA) and the major Chinese oil companies (Petrochina, Sinopec, and CNOOC) are not particularly proficient at developing Venezuela’s increasingly heavy and unconventional petroleum deposits. They can do it [and in fact China does receive over 100,000 barrels per day (bd) from Venezuela], but these shipments occur at a higher cost than if they were done by any number of western-managed oil companies. And given Venezuela’s location relative to China, the transportation logistics are poor since the Panama Canal (even after it is widened) will remain a shipping bottleneck and raise transportation costs. Venezuela oil also is more difficult to refine and Chinese refineries are only starting to be able to process it. All of this further raises the cost of supply to China. It also creates a supply chain that is even more vulnerable to U.S. military interdiction than the existing ones coming from West Africa and the Persian Gulf.

Russia is another major potential oil supplier to China and, indeed, it figured prominently in China’s activities when it began the “going out” strategy in the early part of the new millennium. The goal was to get the Russians to sell an increasing portion of Far Eastern and East Siberian oil production to China, and not Japan. However, the Russians have been much slower than expected to develop their eastern deposits and they have shown themselves quite adept at parrying Chinese commercial and diplomatic advances. China currently receives over 300,000 barrels of petroleum from Russia, but this is a long way from what the Chinese hoped to receive when they opened negotiations over ten years ago.

U.S. interest in the China–Russia–Japan energy triangle has been comparatively muted, but one would think the greater U.S. interest is in seeing more Russian oil end up in Kozmino (near Vladivostok) and not shunted down a short spur to northeast China and Daqing. Besides the security relationship with Japan (and Korea), seeing more Russian crude move to a Pacific port would allow the Russians to market their oil to a variety of regional customers, including not just the Chinese, Japanese, and Koreans, but also if market circumstances warrant it, to west coast U.S. refineries.

The largest supplier of petroleum to China (at over 800,000 bd) is Saudi Arabia. During some months, Saudi Arabia now sells more oil to China than to the United States. Importantly, however, the U.S. government often encourages Saudi Arabia to do this in an effort to gain Chinese support for sanctions against Iran. And, indeed, Iranian supply to China now has dropped to less than 500,000 bd. The United States continues to apply pressure on third world countries not to take Iranian oil, but Iran’s strong desire to sell the oil has resulted in commercial terms that often are too attractive for buyers to resist at least those buyers that can withstand the U.S. pressure.

Both China and India are major purchasers of Iranian petroleum. And because of the last round of U.S. banking sanctions, they have been able to receive these shipments without actually paying Iran. Obviously, this is a very good arrangement for China and India. The arrearages now are said to exceed $20 billion and they are still rising.

One of the most controversial China petroleum sourcing relationships concerns Sudan. At a time when the United States and West European counties were trying to isolate the Sudanese government because of gross violations of human rights, China developed Sudan’s oil reserves and provided financial, diplomatic, and military assistance to the government. By doing so, China helped facilitate the civil war which ultimately claimed the lives of an estimated 1.5–2 million people. But given the instability of the situation on the ground (Chevron previously had withdrawn from the country because it was too dangerous), and given the horrendous public relations nightmare involvement in Sudan created, one can ask why China did this?

The answer is that they saw few alternative ways to secure the petroleum they deemed vital to the regime’s and country’s survival. The second U.S. invasion of Iraq, as well as a concern for rapidly escalating domestic demand, focused the Chinese leadership on the need to increase the size and security of their oil supply lines. With the “going out” strategy they began emphasizing new term contracts from diverse suppliers and the purchase of overseas equity stakes in producer countries. The
previous reliance on a spot market dominated by the international oil companies and the United States just was not going to provide them with the security they felt they needed. As a result of this change, China specifically targeted oil investments in countries subject to U.S. hostility. For one thing, such countries were more likely to welcome Chinese investment, and for another, in the event of Sino–U.S. difficulties these countries were less likely to support a U.S. sanctions policy against China should one occur. Hence, Sudan.

In looking at the quarter of a million barrels of oil a day China now receives from Sudan, it is easy to think that Chinese policymakers consider involvement in Sudan as a success. But why does China have so few ways to secure its petroleum supply except in countries with poor or antagonistic relations with the United States? The answer has little to do with the United States and very much to do with the structure of the international petroleum market and resource nationalism.

Resource nationalism is when a government asserts control over the production and management of domestic natural resources, usually in order to capture a larger share of the resource value. It often is employed as an economic weapon against foreign companies and a political weapon against domestic companies. As a result of the waves of resource nationalism that swept the world since the 1970s, more than 75 percent of all petroleum and natural gas acreage is exclusively available only to the national oil company(ies) of the state in which it is located. And another 15 percent or so is only available to non-national companies on a very restricted and economically disadvantageous basis. This leaves approximately 5 percent of the entire world’s acreage available to investor-owned oil companies or national oil companies not operating in their home market. Consequently, China has to compete with some very large and established international oil companies that have long-lived claims on this very small piece of the world’s petroleum universe. And in spite of the fact that China clearly has the funds to purchase many of these international oil companies outright, political conditions in most of the countries in which these companies are domiciled make such purchases problematic.

The most notable case of such an event occurred in 2005 when CNOOC made an $18.5 billion hostile bid for Unocal. During the attempted takeover, CNOOC and the Chinese government kept insisting that the acquisition was strictly a “commercial affair.” U.S. opponents countered that energy was “strategic” and in the event of a global supply disruption, a CNOOC controlled Unocal could take anti-U.S. actions on behalf of the Chinese government. They also said that CNOOC should not be allowed to make the acquisition with “subsidized” Chinese government funding.

After some very public back and forth between CNOOC, Chevron (the competing bidder), the U.S. Congress, and the Committee on Foreign Investment in the United States (CFIUS), CNOOC withdrew its bid and Unocal was acquired by Chevron. In retrospect it is clear that there was very little about this acquisition that was dangerous for the United States. But the outcome also left unresolved a number of issues about U.S. policy toward China’s petroleum strategy and toward U.S.–China relations in general. One of the most important of these issues concerns how to treat a major acquisition by a foreign, nationally controlled energy company, such as Petrochina or CNOOC.

A primary source of this problem stems from the fact that the world oil “regime” really is managed on two tracks. It has a small and perhaps shrinking quasi-market system of incentives and private ownership, that is, the “international oil company” (IOC) system, and a non-market, statist system, that is, the “national oil company” (NOC) system. The IOC system is dominated by U.S., U.K., Dutch, and Swiss companies and primarily supported by the U.S. government. The NOC system is dominated by the likes of Saudi Aramco, National Iranian Oil Company, Petroleos de Mexico, and Kuwait Petroleum Company and it is supported by their respective governments. China National Petroleum Company (Petrochina’s parent) is, for example, number five on the list of the world’s largest oil companies. And that is all oil companies, not just national oil companies.

But the very existence of NOCs, such as Petrochina, undermines U.S. energy security. Essentially, the rise of NOCs is a modern day variant of mercantilism. Historically, mercantilism has been a method for many developing states to harness the emerging power of their merchant and capitalist classes for the ends of the state. It was based on
the notion that states are in a direct, zero-sum com-
petition with each other for power, resources, and
wealth, and that intervention in the economy to
strengthen one’s side and weaken the other is not
only legitimate, but necessary. It is not concerned
with increasing global economic efficiency, but just
one’s own domestic material prosperity and state
power.

While in the past national power was increased by
a positive balance of trade and the accumulation of
gold and silver, today’s neo-mercantilist powers
seek, among other things, assured access to energy
and other raw materials.11 If one looks at Chinese
petroleum strategy, the hallmarks of neo-
mercantilism are self-evident. China provides subsi-
dized and inexpensive funding to its own companies
for foreign energy acquisitions. It designs domestic
energy strategies and induces or occasionally compels
local companies to fulfill these strategic national
plans.12 It provides preferential access to foreign
exchange for favored domestic energy companies
in its domestic market. It manipulates tax and tariff
regulations for the benefit of its companies operating
abroad. It gives aid and military assistance to encour-
age foreign states to cooperate. It trades diplomatic
support for energy access (most notably in Sudan,
Iran, and Myanmar). It has engaged in a series truly
massive loans to foreign governments in order to
induce them to grant China energy concessions or
long-term purchase contracts.13 It even occasionally
pressures and imprisons foreign businessmen oper-
ating in its domestic market in order to gain a per-
ceived advantage.14

For the United States, pursuit of similar neo-
mercantilist policies is undesirable, and in a practical
sense would be very difficult. In particular, the U.S.
government is in a peculiar position when it comes
to supporting individual petroleum companies. It
generally does not “pick winners” or a favored
company in any given market, and it does not have
an energy “national champion.”15 This leaves the
United States at a disadvantage when it comes to
dealing effectively with a world increasingly
dominated by NOCs like CNPC.

While many countries engage in neo-mercantilist
practices at various times and to differing extents,
the Chinese clearly use them extensively and as
matter of course. Consequently, U.S. interactions
with China over energy are inherently conflictual
because of each side’s desires to reinforce their
vision of how international commerce and politics
should be conducted. The tight integration of
Chinese energy policy and foreign policy only
exacerbates this structural difficulty by regularly
raising specific challenges to the U.S.-sponsored
IOC system. However, the IOC=NOC systems have
coexisted uncomfortably for over 30 years and the
United States has made many accommodations to
this reality over this time.

Notable examples include repeated U.S. govern-
ment action to thwart private sector (and some
Congressional) efforts to use U.S. anti-trust law
against OPEC; allowing the purchase of major stakes
in U.S. refinery assets by Saudi Aramco and PDVSA;
and the purchase by a quasi-national oil company
(Statoil) of a minority interest in an important U.S.
Gulf energy field.16 But what all of these had in
common was a calculation by the U.S. government
that by taking these accommodative or conciliatory
actions it was promoting energy security through
the benefits it received back from the country or
companies involved. What seems to be lacking in
the U.S.–China petroleum relationship is a more
overt sense of quid pro quo. Occasionally, one side
will do something that signifies some flexibility, but
they tend to be the exceptions.17 And while the
U.S. and Chinese governments do talk to each other
about energy, they seem to talk about everything but
the most important issues.

Over the last decade and half, there has been a
series of “strategic energy dialogues” between the
United States and China, but they have dealt with
issues that are not immediately central to the prob-
lems discussed earlier. They focus on such things
as renewable energy research, climate change,
nuclear power, and now, for the first time, shale
gas technology.18 While the dialogues occasionally
allow specific U.S. companies to raise issue with
the Chinese government regarding individual
corporate concerns, they tend to avoid the harder
conflict issues such as U.S. blockage of Chinese
energy market asset purchases in the United States,
or Chinese energy investments in countries which
the United States considers hostile. Obviously these
issues are talked about between the two govern-
ments, but in other venues and usually only after a
problem has arisen and the damage to the relation-
ship is done.
If the discussion were ever to turn to the more critical and problematic aspects of the relationship, they might try to focus on a few of the following:

- Domestic energy subsidies in China;
- Strategic stockpiling transparency in China;
- How, in the absence of Organisation for Economic Co-operation and Development (OECD) membership, can interim steps be taken to gain some of the benefits of International Energy Agency membership?
- How can U.S. energy asset markets be opened up to greater Chinese participation?
- How does the CFIUS process work?
- How can an accommodation with the Russians be facilitated to allow more East Siberian energy to be produced and sold to everyone?
- Is there a framework for settling territorial disputes over seabed resource domains that might fit the Arctic, South China Sea, and Eastern Mediterranean?

Some of these issues obviously are multilateral and final progress could only be made with the involvement of several other countries. A number also are bilaterally relevant for the United States and other countries, particularly India. But creating an understanding between the United States and China, if one can be reached, would make it much more likely that results could be achieved with a wider group of states.19

The outlook for U.S. energy security has not been this positive in decades. The outlook for China’s energy security is not particularly positive and even may be steadily deteriorating. There are many steps that each side can take that would enhance both country’s energy security. Failure to face this challenge could lead to very negative consequences including increased further and intensified Chinese attempts to undermine U.S. interests in a variety of petroleum possessing countries, a naval arms race in the Indian Ocean, and confrontation in the South China Sea.

A primary goal of the U.S. effort should be to get China to support the U.S.-sponsored international petroleum regime. Specifically, this means a greater acceptance of, and reliance on markets. In order to do this, the United States will have to be prepared to offer China a greater participation in this regime. Continually or frequently blocking Chinese advances into the open areas of the petroleum economy will only encourage them to redouble their exploration and development activities in states that the United States finds objectionable. Perhaps, if the United States gave China more international space to expand in less controversial locations, it would be less eager to engage in relationships with states that the United States finds objectionable. This just might be the time for the United States to try something bold that would make both countries and their populations more secure.

Notes

1. Conventional production includes crude oil, condensate, and natural gas plant liquids; unconventional petroleum includes liquids from crops, coal, extra-heavy oil, oil sands, and shale.
2. Currently, there are number of issues that have to be resolved in order for the United States to access fully this increased flow of Canadian petroleum. But the odds are good that they will be resolved in a way that secures the greatest share of Canada’s increased oil for the U.S. market.
3. Since the United States has one of the world’s most efficient refinery systems, it is advantageous and profitable for the United States to import lower valued crude oil, process it, and sell it at a higher price to other countries such as Mexico. And this is not just good for the companies involved, but also for their employees, and for the nation’s balance of payments.
4. Hence, Chinese interest in building a long and expensive pipeline to the Pacific Ocean through Colombia.
5. In an effort to help create a market for ESPO oil in the United States, several cargos of this Russian oil already have been sold to west coast U.S. refiners.
6. Depending on the time period chosen, Angola occasionally has been the number one supplier.
7. It can be "mild" and rely on tax and royalty increases as governments attempt to increase their share of the economic rents; even locations traditionally open to foreign petroleum investment such as Norway and Canada periodically experience this. It can be more "aggressive" and seize a controlling share of existing and future energy projects; Nigeria and Russia often fit this pattern. And it can be "extreme" and completely seize the asset with no cash compensation. Venezuela in 2007 (at least so far) fits this pattern.
8. CFIUS was established under Section 721 of the Defense Production Act of 1950. It is an interagency committee authorized "to review transactions that could result in control of a US business by a foreign corporation or government, in order to determine the effect of such transactions on the national security of the United States."
9. There is a growing discussion in academia and some policy circles that the three main Chinese oil companies have a great deal of independence from the government. However, it would be imprudent at this point to assert that any of these companies would engage in a pattern of defiance on issues of great importance to the Chinese government.
10. An “international regime” is a body of norms, principles, and rules fostering shared expectations of behavior. It creates and encourages regularized patterns of cooperation on specific issues.

11. They also want to encourage exports and discourage imports, especially through the erection of tariff and non-tariff barriers, and currency undervaluation. The point is to protect domestic industries so that they can move up the economic “value chain.”

12. This is most obvious in the refining and marketing sector where China controls retail prices and has designed a very ambitious strategy for refinery construction. This refinery program is a particular challenge for the IOCs.

13. A partial list would include: Russia $25 billion, Ghana, $16 billion, Venezuela $12 billion, Brazil $10 billion, Kazakhstan $5 billion, Ecuador $1 billion.

14. I am of course referring to geologist Xue Feng.

15. Other western states such as Italy, France, and Norway are less reticent in this regard.

16. Allowing China or other countries to purchase minority stakes in areas such as the USG or the Texas oil patch can be advantageous for the United States because it frees up IOC capital that often can be better deployed elsewhere. It also poses even less of a security threat since the assets cannot be removed from the country. And as such they are subject to all current and future U.S. laws and regulations.

17. For example, Petrochina successfully participated in the Halfaya and Rumaila Oilfield tenders in Iraq. It did this under the normal rules governing any IOC involvement in the process. Similarly, the U.S. government did not block the $1 billion acquisition by Petrochina of a one third stake in Chesapeake Energy’s Eagle Ford shale project in Texas.

18. This makes sense because under the IOC system, the U.S. government is best positioned to talk about those sectors and issues over which it has control (i.e., basic research and nuclear power).

19. Similarly, on the investment side, joint discussions between the United States, Canada, and Australia on a common framework for resource purchases by China would greatly strengthen each country’s position vis-à-vis China in any future bilateral discussions.